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IRS LTR: Change in Accounting Method Won't Jeopardize Cooperative's Exemption.

The IRS ruled a rural electric cooperative can retire former members' capital credit accounts by offsetting the amounts of their accounts against outstanding debt owed for electric services without adversely impacting its tax-exempt status.

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Dear * * *

We have considered your ruling request regarding the tax consequences relating to the proposed change of methodology for the retiring all, or portion, of your former members' capital credit accounts, described below.

You were created on Date as a cooperative under the laws of State and have qualified as a cooperative electric company under I.R.C. § 501(c)(12) since that time. Your members elect the board of directors on a one member, one vote basis.

Pursuant to Article VII, Section 2 of your bylaws, you are obligated to account on a patronage basis to all your members for all amounts received and receivable from electric services in excess of operating costs and expenses properly chargeable against the furnishing of such services. Such excess of revenue over expenses is allocated each year to each member in an equity ownership account which you call a capital credit account in proportion to the amount of the member's electrical usage. The amounts allocated to the capital credit accounts are paid out to the members when the Board determines that you are financially able and in retirement of the capital credit accounts to the extent a payment is made. Payments are only made when it is possible to do so and not violate the requirements of your bylaws to keep reserves for operations and maintenance, debt repayment requirements, working capital, and other specified requirements.

A large number of your former members have outstanding balances due on their accounts for electric services. At this time, and pursuant to Article VII, Section 2 of your bylaws, you offset any outstanding balance with the amount of the former member's capital credit account that is scheduled to be retired in that year. In addition, pursuant to Board policy, a former member's capital credit account is fully retired by offset against any outstanding balance due for non-payment for electric services or by payout (or both) after the member has been a former member for seven years.

You would like to change your current policies so that you do not wait for seven years to fully retire a former member's capital account balance if that former member has an outstanding balance from non-payment for electric services. You would like to use the outstanding balance in the former member's capital credit account to offset any outstanding account balance for non-payment for

electric services at the end of fiscal year Year and periodically thereafter.

After the offset occurs, you would retire the former member’s capital credit account in accordance with its normal retirement schedule if there is a residual balance in the capital credit account. In addition, you would cease all collection activities with respect to the former member’s debt to you. If the former member later pays you amounts in excess of any debt remaining in their account, you will return that payment to the former member. The offset to the former member’s outstanding bill would be made at the full amount of the capital credit amount retired. No discount will apply.

You request the following ruling:

The revised method for retiring former members’ capital credit accounts by offsetting the amounts of their capital credit accounts against outstanding debt they owe to you for provision of electric services on an accelerated basis will not adversely affect your tax-exempt status as a rural electric cooperative under I.R.C. § 501(c)(12).

LAW

Section 501(c)(12)(A) 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 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 v. Commissioner, Inc., 44T.C. 305 (1965), acq. 1966-1 C.B. 3.

Rev. Rul. 72-36, supra, describes additional fundamental requirements for operation of cooperatives described in IRC. § 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 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.

The primary issue raised by the change in method for retirement of capital account credits for certain former members is whether it violates any of the cooperative requirements described Puget Sound Plywood, Inc. v. Commissioner, Inc., 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 credit accounts of former members by offsetting the amounts in their capital credit accounts against any outstanding balance they owe the cooperative for provision of electric services 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 since they will receive full credit against a debt owed by them to the cooperative in return for the retirement of the amount in their capital credit account. The debt will be fully extinguished. If they later try to pay the former debt, that money will be returned to them. No collection against the extinguished amount will be attempted once the offset has taken place.

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 since the new policy does not impact this aspect of the cooperative's operations.

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

1. The revised method for retiring former members' capital credit accounts by offsetting the amounts of their capital credit accounts against outstanding debt they owe to you for provision of electric services will not adversely affect your tax-exempt status as a rural electric cooperative under I.R.C. § 501(c)(12).

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 I.R.C. § 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. I.R.C. § 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,

Stephen M. Clarke

Acting Manager,

Exempt Organizations

Guidance Group 1

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