

DRAFTING INFORMATION

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Section 501.—Exemption From Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(c)(12)-1: Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

Tax-exempt electric cooperative. A tax-exempt electric cooperative's (1) distribution and sale of propane in tanks to members is not a tax-exempt activity under section 501(c)(12)(A) of the Code and may adversely affect its tax-exempt status under section 501(c)(12); (2) if the tax-exempt status of the electric cooperative is not adversely affected; income derived from this activity is unrelated business income and subject to unrelated business income

tax; and (3) the income is treated as non-member income for purposes of calculating the 85 percent member income test under section 501(c)(12)(A).

Rev. Rul. 2002-54

ISSUES

1. Whether the distribution and sale of propane in tanks by an electric cooperative to members is a “like organization” activity under § 501(c)(12)(A) of the Internal Revenue Code;

2. If the distribution and sale of propane in tanks is not a “like organization” activity, how the 85 percent member income test of § 501(c)(12)(A) is applied to income derived from this activity;

3. If the distribution and sale of propane in tanks is not a “like organization” activity, is it an activity unrelated to the exempt purpose of an electric cooperative and subject to the unrelated income tax described in §§ 511-513?

FACTS

A is a corporation formed for the purpose of providing electricity to members. A operates according to cooperative principles. A is recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(12). Membership in A is available to any person. A’s members reside in a certain geographic area of State X.

A distributes electricity to members. A also sells propane to members for their personal or business use. Propane in tanks is delivered by truck to the purchasers’ residences or businesses at regular intervals and also on an as needed basis.

In year Y, A’s income is derived as follows: \$95x from sales of electricity to members, \$2x from interest income earned on A’s bank accounts, and \$3x from sales of tanked propane to members.

LAW

Section 501(c)(12)(A) 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.

The Internal Revenue Service (“Service”) position has been that providing light

and water to members on a cooperative basis is a “like organization” activity because it is a public utility type service. *See* Rev. Rul. 67-265, 1967-2 C.B. 205, *updating and restating* I.T. 1671, C.B. II-1, 158 (1923). Congress in 1980 amended § 501(c)(12) by adding § 501(c)(12)(C), which specifically lists electric cooperatives as organizations within the purview of § 501(c)(12). Pub. L. No. 96-605 § 106(a), 94 Stat. 3524 (1980).

Rev. Rul. 83-170, 1983-2 C.B. 97, affirms the public utility type service rationale described in Rev. Rul. 67-265 and states that the definition of “like organization” includes those cooperatives that are engaged in activities similar in nature to a public utility type service. In the revenue ruling, an organization provides cable television service to its members on a cooperative basis. The revenue ruling compares cable television service to a public utility type service because it is a service regulated by the state. The revenue ruling concludes that the cooperative organization is a “like organization” within the meaning of § 501(c)(12)(A) and qualifies for exemption under § 501(c)(12).

The Service has stated that “like organization” activity does not include activities not similar in nature to a public utility type service. In Rev. Rul. 65-201, 1965-2 C.B. 170, an organization sells electrical material, equipment and supplies, and provides equipment repair services to its members on a cooperative basis. The revenue ruling holds that the organization is not a “like organization” because the activities in question are not similar to public utility type services that are conducted by those organizations listed in § 501(c)(12). *See also Consumers Credit Rural Electric Coop. Corp. v. Commissioner*, 37 T.C. 136, 143, *aff’d* 319 F.2d 475 (6th Cir. 1963) (an organization that financed consumer purchases of electrical, water or plumbing appliances was not a “like organization”); *New Jersey Automobile Club v. United States*, 181 F. Supp. 259 (Cl. Ct. 1960), *cert. denied*, 366 U.S. 964 (1961) (providing emergency road, travel and bail bond services were not “like organization” activities).

Section 501(c)(12)(A) provides that organizations whose activities are described in this subsection can qualify for exemption only if 85 percent or more of the income consists of amounts collected from

members for the sole purpose of meeting losses and expenses. *See also* § 1.501(c)(12)-1(a) of the Income Tax Regulations. The 85 percent member income test is computed in each taxable year, and a cooperative may fail the test one year but meet the test in a prior or subsequent tax year. *See* Rev. Rul. 65-99, 1965-1 C.B. 242.

Section 511(a)(1) imposes a tax on the unrelated business taxable income of organizations described in § 511(a)(2).

Section 511(a)(2) states that all organizations exempt under § 501(c) are subject to the unrelated business income tax (other than § 501(c)(1)).

Section 1.511-2(a)(1)(i) provides, in pertinent part, that § 511(a)(1) applies to any organization exempt under § 501(a) (other than § 501(c)(1)).

ANALYSIS

Organizations exempt under § 501(c)(12) include mutual ditch or irrigation companies and telephone or electric cooperatives. If the organization in question does not furnish any of these services, its activity must be a “like organization” activity. As stated in Rev. Rul. 83-170 and Rev. Rul. 67-265, a “like organization” activity is a public utility type service. A public utility type service is the furnishing or sale of the production, transmission, and distribution of electricity, gas, steam or water, sewage disposal service, 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. Rul. 83-170 (cable television is a public utility type service because it is regulated by the state); *see generally* § 168(i)(10). A public utility type service for purposes of § 501(c)(12) also requires an extensive infrastructure, like the delivery of electricity from producers to consumers, the construction of which necessitates large capital investment.

In the factual situation described above, A’s distribution and sale of tanked propane by trucks is not a public utility type service because the rates charged for tanked propane are not and traditionally have not been regulated (aside from safety regulations) by states or the federal government. Also, the distribution and sale of tanked propane by trucks does not require an extensive infrastructure, unlike the distribu-

tion of electricity. Hence, distribution and sale of tanked propane by trucks is not a “like organization” activity under § 501(c)(12)(A).

The 85 percent member income test of § 501(c)(12) requires that a § 501(c)(12) cooperative must receive 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 the income be (1) derived from members and (2) used to pay for services listed in § 501(c)(12). The \$3x A derived from distribution and sale of tanked propane by trucks is from members, but is not used for a service listed in § 501(c)(12) because distribution and sale of tanked propane is not a “like organization” activity. Hence, the \$3x A derived is treated as non-member income for purposes of calculating the 85 percent member income test.

The unrelated business income tax provisions, §§ 511 – 513, provide that the income of a cooperative exempt under § 501(c)(12) is subject to unrelated business income tax if the income is derived from an activity unrelated to its exempt purpose. *See also Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 149 (2d Cir. 2000) (stating that an organization exempt from tax under § 501 may be subject to the unrelated business income tax on income it derives from a trade or business unrelated to its exempt purpose). The distribution and sale of tanked propane, as concluded, is not a “like organization” activity within the meaning of § 501(c)(12)(A). A’s distribution and sale of tanked propane to members is a business, is regularly carried on and is not related to providing electricity to members. *See* § 1.512(a)–1 (stating the definition for unrelated business taxable income). If A’s distribution and sale of tanked propane were not insubstantial, it would jeopardize its exempt status under § 501(c)(12). If it were insubstantial, the \$3x A derived from distribution and sale of tanked propane would be subject to unrelated business income tax.

HOLDINGS

Distribution and sale of tanked propane by trucks is not a “like organization” activity under § 501(c)(12)(A). The \$3x A derived from the distribution and sales of tanked propane to members is non-

member income for purposes of calculating the 85 percent member income test. A’s total income for year Y is \$100x, \$95x (95 percent) of which is derived from members. \$5x (5 percent) of the total income for year Y is derived from nonmembers, \$3x (3 percent) from distribution and sale of tanked propane and \$2x (2 percent) in interest income. A satisfies the 85 percent member income test for year Y. A’s distribution and sales of tanked propane is unrelated to its exempt purpose. A’s exempt status under § 501(c)(12) is not jeopardized if the distribution and sale of tanked propane is insubstantial, but the \$3x A derived from the activity is subject to unrelated business income tax.

This revenue ruling deals only with § 501(c)(12). No inference is intended as to any other provision of law, including the definition of utility or public utility under any other provision.

EFFECTIVE DATE

This revenue ruling is effective for taxable years beginning after December 31, 2002.

DRAFTING INFORMATION

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