



DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street MC 4920 DAL
Dallas, TX 75242

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: NOV 20 2017

Release Number: 201814012
Release Date: 4/6/2018
UIL Code: 501.12-00

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to:
EIN:

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: FEB 19 2018

CERTIFIED MAIL - Return Receipt Requested

Dear :

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(12) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c)(12) of the code is hereby revoked effective January 1, 20xx.

Our adverse determination was made for the following reason(s):

You did not meet the requirement of 85 percent or more of the income consisting of amounts collected from members for the sole purpose of meeting losses and expenses as prescribed by Internal Revenue Code section 501(c)(12)(A) on mutual ditch or irrigation companies for tax years 20xx and 20xx.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, 20xx and for all years thereafter.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91st day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

- 1 -

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that can help protect your taxpayer rights. We can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for our assistance, which is always free, we will do everything possible to help you. Visit taxpayeradvocate.irs.gov or call 1-877-777-4778.

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

Sincerely yours,

Maria Hooke
Director, Exempt Organizations Examinations

Enclosures:
Publication 892

- 2 -

IRS Department of the Treasury
Internal Revenue Service
Tax Exempt and Government Entities
Exempt Organizations Examinations

Date:
May 8, 2017
Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
December 31, 20xx, and 20xx
Person to Contact / ID Number:
Employee ID:
Contact numbers:
Telephone:
Fax:
Manager's Name / ID Number:
Employee ID:
Manager's Contact Number:
Response Due Date:
June 7, 2017

Certified Mail - Return Receipt Requested

Dear :

Why you are receiving this letter

We propose to revoke your status as an organization described in section 501(c)(12) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

What you need to do if you agree

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action – Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(12).

If we don't hear from you

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

Effect of revocation status

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

What you need to do if you disagree with the proposed revocation

If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also

Letter 3618 (Rev. 6-2012)

Catalog Number 34809F

may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

Contacting the Taxpayer Advocate Office is a taxpayer right

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service
Office of the Taxpayer Advocate

For additional information

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Maria Hooke
Director, EO Examinations

Enclosures:
Report of Examination
Form 6018
Publication 892
Publication 3498

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20xx, 12/31/20xx

Issue

Whether _____ qualifies for tax-exemption under Internal Revenue Code ("IRC") section 501(c)(12).

Facts

_____ incorporated in the State of _____ on August 2, 18xx and is currently in "good standing".

The Internal Revenue Service granted _____ exemption under IRC section 501(c)(12) in December 19xx. To this date, this determination has not changed.

_____ is a mutual water cooperative that manages water from mountain run-off and reservoirs. _____ operates and maintains a ditch system used to distribute water to its members. The numbers of shares owned by members are used to determine the amount of water they receive.

The term "shareholder" is synonymous with member. Per _____ shareholder list dated January 22, 20xx, the organization had xxx shareholders and xxx.x outstanding shares. The Board set the annual dues and assessments at \$xxx per share.

_____ primary source of income is from membership dues. The organization also receives rental income from a residential property and non-member use of a ditch. During the period under examination _____ received a crossing fee from a non-member that installed a pipe under a ditch used by the organization.

_____ filed its Form 990 for the 20xx period on November 19, 20xx and its Form 990 for the 20xx period on November 15, 20xx. _____ has not computed the 85% Member Income Test for either year.

The Assigned Agent used _____ trial balance and general ledger to compute the 85% Member Income Test as follows:

20xx Sources of Income	(a) Member Sourced Gross Receipts	(b) Other Sources of Gross Receipts
Membership Dues & Assessments	xxx,xxx.xx	
Stock Transfer Fees	x,xxx.xx	
Investment Income (interest)		xx.xx
Oil and Gas Royalties		xxx.xx

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Ditch House Rents		xx,xxx.xx
Right of Way Crossing Fee		xx,xxx.xx
Recharge Use of Ditch	x,xxx.xx	
Foreign Water Run		xx,xxx.xx
TOTAL INCLUDED SOURCES	xxx,xxx.xx	xx,xxx.xx
MEMBER INCOME % [column a / (column a + b)]		xx.xx%

20xx Sources of Income	(a) Member Sourced Gross Receipts	(b) Other Sources of Gross Receipts
Membership Dues & Assessments	xxx,xxx.xx	
Stock Transfer Fees	x,xxx.xx	
Investment Income (interest)		xx.xx
Oil and Gas Royalties		xx,xxx.xx
Ditch House Rents		xx,xxx.xx
Right of Way Crossing Fee		x,xxx.xx
Recharge Use of Ditch	x,xxx.xx	
Foreign Water Run		xx,xxx.xx
Rent Reimbursement		xx,xxx.xx
City Expense Reimbursement	xx,xxx.xx	
Shared Office Expenses Reimbursement		xx,xxx.xx
TOTAL EXCLUDED SOURCES		
TOTAL INCLUDED SOURCES	xxx,xxx.xx	xx,xxx.xx
MEMBER INCOME % [column a / (column a + b)]		xx.xx %

On February 10, 20xx the Assigned Agent issued Form 4564, Information Document Request (IDR) notifying that it failed the 85% Member Income Test in 20xx and 20xx is required to file Form 1120 instead of Form 990.

is currently in the process of preparing Forms 1120.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20xx, 12/31/20xx

Law

Internal Revenue Code

Pursuant to section 501(c)(12) of the Code there shall be exemption from federal income 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.

Federal Tax Regulations

Pursuant to section 1.501(c)(12)-1 (a) of the Code of Federal Regulations (Regulations), an organization described in section 501(c)(12) of the Code must receive at least 85 percent of its income from amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

Revenue Rulings and Court Cases

Rev. Rul. 65-174, 1965-2 C.B. 169, holds, that gross income derived from a transaction with a third party cannot be offset by amounts owed to that third party.

In *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: (1) subordination of capital; (2) democratic control by the members; and (3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor. Each of these three principles is addressed below.

Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remain in the hands of the members/patrons of the cooperative rather than with nonpatron equity investors in the cooperative. The purpose of this limitation is to insure that the gains that accrue to the cooperative from the business that it transacts with its patrons will largely or completely inure to the benefit of those patrons rather than to its stockholders. To be operating on a cooperative basis, a cooperative must limit the financial return with respect to its equity capital. A cooperative may not be operated for the purpose of paying a return on equity investments.

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Democratic control of the cooperative is typically achieved by voting on a one-member, one-vote basis. The principle of democratic control was further discussed in *Etter Grain Co. v. United States*, 462 F.2d 259 (5th Cir. 1972), in which the court noted that section 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, "envision[s] the exempt association organized according to a model of a widely-based participatory democracy in which all the members are able to exercise a franchise of equal strength." Each member must have a single vote regardless of the size of its investment or the amount of business it does with the corporation.

The issue of democratic control is a question of fact. Rev. Rul. 58-616, 1958-2 C.B. 928, considered the democratic ownership and control concept as it applies to mutual insurance companies. The ruling states that whether democratic control is in the policyholders of a mutual insurance company depends on the circumstances of each case and is determined by the control which the policy holders actually exercise, to the exclusion of any group other than policyholders, and not upon the unexercised power to control which such other group has by statute or otherwise.

The requirement of operation at cost is met if the cooperative's net earnings or savings are distributed to the cooperative's patrons in proportion to the amount of business conducted with them. This requirement relates to "the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the association are required to make periodic allocations of the same among the members in proportion to their active participation as workers."

Taxpayer's Position

representative expressed agreement with the government's position when the Assigned Agent presented the issue.

Government's Position

In order to qualify for exemption under IRC section 501(c)(12), an organization must:

- Be organized and operated as a cooperative,
- Conduct activities described in IRC section 501(c)(12) and the regulations, and
- Derive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
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was organized and operated as a cooperative. See *Puget Sound Plywood, Inc. v. Commissioner*. There was subordination of capital; members shared the risks and benefits associated with . There was democratic control; held monthly meetings where the members vote for the officers, board members and policies that govern the organization. was operating below cost in 20xx and 20xx. Per the 20xx Form 990, expenses exceeded revenue by \$xx,xxx. Per the 20xx Form 990, expenses exceeded revenue by \$xx,xxx.

In 20xx, received xx. xx% of its income from the members, which caused the organization to fail the 85% Member Income Test (third requirement identified). received investment income (\$xx.xx), Oil and Gas Royalties (\$xxx.xx), Ditch House Rents (\$xx,xxx), Crossing Fee (\$xx,xxx), and Foreign Water Run (\$xx,xxx), which constitute nonmember income for purposes of the 85% Member Income Test.

In 20xx only received xx.xx% of its income from the members, which caused the organization to fail the 85% Member Income Test. received investment income (\$xx.xx), Oil and Gas Royalties (\$xx,xxx.xx), Ditch House Rents (\$xx,xxx), Crossing Fee (\$x,xxx), Foreign Water Run (\$xx,xxx.xx), Rent Reimbursement (\$xx,xxx) and Office Expense Reimbursement (\$xx,xxx.xx) constitute nonmember income for purposes of the 85% Member Income Test.

There are no statutory exclusions from the member income test for the non-member income. There are no statutory exceptions for reclassifying the non-member income as member income.

CONCLUSION

did not meet the requirements for exemption under IRC section 501(c)(12) because the organization failed the 85% Member Income Test for the year ended December 31, 20xx, and 20xx. Accordingly, the organization's exempt status should be revoked effective January 1, 20xx and filing requirement changed from Form 990 to Form 1120, *U.S. Corporation Income Tax Return*.