



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: 200717020

Release Date: 4/27/07

Date: January 30, 2007

SE:T:EO:RA:T3

501.12-03

Legend:

State =

Dear _____ :

We have considered your ruling request dated July 31, 2002, regarding the tax consequences relating to the proposed activities described below.

You are exempt from federal income tax under section 501(c)(12) of the Internal Revenue Code (hereafter Code). You are a rural electric cooperative organized under the laws of State. Although you operated in a relatively stable business environment for many years, you have stated that you are now facing direct competitive threats from other energy providers in your service area.

You have proposed to develop new business lines, including the sale of natural gas. You are participating in a pilot program sponsored by State which encourages the sale of natural gas both by existing local distribution companies and by other energy retailers. Thus, you are procuring natural gas on the wholesale market, arranging for transportation by pipeline, and contracting with a service to deliver natural gas to your members. You are also considering the acquisition of a local natural gas distribution company. You intend to create two separate operating divisions, one for electric energy distribution and the other for natural gas distribution.

You have requested the following rulings:

- (1) Your sale of natural gas to members on a cooperative basis using the local distribution facilities of other utilities is a "like organization" activity contemplated under section 501(c)(12)(A) of the Code.
- (2) Your establishment of separate operating divisions for electric and natural gas services to members with separate patronage allocations for gains and losses in each is consistent with cooperative operating principles.

- (3) Your annual compliance with the 85 percent member income test prescribed by section 501(c)(12)(A) of the Code may be computed based on all approved "like organization" activities in the aggregate, and not on each separate function or line of business.

LAW:

Section 501(c)(12) of the Code provides for the exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Revenue Ruling 72-36, 1972-1 C.B. 151, describes certain basic characteristics an organization must have in order to be a cooperative organization described in section 501(c)(12)(A) of the Code. These characteristics include the following: A cooperative must keep adequate records of each member's rights and interests in the assets of the organization. A cooperative must not retain more funds than it needs to meet current losses and expenses. The rights and interests of members in the organization's savings must be determined in proportion to their business with the organization. A member's rights and interests may not be forfeited upon the withdrawal or termination of membership. Upon dissolution, gains from the liquidation of assets should be distributed to all current and former members in proportion to the value or quantity of business that each did with the cooperative over the years.

In Puget Sound Plywood v. Commissioner, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, the court stated that an organization must meet certain common law requirements in order to be a cooperative. These common law requirements include: democratic control of the organization by members, the organization operates at cost for the benefit of members, and the contributors of capital to the organization do not control or receive most of the pecuniary benefits of the organization's operations (i.e. subordination of capital).

Discussion:

Section 501(c)(12) of the Code provides for the federal tax exemption of electric cooperatives and other cooperative organizations not relevant here. While the term "cooperative" is not defined in section 501(c)(12) or the regulations thereunder, a cooperative has been traditionally and historically defined as a voluntary, membership business organization that is organized in response to the economic needs of and to perform services for its members, and not to realize monetary gains as a separate legal entity. A cooperative is organized and operated for the benefit of and is democratically controlled by its members. See Puget Sound Plywood v. Commissioner, 44 T.C. 305, 308 (1966), *acq.* 1966-1 C.B. 3. Hence, to qualify for exemption under section 501(c)(12), an organization must be a cooperative and organized and operated as such. Puget Sound Plywood, supra, describes the principles that are fundamental to the organization and operation of cooperatives. They are: (1) democratic control by the members, (2) operation at cost, and (3) subordination of capital. These principles apply to organizations described in section 501(c)(12).

Democratic control requires that the cooperative be governed by members and on a one-member, one-vote basis. Each member has a single vote regardless of the amount of business he or she does with the organization. The issue of democratic control is a question of fact.

Operation at cost requires that the cooperative's net earnings or savings derived from furnishing services in excess of costs and expenses be returned to its members in proportion to the amount of business conducted with them. This principle ensures that a cooperative's net savings from members are returned to members in proportion to the amount of business each transacts with the cooperative. A cooperative satisfies this requirement by making periodic allocations of patronage to members.

Subordination of capital has two requirements. First, control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remains in the hands of the members rather than with non-patron equity investors. Second, the returns on equity investments must be limited. Hence, the net savings that accrue to the cooperative from the business activities it transacts with its members will largely inure to the benefit of those members rather than to its equity investors. The rationale for these limitations is to ensure that the cooperative remains faithful to its purpose—providing services at the lowest possible prices (or highest possible prices for a marketing cooperative) to its members and not to realize profits for capital. If it were otherwise, the emphasis then would likely be on protection of returns of equity capital rather than services to members, and this would destroy the basic purpose of cooperatives. See Puget Sound Plywood, supra.

Rev. Rul. 72-36, *supra*, also describes additional requirements that are fundamental to the organization and operations of cooperatives described in section 501(c)(12). It requires that a member's rights and interest in the assets of a cooperative cannot be forfeited upon termination of membership. It also requires that upon dissolution, a cooperative must distribute any gains from the sales of its assets to those who were members during the period that the assets were owned.

A fundamental tenet of cooperative operation is that the earnings of a cooperative are allocated and ultimately distributed to its members based on the amount of business (patronage) done with those members. The amount a cooperative member pays for the cooperative's services less the cost of providing such services is allocated to the member. Thus, the presumption is that the cooperative's services are provided at cost to the members. But it is impractical for such a cooperative to return immediately all the amounts or earnings to its members because the cooperative needs to have reserves in order to operate, meet unexpected expenses, or to expand. These amounts or earnings are held by the cooperative for a certain period of time as prescribed by the cooperative's bylaws and are allocated as capital credits to accounts kept for each member. These capital credits are returned to the members or former members when the cooperative redeems them (i.e., sends a check for the amount of the capital credits) at the end of the prescribed time.

In Rev. Rul. 2002-54, 2002-37 I.R.B. 528, the Service explained that organizations exempt under section 501(c)(12) include mutual ditch or irrigation companies and telephone or electric cooperatives. If the organization does not furnish any of those services, its activity must be a

"like organization" activity. The Service went on to say that a "like organization" activity is a public utility-type service. Rev. Rul. 67-265, 1967-2 C.B. 205; Rev. Rul. 83-170, 1983 C.B. 97. A public utility-type service is "the furnishing or sale of the production, transmission and distribution of electricity, gas, steam or water, sewage disposal, or telephone service, traditionally where the rates have been established or approved by a State, a political division, public utility commission or other similar body of a State, or by any agency or instrumentality of the United States." See Rev. Ruls. 83-170 and 2002-54, *supra*.

You are providing natural gas to members under a pilot program sponsored by State, by which you purchase gas at wholesale prices, transport it via pipeline, and deliver it through local suppliers. We find that this service clearly is an enumerated public utility-type service as stated in Rev. Ruls. 83-170 and 2002-54, *supra*, and thus fits squarely within the definition of a "like organization" activity.

Further, we find no statutory or regulatory provisions which would discourage, much less prohibit, you from establishing separate operating divisions to manage your electric and natural gas delivery services, respectively. Creating the most appropriate structure to provide goods or services to consumers is generally a matter of business judgment.

Accordingly based on the foregoing facts and circumstances, we rule as follows:

- (1) Your sale of natural gas to members on a cooperative basis using the local distribution facilities of other utilities is a "like organization" activity contemplated under section 501(c)(12)(A) of the Code.
- (2) Your establishment of separate operating divisions for electric and natural gas services to members with separate patronage allocations for gains and losses in each is consistent with cooperative operating principles.
- (3) Your annual compliance with the 85 percent member income test prescribed by section 501(c)(12)(A) of the Code may be computed based on all approved "like organization" activities in the aggregate, and not on each separate function or line of business.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative. A copy of this letter should be kept in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437