

## **Audit Technique Guide – Local Benevolent Life Insurance Association, Mutual Irrigation and Telephone Companies and Like Organizations – IRC Section 501(c)(12)**

### **Overview**

IRC Section 501(c)(12) exempts from federal income tax benevolent life insurance associations and similar organizations of purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone and electric companies, or like organizations.

The phrase “of local character” applies to benevolent life insurance associations and similar organizations and not to other organizations specified in IRC Section 501(c)(12). Organizations that are similar to benevolent life insurance associations include burial and funeral benefit associations.

Mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations are also exempt from federal income tax per IRC Section 501(c)(12). The IRS has never distinguished between the terms “mutual” or “cooperative” per IRC Section 501(c)(12).

The purpose of an IRC Section 501(c)(12) organization is to offer certain services to its members at the lowest possible cost. To qualify for and maintain exemption per IRC Section 501(c)(12), a cooperative must receive 85 percent or more of its income each year from members. The income must be collected to meet the cooperative’s losses and expenses.

### **Legislative History**

Even before ratification of the Sixteenth Amendment to the U.S. Constitution authorizing income tax, Congress offered exemption from federal excise taxes to cooperative companies and not-for-profit mutual benefit associations. After ratification, the Revenue Act of 1916, P.L. 64-271, Chapter 462, section 11(a)(10), 39 Stat. 756, 767 (1916), and successive revenue acts, exempted mutual or cooperative insurance companies, ditch or irrigation companies, telephone companies, and like organizations from federal income taxes. Electric cooperatives weren’t listed in the 1916 Statute but were added to IRC Section 501(c)(12) in 1980.

The Revenue Act of 1924, Chapter 234, section 231 (10), 43 Stat. 283 (1924), reduced the member-income requirement from 100 percent to 85 percent, allowing cooperatives other sources of income to pay for capital improvements, expansion or purchase real estate. The 85-percent member-income test ensured that cooperatives continued serving members rather than placing their member-source income in investments, such as stocks or bonds, and becoming investment companies. See Cong. Rec. 3433 (1926).

In 1980, P.L. 96–605 amended IRC Section 501(c)(12) providing that the income derived by mutual or cooperative telephone and electric companies from qualified pole rentals won’t be taken into the 85-percent member-income test calculation.

“Qualified pole rentals” is any rental income from the right to use any pole (or other structure that supports wires) that the cooperative uses in offering telephone or electric services to its member. Also, the lessee’s use of the poles must be limited to support wires for use in connection with the transmission of electricity, telephone, or other communications. In this connection, the term “rental” includes the sale of the right to use the pole.

The law change also took out any income from the sale of display listings in a directory furnished to

the members of mutual or co-operative telephone companies from the calculation. The law also amended IRC Section 513 by adding IRC Section 513(g), which provides that the term “unrelated trade or business” doesn’t include engaging in qualified pole rentals.

In 1988, P.L. 100-64 amended IRC 501(c)(12) to provide that you don’t include income derived by mutual or cooperative telephone and electric companies from a loan prepayment under sections 306A, 306B or 311 of the Rural Electrification Act of 1936, effective January 1, 1987, in the 85-percent member-income test calculation.

In 2004, P.L. 108-357 amended IRC Section 501(c)(12) to provide per IRC Section 501(c)(12)(C) that you don’t include the following income received or accrued from mutual or cooperative electric companies in the 85-percent member-income test calculation:

- provision or sale of certain open access electric energy transmission or ancillary services
- provision or sale of certain open access energy distribution or ancillary services
- any nuclear decommissioning transaction
- any asset exchange or conversion transaction

This provision had a sunset provision of January 1, 2007, but the Energy Policy Tax Incentive Act of 2005 made the exclusion permanent.

### Requirements for Exemption under IRC Section 501(c)(12)

An organization must satisfy these three requirements to qualify per IRC Section 501(c)(12):

- be organized and operated as a cooperative.
- conduct activities described in IRC Section 501(c)(12) and the regulations.
- derive 85 percent or more of its income from members.

### Organizational and Operational Test – Basic Cooperative Principles

The term “cooperative” isn’t defined in IRC Section 501(c)(12) or the regulations. Rather, the definition comes from common law.

In *Puget Sound Plywood v. Commissioner*, 44 T. C. 305, 307-308 (1965), acq. 1966-1 C.B. 3, the Tax Court described a cooperative as an organization of members who sought “[f]or themselves to own and manage the [organization], as distinguished from having it owned and managed by outside equity investors; and then to have their [organization] turn back to the members the excess of the receipts from the store sales over the cost of the goods sold and the expenses of operation.”

This description identifies three basic principles or requirements:

- Democratic control by the members
- Vesting in and allocating all excess operating revenues (over expenses incurred to generate the revenues) among the members, i.e., operating at cost
- Subordination of capital

**Democratic Control.** Members that participate in the cooperative’s endeavors must remain in

control of an IRC Section 501(c)(12) cooperative. A cooperative satisfies this requirement by periodically holding democratically conducted meetings with members, each with one vote, electing officers to operate the organization.

**Operating at Cost.** A cooperative must return excess operating revenues to its member-patrons. The cooperative mustn't operate either for profit or below cost. The excess is usually called savings rather than profit because it's the amount not spent to obtain services for members or to operate the cooperative. A cooperative's savings belong to its members, not the organization, and it must allocate the savings to its members in proportion to the amount of business it did with each.

**Subordination of Capital.** Those who contribute capital to the cooperative neither control the operations, nor receive most of the pecuniary benefits of its operations. This principle distinguishes a cooperative from a for-profit corporation, which is shareholder-oriented. The theory behind this requirement is that members band together to share their interest, risk, and burden to obtain services or benefits rather than invest as equity owners.

Subordination of capital has two components:

- Members control and own the savings or monetary benefits from the IRC Section 501(c)(12) cooperative that stay with them rather than going to shareholders or equity investors.
- The cooperative must limit its return on capital to ensure savings or monetary benefits go to its members rather than its shareholders.

**Fundamentals.** Rev. Rul. 72-36, 1972-1 C.B. 151, sets out organizational and operational requirements to ensure an IRC Section 501(c)(12) cooperative complies with certain fundamental principles:

- The organization must keep adequate records of each member's rights and interest in the organization's assets.
- The organization must distribute any savings to members in proportion to the amount of business done with them based on the "operation at cost" principle.
- The cooperative must not retain more funds than it needs to meet current losses and expenses (also based on the "operation at cost" principle).
- The cooperative can't forfeit a member's right and interest in the organization upon termination of membership.
- Upon dissolution, the cooperative must distribute any gains from the sale of any appreciated asset to all who were members while the cooperative owned the asset in proportion to the amount of business done with each, so far as practical.

**Note:** Rev. Rul. 81-109, 1981-1 C.B. 347, which modified Rev. Rul. 72-36 for a mutual ditch company that operated in a traditional manner consistent with a state statute, allowing the company to qualify under IRC Section 501(c)(12) despite that it didn't meet all the requirements of Rev. Rul. 72-36.

IRC Section 501(c)(12) Cooperative Operations. Neither IRC Section 501(c)(12) nor its regulations define "member." However, the definitions for non-exempt cooperatives (IRC Section 521 farmers' cooperatives and Subchapter T cooperatives) apply because they parallel IRC Section 501(c)(12) cooperatives. Treas. Reg. section 1.1388-1(c)(3)(ii)(c) defines "member" as a person (individual, corporation, or cooperative) entitled to participate in the cooperative's management. Since a

member usually gets services from the cooperative, he/she is also a patron. Treas. Reg. sections 1.1388-1(e) and 1.522-1(b)(2) define “patron” as any person, whether member or nonmember, with or for whom the cooperative does business on a cooperative basis.

## The Activities Test

The five categories of organizations that can qualify for exemption are:

- Benevolent life insurance associations of a purely local character
- Mutual ditch or irrigation companies
- Mutual or cooperative telephone companies
- Mutual or cooperative electric companies
- Like organizations

**Benevolent Life Insurance Associations.** The requirement of “purely local character” means the business is confined to a particular community, place, district, or locality, irrespective of political subdivision. An insurance association can conduct business in several political subdivisions such as counties if they constitute a locality or community.

- The locality restriction doesn’t require it to terminate membership if a member moves out of the locality in which it operates. [Rev. Rul. 83-43, 1983-1 C.B. 108](#)
- Rev. Rul. 64-193, 1964-2 C.B. 151, held that a “purely local character” didn’t include an insurance association doing business within a 75 mile radius of a home office that included three separate large metropolitan areas. The ruling reasoned that “purely local character” implies a single locality, not three metropolitan areas.

**Mutual Ditch or Irrigation Activities.** Mutual ditch or irrigation companies are cooperatives that operate a ditch or irrigation water system. The Code and regulations don’t define ditch or irrigation, but the common meaning of both is to bring, channel, or control water to or away from land.

- [Rev. Rul. 68-564, 1968-2 C.B. 221](#), held that constructing and maintaining structures or improvements to prevent erosion of riverbanks are activities like those of ditch or irrigation companies.

**Telephone and Electric Activities.** IRC Section 501(c)(12)(A) expressly offers exemption of cooperatives that offer telephone services. Telephone services include local and long distance services. Electric cooperatives also are exempt under IRC Section 501(c)(12)(C).

### **Like Organization Activities.**

- Cable television services operating on a cooperative basis are like organizations described in IRC Section 501(c)(12). [Rev. Rul. 83-170, 1983-2 C.B. 97](#). See, also, Rev. Rul. 67-265, 1967-2 C.B. 205 (organization furnishing light and water can qualify under IRC Section 501(c)(12) as a “like organization.”)
- The Eighth Circuit Court of Appeals held that offering burial and funeral benefits is within the definition of “like activities” similar to offering benevolent life insurance, *Thompson v. White River Burial Association*, 178 F.2d 954 (8th Cir. 1950).

## Not Like Organizational Activities.

- Nonprofit automobile clubs furnishing travel and other services to members. *New Jersey Automobile Club v. United States*, 181 F. Supp. 259 (Cl. Ct. 1960), Cert. denied, 366 U.S. 964 (1961).
- A housing cooperative operated for the personal benefit of its tenant-owner members isn't a "like organization" within the meaning of IRC Section 501(c)(12). Rev. Rul. 65-201, 1965-2 C.B. 170.
- Offering electric services doesn't include financing purchases of electrical, water, or plumbing appliances. See *Consumers Credit Rural Electric Coop. Corp. v. Commissioner*, 37 T.C. 136, 143 (1961), aff'd 319 F.2d 475 (6th Cir. 1963).
- Rev. Rul. 65-201, 1965-2 C.B. 170, held that the sale by a nonprofit cooperative of electrical materials, equipment, and supplies, as well as the provision of equipment manufacturing, repair, and testing services to its members, isn't a "like organization" within the meaning of IRC Section 501(c)(12).
- Rev. Rul. 2002-54, 2002-2 C.B. 527, held that distribution and sale by an exempt electric cooperative of tanked propane by trucks is not a "like organization" activity under IRC Section 501(c)(12)(A).

## The 85-Percent Member-Income Test

**Annual Testing.** A cooperative must complete the 85-percent member-income test in each taxable year. A cooperative may fail the test one year but meet the test in a prior or subsequent year. Rev. Rul. 65-99, 1965-1 C.B. 242. The member-income test considers only income received or accrued in the annual accounting period. Rev. Rul. 68-18, 1968-1 C.B. 271. See also IRC Sections 451(f) and IRC 166.

### Definition of Income.

IRC Section 501(c)(12) and the regulations don't define income. Rev. Rul. 74-362, 1974-2 C.B. 170, obsoleted by Rev. Rul. 81-291, 1981-2 C.B. 131, for reasons not related to this discussion, states that income means "gross income" for the 85-percent member-income test. [Rev. Rul. 80-86, 1980-1 C.B. 118](#), defined "gross income" as gross receipts less cost of goods sold, trade discounts, allowances of goods sold, and refunds on returned goods. It held that an exempt electric cooperative doesn't include income from its sales (at cost) of excess natural gas.

**Gross Receipts and Cost of Goods Sold.** IRC Section 501(c)(12) cooperatives must not deduct the cost of goods sold from gross receipts to determine gross income for calculating the 85-percent member-income test. See instructions for Forms 990 and 990-EZ. IRC Section 501(c)(12) cooperatives that formed before 1998 may continue to deduct the cost of goods sold from gross receipts, as long as they have consistently used this method in the past.

**Note:** Before 1998, the IRS maintained that in the sale of electricity, gross income means gross receipts with a deduction for cost of goods sold. However, Prop. Treas. Reg. section 1.501(c)(12)-2 (49 Fed. Reg. 1244 (Jan. 10, 1984)) were withdrawn (58 Fed. Reg. 25587 (April 27, 1993)). Therefore, IRC Section 501(c)(12) cooperatives don't have to deduct the cost of goods sold from gross receipts. See [Forms 990](#) and [990-EZ](#) instructions for tax years 1998 and after which reflect this position.

- *No Netting.* Gross income derived from a transaction with a third party can't be offset by amounts owed to that third party. Rev. Rul. 65-174, 1965-2 C.B. 169; Rev. Rul. 74-362, 1974-2 C.B. 131, obsoleted by Rev. Rul. 81-291, 1981-2 C.B. 131.
- *No Reductions.* Rents, dividends, and interest must be included in gross income without reduction.

**Non-income Items.** Many IRC Section 501(c)(12) cooperatives receive grants from state or federal agencies. A government grant is a contribution to capital, which under IRC 118(a) isn't income if it meets the following conditions from Rev. Rul. 93-16, 1993-1 C.B. 26:

- The grant must become a permanent part of working capital.
- The grant must not be compensation for specific quantifiable services received by the government.
- The grant's use is subject to meaningful conditions negotiated between the cooperative and the government.
- The grant must benefit the cooperative commensurate with its value.
- The grant must generate additional income through increased public use.

#### **Excluded Income.**

*Qualified Pole Rentals.* Many electric and telephone cooperatives rent their electric or telephone poles. For example, an electric cooperative may allow a telephone or cable television company to use its poles in return for rent. IRC Section 501(c)(12)(B)(ii) and (C)(i) exclude qualified pole rental income from the member-income test computation. See IRC Section 501(c)(12)(D) for defining "qualified pole rental."

*Billing and Collection Services of Telephone Cooperatives.* IRC Section 501(c)(12)(B)(i) excludes "communication services" from the 85-percent member-income test. Many exempt telephone cooperatives administer billing and collection of fees for nonmember long-distance carriers that offer long-distance telephone service to their members. In *Golden Belt Telephone Cooperative v. Commissioner*, 108 T.C. 498 (1997), the Tax Court held that billing and collection are communication services because the Federal Communication Commission had interpreted the phrase to include them. The IRS, in A.O.D. 1998-03, 1999-1 C.B. 5, acquiesced the result but disagreed with the court's reasoning. The IRS reasoned that billing and collection are communication services excluded under IRC Section 501(c)(12)(B)(i) because they are a step in completing long- distance telephone calls for members.

*Income Derived from Directory Listings.* Many IRC Section 501(c)(12) telephone cooperatives sell display space in the telephone directories furnished to their members. IRC Section 501(c)(12)(B)(iii) excludes this income from the 85- percent member-income test.

#### **Member Income**

- Member income has a two-prong test:
  1. First, the cooperative must collect it from its members.
  2. Second, members must pay it for services described in IRC Section 501(c)(12). This analysis comes from IRC Section 501(c)(12)(A), which requires that member income

be collected to meet losses and expenses from IRC Section 501(c)(12) activities. See also, [Rev. Rul. 2002-54, 2002-2 C.B. 528](#).

- Cooperatives may have several types of members. In general, per IRC Section 501(c)(12), members are those entitled to participate in the cooperative's management and share in patronage capital. See Rev. Rul. 72-36, 1972-1 C.B. 151 for the fundamental principles of 501(c)(12) status, modified by Rev. Rul. 81-109, 1981-1 C.B. 347. See, also, [Rev. Rul. 78-238, 1978-1 C.B. 161](#). If the cooperative has more than one type or class of "members," determine which are members (as defined in IRC Section 501(c)(12)). A government agency may be a member or nonmember. Rev. Rul. 68-75, 1968-1 C.B. 271 (neither IRC Section 501(c)(12) nor the underlying regulations preclude this type of agency from membership, despite local law or other authority). Generation and Transmission cooperatives (G&Ts) may have members that aren't distribution cooperatives.

**Nonmember Income**, for example, includes:

- Interest from nonmember sources
- Rental income
- Installment sales of assets
- Income from nonmember patrons
- Dividend income from a wholly-owned for-profit entity that isn't a cooperative and not a member. Rev. Rul. 2002-55, 2002-2 C.B. 529.

**Classifying Income as Member or Nonmember Income.** Each transaction for which income is realized must be classified as member income, nonmember income, or excluded income. Member income is member-sourced and derived from activities conducted according to cooperative principles. IRC Section 501(c)(12); [Rev. Rul. 72-36, 1972-1 C.B. 151](#); [Rev. Rul. 78-238, 1978-1 C.B. 161](#); [Rev. Rul. 80-86, 1980-1 C.B. 118](#); [Rev. Rul. 2002-55, 2002-2 C.B. 529](#).

### General Examination Guidelines

Analyze and verify all sources of income to determine the purpose for which income is derived from members.

Determine if 85 percent or more of the income includes amounts collected from members for the sole purpose of meeting losses and expenses.

- Include gains from sales of property, interest on tax-exempt securities, and income from contracts entered into with the United States or any of its agencies.
- Exclude losses on sales of property and voluntary contributions which are in the nature of gifts.
- Exclude income received or accrued from another telephone company for performing communication services involving the completion of long distance calls to, from, or between its members in the case of a mutual or cooperative telephone company.
- Exclude income received or accrued from the sale of display listings in a directory furnished to members of a mutual or cooperative telephone company.

- Exclude income received or accrued from qualified pole rentals by a mutual or cooperative telephone or electric company.
- Exclude income IRC Section 501(c)(12) cooperatives realize from repayments at discount of loans borrowed from the federal Rural Utilities Service (RUS) (formerly Rural Electrification Administration) or other U.S. government loans only if the repayments were before 1990. This exclusion lapsed after December 31, 1989. See Technical and Miscellaneous Revenue Act of 1988.
- Include any income realized from the repayments at discount of RUS loans made after 1989 for calculating the 85-percent member- income test.

**Note:** In general, income includes the amount from a loan repayment at discount. This amount is usually the difference between the discounted amount and the loan’s face value. See IRC 61; see also Rev. Rul. 82-202, 1982-2 C.B. 35, and Rev. Rul. 91-31, 1991-1 C.B. 19.

- Exclude income of wholly-owned but separately established for-profit entity. [Rev. Rul. 2002-55, 2002-2 C.B. 529](#)
- Exclude income received or accrued from the sale of electric energy transmission services or ancillary services if these services are given on a nondiscriminatory open access basis under an open access transmission tariff (or under an independent transmission provider agreement) approved or accepted by the Federal Energy Regulatory Commission (FERC).
- Exclude income received or accrued from the sale of electric energy distribution services or ancillary services if these services are offered a nondiscriminatory open access basis to distribute electric energy not owned by the mutual or cooperative electric company.
- Exclude income derived from nuclear decommissioning transactions (as defined in IRC Section 501(c)(12)(F)).
- Exclude income derived from any asset exchange or conversion transaction (as defined in IRC Section 501(c)(12)(G)).

Determine purpose and necessity for any reserves held.

Ascertain “reasonableness” of the reserves based on facts and circumstances.

### Examination Issues – Cooperative Principles

**Providing Multiple Services.** Historically, exempt cooperatives engaged in only one activity, such as a telephone cooperative that offered local and long-distance telephone service. Recently, exempt cooperatives have expanded to include other services. For example, many telephone cooperatives now offer cellular (or wireless) telephone and internet services. In keeping with cooperative principles, the cooperative must equitably allocate costs or savings among its member-patrons of each service so savings or losses are returned to each member in direct proportion to his/her patronage. However, many exempt cooperatives have combined two or more services for allocation purposes. The organization can do this without violating the “operate at cost” requirement if it meets the following criteria:

- Member-patrons of one service are also patrons of the other services in the allocation unit.

- The articles of incorporation, bylaws, or written policies specifically detail all allocation units' composition and how savings or losses will be allocated in each unit.
- The cooperative informs each allocation unit's members of the risk-sharing and benefits of combining different services into one allocation unit.
- A majority of the cooperative's members agree to the grouping.
- The members periodically vote to affirm the agreement.

**Issuance of Non-Voting, Interest-Bearing Stock.** To raise capital, some exempt cooperatives have sought the IRS's permission to issue a class of stock that a) pays a dividend at a fixed or state regulated rate, b) doesn't allow the stockholder to participate in the cooperative's savings, and c) doesn't give the stockholder voting rights.

- Although neither IRC Section 501(c)(12) nor the regulations prohibit it, this stock issuance may violate the "subordination of capital" principle (depending upon facts and circumstances).
- For example, an IRC Section 501(c)(12) telephone cooperative that issues 10,000 shares of stock at \$1 par value with an annual interest rate of 8 percent and sells all shares would pay \$80,000 in dividends annually to stockholders. Depending on its financial situation, the stock may raise doubt that the cooperative would return net savings to member-patrons by the services performed for them rather than distribute them to stockholders as a return on capital.
- Whether this occurred is a question of fact that you'd have to determine. Whether stock with different characteristics from the one described violates the "subordination of capital" principle is also a question of fact in your examination.

**State Laws.** IRC Section 501(c)(12) and the regulations don't require a cooperative to organize under a state cooperative statute, but many states do have statutes that govern cooperatives described in IRC Section 501(c)(12). Although state statutes don't usually cause conflicts with cooperative principles, review the governing instruments to determine if they satisfy a cooperative's organizational and operational requirements.

- [Rev. Rul. 81-109, 1981-1 C.B. 347](#), resolved that a mutual ditch organization qualified for exemption under IRC Section 501(c)(12) although it didn't meet some cooperative requirements because it operated as required by state law.
- The revenue ruling noted that several state laws and practices governing cooperatives allowed them to operate in the manner described, but Congress hasn't amended IRC Section 501(c)(12) to provide that state laws shouldn't govern in this circumstance. Congressional inaction was that state law should control if it conflicts with cooperative requirements.

### Examination Issues – Activities Test

**Telecommunication Services.** Many exempt cooperatives have expanded to offer wireless or cellular services, internet access, paging services, home security monitoring, medical alert services, and environmental monitoring (energy consumption, temperatures, etc.). These services allow member-patrons to communicate with others by voice, writing, or other forms. The current EO position is that these services are types of communication services permitted under IRC Section 501(c)(12). See [Rev. Rul. 57-420, 1957-2 C.B. 308](#).

**Direct Satellite Television Service.** Paid television service has also changed. Many IRC 501(c)(12) cooperatives are starting to offer direct satellite television to member-patrons.

- [Rev. Rul. 83-170, 193-2 C.B. 97](#), modifying Rev. Rul. 72-36, 1972-1 C.B. 151, held that a cooperative offering cable television to its members could qualify for exemption as a *like* organization under IRC Section 501(c)(12). It equated the term *like* with a public utility or public-utility type service. It compared cable television to public utilities and considered state law regulating cable television as a public utility.
- The current EO position is also applicable to direct satellite television service.

**Natural Gas.** Many exempt electric cooperatives have begun offering natural gas to member-patrons, usually by pipeline. [Rev. Rul. 67-265, 1967-2 C.B. 205](#), and [Rev. Rul. 83-170, 193-2 C.B. 97](#), defined *like* organization to include offering public-utility type services. However, an exempt electric cooperative's distribution and sale by of tanked propane by trucks is not a "like organization" activity. [Rev. Rul. 2002-54, 2002-2 C.B. 528](#).

### Examination Issues – The 85-Percent Member-Income Test

**Redemption of Accounts at Discount.** Many IRC Section 501(c)(12) cooperatives, especially electric and telephone, keep amounts of savings as reserves for improvements, business expansion, unexpected expenses, etc. The cooperative creates a capital credit account for each member-patron with his amount. Periodically, cooperatives make a distribution from the accounts (called a "redemption" or "retirement of capital credit accounts") to the member-patron. Many cooperatives redeem capital credit accounts at a discount of the face value by paying a portion of it to the member and crediting the difference to an equity account in that member's name.

- The discounted amount is not a patronage savings or dividend because it's not paid based on the amount of business done with the member-patron, but should the difference be included in computing the 85-percent member-income test?
- Under the tax benefit doctrine, a recovered item that produced an income tax benefit in a prior year must be included in income in the year it is recovered. However, an exempt cooperative won't usually receive a tax benefit by redeeming capital at a discount, because there hasn't been a related deduction, such as an offset to unrelated business income. If there was no tax benefit, there's no income. Therefore, ignore the redemptions for the 85-percent member income test.

**Aggregating Gross Receipts of IRC Section 501(c)(12) Cooperatives and Their Subsidiaries.** An exempt cooperative may engage in many different business activities through subsidiaries: 1) A subsidiary may provide IRC Section 501(c)(12) services to its parent's members that the parent doesn't provide; 2) It may carry on business with nonmembers on a non-cooperative basis; 3) It may conduct business activities unrelated to the parent's exempt purposes. The first activity listed won't adversely affect an IRC Section 501(c)(12) parent's exempt status and the parent continues to meet the 85-percent member-income test. However, the second and third activities may jeopardize the parent's exempt status. Parent subsidiary activities raise whether a subsidiary's gross income should be combined with its parent's to compute the 85-percent member-income test.

- [Rev. Rul. 2002-55, 2002-2 C.B. 529](#), held that an IRC Section 501(c)(12) telephone cooperative that owned a separate for-profit entity that wasn't a cooperative and a member shouldn't include the income of the for-profit entity in satisfying the 85-percent member-income test. However, include any payment the cooperative received from the for-profit entity as

nonmember income.

**Interrelationship Among Unrelated Business Activities, the Activities Test, and the 85-Percent Member-Income Test.** Some IRC Section 501(c)(12) cooperatives offer IRC Section 501(c)(12) services and services not described in IRC Section 501(c)(12). For example, an exempt electric cooperative may also sell and service electric appliances. This raises issues of both exemption and unrelated business income tax (UBIT). Apply the activities test, UBIT test, and the 85-percent member-income test separately to the activities and income of the exempt cooperative.

- IRC 511(a)(2) says that organizations described in IRC Section 501(c) are subject to UBIT. Therefore, an IRC Section 501(c)(12) organization can conduct some unrelated activities but may jeopardize its exempt status if those activities are more than an insubstantial amount. Whether insubstantial or not is a matter of facts and circumstances.
- Even if an unrelated activity doesn't affect exemption, it may still be subject to UBIT under IRC 511. For example, an IRC Section 501(c)(12) electric cooperative's distribution and sale of tanked propane, a "not-like-organization" activity, is an unrelated activity. If substantial, the activity in the ruling would jeopardize the cooperative's exempt status. However, if insubstantial, the income derived from the activity is subject to UBIT under IRC Section 511. See [Rev. Rul. 2002-54, 2002-2 C.B. 528](#).

### Examination Issues – Unrelated Business Taxable Income

IRC 511 imposes a tax on the unrelated business taxable income of most IRC Section 501(c) organizations, including IRC Section 501(c)(12) cooperatives. See *Bartels Trust fbo Univ. of New Haven v. U.S.*, 209 F.3d 147 (2d Cir. 2000); cert. denied 531 U.S. 978 (2000). Each item of an exempt cooperative's income must be included in computing the 85-percent member-income test. Unrelated taxable income is usually nonmember income for purposes of this test. Nonmember income, however, isn't necessarily subject to UBIT. For example, interest income a IRC 501(c)(12) telephone cooperative receives from the bank, a member of the cooperative, though not member income for purposes of the 85-percent member-income test, wouldn't be subject to UBIT because of the exception to UBIT for interest income. See IRC Section 512 for the definition of "unrelated business taxable income," and IRC 513 for the definition of "unrelated trade or business."

If the organization has unrelated activities and they're insubstantial, the income derived from these activities is subject to unrelated business income tax. An electric cooperative's distribution and sale of tanked propane by trucks is unrelated to its exempt purpose, and income derived from this activity is subject to unrelated business income tax. However, if the activity is insubstantial, it wouldn't jeopardize the exempt status of the electric cooperative under IRC Section 501(c)(12).

**Advertising in Directories.** Some types of "advertising" income are unrelated trade or business:

- Display advertisements (whether placed by members or nonmembers) are unrelated trade or business. Rev. Rul. 74-38, 1974-1 C.B. 144, clarified by Rev. Rul. 76-93, 1976-1 C.B. 170.
- Payments for business listings ordinarily confer minimal commercial benefit and aren't unrelated trade or business. Treas. Reg. section 1.513-1(d)(4)(iv), Example (6); [Rev. Rul. 76-93, 1976-1 C.B. 170](#). See IRC Section 501(c)(12)(B)(iii) and Rev. Rul. 79-370, 1979-2 C.B. 238, on the sale of display listings in membership directories.

**Debt-Financed Income.** Income from debt-financed investments may be included in unrelated business taxable income under IRC Section 514(a) (such as arbitrage investments of RUS loan funds).

*Southwest Tex. Elec. Coop. v. Commissioner*, T.C. Memo. 1994-363 (1994), aff'd 67 F.3d 87 (5th Cir. 1995); *Kern County Elec. Pension Fund v. Commissioner*, 96 T.C. 845 (1991), aff'd without published opinion, 988 F.2d 120 (9th Cir. 1993).

**Depreciation Recapture.** IRC Sections 1245 and IRC 1250 depreciation recapture rules override IRC Section 512(b)(5). Treas. Reg. section 1.1245-6(b); 1.1250-1(c)(2).

**Controlled Organizations.** Payments from affiliated organizations or subsidiaries may be taxable under IRC Section 512(b)(13).

**Qualified Pole Rentals.** Qualified pole rentals aren't income from unrelated trade or business. IRC Section 513(g).

### Benevolent Life Insurance Companies

In the case of benevolent life insurance companies, evaluate the policies issued to determine:

- Whether activities are confined to a territorial unit "purely local in character."
- Whether coverage includes life insurance benefits or burial and funeral benefits payable in cash.
- Whether coverage for sickness, accident or health benefits are in addition to death benefits.
- If premiums are payable as a result of assessments or if premiums are at established rates with policyholders subject to additional assessments and return of an unexpended balance.

If the organization returns excess premiums to members, determine whether there's a preexisting obligation, and whether returns are based on business done with the organization.

### Exempt Telephone Cooperatives

Cooperatives offer telecommunications products and services in a rapidly changing industry by investing in technologies such as fiber optic cabling, digital switching equipment, enhanced network services (such as ISDN) to offer enhanced services (such as voice messaging systems), personal communications services (cellular and portable radio communications services for individuals and businesses), interactive video networks and information services.

Cooperatives have been diversifying, venturing into satellite television service, and selling satellite reception equipment, even offering cable television service. Some cooperatives belong to the National Rural Telecommunications Cooperative (NRTC), which offers alternative television programming. Many of these satellite and cable television services are for-profit (non-cooperative) businesses organized as divisions or subsidiaries of the cooperative.

Under the Communications Act of 1934 (the Act), the Federal Communications Commission (FCC) regulates certain telecommunication companies engaged in interstate commerce activities (including telephone cooperatives). The Act, FCC, and ratemaking rules determine the source and nature of regulated and unregulated telecommunication, and cooperatives offering other goods and services. To offer the FCC with necessary ratemaking information, cooperatives must use a prescribed system of accounting called the "Uniform System of Accounts," or "USoA." This accounting system presents telephone companies' financial information in a specified format, identifying regulated and unregulated income, expense and capital expenditures, included or excluded from the rate base.

Many cooperatives' operations are financed by loans from Rural Utilities Service (RUS), Rural

Telephone Bank, Bank for Cooperatives, Rural Telephone Finance Cooperative, and other federal agencies. RUS loans finance 70-90 percent of telephone plants. RUS requires cooperatives to follow FCC's USoA for their loans. 7 C.F.R. § 1770.11.

## Research Resources

**Federal Communication Commission.** FCC's two main divisions affecting cooperatives are listed below. Find audit information at [www.fcc.gov](http://www.fcc.gov) and follow the menu to the pertinent divisions.

- *Pricing Policy Division (Wireline Competition Bureau).* Administers the Communications Act rules that require the charges, practices, classifications, and regulations of communications common carriers providing interstate and foreign services to be just and reasonable.
- *Investigation and Hearing Division (Enforcement Bureau).* Responsible for common carrier audits and for suspected or alleged common carriers non-compliance with various market-related requirements.

**Rural Utilities Service.** The Technical Accounting and Auditing Staff oversees the accounting regulations by which the RUS loan recipient cooperatives must abide by. See <https://www.rd.usda.gov/> for the regulations and examples in bulletins.

## Overview – FCC Regulations and Telephone Cooperatives

Traditional FCC ratemaking allows telephone companies to recover their allowable costs to provide regulated telecommunications service plus a reasonable rate of return on investment. *M. Kellogg et al.*, Federal Telecommunications Law §§ 9.2, 9.8 (1992).

When cooperatives' members converse with others on interstate or intrastate long-distance telephone calls, they use their telephone cooperative's facilities (a local exchange carrier, LEC) plus one or more interexchange carriers (ICs) (such as AT&T) and another LEC. Each of these earns a return on investment and recovers the cost of offering long-distance service. The FCC, through its ratemaking authority, apportions the long-distance charges the end-user pays among them.

Before January 1, 1984, divestiture of local exchange subsidiaries, AT&T, Bell Operating Companies, and independent telephone companies (including cooperatives) participated in joint interstate rates. The local exchange carriers reported all long-distance charges for their members' calls to the pertinent Bell company. AT&T handled the long-distance settlements through the Bell company, which in turn remitted a share of the charges back to the local carrier. See generally, Rev. Rul. 74-362, 1974-2 C.B. 170.

The FCC replaced this system with one that tariffed access charges, setting the rules for the charges that interexchange carriers (such as AT&T) and end users, like telephone cooperatives' members) paid for access to local carriers for interstate telephone service.

Telephone companies incur two types of costs for long distance service. One varies with the number of access lines needed (non-traffic-sensitive), and the other varies with the traffic level (traffic-sensitive).

- *Non-Traffic-Sensitive Costs.* When cooperatives' members pick up the receiver and hear a dial tone, they can access local and long-distance telephone service. The cost of accessing either one is non-traffic-sensitive because the cost doesn't vary with amount of usage. The FCC reasoned that a subscriber ("end user") who doesn't place calls (local or long-distance) would

have the right to pay a flat fee. For the same reason, the FCC imposed a flat amount per line (“subscriber line charge”) for the interstate portion of calls as end users and cooperatives’ members pay these subscriber line charges to their cooperative. Per 85-percent member-income test, revenue recorded in Account 5801, End User Revenue isn’t excluded under IRC Section 501(c)(12)(B)(i) because it’s assessed upon the members as end users, not upon another telephone company (e.g., AT&T). Also, it’s not unrelated taxable business income because it’s collected from members for the sole purpose of meeting cooperatives’ losses and expenses (i.e., certain non-traffic-sensitive costs).

- *Traffic-Sensitive Costs.* The FCC considered but rejected requiring that end users bear all local exchange carriers’ (i.e., telephone cooperatives’) costs to offer long-distance service, both traffic-sensitive and non-traffic-sensitive. Instead, the FCC decided that the LECs must recover their traffic-sensitive costs from interexchange carriers (e.g., AT&T) through access charges based upon amount of usage. The ICs pass these costs on to their subscribers (those who use their long distance carrier, e.g., AT&T) through toll charges for long-distance calls. To complete long distance calls, it uses the LECs’ facilities and operators. LECs recover their long-distance traffic-sensitive costs through access charges the ICs pay for using their facilities. Access revenues received or accrued from another telephone company involving completing long-distance calls to, from or between members of telephone cooperatives are excluded from the 85-percent test under IRC Section 501(c)(12)(B)(i).

### Billing and Collection

Billing and collection for third parties (data processing, creating, mailing, and collecting invoices) weren’t considered communication services under IRC Section 501(c)(12)(B)(i). See Notice 92-33, 1992-2 C.B. 363. This is no longer the position of the Service. Telephone cooperatives receive income for performing billing and collection services for other telephone companies is excluded income per 85-percent member-income test. *Golden Belt Tel. Assn., Inc. v. Commissioner*, 108 T.C. 498 (1997), acq. in result only, A.O.D. 1998-03, 1999-1 C.B. 5.

### State Regulations

Many state public utility commissions (PUCs) regulate local telephone rates. You may find documents telephone cooperatives file with state PUCs useful to gather information.

### Rural Utility Service (RUS) Regulation of Telephone Cooperatives

Many telephone cooperatives request RUS financing for their new telecommunications plant construction and replacement or refinancing of new or existing plants. RUS only lends for construction of capital assets, not for maintenance or repairs. As a result, cooperatives have an economic incentive to classify disbursements as capital expenditures (as opposed to current expenses). After loan approval and promissory note execution, RUS becomes the first mortgage holder on all of the cooperative’s property. The cooperative deposits the RUS loan proceeds into a special trustee account and spends its own funds to construct the new plant. When construction is complete, RUS reviews and approves/disapproves the cooperative’s documentation of construction expenditures. The cooperative can withdraw the approved amount from the trustee account and deposit the funds in its own cash accounts. The cooperative must reimburse the trustee account for any construction expenditure disallowed later.

To ensure loan repayments, RUS requires telephone cooperatives to follow FCC’s Uniform System of

Accounting. Its audit procedures are published at 7 C.F.R. § 1770.10 *et seq.* and on its internet site. An RUS mortgage requires that the cooperative submit detailed annual financial reports to RUS, including certified audits and other reports, all of which are public information. If the cooperative doesn't comply with these (and other) requirements, RUS may declare the loan in default, suspend future lending, and exercise other remedies under the mortgage. RUS headquarters staff and field accountants review a cooperative's records, reports, and certified financial statements at least once every three years. Field accountants look at direct cost accumulation for plant construction and overhead allocations for construction, retirement, and maintenance and perform non-opinion audits of the cooperative's loan fund transactions. These RUS field reports also are public documents.

### The FCC/RUS Uniform Systems of Accounts (USoA)

**Overview.** The FCC regulates certain activities of telecommunications companies (including telephone cooperatives) engaged in interstate commerce. To identify regulated and nonregulated income, expenses, and capital expenditures affecting the rate base, the FCC requires the companies/cooperatives to keep financial records according to its Uniform System of Accounting (USoA) and to file annual financial reports. The USoA follows Generally Accepted Accounting Principles (GAAP) in many instances.

**USoA Objectives.** In general, regulated telecommunications companies recover their allowable costs to offer regulated goods and services and earn a return on investment. (Operating income and expense affecting the rate base are sometimes referred to as "above the line" and non-operating income and expense as "below the line"). The USoA separates *regulated* (operating income and expense) from *nonregulated* activities (non-operating income and expense). This accounting separation purpose is to prevent telecommunications companies from imposing costs and risks of nonregulated activities on the ratepayers (cooperative's members). Expense accounts are grouped by type (such as wages) and function (such as engineering expense). Be aware of differences among regulatory accounting, income tax accounting, and GAAP.

**Reporting to RUS.** RUS also requires telephone cooperatives to keep detailed books and detailed financial information and reporting on cooperatives' activities such as corporate structure, reorganizations and acquisitions, investments in affiliated companies, and extraordinary gains and losses. RUS requires cooperatives to follow the FCC's USoA with some modifications. Refer to publication of the USoA at 47 C.F.R. Part 32 and 7 C.F.R. § 1770.

**Classification of Telephone Companies.** Reporting obligations vary with the revenues of the telephone company. Companies with regulated telecommunications revenues exceeding \$100 million are Class A companies. All other companies are Class B companies. Almost all cooperatives are Class B companies. Accordingly, these guidelines cite the rules for Class B companies.

**Recordkeeping and Accounting Requirements.** According to FCC regulations, cooperatives must keep books of account, records, minute books, memoranda, etc., to support all entries and keep financial records "with sufficient particularity to show fully the facts pertaining to all entries" in the USoA and subsidiary records, as necessary. They must use the accrual method of accounting (as defined in GAAP), and account for regulated (defined in 47 C.F.R. § 32.9000) activities separately.

**Non-Regulated Activities.** Non-regulated activities also must be accounted for separately. This separate accounting may give useful information for the 85-percent test or UBIT or both. For rules on revenues from non-regulated activities, see § 32.4999(l). For example, cable TV and direct broadcast TV aren't non-regulated activities.

**Assets and Expenses.** Two methods to account for are assets and expenses:

- Dual Use. Where regulated activities and nonregulated activities use the same assets, cooperatives must maintain subsidiary records reflecting assets used and expenses incurred in each type of activity. Nonregulated activities involving dual use assets are reported as part of telephone company operations.
- No Dual Use. Where there is no dual use of assets, the cooperative must keep a separate set of books for its nonregulated activities.

**USoA Accounts for Telephone Cooperatives.** FCC/RUS USoA accounts have four digits. The first digit indicates the account classification (for example, an account beginning with “5” is a revenue account). For RUS reporting, the RUS subaccounts are preceded by “REA.” For example, the account for Cash General Fund is REA 1120.11. All Accounts are in 47 C.F.R. Part 32.

**The telephone cooperative balance sheet accounts are:**

1120 – 1500	Current and Noncurrent Assets
2001 – 2690	Telecommunications Plant in Service
3100 --3600	Depreciation and Amortization Reserves
4010 -- 4550	Liabilities and Stockholders’ Equity (or patronage capital accounts)

**The telephone cooperative income and expense accounts are:**

5000 – 5302	Operating Revenue
6110 – 6790	Operating Expense
7100 – 7990	Other Operating Revenues and Expenses (i.e., accounts for activities peripheral to the cooperative’s main operations)

**Entities Covered by Financial Statements.** A cooperative’s financial statements must comply with SFAS No. 94, “Consolidation of All Majority-Owned Subsidiaries.” If the cooperative owns a majority interest in one or more subsidiaries, it must prepare consolidated financial statements that includes each subsidiary and supplementary schedules presenting a balance sheet and income statement. They must prepare RUS Form 479 on an unconsolidated basis. The RUS regulations contain sample financial statements (with accountants’ notes) for a telephone cooperative.

**RUS Regulations on CPAs’ Audits of RUS Borrowers.** The CPAs must prepare and submit the following annual reports to RUS:

- Auditor’s Report (on the cooperative’s financial statements, including accountants’ notes and statements of cash flows)
- Report on Compliance with Applicable Laws and Regulations (as required by SAS No. 63, “Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,” and Generally Accepted Government Auditing Standards (GAGAS))
- Report on Internal Controls
- Management Letter, including disclosure of material transactions with related parties, e.g.,

officers and directors (these reports and the management letter are public documents)

- Sample Financial Statements. See 7 C.F.R. § 1773 Appendix B for sample financial statements, auditor's report, compliance report, and report on internal controls, and Appendix C for a sample management letter

We don't cover all aspects of the USoA, GAAP, and GAGAS for auditing cooperatives. Review the particular provisions relevant to your examination and contact the pertinent agency for questions:

- FCC, Deputy Chief, Pricing Policy Division (Wireline Competition Bureau) - (202) 418-1520
- FCC, Deputy Chief, Investigation and Hearing Division (Enforcement Bureau)- (202) 418-7450
- RUS, Technical Accounting and Auditing Staff- (202) 720-5227

### Examination Planning

Consult the following for help in planning and conducting the examination:

- State Public Utility Commissions. If one or more PUCs regulate the cooperative, contact the PUC(s) about the cooperative's filings and PUC orders.
- Federal Communications Commission. Financial reports are filed with the FCC's Common Carrier Bureau, FCC, Washington, D.C. 20554.
- Rural Utilities Service.

### Requesting the Assistance of Specialists

**Assistance from Other Functions.** If you need to examine an entity not under TE/GE's jurisdiction of (such as a joint venture with another telephone company), request help from the function responsible for examining that entity as soon as you identify the need.

**Note:** The Specialist Referral System (SRS) on the TE/GE website automates the referral request process. You can generate a referral request online which automatically notifies the appropriate Field Specialist Manager of your request. The manager then assigns an examiner to the case at his/her discretion.

Use these specialists for assistance:

**Utilities Industry Specialist/Media/Communications Industry Specialist.** The industry specialists (including cable television and direct TV) can help:

- identify unique industry issues and IRS position
- give insight into the economic conditions of the industry
- describe accounting and business practices
- suggest examination procedures and computer programs that may apply

**VEBA (Voluntary Employees' Beneficiary Association) Industry Specialist.** The industry specialist can help with examining VEBAs.

**Computer Audit Specialist.** If you need a computer audit specialist, get a description of the cooperative's hardware, software (including accounting software), and formats of files and records.

**Engineer.** Refer all cooperative returns with assets of \$10 million or more for engineering action. When examining exempt and nonexempt cooperatives, the engineer is a valuable resource (for example, tax exempt bonds, construction techniques, machinery and building design, repairs, depreciation, depletion and valuation of assets). Involve the engineer in the examination's early planning stages.

**Excise Tax Specialist.** Examining cooperatives often raise excise tax issues which may require consulting an excise tax specialist.

**Employee Plans.** The industry specialist can help with examining the cooperative's pension and profit sharing plans.

### Initial Document Requests

Obtain and review these documents to gain an understanding of the cooperative's activities, income, expenses, capital structure, and related organizations:

- Articles of incorporation (and all amendments)
- Bylaws (and all amendments)
- A list of the subsidiaries and associated companies' names and addresses
- The cooperative and of all subsidiaries and associated companies' names and addresses of all directors, trustees, and officers
- Minutes of meetings of board of directors and of all board committees
- Annual reports, financial statements (including statements of cash flow and accountants' notes), and tax returns for all subsidiaries and associated companies
- All reports filed with RUS (including but not limited to: RUS Form 479; audited financial statements, including statements of cash flow and accountants' notes); auditor's report, compliance report, report on internal controls and management letter
- RUS Field Reports on the cooperative (from RUS field accountants, field engineers, or general field representatives)
- Any prepayment agreement(s) between the cooperative and RUS (concerning prepayment of RUS loans)
- Any debt restructuring plan entered into between the cooperative and RUS
- Methods and Procedures Manual (procedures to record transactions)
- A chart of accounts correlating general ledger accounts to USoA Accounts
- The cooperative's 85-percent test worksheets
- Patronage dividends
- An analysis of income and expense
- All reports and other filings with PUCs and PUC orders (if applicable)
- Records of transactions with subscribers (as appropriate): applications for service, service

orders, subscriber's record cards, toll tickets and toll settlements, subscriber's monthly bill, and adjustment vouchers

- Subscriber's ledgers (ledgers, cards, or stubs), paystation accounting
- Control of subscriber's accounting (subscriber accounts grouped into control units), collection posting and reconciling cash collections, collection of delinquent accounts
- All agreements between the cooperative and any subsidiary or associated company
- Qualified employee retirement plans: the official plan and trust documents, any determination letters issued to qualified plans, records of employer and employee contributions, account balances or accrued benefits and employee compensation
- Non-qualified deferred compensation plans: employee benefit plans and related documents (such as trusts, insurance contracts, and private letter rulings), records of employer and employee contributions and account balances or accrued benefits
- All other employee benefit plans: including accident and health plans, cafeteria plans and VEBA's, related documents (including any trust instruments)
- All arrangements for compensation of directors (including qualified and non-qualified deferred compensation plans)
- A schedule of all funded reserves (including any trusts or VEBA's for payment of welfare benefits or postretirement benefits)
- Joint operating agreements, settlement agreements, cost-pooling agreements (see 47 C.F.R. § 32.14(e))
- All documents about any waiver of any provision in the FCC's USoA or requested FCC approval of accounting for unusual items or contingent liabilities
- [Forms 720](#) filed for the examination period
- Members' names and addresses
- Securities and Exchange Commission Forms 10-K filed by the cooperative (if applicable)
- The method used to compute patronage dividends
- Workpapers to support claimed patronage dividends
- Notification letters to all members on allocations of patronage dividends
- Newsletters and other communications to members
- Tax-exempt bond information, as necessary

### Examination of Financial Statements and Reports to Regulatory Agencies

**Methods of Accounting.** Although basic principles are the same, the accrual method of accounting required per RUS, income tax accounting, and GAAP differ. When this occurs, income tax accounting rules control. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979); Treas. Reg. section 1.446(e)-1; Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Proc. 92-20, 1992-1 C.B. 685. Many differences affect timing of income and expense, gain and loss, and raising issues under IRC Sections 61, 118, 451, 1001,

1231, and IRC Sections 446 and 481 for changes in methods of accounting. They also may affect IRC Sections 461 and 512 issues.

**IRC Section 451(f).** Accrual basis telephone utilities must recognize income from furnishing telephone and other communications services to customers not later than the taxable year in which they provide the service. Utilities may not accrue income relying on when they bill customers. Cooperatives may need to adjust their income. For IRC 481(a) adjustments resulting from IRC Section 451(f), see P.L. 99-514 §§ 821(b)(2), (3) and 100-647 § 1008(h). S. Rep. No. 313, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 3) 120-121; H. Conf. Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 4) II-322-324. For prior law (cycle billing vs. budget billing), see Rev. Rul. 72-114, 1972-1 C.B. 124.

**Rate Increases.** For financial accounting, utilities report a permitted rate increase as revenue in the year in which the new rate order is issued. For income tax accounting, recognize increased income when it's properly earned or accrued. Notify your manager when the USoA differs from income tax accounting for:

- Reporting purposes ([Forms 990](#) and [990-T](#)) or
- Calculating member income in applying the 85-percent test.

**Statement of Cash Flows.** Cooperatives' financial statements must include a statement of cash flows. FAS No. 95. The statement gives information on the cooperative's ability to generate positive cash flows, to pay patronage dividends and need to borrow funds. This statement may help you assess whether the cooperative operates according to cooperative principles (including the reasonableness of cash reserves).

**Cash Flows from Investing.** Activities reflect the operations of subsidiaries. Activities reflect the operations of Analyze the statement of cash flow (or, if they use a condensed statement of cash flow, review a more detailed cash flow statement). If appropriate, request the underlying workpapers.

### The 85-Percent Member-Income Test

**Effect of Accounting Methods.** The differences in accounting methods among USoA, GAAP, and income tax that affect timing of income and expense, gain and loss, and raising issues may also affect the 85-percent test in IRC Section 501(c)(12).

Exhibit 1 (below) shows the income tax treatment of certain USoA Accounts to apply the 85-Percent Test.

**Members.** In general, subscribers the cooperative serves are members of the cooperative. These guidelines assume that all subscribers are members. Cooperatives must keep records of membership subscriptions. See the accounts for "Subscriptions to Memberships" and "Subscriptions to Members' Equity Certificates." The cooperative's subscription ledger should show the amounts due, paid, and owed for each subscriber. New members usually pay a membership fee, which is applied to a final bill or refunded in cash.

**Revenue Accounts.** These accounts are divided into five groups: 1) Local Network Service, 2) Network Access Services Revenues, 3) Long-Distance Network Services Revenues, 4) Miscellaneous Revenues, and 5) Uncollectible Revenues. Network Access Services Revenues and Long-Distance Network Services Revenues, combined, are the largest revenue sources for most cooperatives.

**Telecommunications Services.** FCC determines the amount, type and source of cooperatives'

revenue from regulated telecommunications services. Cooperatives must comply with the USoA, classifying and reporting revenues from regulated and unregulated services. See Exhibit 1 (below) for accounts used to record income from these categories for telecommunications services.

**Telecommunications Accounts Receivable.** Account 1180 includes all amounts billed to subscribers (local and long-distance service, member income, nonmember income, and excluded income). Also, see accounts 1181, 5301, and 5302. Taxpayers must use the specific charge-off method in accounting for losses on bad debts. So, it may be necessary to adjust accrued income to compute member, nonmember, and excluded income. Review accounts 1190 and 1191.

**Income from Interest and Dividends.** Review the following accounts:

- *Cash accounts.* Cooperatives must invest cash in income-producing accounts and must primarily consider safety and liquidity. Trace earnings to the appropriate revenue accounts or other income accounts; determine if earnings are member or nonmember, and trace to [Form 990](#).
- *Other Investment Funds.* Trace investment income attributable to these accounts to Form 990.
- *Revenue Accounts.* Analyze dividend and interest income accounts and accounts receivable and other non-operating income and expense accounts. Note that the account “Allowance for Funds Used During Construction” exists solely for regulatory purposes. Dividends received and receivable from affiliated companies are recorded in “Investments in Affiliated Companies.”
- *Interest Income from “Cushion of Credit Accounts.”* Determine if interest income from “cushion of credit accounts” is reported. If so, it is nonmember income. Cooperatives with RUS loans may deposit amounts in cushion of credit accounts at the U.S. Department of the Treasury. These accounts can only pay principal and interest on RUS loans. If necessary, request a transcript of RUS’s loan receivable accounts for the cooperative and analyze deposits and accrued interest income applied to installments of principal and interest on RUS loans.
- *Notes Receivable.* Review accounts for amount, timing, and source of interest income.

**Forgiveness of Indebtedness Income from Reacquisition of Long-Term Debt.** When cooperatives reacquire their debt before maturity, the face amount appears in “Reacquired Debt.” For income tax, discharge of indebtedness income is (nonmember) gross income in the taxable year realized unless TAMRA § 6203 applies. IRC Sections 61(a)(12), 451(a), 501(c)(12)(B)(iv).

**Other Investment Income, Gain or Loss.** Review accounts for gains and losses from foreign exchanges, nonregulated use of regulated facilities, disposition of land and certain property, and nonregulated net income.

**Premium Income.** If a cooperative has bond financing (uncommon), it may have premium income. Cooperatives must maintain separate accounts for premium, discount, and expense for each class and series of long-term debt. See the account for “Premium on Long-Term Debt.” Also, see Treas. Reg. section 1.61-12(c).

**Rural Telephone Bank (RTB).** RTB, a United States agency, offers cooperatives financing to supplement REA loans. Cooperatives who borrow from RTB must purchase Class B stock. Class B stockholders may receive patronage dividends in the form of additional stock, par value of

purchased stock, or stock received as a patronage refund. See accounts for “Investments in Non-affiliated Companies,” “Investments in Nonaffiliated Companies-Class B RTB Stock,” “Investments in Non-affiliated Companies-Class C RTB Stock,” and “Other Margins.”

**Gains and Losses on Disposition of Plant.** Gains and losses from disposition or retirement of telecommunications plant and other assets are included in gross income in the taxable year realized and recognized. FCC/RUS USoA rules on plant accounting differ radically from income tax accounting in many ways such as acquisitions, retirements, depreciation reserves, adjusted basis and realization.

- *Accounting for Telecommunications Plant.* Telecommunications plant is the largest asset account on the balance sheet. For FCC/RUS reporting, plant and equipment are economic resources to offer future service. Their cost must be rationally and systematically allocated to the future periods that benefit from these assets. Telecommunications plant includes plant in service, under construction, or held for future use and goodwill. Assets cover land, buildings, vehicles, office furniture, and equipment. Cooperatives must maintain detailed property records. The required records for jointly owned property must identify all joint owners. The controlling account for subaccounts is “Telecommunications Plant in Service-Classified.”
- *Plant Accounts.* Amounts in plant accounts may differ from income tax basis rules.
- *Depreciation.* It’s generally computed on the straight line method over the property’s service life.
- *Retirement of Telecommunications Plant.* When the plant is obsolete, abandoned, lost, or destroyed, credit its account with the original cost of the retired item (whether or not the item is replaced).
- *Transactions with Affiliated Companies.* Transfers of assets between the cooperative and its affiliates must be booked according to special rules. These transactions may be treated differently and raise examination issues. See IRC Sections 267, 482.

**Investments in Nonaffiliated Companies.** Debt and equity investments are booked at acquisition cost. Each investment must be kept in separate records. A temporary decline in value is charged to “Other Capital.” Permanent decline in value becomes a current period loss.

**Cable Television.** Cable television activities conducted in a cooperative’s division are recorded in “Non-regulated Investments” and “Non-regulated Net Income.”

**Miscellaneous.** Entries in the following accounts may reveal member, nonmember, or unrelated trade or business income:

- Other operating income and expenses
- Extraordinary income credits
- Extraordinary income charges
- Property held for sale or lease
- Nonregulated operating revenue
- Nonregulated investments

- Non-operating plant
- Non-operating margins
- Carrier billing and collection revenue
- Land and support assets
- General purpose computers

### Unrelated Business Taxable Income (UBI)

Some directory advertising revenues may raise UBI issues in telephone cooperatives examinations. IRC Sections 512, 513; Treas. Reg. section 1.513-1(d)(4)(iv), Example (6); [Rev. Rul. 74-38, 1974-1 C.B. 144](#), clarified by [Rev. Rul. 76-93, 1976-1 C.B. 170](#).

- Display advertisements (whether placed by members or nonmembers) are unrelated trade or business
- Payments for business listings ordinarily confer minimal commercial benefit and aren't unrelated trade or business

### Cooperative Principle – Subordination of Capital (Patronage Account)

Cooperatives must keep detailed records on members' names and addresses and a patronage capital ledger. Under cooperative principles, the excess of operating revenues over operating expenses for each year is capital furnished by member-patrons. The cooperative assigns this capital to members based on each year's margins:

- At the end of each year, revenue and expense from furnishing telecommunications and other services are closed into "Operating Margins" and "Non-Operating Margins" accounts. Patronage capital credits appear in "Other Margins." Note: These accounts can't be used (unless adjusted) in the 85-percent test because they reflect *net* income from operations and because the income accounts don't uniformly parallel member/nonmember classifications in IRC Section 501(c)(12).
- Then, transfer the balance in the accounts to the "Patronage Capital Assignable" account. Patronage capital is assigned to individual members based on patronage, under the cooperative's bylaws.
- After the margins are allocated to members, this amount is transferred from "Patronage Capital Assignable" account to "Patrons' Capital Credits Assigned."
- When the board of directors authorizes the return of capital credits to member-patrons, the amount authorized is transferred to "Patronage Capital Payable."
- Forfeited membership fees appear in the "Members' Equity - Other" account. Determine if forfeitures are treated consistent with [Rev. Rul. 72-36, Q 4, 1972-1 C.B. 151](#) modified by Rev. Rul. 81-109, 1981-1 C.B. 347.
- The cooperative's CPAs must analyze patronage capital accounts and a sample of membership transactions.
- Cooperatives aren't required to file Forms 1099 to report payments of patronage

dividends. Treas. Reg. section 301.6044-2(b)(2)(iii).

### Package Audit Considerations – Excise Taxes

Cooperatives must collect and pay federal excise taxes on certain communications services. These guidelines summarize the communications tax. Consult an excise tax specialist if you need additional help. The following services are taxable:

- local telephone service
- toll (long-distance) telephone service
- teletypewriter exchange service

The tax rate is three percent on the total amount paid for the services. State or local taxes (but not gross receipts or gross earnings taxes) that are separately stated on the bill are not included in the tax base.

The cooperative may be allowed a credit or refund for collecting the tax from members if it establishes that it repaid the amount collected to members or obtains the members' consent to allow a credit or refund. In general, crediting members' patronage capital account has the same effect as refunding the overpaid tax to members. Rev. Rul. 68-206, 1968-1 C.B. 557, amplified Rev. Rul. 70-13, 1970-1 C.B. 273.

The excise taxes on using certain large vehicles may also apply. See IRC Section 4481.

Cooperatives must file [Form 720](#) quarterly (reporting communications tax) and [Form 2290](#) (reporting highway use tax). For exemption certificates, see IRC Section 4253(l).

### Nonexempt Telephone Cooperatives

**Overview.** If you need to prepare a [Form 1120](#) for any years under examination, seek help from the utilities industry specialist, the farmers' cooperatives industry specialist, and, as appropriate, the media/communications industry specialist or VEBA (Voluntary Employees' Beneficiary Association) industry specialist. Many aspects of the USoA not covered in these guidelines may be useful to prepare [Form 1120](#).

**Patronage Deductions.** Nonexempt cooperatives not subject to Subchapter T may exclude patronage dividends paid or allocated to patrons, according to their bylaws. Rev. Rul. 83-135, 1983-2 C.B. 149. Ask the cooperative for information to analyze patronage and non-patronage income and expense.

**IRC 277.** Nonexempt telephone cooperatives are subject to IRC 277, a method of accounting (as defined in IRC Section 446). Treas. Reg. section 1.446-1(e)(2)(ii)(a); *Concord Consumers Hous. Coop. v. Commissioner*, 89 T.C. 105, 116 (1989).

### Exempt Rural Electric Cooperatives

These guidelines offer suggestions on issues, documents, and techniques for examining rural electric cooperatives and don't attempt to cover every issue that might arise in an examination.

Examinations of generation and transmission cooperatives (G&Ts) and distribution and transmission cooperatives, for example, present different issues and are usually examined under the Team Examination Program. Further, the guidelines don't intend to require examiners to exhaustively review all areas in examining every rural electric cooperative. Examiners must use their professional judgment to determine the scope and depth of each examination.

## Overview – Electric Utilities and Rural Electric Cooperatives

**Electric Utilities.** Electric utilities (including rural electric cooperatives) were once monopolies. Now they confront many challenges, including increased competition from independent power producers and other electric utilities. Industry and government consumers demand electricity at the lowest cost, and, increasingly, if dissatisfied with rates from the local electric utility, they may build their own generating plants (and bypass the electric utility altogether) or purchase electricity from another electric utility. Changes in economics and technology are also challenges to electric utilities. It remains to be seen how much the internet will affect electric utilities as an industry.

**Trends.** Industry analysts forecast several trends that will likely generate new accounting and tax questions:

- Price competition among competing utilities
- Mergers among electric utilities (including G&Ts)
- Joint ventures between cooperatives and other utilities to own and operate power generation plants
- Sharing of services

**Rural Electric Cooperatives.** Rural electric cooperatives (cooperatives) offer electric power to members and other consumers. G&Ts construct and operate power plants (alone or in arrangements with other utilities) and sell electricity at wholesale to their member distribution cooperatives, which, in turn, sell electricity retail to consumers. Distribution cooperatives are members of G&T cooperatives. The distribution cooperatives purchase electricity from their G&Ts to furnish electricity to consumers. Each cooperative, in turn, may be a member of other cooperatives, including cooperative subsidiaries. To carry out their activities, G&Ts and distribution cooperatives acquire land and land rights (including easements, water and power rights, diversion rights, and submersion rights). They own (or lease) and operate electric generating plant and transmission and distribution plant, office space, furniture, and equipment. (Some distribution cooperatives aren't members of a G&T and purchase power from other sources.) Cooperatives also contract for fuel/power supply and operate power plants jointly with other utilities.

**Joint Ventures.** G&Ts often join with other electric utilities to build and operate power generating stations. The joint ventures may own the station as tenants in common, operating the station and sharing its capacity and energy according to various operating agreements, station agreements, and load management agreements. These joint ventures may raise issues bearing on the 85-percent member-income test.

**Diversification.** Cooperatives are diversifying, offering water management and sewage treatment, venturing into economic development, offering satellite television service, selling satellite reception equipment, and, less commonly, offering cable television service. Many cooperatives belong to the National Rural Telecommunications Cooperative (NRTC) which offers Rural TV programming via satellite. Many of the satellite and cable television services are for-profit (non-cooperative) businesses.

## State and Federal Regulation of Electric Cooperatives

Regulation of electricity rates differs from state to state. To determine if rates are regulated by the state governing the electric cooperative being examined, check with the state's public utility

commission.

Federal Energy Regulatory Commission (FERC) regulates the rates, terms, and condition of interstate wholesale electric power sales and transmission services. Certain G&Ts file annual reports with FERC (FERC Form 1). These reports are public information.

### Rural Utility Service (RUS) Regulation of Electric Cooperatives

Like telephone cooperatives, many electric cooperatives finance their utility plant through loans from or guaranteed by the Rural Utilities Service (“RUS,” formerly known as “REA”). G&Ts generally borrow from the Federal Financing Bank (FFB) or from private lenders with a RUS loan guaranty.

RUS loans to electric cooperatives work in essentially the same way as those to telephone cooperatives.

To ensure repayment of loans, RUS also requires electric cooperatives to follow its USoA and audit procedures. For electric cooperatives, the procedures are published at 7 C.F.R. § 1767.10 *et seq.* and on the RUS internet site.

RUS holds a first mortgage on all of the cooperative’s property. The mortgage requires the cooperative to submit detailed annual financial reports to RUS, including certified audits and other reports, all of which are public information. If the cooperative doesn’t comply with these (and other) requirements, RUS may declare the loan in default, suspend future lending, and exercise other remedies under the mortgage. RUS field accountants (sometimes referred to as general field representatives) review the loan fund records, reports, and financial statements of active borrowers at least once every three years. Field accountants look at direct cost accumulation for utility plant construction and overhead allocation among construction, retirement, and maintenance. The field accountants perform non-opinion audits of the cooperative’s loan fund transactions. The RUS Field Reports are public documents.

### RUS Uniform System of Accounts for Electric Cooperatives (USoA)

**Reporting to RUS.** RUS requires electric cooperatives to keep detailed financial information and reporting on activities. The USoA is based on FERC’s accounting system with some modifications. RUS’s Uniform System of Accounts for electric cooperatives is published at 7 C.F.R. § 1767 and its Accounting Methods and Procedures (required of all borrowers) at 7 C.F.R. § 1767.15. RUS also publishes Accounting Interpretations on the USoA. The methods and procedures mandate the entries to book particular transactions and help understand the proper accounting treatment of items. Many accounts and account numbers in the USoA remain unchanged from year to year, so these examination guidelines can generally be used year to year.

**Recordkeeping and Accounting Requirements.** Cooperatives must keep books of account to support all entries and all supporting books, records, minute books, memoranda, etc. Cooperatives must use the accrual method of accounting (as defined in GAAP). They must maintain separate accounting records for each power plant and any other utility department (such as gas or water). The USoA contains the following Accounts:

#### Balance Sheet Accounts for Electric Cooperatives

100-199	Assets and Other Debits
200-299	Liabilities and Other Credits

300-399	Plant Accounts
433, 436-439	Retained Earnings Accounts

### **Income and Expense Accounts**

400-432; 434-435	Income Accounts (Net Income)
440-459	Revenue Accounts
500-599	Production, Transmission, and Distribution Expenses
900-949	Customer Accounts, Customer Service and Informational, Sales, General and Administrative Expenses

**Non-Balance Sheet Accounts.** Most USoA non-balance sheet accounts are paired revenue and expense accounts. Income accounts (generally, the less significant accounts) combine revenue and expense into a single account. Certain non-balance sheet accounts show revenue and expense for transactions between different departments within the cooperative. Because there are numerous timing and permanent differences between RUS accounting and income tax accounting, you may need to adjust the amounts shown on the financial statements in an examination.

**Contact.** We can't explore all aspects of the USoA, GAAP, and Generally Accepted Government Auditing Standards (GAGAS) relevant to cooperatives' examinations in this section. Examiners may, however, contact RUS's Technical Accounting and Auditing Staff with questions at (202) 720-5227.

**Subsidiaries.** A cooperative's financial statements must comply with FAS No. 94, "Consolidation of All Majority-Owned Subsidiaries." If the cooperative owns a majority interest in a subsidiary, the cooperative must prepare consolidated financial statements including the subsidiary, together with supplementary schedules presenting a balance sheet and income statement for each subsidiary. RUS Forms 7 and 12 must be prepared on an unconsolidated basis. The RUS regulations contain sample financial statements (with accountants' notes) for an electric cooperative.

**RUS Regulations on CPAs' Audits of RUS Borrowers.** The CPAs must prepare and submit the following annual reports to RUS, which are public documents:

- Auditor's report (financial statements, accountants' notes, and statements of cash flow)
- Report on Compliance with Applicable Laws and Regulations
- Report on internal controls
- Management Letter (including disclosure of material transactions with related parties)

### **Examination Planning**

Consult the following for help to plan and conduct the examination:

- State Public Utility Commissions. If one or more PUCs regulate the cooperative, contact the PUC(s) about the cooperative's filings and PUC orders.
- Federal Energy Regulatory Commission. Contact the Office of Chief Accountant at (202) 219-2600.
- Rural Utilities Service. Contact the Director of the Program Accounting Services Division at

(202) 720-9450.

### Initial Document Requests

Request and review the documents listed below for an understanding of the electric cooperative's activities, capital structure, and related organizations.

Request documents from all electric cooperatives:

- Articles of Incorporation (and all amendments)
- Bylaws (and all amendments)
- A list of all subsidiaries and associated companies' names and addresses
- All the cooperative's, subsidiaries' and associated companies' directors, trustees and officers names and addresses
- Minutes of meetings of board of directors and of all board committees
- Annual reports, financial statements (including statement of cash flows and accountants' notes) and tax returns for all subsidiaries and associated companies
- RUS Forms 7 Financial and Statistical Report, Operating Report-Financial, Form 12
- RUS Field Reports on the cooperative (from RUS field accountants, field engineers, or general field representatives)
- Any debt restructuring plan entered into between the cooperative and RUS
- Methods and Procedures Manual (procedures to record transactions)
- A chart of accounts correlating general ledger accounts to USoA Accounts
- The cooperative's 85-percent test worksheets
- The cooperative's policy book on patronage capital and patronage dividends
- An analysis of income and expense
- An analysis of deferred credits and deferred debits with supporting documentation (this analysis is required in 7 C.F.R. § 1773)
- All reports filed with RUS (including but not limited to: RUS Forms 7, 12; audited financial statements, including statement of cash flows and accountants' notes); auditor's report, compliance report, report on internal controls and management letter
- All reports and other filings with PUCs and PUC orders (if applicable)
- All agreements between the cooperative and any subsidiary or associated company
- Qualified employee retirement plans: the official plan and trust documents, any determination letters issued to qualified plans, records of employer and employee contributions, account balances or accrued benefits and employee compensation
- Nonqualified deferred compensation plans: employee benefit plans and related

documents (e.g., trusts, insurance contracts, private letter rulings), records of employer and employee contributions and account balances or accrued benefits

- All other employee benefit plans: including accident and health plans, cafeteria plans and VEBA's, related documents (including any trust instruments)
- All arrangements for compensation of directors (including qualified and non-qualified deferred compensation plans)

Request newsletters and other communications to members from distribution cooperatives.

## Examination of Financial Statements and Reports to Regulatory Agencies

**Methods of Accounting.** See discussion above.

**IRC Section 451(f).** Electric cooperatives on the accrual basis of accounting must recognize income from the sale of electricity to customers not later than the taxable year in which they provide it. These electric cooperatives may not rely on the meter-reading or customer billing date when accruing income.

- Check if the cooperative accrues all unbilled revenue associated with its purchased gas adjustment or deferred fuel adjustment.
- Check to ensure that these unbilled accruals aren't netted against unbilled fuel costs to provide electricity.
- Look at the "Accrued Utility Revenue." Even when IRC Section 451(f) applies, RUS rules of accounting may allow the electric cooperative to choose whether to accrue estimated revenue for electricity sold but not billed as of the end of the taxable year. As a result, the cooperative may need to adjust income for the 85-percent member-income test.

## Timing Differences Between RUS Accounting and Income Tax Accounting

- Distribution cooperatives generally use cycle billing or budget billing. Cycle billing is based on monthly meter reading and billing cycle. Budget billing is based on an annual projected budget; and customers are billed a level amount monthly with an annual adjustment reflecting actual electricity consumption. On billing methods, see Rev. Rul. 72-114, 1972-1 C.B. 124. Determine whether the cooperative accrues income consistently and according to IRC Section 451(f).
- Accounts for "Memberships Issued," "Customer Advances for Construction," or "Donated Capital" may raise issues under the 85-percent test and IRC Sections 118, 446, or 481. See Rev. Rul. 75-557, 1975-2 C.B. 33, clarified by Rev. Rul. 76-61, 1976-1 C.B. 12.
- Amounts in "Customer Deposits" usually represent security deposits for electricity. *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990); Rev. Proc. 91-31, 1991-1 C.B. 566.
- The "Accumulated Provision for Rate Refunds" and "Provision for Rate Refunds" accounts may also affect the timing of income, expense, gain, or loss.

## Margin Stabilization Plans

In 1988, RUS (then REA) published proposed regulations for borrower rural electric cooperatives to

gain approval for a “margin stabilization plan.” If REA approved, the electric cooperatives could use accounting methods to defer certain current revenues or expenses to future periods. Under the proposed regulation, the electric cooperative submitted a private letter ruling (PLR) from IRS and REA that essentially deferred the cooperative’s tax exempt status and operation as a cooperative under the tax law. REA’s proposed regulation also stated that a cooperative could elect to implement a margin stabilization plan stating the cooperative was aware of and accepted responsibility for a potential adverse effect on its tax exempt status. REA required the cooperative to submit the resolution with substantiation of a formal PLR application to the IRS.

Subsequently, the REA/RUS modified the proposed regulation to require the cooperative to submit a board of director’s resolution stating that in lieu of a favorable PLR from the IRS, the cooperative would allocate margins based upon current operating performance, absent any effects of a margin stabilization plan.

RUS has placed a moratorium on approving margin stabilization plans since 1994. Electric cooperatives can elect to discontinue the plan they had implemented, but if they choose to do so, they must notify RUS and recognize income in the year of discontinuance. Otherwise, those electric cooperatives that implemented an REA-approved plan under the proposed procedures may continue to defer certain income and expenses to future periods.

Electric cooperatives must maintain certain financial ratios or their RUS loans are in default. To meet the required ratios, some cooperatives under a margin stabilization plan average their margins. The cooperative selects a target margin by which income is to exceed expenses (usually the ratio required by RUS) and show it as income in financial statements and RUS reports, as opposed to the actual income and expense accrued that year. In a good year, the cooperative books the excess of income over expense as a deferred credit; in a bad year, the operating loss is booked as a deferred charge. GAAP allows this under certain conditions, as does RUS, if the cooperative meets certain requirements and discloses the plan in its financial statements.

These plans raise issues with respect to the 85-percent test and [Rev. Rul. 72-36](#), 1972-1 C.B. 151, modified by Rev. Rul. 81-109, 1981-1 C.B. 347. See EO Technical Instruction Program for FY 1994, “Current Issues Affecting Certain Cooperatives and Like Organizations Described Under IRC § 501(c)(12).”

The IRS’s position is that using margin stabilization plans could result in erroneously calculating member income to meet the 85- percent member-income test. For an electric cooperative company using this type of plan, determine whether the organization has an IRS PLR. If so, determine if the cooperative is following all of the letter’s provisions. If it doesn’t have a PLR, determine if the organization:

- Includes income deferred under the margin stabilization program in the calculation of the 85-percent member-income requirement in the year it is received or earned;
- Applies income or reserve deferred or set aside under the margin stabilization plan to future years’ revenues within five years from the date that reserve is deferred or accumulated (This must serve to avoid an accumulation of unreasonable reserves. See Question 2 of [Rev. Rul. 72-36, 1972-1 C.B. 151](#));
- Discloses the operation of the margin stabilization plan to member-patrons;
- Maintains records to determine each member’s rights and interests in the cooperative’s assets, including reserves set aside under the margin stabilization plan (see Question 3 of

[Rev. Rul. 72-36, 1972-1 C.B. 151](#), modified by Rev. Rul. 81-109, 1981-1 C.B. 347).

### The 85-Percent Member-Income Test and Unrelated Business Taxable Income

See Exhibit 2 (below), “Applying the 85-Percent Test: Analysis of RUS Uniform System of Accounts (Selected Revenue, Income, Expense and Balance Sheet Accounts)” which illustrates the income tax treatment of certain USoA Accounts.

**Operating Revenue from Sale of Electricity.** The total amount of the electric operating revenue accounts is entered in “Operating Revenue.” A cooperative’s electricity customers vary: residential, commercial, industrial, agricultural, governmental consumers, or other public utilities. To verify meeting the annual 85-percent test and to check for possible unrelated trade or business, review accounts that classify sales to members/nonmembers. Compare information on members to those whom the cooperative supplies with electricity. For example, through accounts “Public Street/Highway Lighting” and “Other Sales to Public Authorities,” determine whether a local, state, or federal government agency is a member of the cooperative. Determine if commercial customers are members or nonmembers. Review “Sales for Resale” and “Commercial and Industrial Sales” accounts for member/nonmember income.

**Accounts Receivable and Uncollectible.** Review customer accounts for member/nonmember income: “Customer Accounts Receivable,” “Customer Accounts Receivable-Electric,” “Customer Accounts Receivable-Other,” “Accumulated Provision for Uncollectible Customer Accounts-Credit,” and “Uncollectible Accounts.” Taxpayers must use the specific charge-off method in accounting for losses on bad debts. Utilities aren’t barred from charging off uncollectible accounts merely because they must continue to serve customers in arrears on their accounts. For the change in method of accounting from reserve to specific charge-off and IRC 481(a) adjustment, see P.L. 99-514 § 805(d)(2).

**Electricity Purchased for Resale.** The account “Purchased Power” shows the cost of electricity purchased for resale and all net settlements for exchange of electricity (including economy power, off-peak power for on-peak power, and spinning reserve capacity). The cooperative must maintain records by months, showing the demands, demand charges, kilowatt-hours, and prices under each purchase contract and the charges and credits under each exchange or power pooling contract.

**Income from Interest and Dividends.** Review the following accounts:

- *Cash Accounts.* Cooperatives must invest cash in income-producing accounts and must primarily consider safety and liquidity. Review the cash accounts, trace earnings to the appropriate revenue accounts or income accounts, determine if earnings are member or nonmember, and trace to [Form 990](#).
- *National Utilities Cooperative Finance Corporation (CFC).* Many cooperatives also borrow from the CFC and pay a membership fee to join. As part of the financing, they execute a subscription agreement with the CFC to purchase interest-bearing capital term certificates. These transactions are booked in “Subscriptions to Capital Term Certificates-CFC,” “Other Long-Term Debt Subscriptions,” “Interest and Dividends Receivable,” and “Interest and Dividend Income.”
- *Interest Income from “Cushion of Credit Accounts”.* Determine whether the cooperative reports interest income from “cushion of credit accounts.” Cooperatives with RUS loans may deposit amounts into cushion of credit accounts at the U.S. Department of the Treasury. These accounts can only be used to pay principal and interest on RUS loans.

When interest rates from other investments fall below the U.S. Department of the Treasury paid percentage, cooperatives often increase deposits to their cushion of credit accounts. If necessary, request a transcript of RUS's loan receivable accounts to analyze deposits and accrued interest income applied to installments of principal and interest on RUS loans.

**Forgiveness of Indebtedness Income from Reacquisition of Long-Term Debt.** Under the USoA, when cooperatives reacquire or redeem their debt, the difference between the amount paid upon reacquisition and the face value (with certain modifications) is booked to the "Unamortized Loss on Reacquired Debt" or the "Unamortized Gains on Reacquired Debt" account. In general, for income tax, discharge of indebtedness income is nonmember gross income in the taxable year realized.

**Rental Income.** Analyze "Rents Receivable Non-Operating Rental Income." Review "Electric Plant Leased to Others" and "Revenues from Electric Plant Leased to Others" accounts for source and amount of rental income for the 85-percent test and unrelated trade or business taxable income. Qualified pole rentals are recorded in "Rent from Electric Property."

**Gains and Losses.** The USoA rules on plant accounting and realization differ from the income tax rules on adjusted basis and realization:

- *Transfer of Electric Plant and Other Property.* When an electric plant is transferred, the net amount (book cost less accumulated depreciation) minus the consideration received and sales expenses is credited to "Electric Plant Purchased or Sold." If it is a significant amount, it is closed into Deferred Gains from Disposition of Utility Plant or Deferred Losses from Sale of Utility Plant and usually amortized over five years.
- *Income Tax Accounting.* Gains and losses from disposition or retirement of utility plant and other assets are included in gross income in the taxable year realized and recognized. Review and reconcile activity in these accounts with income tax accounting rules.

**Transfer of Clean Air Act Allowances.** The Clean Air Act Amendments of 1990 established a system to issue emission allowances for airborne pollutants, implemented by the Environmental Protection Agency. Electric utilities are issued emission allowances authorizing the emission of a specified amount of airborne pollutants during a specified calendar year or later period. Starting in 1993, unused allowances may be sold, traded, or held in inventory for use against emissions in future years. G&T cooperatives may have gains and losses from transfers of clean air allowances – USoA treatment may vary.

**Associated (Affiliated) Companies and Subsidiaries.** These accounts may raise issues about the 85-percent test, operation as a cooperative, unrelated trade or business, and employment taxes.

- A cooperative may invest in an associated company embracing corporations, joint ventures, and funded deferred compensation plans. Cooperatives must keep accounts and records to accurately report transactions with subsidiaries. The results of subsidiaries' operations appear on the cooperative's balance sheet in the accounts "Investment in Subsidiary Companies," "Equity in Earnings of Subsidiary Companies," and "Unappropriated Undistributed Subsidiary."
- "Review Investment in Associated Companies," "Other Investments in Associated Organizations," "Temporary Cash Investments," "Notes Receivable from Associated Companies," "Notes Payable to Associated Companies," "Accounts Receivable from Associated Companies," "Accounts Payable to Associated Companies," and "Advances

from Associated Companies.” These accounts show the book cost of investments in securities issued to each associated company or joint venture, any advancements, and accrued interest on any debt.

**Economic Development Loan Fund.** Cooperatives are encouraged to participate in the Rural Economic Development Loan and Grant Program administered by the Rural Business-Cooperative Service. RUS offers interest-free loans or grants to cooperatives to promote rural economic development and job-creation projects through revolving loan funds and pass-through grants. Interest earned on rural economic development loans appears in “Interest and Dividends Receivable” and “Interest and Dividend Income” accounts. Analyze activity in these accounts in connection with the 85-percent test.

**Miscellaneous.** Entries in the following accounts may reveal member, nonmember, or unrelated trade or business income:

- The accounts “Electric Plant Held for Future Use,” “Nonutility Property” or “General Plant” (particularly “Communication Equipment”) may suggest nonmember income and/or unrelated business such as industrial parks or non-cooperative cable TV service.
- *Sale of Nuclear Materials* (as opposed to reuse). “Nuclear Materials Held for Sale” is debited for salvage value, and “Accumulated Provision for Amortization of Nuclear Fuel Assemblies” is credited. Any difference between salvage value and the amount realized is credited/debited to “Nuclear Fuel Expense.”
- *Make Ready Charges Received from Cable Television Companies.* The cooperative and a cable television company (an affiliate or an unrelated firm) may agree to place lines, attachments, or apparatus on the cooperative’s poles for transmission of TV signals. To make the poles ready, the cooperative incurs labor and materials costs. Make ready charges may be booked in several ways: as a reimbursement, as contract work, or as reductions in expenses.
- *Sales of Timber, Sand and Gravel.* See “Miscellaneous Non-Operating Income.”

### Cooperative Principle – Subordination of Capital (Patronage Account)

Cooperatives must keep detailed records on names and addresses of members and a patronage capital ledger.

**The Patronage Capital Cycle.** Cooperatives must operate on a cooperative, or nonprofit, basis. Each year, the excess of operating revenues over operating expenses is capital furnished by member-patrons. They assign this capital or margins to members based on each year’s margins. Cooperatives typically pay patronage dividends on a FIFO basis. Recordkeeping and procedures are basically the same as those of telephone cooperatives.

### Nonexempt Electric Cooperatives

**Overview.** If you need to prepare a [Form 1120](#) for any years under examination, you may contact the following for help: the utilities industry specialist, the farmers’ cooperatives industry specialist (patronage deductions, IRC 277), the media/communications industry specialist, and the VEBA (Voluntary Employees’ Beneficiary Association) industry specialist (IRC Sections 501(c)(9), 419, 419A). Preparing Form 1120 instead of [Form 990](#) may be somewhat complicated, particularly when the cooperative moves in and out of exempt status, files [Form 990-T](#), and pays tax under IRC Section

511 (resulting in a credit on [Form 1120](#)).

**Patronage Deductions.** Nonexempt cooperatives not subject to Subchapter T may exclude patronage dividends paid or allocated to patrons, according to their bylaws. Rev. Rul. 83-135, 1983-2 C.B. 149. You'll need information from the cooperative to analyze patronage and non-patronage income and expense.

**IRC 277.** Nonexempt electric cooperatives are subject to IRC 277, a method of accounting (as defined in IRC Section 446). Treas. Reg. section 1.446-1(e)(2)(ii)(a); *Concord Consumers Hous. Coop. v. Commissioner*, 89 T.C. 105, 116 (1989).

Exhibit 1

Applying the 85-Percent Test - Cooperative Telephone Companies

**Applying the 85 Percent Test:**  
**Analysis of FCC/RUS Uniform System of Accounts**  
**(Selected Revenue, Income, Expense and Balance Sheet Accounts)<sup>1</sup>**

USoA	ACCOUNT NAME	MEMBER	NON-MEMBER	EXCLUDED
<b>Revenue</b>				
5000	Basic Local Service <sup>3</sup>	X		
5001	Basic Area	X		
5002	Optional Extended Area	X		X
5003	Cellular Mobile	X		
5004	Other Mobile Services	X		
5040	Local Private Line	X		
5050	Customer Premises	X		
5060	Other Local Exchange	X	X	
5069	Other Local Exchange Settl.	X		
5080	Network Access <sup>3</sup>	X		X
5081	End User	X	X	
5082	Switched Access			X
5083	Special Access	X		X
5084	State Access			X
5100	Long Distance Message <sup>3</sup>			X
5110	Unidirectional Long Distance			X
5111	Long Distance Inward-Only			X
5112	Long Distance Outward-Only			X
5120	Long Distance Pr. Network <sup>3</sup>			X
5121	Subvoice Gr. LD Pr. Network			X
5122	Voice Gr. LD Private Network			X
5123	Audio Pr. Gr. LD Pr. Network			X
5124	Video Pr. Gr. LD Pr. Network			X
5125	Digital Tr. LD Pr Network			X
5126	LD Pr. Network Switching			X
5128	Other LD Pr. Network Rev.			X
5129	Other LD Pr Network.			X
5160	Other Long Distance			X
5169	Other Long Distance Revenue Settl.			X
5200	Miscellaneous <sup>3</sup>	X	X	
5230	Directory <sup>2</sup>	X	X	X
5240	Rent	X	X	

<sup>1</sup> This Exhibit is a general guide to the range of classification of USoA revenue and income accounts for purposes of IRC 501(c)(12)(A), (B). Some Accounts may contain member, nonmember or excluded income (alone or in combination), depending upon the nature of the transactions, the parties thereto and/or in what taxable year the transactions occurred. As noted above, these guidelines assume that all subscribers are members.

Exhibit 1, Continued

Applying the 85-Percent Test - Cooperative Telephone Companies

USoA	ACCOUNT NAME	MEMBER	NON-MEMBER	EXCLUDED
5250	Corporate Operations		X	
5261	Special Billing Arrangements	X	X	
5262	Customer Operations Revenue	X	X	
5263	Plant Operations	X		
5264	Other Incidental Regulated	X	X	
5269	Other Revenue Settlements	X	X	
5270	Carrier Billing & Collection <sup>2</sup>			X
5280	Non-regulated Operating	X	X	
5300	Uncollectible Rev. <sup>3</sup>	X	X	X
5301	Uncollectible Revenue – Telecommunications	X	X	
5302	Uncollectible Revenue – Other	X	X	X
7100	Other Operating Income & Expenses <sup>1</sup>	X	X	
7110	Income from Custom Work <sup>1</sup>	X	X	
7130	Return from Non-regulated Use of Regulated Facility <sup>1</sup>	X		
7140	Gain/Loss from Foreign Exchange <sup>1</sup>	X		
7150	Gain/Loss fro Disposition of Land <sup>1</sup>	X	X	X
7160	Other Operating Gains & Losses <sup>1</sup>		X	
REA 7300.1	Dividends <sup>1</sup>		X	
REA 7300.2	Interest Income <sup>1</sup>	X	X	
REA 7300.4	Allowance for Funds Used During Construction <sup>1</sup>	N/A	N/A	N/A
REA 7300.5	Gain/Loss from Disposition of Certified Property <sup>1</sup>	X	X	
REA 7300	Other Non-operating Income and Expense <sup>1</sup>	X		
7300.3	Income Fr. Sinking Fund		X	
7310	Dividend Income <sup>1</sup>		X	
7320	Interest Income <sup>1</sup>	X	X	
7330	Income Fr. Sinking Fund		X	
7340	Allowance for Funds Used During Construction <sup>1</sup>	N/A	N/A	N/A
7350	Gains or Losses from Disposition of Property <sup>1</sup>	X	X	
7360	Other Non-operating Income <sup>1</sup>	X		
REA 7600	Extraordinary Income Credits <sup>1</sup>	X	X	X
REA 7600	Extraordinary Income Charges <sup>1</sup>	X	X	X
7990	Nonregulated Net Income <sup>1</sup>		X	

Exhibit 2

Applying the 85-Percent Test - Cooperative Electric Companies

Applying the 85 Percent Test:  
Analysis of FCC/RUS Uniform System of Accounts  
(Selected Revenue, Income, Expense and Balance Sheet Accounts) <sup>a</sup>

USoA	ACCOUNT NAME	MEMBER	NON-MEMBER	EXCLUDED
411.6	Gains from Disposition of Utility Plant <sup>1</sup>		X	
411.7	Losses from Disposition of Utility Plant <sup>1</sup>		X	
411.8	Gains from Disposition of Allowances <sup>1</sup>		X	
411.9	Losses from Disposition of Allowances <sup>1</sup>		X	
412	Revenues from Electric Plant Leased to Others		X	
414	Other Utility Operating Income <sup>2</sup>	X	X	X
415	Revenues from Merchandising, Jobbing and Contract Work	X	X	
418	Nonoperating Rental Income <sup>2</sup>		X	
418.1	Equity in Earnings of Subsidiaries <sup>1,2</sup>			X
419	Interest and Dividend Income <sup>2</sup>	X	X	
419.1	Allowance for Funds Used During Construction <sup>1</sup>	N/A	N/A	N/A
421	Misc. Nonoperating Income <sup>2,4</sup>	X		X
421.1	Gain on Disposition of Property <sup>1</sup>	X	X	
421.2	Loss on Disposition of Property <sup>1</sup>	X	X	
428.1	Amortization of Loss on Recquired Debt <sup>1</sup>		X	X
429	Amortization of Premium on Debt – Credit <sup>1</sup>	X		
429.1	Amortization of Gain on Recquired Debt <sup>1,4</sup>		X	X
434	Extraordinary Income <sup>2</sup>	X		
440	Residential Sales <sup>3</sup>	X		
440.2	Residential Sales – Seasonal <sup>3</sup>	X		
441	Irrigation Sales <sup>3</sup>	X		
442	Commercial and Industrial Sales <sup>3</sup>	X		
442.1	Commercial and Industrial Sales – 1000 kVA or Less <sup>3</sup>	X		
442.2	Commercial and Industrial Sales – Over 1000 kVA <sup>3</sup>	X		
444	Public Street and Highway Lighting <sup>3</sup>	X	X	
445	Other Sales to Public Authorities <sup>3</sup>	X	X	
446	Sales to Railroads and Railways <sup>3</sup>	X	X	
447	Sales for Resale <sup>3</sup>	X	X	

<sup>a</sup> This Exhibit is a general guide to the range of classification of USoA revenue and income accounts for purposes of IRC 501(c)(12)(A), (B). Some Accounts may contain member, nonmember or excluded income (alone or in combination), depending upon the nature of the transactions, the parties thereto and/or in what taxable year the transactions occurred.

Legend:

- <sup>1</sup> This Account combines revenue and expense. § 32.7099.
- <sup>2</sup> This Account may record unrelated trade or business activities.
- <sup>3</sup> This Account summarizes other Accounts.

N/A: Not applicable.  
See 7 C.F.R. § 5000 et seq.