



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200907040**
Release Date: 2/13/2009

Date: November 19, 2008

501.12-03

Legend:

State =
U =
V =
W =

Dear :

We have considered your ruling request dated July 6, 2005, regarding the tax consequences relating to the proposed transaction described below.

You are exempt from federal income tax under section 501(c)(12) of the Internal Revenue Code (hereafter Code). You are a cooperative under the laws of State. You have approximately U current and former members, with approximately V active member accounts in the southwestern part of State. Your members elect the board of trustees on a one member, one vote basis.

Pursuant to Article VI, Section II of the bylaws, all funds and amounts received from your members for the furnishing of electric energy that are in excess of operating costs and expenses, shall be furnished by the members as capital. You are obligated to allocate all such amounts to your members through their capital accounts. "All such amounts credited to the capital account of any member shall have the same status as though they been paid to the member in cash in pursuance to a legal obligation to do so and the member had then furnished [you] corresponding amounts for capital."

Your books and records are set up in a manner that at the end of each fiscal year the amount of capital, if any, furnished by each member is clearly reflected and credited in an appropriate record to the capital account of each member. Each member will be notified of the amount credited to his or her account at a reasonable time after the end of each fiscal year.

As of December 31, 2003, you have allocated W in patronage capital to your members and former members. Historically, you have retired (by cash payments) the previously allocated patronage capital on a cycle of approximately 25 years, using the first-in, first-out (FIFO) method or a combination of FIFO and the last-in, first-out (LIFO) methods. Under Article VII, Section 2(B) of your bylaws, the determination related to the retirement of capital credits of the method, basis, priority, and order of retirement is based on the decision of your board of directors.

In an effort to strengthen your balance sheet, you propose to retire the current patronage allocations to current and former patrons on an accelerated basis. This retirement would occur through a payment to the members that would reflect a discount from the stated amount of the allocated patronage. You have proposed using a discount rate equal to the *Wall Street Journal* Prime Rate on either December 31 or June 30 of each year nearest the refund date of the patronage refund, plus 1 percent and a discount period equal to the number of years of patronage capital then outstanding (that is, approximately 25 years).

You represent that your board of directors has proposed a draft policy to retire previously allocated patronage at a discount. The proposed program is not voluntary; you have stated that making the program voluntary would significantly add to your recordkeeping responsibilities.

Under this policy, you may pay the discounted amount to current and former members and record the discount as part of your net savings. Thus, your members retain a continuing property right in the net savings for the difference between the stated value of the patronage allocation and the discounted value that has been paid. You represent that you are not causing your current and former patrons to forego any of their previously allocated capital credits. Rather, you note that the "discounted retirement" represents the present value of the allocated capital credits (assuming the discount rate and discount period are reasonable).

Sometimes your former members fail to claim the cash retirement of their capital credits, and your efforts to locate them are unsuccessful. You represent that under your draft policy, you will attempt to contact such members by publishing their names in a separate insert to your newsletter and on your web site. If the former member fails to claim the retired amount within three years, followed by a 60-day second written notice, the amount reverts to you as a contribution to capital and is recorded as part of your net savings. These amounts are not reallocated for any current or former members, and are retained by you to benefit current and former members.

You request the following rulings:

1. Your bylaws and draft policy related to your capital credit rotation of a discounted cash amount will not adversely affect your cooperative status.
2. Your patronage allocations are qualified exclusions.
3. Your draft policy related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect your cooperative status.

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 interest 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, including 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 organize and operate 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). Rev. Rul. 72-36 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.

Section 501(c)(12)(A) provides that a cooperative exempt under this Code section must derive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses in order to qualify for and maintain tax exemption. The 85 percent member income test requires that 85 percent or more of the cooperative's income be derived from members and used to pay for services listed in section 501(c)(12). See Rev. Rul. 2002-54, 2002-37 I.R.B. 527 (Sept. 16, 2002) and Rev. Rul. 2002-55, 2002-37 I.R.B. 529 (Sept. 16, 2002). In each particular tax year, the cooperative must combine all income received and calculate under this test. The cooperative is not tax-exempt under section 501(c)(12) of the Code if less than 85 percent of its income is derived from members and used to pay for services listed in section 501(c)(12).

If the cooperative is not exempt under section 501(c)(12), it is a non-exempt, taxable cooperative. Its income is taxable in the same manner as the income of a taxable corporation but with one exception. The exception is that the income attributable to business done with or for members or patrons is deductible from the income of the cooperative. In order for the income to be "patronage source" and deductible from gross income, the income at issue must be produced by a transaction directly related to the cooperative's enterprise so that the transaction facilitates the cooperative's carrying on of that enterprise. See Farmland Industries, Inc. v. Commissioner, T.C. Memo 1999-388. In the case of an electric cooperative, the patronage source income includes the refunds of part of the prices initially paid by members or patrons for electricity service obtained through the cooperative. In order to deduct patronage source income from gross income, an electric cooperative must allocate the patronage source income to the members or patrons in proportion to their patronage. See generally Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. 674, 685-686 (1958).

A. Redemption of Capital Credits at Discount

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 cooperative 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.

Your bylaws provide for the redemption of capital credits at a discount. The redemption program provides for the redemption of your current and former members' capital credit accounts earlier than the 25-year holding period or cycle. The redemption is at a discount, i.e., the capital credits are not paid on the face value of the accounts but at the present value. You will transfer the difference between the discounted amount and the original amount in the capital credit accounts to your net savings account. The redemption program will not be voluntary to current or former members.

The primary issue raised by the operation of the redemption program is whether it violates any of the cooperative requirements described in Puget Sound Plywood, supra, and Rev. Rul. 72-36. The cooperative principle of democratic control by members is satisfied because the redemption of capital credits at discount will not affect member voting rights or governing rights. We also note that the cooperative (and its board of directors and management) has fiduciary duties to former members, and the former members can enforce their rights in the courts. See Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982). The cooperative principle of operating at cost is satisfied because the members' right to receive the excess (i.e. capital credits) over the cost of electricity service is also not adversely affected.

The cooperative principle of subordination of capital is satisfied because the proposed redemption program does not adversely affect the members' control and ownership of the cooperative assets. The cooperative requirement that there is no forfeiture of former members' rights to assets of the cooperative is not violated. Specifically, the redemption program permits members and former members to receive the present value of their capital credit accounts (i.e., patronage savings) at a date earlier than the 25-year holding period or cycle. The discount rate is in accordance with the prevailing market rate.

B. Patronage Allocations Are Qualified Exclusions

Regarding whether your patronage allocations are qualified exclusions, in Pomeroy Cooperative Grain Co. v. United States, supra, the U.S. Tax Court held that allocations must represent true patronage dividends to be given an exclusion from gross income. The court went on to say that three prerequisites must be satisfied to exclude patronage dividends from gross income:

- (1) The allocation must have been made under a pre-existing legal obligation, one which existed when the patrons transacted their business with the cooperative.
- (2) The allocation must have been made out of profits or income realized from transactions with the particular patrons (members) for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations.
- (3) The allocations must have been made equitably, so that profits realized from selling merchandise or services to patrons, and profits from marketing products purchased from patrons, were allocated ratably to the particular persons whose patronage created each particular type of profit.

You maintain that your patronage dividends are excluded from gross income because they were made under a pre-existing legal obligation, were made on the basis of patronage, and were made from profits derived from the patrons' business dealings with you.

Based on your representations, it appears that the requirements set forth by the U.S. Tax Court in the Pomeroy Cooperative Grain case have been satisfied, and we have found no contrary authority.

C. Transfer to Net Savings of Unclaimed Credits

Your draft policy provides that you shall recover any capital credits and patronage dividends that remain unclaimed for one year following your attempted payment to the patron or former patron. You propose that these amounts would be transferred to your net savings account.

Your draft policy does not violate the cooperative requirements of democratic control by members and non-forfeiture of a member's right to your assets because your directors are subject to and responsive to the control of the members. We also note that the members of the cooperative elect the directors, and any members may submit resolutions to change the cooperative operations, subject to approval of the majority of members. Consequently, the transfer of unclaimed capital credits to your net savings does not violate any cooperative requirements and, therefore, your exempt status under section 501(c)(12) is not adversely affected, assuming you satisfy the 85 percent member income test for the particular tax year. This ruling does not supersede state escheat or abandoned property laws.

We understand that other cooperatives have had success in locating former members through their web sites. We would urge you to use your web site to locate former members that have not claimed their capital credits, though you are not required by statute or regulation to do so.

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

1. The capital credit rotation program as described in your bylaws and draft board policy will not adversely effect your federal tax exemption under section 501(c)(12) of the Code.

2. Your patronage allocations derived from activities described in section 501(c)(12) of the Code are qualified patronage exclusions.
3. Your draft policy related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect your cooperative status.

This ruling is conditioned on the understanding that there will be no material changes in the facts upon which it based. Also, we express no opinion as to the tax consequences of the transactions under other provisions of the Code or state laws.

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 Internal Revenue 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. You should keep a copy for your permanent records.

Sincerely,

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

Enclosure
Notice 437