TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **201309017**
Release Date: 3/1/2013
Date: December 5, 2012

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL: 501.12-02

Legend:

State =
U =
V =
W =
Policy =
Date 1 =

Dear :

We have considered your ruling request regarding the tax consequences relating to the proposed transactions described below.

You are exempt from federal income tax under I.R.C. § 501(c)(12). You are a cooperative under the laws of State. You have approximately U current and former members, with approximately V active member accounts in State. Your members elect the board of directors on a one member, one vote basis.

Pursuant to Article VII, Section 2 of the bylaws, you are obligated to account on a patronage basis to all your members for all amounts received and receivable from telephone services in excess of operating costs and expenses properly chargeable against the furnishing of such services. You are required to pay by credits to a capital account for each member all such amounts in excess of operating costs and expenses. 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. At the end of each fiscal year, each member will be notified of the amount credited to his or her account.

As of Date 1, 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) and last-in, first-out (LIFO) methods. Under Article VII, Section 2 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 discretion 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 members on an accelerated basis. As part of your capital credit retirement program, you propose to retire capital credits based on a combination of FIFO and LIFO methodology. 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 Interest Rate on either December 31 or June 30 of each year nearest the refund date of the patronage refund, plus 2 percent and a discount period equal to (or within a reasonable industry standard of 25 to 30 years) the number of years of patronage capital then outstanding (that is approximately 20 years).

You represent that your board of directors has adopted Policy to retire previously allocated patronage at a discount. The proposed program is not voluntary to the members. You have stated that making the program voluntary would significantly add to your recordkeeping.

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 members 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 Policy, you will attempt to contact such individuals by publishing their names in a separate insert to your newsletter and on your web site. If a former member who has signed a voluntary capital credit agreement fails to claim the retired amount, the amount reverts to you as a contribution to capital and is recorded as part of your net savings. For others, the policy will hold that upon the expiration of three years from the date when the payment was mailed to the member or former member, unless such payment is claimed, it will be remitted to State. State may, subject to limitations, return a portion of these remittances to you under state statutes. These amounts are not reallocated for any current or former members, and are retained by you to benefit current and former members.

In a subsequent correspondence, you state that you plan to maintain two separate capital credit accounts on behalf of your members. Your existing accounts represent capital credits allocated but not yet retired under your general capital credit allocation and retirement methods. These accounts would be subject to redemption at a discount, as provided for by your board of directors.

Your second capital credit account is in the form of an equity offering, which you have said would represent a "present net value differential." You defined this term as the difference between the face value of the retirement of capital credits at maturity less the amount paid currently to the member under the discounted capital credit method. These additional accounts would not earn any rate of return or entitle the member to additional voting rights. The amounts to be credited to these proposed accounts would be paid at liquidation or dissolution of the cooperative, rather than becoming part of the net savings as you originally proposed.

You have said that members would receive individual written notice of amounts credited to their capital accounts representing the net present value differential. This notice would be similar to, and done in conjunction with, the annual notice members receive regarding their allocated capital credits.

In addition, you have stated that you will post a message on your web site that addresses members' rights in both allocated capital credits and the net present value differential. You will also post a web site message reminding members to keep their address current so you can pay unretired capital credit allocations and net present value differential at dissolution. "This will serve as a continuous reminder to the members of their equity interest in the cooperative," you have concluded.

You request the following rulings:

1. The revised bylaws and <u>Policy</u> related to your capital credit rotation of a discounted cash amount will not adversely affect your tax-exempt status under I.R.C. § 501(c)(12).

2. Your patronage allocations are qualified patronage exclusions.

3. The difference between the stated value of written notices of patronage allocation and the discounted value rotated to your members is not included in your gross income and thus does not adversely affect your tax-exempt status under the provisions of I.R.C. § 501(c)(12); and

4. Your policy related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect your tax-exempt status under I.R.C. § 501(c)(12).

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.

Rev. Rul. 72-36, 1972-1 C.B. 151, describes certain basic characteristics an organization must have in order to be a cooperative organization described in § 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.

The ruling also addresses a situation involving forfeiture of a former member's rights and interests where the bylaws provide for such action upon withdrawal from the cooperative or termination. It states that even if forfeiture is permitted by the bylaws, the organization has not operated on a cooperative basis and should not be recognized as tax-exempt.

In *Puget Sound Plywood, Inc. 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 cooperative telephone companies or like organizations, including other cooperative organizations not relevant here. While the term "cooperative" is not defined in I.R.C. § 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 Inc.,v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3. Hence, to qualify for exemption under I.R.C. § 501(c)(12), an organization must be a cooperative and organize and operate as such. *Puget Sound Plywood v. Commissioner* 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 I.R.C. § 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 annual 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 Inc.,v. Commissioner,* 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3.

Rev. Rul. 72-36, *supra*, describes additional fundamental requirements for operation of cooperatives described in I.R.C. § 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. 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 20-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 *Puget Sound Plywood, Inc., v. Commissioner,* 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, 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 20-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*, 31 T.C. 674, 685-686 (1958), the U.S. Tax Court held that allocations must represent true patronage dividends to be given an exclusion from gross income. According to the court, three prerequisites must be satisfied to exclude patronage dividends from gross income:

(1) The allocations must have been made under a pre-existing legal obligation, one which existed when the patrons transacted their business with the cooperative.

(2) The allocations 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 *Pomeroy Cooperative Grain Co. v. United States*, 31 T.C. 674, 685-686 (1958) have been satisfied, and we have found no contrary authority.

C. Proposed Equity Offering Payable at Dissolution

As noted above, you have proposed an equity offering, representing a "present net value differential," that would feature issuance of equity certificates (but only if required by law) and would be payable at dissolution or liquidation.

Based on the facts presented, we do not believe that your establishment of a second capital account for each member would create taxable income to you as a cooperative. Analogizing to a corporate transaction, under I.R.C. § 1032, a corporation will not recognize gain or loss on the receipt of money or property in exchange for stock. Therefore, when a stockholder contributes money in exchange for stock in the corporation, the corporation does not have taxable income.

Applied to a cooperative, so long as members contribute money to the cooperative in their capacity as members, the cooperative would not have income. It appears that you are simply transferring the money already received into a new capital account for each member. The terms of the "new" capital account are the same as the "old" capital account. As a result, it appears that nothing has changed—the separate accounts are simply an organizational tool.

D. Transfer to Net Savings of Unclaimed Credits

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

Your 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 I.R.C. § 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.

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

1. The revised bylaws and Policy related to your capital credit rotation of a discounted cash amount will not adversely affect your tax-exempt status under I.R.C. § 501(c)(12).

2. Your patronage allocations are qualified patronage exclusions.

3. The difference between the stated value of written notices of patronage allocation and the discounted value rotated to your members is not included in your gross income and thus does not adversely affect your tax-exempt status under the provisions of I.R.C. § 501(c)(12) of the Code.

4. Your policy related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect your tax-exempt status under I.R.C. § 501(c)(12).

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.

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.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Mary J. Salins
Manager, Exempt Organizations
Technical Group 4

Enclosure
Notice 437