

Certain requirements that cooperative companies must meet for exemption under section 501(c)(12) of the Code are explained.

The Internal Revenue Service has received inquiries from cooperative companies regarding certain requirements for exemption from Federal income tax under section 501(c)(12) of the Internal Revenue Code of 1954.

Section 501(c)(12) of the Code provides for exemption from Federal income tax of mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, if 85 percent or more of their income consist of amounts collected from members of the sole purpose of meeting losses and expenses.

Section 1.501(c)(12)-1(a) of the Income Tax Regulations provides that excess funds on hand at the end of the year may be retained to meet future losses and expenses, or returned to members.

The specific questions and their answers are as follows:

Question 1.

Should the interests of members in the savings of an organization be determined in proportion to their business with the organization?

Answer:

Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.

Question 2.

Can funds be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes?

Answer:

Yes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the

particular circumstances of each case.

Question 3.

Where an organization retains funds for purposes other than meeting current losses and expenses, must the organization's records show each member's rights and interest in the funds it retains?

Answer:

Yes. To maintain its mutual or cooperative character an organization must keep such records as are necessary to determine, at any time, each member's rights and interest in the assets of the organization.

Question 4.

What is the effect on exemption of a forfeiture of a former member's rights and interest where the bylaws provide for such forfeiture upon withdrawal or termination?

Answer:

If, under the bylaws, a member's rights and interest have been forfeited, the organization has not operated on a mutual or cooperative basis and is therefore not exempt.

Question 5.

Where, upon dissolution, an organization has gains from the sale of an appreciated asset, how should these gains be distributed?

Answer:

Such gains should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.