

Rev. Rul. 81-109, 1981-1 C.B. 347

Mutual ditch company. A mutual ditch company that operates in a traditional manner consistent with the provisions of a particular state statute may qualify for exemption under section 501(c)(12) of the Code, even though it does not satisfy all of the requirements of Rev. Rul. 72-36. Rev. Rul. 72-36 modified.

ISSUE

Does a mutual ditch company that is operated in a traditional manner that is consistent with the provisions of a particular state statute, under the circumstances described below, qualify for exemption from federal income tax under section 501(c)(12) of the Internal Revenue Code, even though it does not satisfy all the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151?

FACTS

The organization was created in 1874 as a mutual ditch company to maintain and operate an irrigation system for the use and benefit of its members. In accordance with its by-laws and with the law of the state in which it is located, a person becomes a member in the organization when he purchases stock entitling him to certain water rights and the services of the organization. The shares of stock are personal property and freely alienable with all the right, title, and interest to the water and the assets of the organization passing to the purchaser upon sale, with the member's interest in the water and assets being extinguished.

The shares of stock are assessable to provide funds to operate and maintain the irrigation system. Assessments are considered liens upon the stock. Unpaid assessment liens may be enforced by the involuntary sale of the affected shares. The proceeds from such a sale are used to satisfy the lien and any excess funds are returned to the delinquent former shareholder. As in the case of a regular sale of stock, all right, title, and interest represented by the affected shares are transferred to the purchaser. The former member's interest in the organization is extinguished and he has no claim to the organization's assets upon dissolution or otherwise. Upon dissolution, the assets of the organization are to be distributed to the then existing shareholders in proportion to the amount of stock held by each shareholder.

The organization does not issue patronage certificates and it has never distributed any net earnings to members, but the funds it has retained in excess of those needed to meet current losses and expenses have not been accumulated beyond the reasonable needs of the organization's business.

The organization's method of operation, as described above,

is consistent with the applicable provisions of the state law. These provisions were originally enacted into law in 1877, and were a codification of the pre-existing common law. Since enactment, they have remained in effect without substantial change.

LAW AND ANALYSIS

Section 501(c)(12) of the Code provides for the exemption from federal income tax of mutual ditch or irrigation companies.

Rev. Rul. 72-36 states that the interest of members in the savings of an organization described in section 501(c)(12) of the Code should be determined in proportion to their business with the organization and that funds can be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding services, or maintaining reserves for necessary purposes. Rev. Rul. 72-36 also states in relevant part as follows:

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.

Although a member receives the proceeds from the sale of his stock, the amount of the proceeds does not necessarily equal or approximate his share of the annual savings retained by the organization while he was a member, which is determined in proportion to his business with the organization. The fair market value of a share of stock is the price at which a willing seller and a willing buyer will trade. It is determined by a number of factors other than the amount of the member's share of the annual savings, such as the availability of memberships in the organization and the desire of the buyer for water rights and the services of the organization.

The organization's bylaws provide that upon dissolution its retained savings will be distributed only to persons who are shareholders at the time of dissolution and that the distribution will be on the basis of the shares of stock held. Inasmuch as a former shareholder does not receive from the organization his pro-rata share of the annual savings accumulated while he was a member when his membership is terminated upon the sale of his stock, he should receive the distribution upon dissolution. The failure of the bylaws to provide for a distribution of a former shareholder's interest in the retained savings results in a forfeiture of his interest in the retained savings. Therefore, the organization does not meet the requirements set forth in the answer to Question 4 of Rev. Rul. 72-36.

Moreover, the assets owned by the organization at the time of its dissolution will be distributed only to the existing shareholders, and the distribution may include net gains from the sale of appreciated assets. Persons who were members during the period in which the assets were owned by the organization but who are not members at the time of its dissolution will not share in the distribution of such net gains. Therefore, the organization does not meet the requirement set forth in the answer to Question 5 of Rev. Rul. 72-36.

Even though the organization does not comply with these requirements of Rev. Rul. 72-36, it is necessary to give some consideration to the historical context within which mutual ditch and irrigation companies were created and have operated.

Traditionally, the laws and practices governing such organizations provided for their operation of a stock basis with the shares of stock representing both the members' water rights and their proportionate shares of the assets of the company. Prior to the time that Congress enacted section 11(a)(10) of the Revenue Act of 1916, which originally provided for the exemption

of mutual ditch and irrigation companies operated on a cooperative basis, organizations of this type, operating in a manner similar to that of the organization described in this case, were well established entities in a number of western states. Under the applicable state law, such organizations issued stock representing both water rights and equitable interest in the organization's assets. Such stock was considered personal property and freely alienable. The organizations also had the power to assess the outstanding stock for the costs of operation and maintenance and to enforce any assessment lien through foreclosure and forced sale, thereby transferring a delinquent shareholder's interest to the purchaser.

The organization was created a number of years prior to the enactment of the earliest federal tax legislation pertaining to mutual ditch and irrigation companies. Since that time, it has continued to operate in a traditional manner that is consistent with the provisions of the state statute. In view of the fact that such organizations were operating in this manner when Congress originally enacted legislation providing for their exemption from federal income tax, and the fact that there have been no major changes in the applicable federal tax provisions in the intervening years, it is clear that Congress intended and still intends that mutual ditch and irrigation companies operated in the manner and under the circumstances described above would qualify for exemption from federal income tax under section 501(c)(2) of the Code.

HOLDING

Even though the mutual ditch company does not satisfy all of the requirements of Rev. Rul. 72-36, under the circumstances described above, it qualifies for exemption from federal income tax under section 501(c)(12) of the Code.

APPLICATION INSTRUCTIONS

Even though an organization considers itself within the scope of this revenue ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(12) of the Code. See section 1.501(a)-1 of the Income Tax Regulations.

In accordance with the instructions to Form 1024, the application should be filed with the District Director of Internal Revenue for the key district indicated therein.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 72-36 is modified.