

Internal Revenue Service
EO Area Manager, Pacific Coast

Department of the
24000 Avila Road
Laguna Niguel, C

Date: May 14, 2001

[REDACTED]

Employer Identification Number:

Person to Contact:

Contact Telephone Numbers:

[REDACTED] Phone
[REDACTED] FAX

Dear Sir or Madam:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(12) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code. However, we have concluded that you do not qualify under another subsection.

As your organization has not established exemption from Federal income tax to file an annual income tax return on Form 1041 if you are a Trust, or Form [REDACTED] if you are a corporation or an unincorporated association.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

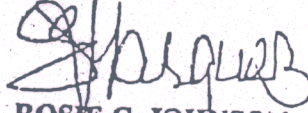
You have the right to protest this proposed determination if you believe it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal Procedures for Unagreed Issues." The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

Enter Name of Organization

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If we do not hear from you within the time specified, this will become our final determination.

Sincerely,



ROSE C. JOHNSON
Director, Exempt Organizations

FOR

Enclosures: 3

ORGANIZATION: [REDACTED]
CASE #: [REDACTED]
AGENT: [REDACTED]
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ISSUE: Is the organization qualified for exemption under Internal Revenue Code section 501(c)(12)?

FACTS: The organization was formed on [REDACTED] and their application for recognition of exemption was received by the Service on [REDACTED]. The following is the organization's statement of activities that was included in their application:

The corporation owns water rights granted by [REDACTED]. It also owns easements for its canal and diversionary works. The water is used for irrigation of farm lands (sic) owned by the corporation's stockholders. Each farmer owns shares of stock equated in general to the number of acres that farmer irrigates. The water is delivered by [REDACTED] to the canal of the corporation. The water master of the corporation delivers the water to the lateral ditches of the stockholders who take the water through their lateral ditches to their respective farms. The cost of delivering the water, maintaining the canal and diversionary works and the overhead costs to the corporation are paid from assessments made by the corporation on the shares of its stock owned by the (sic) shareholders. There is no intent to make any profits. The corporation does try to keep a relatively small reserve fund to meet emergencies.

The first two paragraphs contained in the Sixth Article of the organization's Articles of Incorporation which was received by [REDACTED], states the following:

That the amount of capital stock of this corporation shall be \$ [REDACTED], divided into [REDACTED] shares with a par value of \$ [REDACTED] each. All stock shall be common stock and when fully paid shall not be subject to call. Each share of stock shall be entitled to one vote and all stock shall have equal rights.

The ownership of said stock shall be limited and shall be held and transferred as provided for in the By-laws. No share shall have pre-emptive rights, and each stockholder may vote by written proxy pursuant to any limitations contained in the By-Laws (sic). All stock shall be subject to assessment for use in paying all of the expenses of the corporation, including the expenses of maintenance and operation of the irrigation system.

The organization filed an amendment to their Articles of Incorporation, which was accepted by [REDACTED]. The Sixth Article was amended. The first paragraph states:

That the amount of capital stock of this corporation shall be \$ [REDACTED] divided into [REDACTED] shares with a par value of \$ [REDACTED] each. All stock shall be common stock and when fully paid shall not be subject to call. Each share of stock shall be entitled to one vote and all stock shall have equal rights.

In an attempt to comply to my [REDACTED] correspondence, which requests that the organization conform with Revenue Ruling 72-36, the organization filed another amendment, which was accepted by [REDACTED]. The Seventh Article contains four sections. Of importance is Section 4 of the Seventh Article, which states:

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In the event of dissolution or liquidation of the Corporation, after all outstanding taxes and indebtedness of the Corporation shall have been paid, together with all costs of dissolution or liquidation, all gains from the sale of an appreciated asset, as well as all other assets, including funds of the Corporation, shall be returned to the stockholders on a per share basis.

In the organization's correspondence dated [REDACTED], Section 1.c. of Item 2) states:

A stockholder's rights in the corporation, being represented by shares of stock, are never forfeited. When the land is sold or inherited the water rights (shares of stock in the corporation) go with the land. If the land is to be used for purposes that do not require irrigation water, the water right (shares of stock in the corporation) is transferred to someone else who can use the water for irrigation.

Additionally, Section 1.d. of Item 2) of the same correspondence states, "The owner of the shares of stock, on a per share basis, will receive that share holder's share of all gains from the sale of appreciated assets and any other benefits received from the corporation."

Furthermore, Item 2), Section 1.e. states:

An updated record is kept on all stockholders and the shares of stock he owns, as well as the assessments made and payments received therefore so that members rights and interests in the corporations assets are fully represented by the shares of stock each shareholder owns.

LAW: Revenue Ruling 72-36 sets forth certain basic cooperative characteristics that an organization must have in order to receive a favorable ruling of exemption. It provides as follows:

- a) The rights and interests of members in the organization's savings must be determined in proportion to their business with the organization.
- b) Excess funds remaining at the year's end may be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding its services and maintaining reserves for necessary purposes, but such funds may not be accumulated beyond the reasonable needs of the organization's business.
- c) A member's rights and interest may not be forfeited upon withdrawal or termination of membership.
- d) Gains from the sale of appreciated assets should be distributed to all persons who were members during the period in which the assets was owned by the organization in proportion to the amount of business done by these members during the period insofar as is practicable.
- e) The organization must keep such records as are necessary to determine at any time each member's rights and interest in its assets.

In Revenue Ruling 78-238, it was determined that the Service would not follow the Peninsula Light Co., Inc. decision.

The Ninth Circuit Court decided in Peninsula Light Co., Inc. v. United States, 552 F.2d 878 (9th Cir. 1977) that the organization, which was incorporated in 1925 and granted exemption by the Internal Revenue Service in 1934, qualified for exemption as a mutual or cooperative organization under

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Internal Revenue Code section 501(c)(12). Although the organization was formed for the purpose of distributing electric power to its members, it was not operated on a patronage basis; its charter provides, instead, that each member has an equal share in the organization's assets, with its net assets upon dissolution to be divided equally among its then-current members, and whose former members' rights and interests are forfeited upon termination of membership.

In Revenue Ruling 81-109, it was found that mutual ditch companies that operate in a traditional manner that is consistent with the provisions of a particular state may qualify for exemption under section 501(c)(12) of the Code even though it does not satisfy all of the requirements of Revenue Ruling 72-36. This revenue ruling involved an organization, created in 1874 as a mutual ditch company, which maintained and operated an irrigation system for the use and benefit of its members. In accordance with its bylaws and with the law of the state in which it is located, a person becomes a member in the organization when he purchases stock entitling him to certain water rights and the services of the organization. The shares of stock are personal property and freely alienable with all the right, title and interest to the water and the assets of the organization passing to the purchaser upon sale, with the member's interest in the water and assets being extinguished.

The organization's method of operation was consistent with the applicable state law provisions, which were originally enacted in 1877 and were a codification of the pre-existing common law; the provisions have remained in effect without substantial change. Prior to the time that Congress enacted section 11(a)(10) of the Revenue Act of 1916, which originally provided for the exemption of mutual ditch and irrigation companies operated on a cooperative basis, organizations such as the one described in Revenue Ruling 81-109 and operating in a similar manner, were well established entities in a number of western states.

Because such organizations operated in this manner when Congress originally enacted legislation providing for their exemption from federal income tax and the fact that there have been no major changes in the applicable federal tax provisions in the intervening years, those organizations qualified for exemption under Internal Revenue Code section 501(c)(12).

TAXPAYER POSITION: In an attempt to meet Revenue Ruling 81-109, the organization provided the [REDACTED]. This document prescribes the language that should be contained in a governing document for incorporated and unincorporated entities as well as any actions that should be taken.

The organization highlighted several sections, which they indicated relate to the nonprofit status of Idaho's irrigation companies. The sections cited are as follows:

[REDACTED]. This act shall be known and may be cited as the [REDACTED] and shall apply to any type of lawful nonprofit corporation formed under the provisions of this act or other laws of this state.

[REDACTED] Unless the context otherwise requires this act:
(20) "Member" shall also mean stockholder(s) or shareholder(s) wherever and whenever those terms are used in this act, and shall apply to all nonprofit corporations formed under this act or other laws of this state which have stockholders or shareholders and issue shares of stock instead of memberships.

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(21) "Membership" refers to the rights and obligations a member or members have pursuant to a corporation's articles, bylaws and this act.

[REDACTED] (1) The articles of incorporation must set forth

(5) The articles of incorporation may authorize assessments to be levied upon all members or classes of membership alike, or upon the outstanding shares or stock of the corporation that issues shares of stock instead of memberships pursuant to its articles of incorporation, or in different amounts or proportions or upon a different basis upon different members or classes of membership, and may exempt some members or classes of membership from assessments. The articles of incorporation may fix the amount and method of collection of assessments, or may authorize the board of directors to fix the amount thereof, from time to time, and may make them payable at such times or intervals, and upon such notice and by such methods as the directors may prescribe. Assessments may be made enforceable by civil action or by the forfeiture of membership, or both, or by the sale of shares of the capital stock of a stockholder in a corporation that issues shares of stock instead of memberships, when authorized by the articles of incorporation of said corporation, upon notice given in writing twenty (20) days before commencement of such action or such forfeiture. If the articles of incorporation so provide, assessments may be secured by a lien upon real property to which membership rights are appurtenant, if appropriate, or upon the shares of stock of a stockholder or shareholder corporation, when authorized by its articles of incorporation.

[REDACTED] Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its affairs including, without limitation, power

- (4) To purchase, receive, lease or otherwise acquire, and own, hold, improve, use and otherwise deal with, real property, including water and water rights, and personal property, or any legal or equitable interest in property, wherever located;
- (14) To impose dues, assessments, admission and transfer fees upon its members, and to levy assessments upon the outstanding shares of stock, of a corporation with capital stock, if authorized by the articles of incorporation of the corporation;

[REDACTED] Except as provided in its articles or bylaws, a corporation may admit members for no consideration or for such consideration as is determined by the board, or by the articles of incorporation.

[REDACTED] (1) A member may resign at any time. A person ceases to be a stockholder only when that person's shares of stock have all been disposed of.

(2) The resignation of a member, or the disposal of all stock of a stockholder, does not relieve the member from any obligations the member may have to the corporation as a result of obligations incurred or commitments made prior to the resignation.

[REDACTED] (1) Unless the articles or bylaws provide otherwise, each member is entitled to one (1) vote on each matter voted on by the

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members, or by one (1) vote for each share of stock in a corporation that issues shares of stock instead of memberships, when authorized by the articles of incorporation of said corporation.

Upon further review of the document, a section pertaining to canal companies was found. It read as follows:

[REDACTED]
[REDACTED] Should any provision of this chapter, as it pertains to canal companies or carey (sic) act companies, conflict with [REDACTED], the provisions of [REDACTED], shall prevail.

CONCLUSION: Nothing could be found regarding the dissolution of canal companies in [REDACTED]. Based on the information presented by the organization, they do not qualify for exemption under Internal Revenue Code section 501(c)(12) as a mutual ditch or irrigation company because they do not meet Requirements c) and d) of Revenue Ruling 72-36.