



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200625033**
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Date: March 28, 2006

501.12-03

Legend:

State =
U =
V =
W =

Dear _____ :

We have considered your ruling request dated October 29, 2003, 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 patron accounts in the west central part of State. Your members elect the board of directors on a one member, one vote basis. The margins from the patronage-sourced income are allocated to members in the form of capital credits on the basis of their patronage for that year. Pursuant to Article VII, Section 2 of the bylaws, the books and records are set up in a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron. At the end of each fiscal year, each patron will be notified of his patronage balance.

As of December 31, 2003, your organization has allocated and has an unretired patronage capital of W. Presently, you are retiring the previously allocated patronage capital on a cycle of between 18 and 20 years.

You propose to retire the current patronage allocations to current and former members 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 payment. The proposed redemption program is not voluntary.

Under the proposed retirement program, you will retire capital credits earlier than the current holding period or cycle. The capital credits would be paid on a discount. You propose to calculate the annual discount rate using the thirty-year U.S. Treasury bond as a benchmark, and then adding to this rate an appropriate risk factor as determined by your board of directors.

You have proposed certain changes to your bylaws. Following ratification by the members:

1. The board of directors shall have absolute authority to discount some or all of the patronage capital of the members without obtaining any further member consent.
2. The board of directors shall have absolute authority to set the discount rate annually based on your cost of equity capital and establish the period for discounting.
3. The board of directors shall have absolute authority without any further consent required to discount some or all of the patronage capital of members who express the desire to be disconnected from your network and resign their memberships.
4. With respect to those members who disconnect from your network after the ratification date and who do not have their patronage capital immediately redeemed at a discount, the board of directors will still have authority to discount their patronage capital balances.

You have requested a ruling that your proposed changes will not cause you to lose your exempt status under section 501(c)(12) of the Code.

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). 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.

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.

Your bylaws will 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 a cycle of approximately 18 years. 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 for 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 the 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 an 18-year holding period or cycle. The discount rate is in accordance with the prevailing market rate.

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

Following the ratification by members and incorporation into the bylaws of the provisions

described above, you will still be operating on a cooperative basis. Therefore, the capital credit retirement program as described in your amended bylaws will not adversely effect your federal tax exemption under section 501(c)(12) of the Code, assuming you continue to meet the 85 percent member income test provided in section 501(c)(12).

This ruling is based on the understanding that there will be no material changes in the facts and representation upon which it is based. Except as we have ruled herein, we express no opinion as the tax consequences of the transactions under other sections of the Code and Income Tax Regulations.

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 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.

Sincerely,

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