Bond Case Briefs

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IRS Rules on Tax Treatment of Cooperative's Proposed Settlement.

The IRS ruled that an electric cooperative's tax-exempt status will not be jeopardized by a proposed settlement with former members to redeem their capital credits, that the discounted portion of redeemed capital credits will not be included in income, and that the redemption of capital credits will constitute patronage dividends or sourced income.

Citations: LTR 201423027

Contact Person: * * *
Identification Number: * * *
Telephone Number: * * *

UIL 501.12-03
Release Date: 6/6/2014
Date: March 13, 2014

Employer Identification Number: * * *

LEGEND:

State = * * *
Date = * * *
X = * * *
Year = * * *

Dear * * *:

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

FACTS

You are an electric cooperative, formed as a cooperative, nonprofit, membership corporation under the laws of State on Date. You are organized under your bylaws to operate on a cooperative, nonprofit basis for the mutual benefit of your members. You are exempt from federal income tax under § 501(c)(12) of the Internal Revenue Code ("Code"). In the past you have satisfied, and you expect to continue to satisfy, the member income requirements for exemption under § 501(c)(12).

You have approximately X current members. Your members are entitled to vote on all matters presented at meetings of the members, and all questions put to vote to the members are generally decided by majority vote. Your governing board is composed of nine trustees, all of whom are elected by the members at your annual meetings. Members elect the trustees on a one member, one vote basis. In addition, a trustee may be removed and replaced by a majority vote of the members

upon a member initiated petition signed by the lesser of 10% or 400 members.

Pursuant to your bylaws, you are obligated to account to all of your members on a patronage basis for all amounts received and receivable from electric energy in excess of operating costs and expenses properly chargeable against the furnishing of such services. You are required to credit to a capital account all such amounts in excess of operating costs and expenses for each member. You are obligated to maintain books and records reflecting the amount of capital credited to each patron's account on an annual basis and to notify members of the capital credited to their accounts within a reasonable time after the close of the fiscal year.

Your bylaws provide that, in the event of your dissolution or liquidation, all of your outstanding indebtedness will be paid first, and then outstanding capital credits of current and former members will be retired, without priority, on a pro rata basis. The remaining property and assets — representing your "net savings" account — will then be distributed among the members and the former members in proportion to the patronage each bears to the total patronage of all members during the seven years next preceding the date of filing of the certificate of dissolution.

Your bylaws also provide that, at any time prior to dissolution or liquidation, capital credited to the members' accounts may be retired in full or in part if the Board determines that your financial condition would not be impaired thereby. In the event of a capital credit retirement occurring earlier than the time scheduled by the Board, the amount of the capital credit may be discounted to present value in accordance with applicable accounting standards and as the Board may determine to establish the amount to be received by the distribute in respect to such early retirement.

The Board has adopted a policy for the regular assignment and retirement/payment of capital credits ("Policy"). The Policy provides that, upon payment of discounted capital credits, the difference between the discounted value paid and the stated value of the member's or patron's capital account will be credited to an equity account in the name of the member or patron to be held as retired capital. Thus your members retain a continuing property right in the net savings for the difference between the stated value of the patronage allocation and any discounted value that has been paid.

In Year you were sued by a group of former members ("Former Members") who allege that you should immediately retire capital credits of a member once the member ceases taking power from you and thus ceases to be your customer. You have negotiated a settlement proposal with the Former Members ("Settlement Proposal"), which provides that, after off-setting their bad debt, you will then discount to present value all capital credits of the Former Members and pay out such capital credits over a defined period.

The parties have agreed that the rate of return of a competing electric utility within your service area should be used as the capital credit discount/present value rate. The capital credits allocated to the Former Members will be discounted on a ten-year basis, and then immediately retired as a condition of the settlement. Pursuant to the Settlement Proposal, the Former Members will receive their pro rata share of the discounted capital credit amount, less attorneys' fees, administrative costs, and payment of compensation to the class representatives.

The discounted portion of the Former Members' redeemed capital credits — the difference between the discounted amount and the original amount in the capital credit account — will be retained on your books as permanent equity and available for distribution to the members and former members upon dissolution and liquidation as part of your net savings account. It will not be reallocated to the capital credit accounts of current members.

You request the following rulings:

1. The proposed transaction consisting of your (a) entering into a settlement agreement consistent with the terms of the Settlement Proposal, (b) redeeming capital credits of the Former Members at a discount rate pursuant to the terms thereof, and (c) transferring the discounted portion to your permanent equity will not adversely affect your tax-exempt status under § 501(c)(12).

2. The discounted portion of the Former Members' redeemed capital credits will not be included in your income for purposes of the 85 percent member income test under § 501(c)(12).

3. The redemption of the capital credits of the Former Members pursuant to the Settlement Proposal will constitute patronage dividends or patronage sourced income.

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). 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.

This 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 mutual or cooperative electric companies, and 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 organized and operated 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.

The primary issue raised by the transaction described in the Settlement Proposal 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 transaction described in the Settlement Proposal is consistent with the fiduciary duties of the cooperative (and its board of

directors and management) to former members, and their ability to 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 over the cost of electricity service (i.e. capital credits) is also not adversely affected.

The cooperative principle of subordination of capital is satisfied because the transaction described in the Settlement Proposal 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 terms of the Settlement Proposal permit the Former Members to receive the present value of their capital credit accounts at a date before dissolution and liquidation of the company. The discount rate is in accordance with the prevailing market rate. Further, by discounting to present value, the Former Members are not treated more favorably than current members.

B. Transfer of Discount Portion of Capital Credits to Net Savings

Pursuant to the Policy, the difference between the discounted value paid to Former Members and the value stated in the member's account will be credited to an equity account within your net savings account in the name of that member. In accordance with your Bylaws, the retired capital in the net savings account will be distributed to Former Members upon dissolution prior to distributing any remaining amounts in the net savings account.

Based on the facts presented, we do not believe that your establishment of this second capital account for each member would create taxable income to you as a cooperative. Analogizing to a corporate transaction, under § 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 the member contributed money to the cooperative in the capacity of a member, the cooperative would not have income.

It appears that, according to your Policy, you are simply transferring money already received from members from one equity account to another equity account. As a result, it appears that nothing has changed and you will not receive any income pursuant to the transaction. The transfer of the discounted portion from the Former Members' capital credit accounts to an equity account within the net savings account where their continuing equity interest will be recorded is simply an organizational tool.

C. Redemption of Capital Credits Constitute Patronage Dividends or Patronage Sourced Income

Regarding whether the redemption of capital credits are excluded from income as patronage dividends or patronage sourced income, in Pomeroy Cooperative Grain Co. v. United States, 31 T.C. 674, 685-686 (1958), the U.S. Tax Court held that an allocation 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 the redemption of the Former Members' capital credit accounts qualify as patronage dividends, excluded from gross income, because they will be made under a pre-existing legal obligation, on the basis of patronage, and 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.

RULING

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

1. The transaction described in the Settlement Proposal, consisting of your (a) entering into a settlement agreement, the terms of which are not yet finalized, but will be consistent with the Settlement Proposal, (b) redeeming capital credits of the Former Members at a discount/present day value rate pursuant to the terms thereof, and (c) transferring the discounted portion to your permanent equity will not adversely affect your tax-exempt status under Section 501(c)(12) of the Code.

2. The discounted portion of the Former Members' redeemed capital credits will not be included in your income for purposes of the 85 percent member income test under Section 501(c)(12) of the Code.

3. The redemption of the capital credits of the Former members pursuant to the Settlement Proposal will constitute patronage dividends or patronage sourced income.

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

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