E. GENERAL SURVEY OF I.R.C. 501(c)(12) COOPERATIVES AND EXAMINATION OF CURRENT ISSUES

by
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1. Introduction

This article discusses general cooperative principles and rules governing I.R.C. 501(c)(12) cooperatives, the history of I.R.C. 501(c)(12) and other requirements that affect operations of I.R.C. 501(c)(12) cooperatives, and current issues.

2. I.R.C. 501(c)(12)

I.R.C. 501(c)(12) provides federal income tax exemption for benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, electric companies, or "like organizations". The Service has never distinguished the terms "mutual" or "cooperative" for purposes of I.R.C. 501(c)(12). This article will use the term "cooperative."

The purpose of an I.R.C. 501(c)(12) organization is to provide certain services to its members at the lowest possible cost. To qualify for and maintain exemption under I.R.C. 501(c)(12), a cooperative must receive 85 percent or more of its income each year from members. The income must be collected solely to meet the cooperative's losses and expenses.

3. General History of Cooperatives

The cooperative form of organization originated in England in the early 1800's to improve the economic lot of workers and farmers, two groups that suffered during the industrial revolution. Workers, with little bargaining power, suffered low wages. Farmers operated in an especially precarious economic environment, paying retail prices for their raw materials, but selling their output wholesale in markets that fluctuated widely and unpredictably. To gain economic power, workers and farmers organized and pooled resources to form sufficient capital to control the means of production, obtain supplies and services, or market their goods or services. The cooperative became very popular, and it spread to and throughout the United States.

Congress recognized the contributions and importance of cooperatives even before ratification of the Sixteenth Amendment to the Constitution authorized the income tax. Congress provided exemption from federal excise taxes to cooperative companies, not-for profit mutual benefit associations, and agricultural, horticultural, and domestic

building and loan associations. *See*, The War Revenue Act of 1898, Pub. L. No. 55-133, 30 Stat. 448 (1898) and Pub. L. No. 61-5 §38, 36 Stat. 11, 115 (1909).

4. Legislative History of I.R.C. 501(c)(12)

After ratification of the Sixteenth Amendment, exemption from federal income taxes for mutual or cooperative insurance companies, ditch or irrigation companies, telephone companies and "like organizations" was first enacted in the Revenue Act of 1916, Pub. L. No. 64-271, ch. 462 § 11(a)(10), 39 Stat. 756, 767 (1916) ("1916 Statute"), reenacted in successive revenue acts, and in the 1939, 1954 and 1986 Internal Revenue Codes. Electric cooperatives, which were not specifically listed in the 1916 Statute, but were recognized by the Service as "like organizations" in I.T. 1671, C.B. II-1, 158 (1923) and Rev. Rul. 67-265, 1967-2 C.B. 205, were added to I.R.C. 501(c)(12)(C) in 1980.

Before 1924, the statute limited cooperatives' income to assessments, dues, and fees from members. The Revenue Act of 1924, ch. 234, § 231(10), 43 Stat. 283 (1924), reduced the member-income requirement to 85 percent, allowing cooperatives to earn up to 15 percent of their income from nonmember sources. Congress intended to allow cooperatives to have other sources of income, such as interest on bank accounts, to pay for capital improvements, expansion, or to purchase real estate. *See* 65 Cong. Rec. 7128-7129 (1924). The 85 percent member-income test was intended to insure cooperatives continued serving members rather than placing their member-source income in investments, such as bonds or stocks, and becoming investment companies. *See* Cong. Rec. 3433 (1926).

5. Other Cooperatives

Congress also provided special tax rules for two kinds of cooperatives in addition to those described in I.R.C. 501(c)(12). These are "Subchapter T" cooperatives and farmers' cooperatives.

Subchapter T cooperatives are governed by I.R.C. sections 1381-1388 (these provisions are in Subchapter T of the Code). These cooperatives may conduct any kind of business. Examples are housing, insurance, etc. Their members or patrons can include individuals or organizations.

Subchapter T cooperatives are not exempt from federal income tax. Rather, their earnings are taxed at either the cooperative level or member-patron level, or both. A subchapter T cooperative must usually pay tax on patronage source earnings it retains. It can deduct patronage-source earnings it distributes to its member-patrons from its gross income. Only patronage-source earnings are eligible for deduction by the cooperative, and they are taxable income to member-patrons who receive them. A Subchapter T

cooperative is subject to tax on its net non-patronage source earnings, and patrons are subject to tax on distributions of non-patronage income.

I.R.C. 521 and in Subchapter T provisions govern farmers' cooperatives. Farmers' cooperatives purchase supplies needed for farming on behalf of member-patrons and in turn market member-patrons' farm products. Member-patrons must be engaged in farming, which includes raising livestock, poultry, and fish, growing fruit, maintaining nurseries, etc.

Like a Subchapter T cooperative, a farmers' cooperative's earnings are taxed at either the cooperative level or the patron level. Unlike Subchapter T cooperatives, farmers' cooperatives are "exempt" from federal income tax because they can reduce taxable earnings to zero by taking certain deductions from gross income under I.R.C. 521 and Subchapter T. For example, a farmer's cooperative can deduct non-patronage source net income and dividends it pays to shareholders.

A major difference between I.R.C. 501(c)(12) cooperatives and farmers' and Subchapter T cooperatives is that an I.R.C. 501(c)(12) cooperative's earnings are not subject to federal income tax. Thus, they do not need to take deductions if they continue to meet the requirements for exemption under I.R.C. 501(c)(12).

6. Requirements for Exemption under I.R.C. 501(c)(12)

An organization must satisfy three requirements to qualify under I.R.C. 501(c)(12). First, it must be organized and operated as a cooperative. Second, it must conduct activities described in I.R.C. 501(c)(12) and the regulations. Third, it must derive 85 percent or more of its income from members. These three requirements can be categorized as: (1) the cooperative organizational and operational test; (2) the activities test; and (3) the income source test.

7. Organizational and Operational Test – Basic Cooperative Principles

A common requirement under I.R.C. 501(c)(12), I.R.C. 521 and Subchapter T is cooperative organization and operation. What is a cooperative? The term is not defined in I.R.C. 501(c)(12), I.R.C. 521, Subchapter T, or the regulations. Rather, the definition comes from the common law.

The Tax Court, in Puget Sound Plywood v. Commissioner, 44 T.C. 305, 307-308 (1965), *acq.*1966-1 C.B. 3, described a cooperative as comprised of members who sought "(1) [f]or themselves to own and manage the [organization], as distinguished from having it owned and managed by outside equity investors; and then (2) to have their [organization] turn back to the members the excess of the receipts from the store sales over the cost of the goods sold and the expenses of operation." This description identifies

three basic principles or requirements: (1) democratic control by the members; (2) vesting in and allocating among the members all excess operating revenues over the expenses incurred to generate the revenues (i.e. operating at cost); and (3) subordination of capital.

These basic requirements apply to cooperatives described in section 501(c)(12) as well as those described in Subchapter T and I.R.C. 521. They must be satisfied to qualify for and maintain exemption under I.R.C. 501(c)(12).

A. Democratic Control

This requirement assures that members participating in the cooperative endeavor remain in control of an I.R.C. 501(c)(12) cooperative. A cooperative satisfies this by periodically holding democratically conducted meetings, with members, each with one vote, electing officers to operate the organization.

B. Operating at Cost

This requires that a cooperative return the excess of net operating revenues over its cost of operations to the member-patrons. In other words, the cooperative must not operate either for profit or below cost. The excess is usually called "savings" (rather than profit) because it is the amount not spent to obtain services (telephone, electricity, etc.) for member-patrons or to operate the cooperative. A cooperative's savings belong to its member-patrons, not the organization, and it must allocate the savings to its member-patrons in proportion to the amount of business it did with each.

C. Subordination of Capital

This requires that contributors of capital to the cooperative, in their status as equity owners, neither control the operations nor receive most of the pecuniary benefits of the cooperative's operations. That is, cooperatives are oriented to member-patrons. This distinguishes the cooperative from the for-profit corporation, which is shareholder-oriented. The idea behind this requirement is that members of a cooperative band together to share interest, risk, and burden to obtain services or benefits, whether water, telephone, electricity, etc., rather than simply invest as equity owners.

This requirement has two components. First, members control an I.R.C. 501(c)(12) cooperative and own the savings or pecuniary benefits from its business, which stay with them rather than go to shareholders or equity investors. Second, a cooperative must limit return on capital (e.g. dividends to shareholders) to insure savings or pecuniary benefits benefit member-patrons rather than shareholders.

D. Additional Requirements

Rev. Rul. 72-36, 1972-1 C.B. 151, sets out organizational and operational requirements an I.R.C. 501(c)(12) cooperative must satisfy to insure democratic control, operation at cost, and subordination of capital. They are:

- The organization must keep adequate records of each member's rights and interest in the assets of the organization;
- The organization must distribute any savings to members in proportion to the amount of business done with them (based on the operation at cost principle);
- The cooperative must not retain more funds than it needs to meet current losses and expenses (also based on the operation at cost principle);
- The cooperative can not forfeit a member's right and interest in the organization upon termination of membership; and
- Upon dissolution, the cooperative must distribute any gains from the sale of any appreciated asset to all who were members while the cooperative owned the asset in proportion to the amount of business done with each, so far as practical.

Whether a cooperative satisfies the basic cooperative principles or the requirements of Rev. Rul. 72-36 is a question of fact. A specialist must review the documentation (bylaws, articles of organization, etc.) to determine if the cooperative has satisfied these principles and requirements.

E. Violations of Cooperative Requirements

If an I.R.C. 501(c)(12) cooperative violates any cooperative requirement, it loses exemption from federal income tax because it is no longer a cooperative.

F. Operations of an I.R.C. 501(c)(12) Cooperative

I.R.C. 501(c)(12) cooperatives are essentially member or consumer service organizations that provide members goods or services permitted by I.R.C. 501(c)(12).

Who are members? I.R.C. 501(c)(12) and the regulations do not define "member," but the definitions for I.R.C. 521 and Subchapter T apply as they parallel I.R.C. 501(c)(12). Section 1.1388-1(c)(3)(ii)(c) of the Income Tax Regulations defines member as a "person" (an individual, corporation, or cooperative) entitled to participate in the cooperative's management. As a member usually gets services from the cooperative, he or she is also a patron. A "patron" is any person (an individual, corporation, etc,), whether member or non-member, with or for whom the cooperative does business on a cooperative basis. Sections 1.1388-1(e) and 1.522-1(b)(2) of the regulations.

The following example illustrates the (very) basic operations of an I.R.C. 501(c)(12) electric cooperative.

X, an electric cooperative, buys electricity from a power generating utility company. X collects money from its members to defray the costs and expenses of buying the electricity for its members. It must return the excess over the costs to the members or nonmembers by the amount of business done with each. The excess amount is known in cooperative terminology as "savings" or "patronage dividend," for it is an adjustment in the price X charges its members. The savings reduce members' electric costs.

X may keep a reasonable amount of the savings as reserves for capital improvement, unexpected expenses, expansion, etc. But X must inform each member of the amount of savings attributable to the business the member has done with it. X does this by "written notices," and credits each member's account in its books. This procedure is known in cooperative terminology as "allocation," and the account is usually called a "capital credit account" (the balance sheet account approximating retained earnings) reflecting the member ownership of the amount in the accounts. When there are excess reserves, the board of directors authorizes "redemption" of amounts in the accounts, and X makes payments from the accounts to the members. In effect, X is returning part of the fees it charged members for electricity.

8. Current Issues Concerning Cooperative Principles

A. Providing Multiple Services Within a Cooperative

Historically, most I.R.C. 501(c)(12) cooperatives engaged in one activity. For example, a telephone cooperative would only provide local and long distance telephone services or an electric cooperative would only provide electricity. Recently, however, I.R.C. 501(c)(12) cooperatives have followed the trend in the utility industry to expand to other lines. For example, telephone companies now also offer cellular (or wireless) phone and Internet services. (Section 9, below discusses whether these services are activities described in I.R.C. 501(c)(12)).

Under the basic cooperative requirement to operate at cost, an I.R.C. 501(c)(12) cooperative must account to members and patrons for all costs and savings that result from a particular service. It must equitably allocate costs or savings among members or patrons of each particular service so savings or losses are returned to each member in direct proportion to his or her patronage. So, an I.R.C. 501(c)(12) cooperative must account for savings, costs, and losses from each service separately to ensure that savings or losses can be allocated properly to each member or patron.

Many I.R.C. 501(c)(12) cooperatives have combined two or more services for purposes of allocating savings, costs, and losses. For example, a cooperative may

combine local and long distance telephone services with cellular phone service and Internet service. A cooperative can combine different services without violating the requirement to operate at cost if it meets the following criteria:

- Many member-patrons of one service are also patrons of the other services in the allocation unit;
- The cooperative's articles of incorporation, bylaws, or written policies specifically detail the composition of all allocation units and how savings or losses are to be allocated in each unit;
- It informs members of each allocation unit the risk-sharing and benefits of combining different services in one allocation unit;
- A majority of the cooperative's members agree to the grouping; and
- Members periodically vote to affirm the agreement.

These criteria are designed to ensure that in establishing allocation units a cooperative does not divert a substantial amount of savings or losses from one group of members to another.

B. Issuing Shares of Non-voting, Interest Bearing Stock

Many I.R.C. 501(c)(12) cooperatives need outside capital to finance their exempt business activities. One way to raise outside capital is issuing stock. The Service has received requests to approve the issuance of a class of stock that has the following characteristics: (1) dividend payment; (2) dividend rate is fixed at eight percent per year or the legal rate permitted in the state the cooperative was formed; (3) shareholders cannot directly or indirectly participate in the cooperative's savings or profits; and (4) shareholders will not have voting rights.

Neither I.R.C. 501(c)(12) nor the regulations prohibit (or authorize) issuing stock with these characteristics. (I.R.C. 521(b)(2) and section 1.521-1(a)(2) of the regulations permit a farmers' cooperative to issue non-voting stock with a dividend fixed at the greater of eight percent per year or legal rate of interest in the state of incorporation. Also, the shareholders of this stock have no distribution rights other than fixed dividends.) But, an I.R.C. 501(c)(12) cooperative cannot issue unlimited or numerous shares of non-voting stock and remain a cooperative without violating the subordination of capital principle.

To illustrate, assume an I.R.C. 501(c)(12) electric cooperative issues 10 million shares of stock at $1 par value with an annual interest rate of eight percent. If the cooperative sold all the shares, it would pay $800,000 in dividends annually to equity holders. Depending on its financial situation, the stock may raise doubt that the cooperative would return net savings to member-patrons by the services performed for

them rather than distribute them to shareholders as return on capital. Whether this occurs is a factual question that must be determined during examination. Whether stock with different characteristics violates the subordination of capital principle is also a question of fact.

C. Redemption or Retirement of Capital Credit Accounts

Many I.R.C. 501(c)(12) cooperatives, especially electric and telephone cooperatives, keep amounts of savings as reserves for improvements, business expansion, defrayal of unexpected expenses, etc. The cooperative creates a capital credit account for each patron showing the amount of savings that belong to that particular patron.

Many I.R.C. 501(c)(12) cooperatives periodically distribute amounts in these accounts to account holders. This distribution is called redemption or retirement of capital credit accounts. Cooperatives usually redeem capital credit accounts as soon as the overall financial condition of the cooperative permits. Redemption is good for the cooperative because it shows members and patrons that their cooperative operates on a non-profit basis and for their maximum benefit. Cooperatives usually retire capital credit accounts on a revolving basis, redeeming the oldest accounts first.

(1) Redemption of Accounts at Discount

The Service has received requests from cooperatives that want to redeem capital credit accounts at a discount rather than at face value. The cooperative pays the discounted amount to the member-patron, and credits the difference between the face value to a separate equity account in the name of that member or former member. The amount in this equity account would be distributed to the member on dissolution, after payment of all debts, liabilities, and amounts in the capital credit accounts.

A discounted redemption program raises two issues: (1) whether the difference between the accounts' face values and the discounted amounts paid is income for purposes of the 85 percent member income test; and (2) whether it violates any cooperative requirements. The first issue is discussed in section 9E(2) below.

A redemption program potentially violates two cooperative requirements: (1) a member's rights and interest in the assets of the cooperative cannot be forfeited if his or her membership ends; and (2) on dissolution, a cooperative must distribute any gains from the sale of its assets to all who were members while it owned the assets. A discounted redemption program as described above would not violate these two requirements because current and former members retain their interests via the equity accounts and would receive their share of any assets on dissolution. Whether a redemption program with different characteristics would satisfy the cooperative requirements requires considering the relevant facts and circumstances.

D. Cooperative Principles and State Laws

I.R.C. 501(c)(12) and the regulations do not require a cooperative to organize under a state cooperative statute, unlike I.R.C. 521 farmers' cooperatives. But, many states have cooperative statutes that govern cooperatives described in I.R.C. 501(c)(12). For example, section 57.001 of the Texas Nonprofit Water Supply or Sewer Service Corporations statute governs the formation and operation of nonprofit water and sewer organizations.

State cooperative statutes do not usually cause conflicts with the cooperative principles (democratic vote, non-forfeiture of assets of former members, etc.). In reviewing a cooperative's governing instruments to determine if it satisfies all organizational and operational requirements, a determination specialist should also review the State's cooperative statute to ensure there is no conflict.

One area where state cooperative statutes and cooperative principles have conflicted concerns ditch or irrigation cooperatives. Rev. Rul. 81-109, 1981-1 C.B. 347, resolved a conflict by holding that a mutual ditch organization qualified for exemption under I.R.C. 501(c)(12) though it did not met some cooperative requirements, because it operated as required by state law. State law authorized that members purchase stock in the cooperative, which was formed in 1874. The stock entitles a member to certain water rights and services. The stock is assessable to provide funds to operate and maintain the irrigation system. The shares are personal property and freely alienable with all the right, title, and interest to the water and assets of the organization. On dissolution, the assets of the organization would be distributed to the current stockholders in proportion to the amount held by each. Thus, a member who sells his or her stock forfeits any claim to the cooperative's assets on dissolution, which conflicts with the cooperative requirements of non-forfeiture of interest and that, so far as practicable, any gain from the sale of assets be distributed to members and former members in proportion to the amount of business done by each while the cooperative owned the assets.

Rev. Rul. 81-109 noted that several state laws and practices governing cooperatives allowed them to operate in the manner described above, but Congress has not amended I.R.C. 501(c)(12) or its predecessor to provide state laws should not govern in such a circumstance. Congressional inaction despite knowledge of conflicts was interpreted as its intent that state law should control if it conflicts with cooperative requirements.

9. Activities Test

I.R.C. 501(c)(12) describes four specific categories of organizations that can qualify for exemption: benevolent life insurance associations, ditch or irrigation companies, telephone companies, and electric companies. I.R.C. 501(c)(12) also provides for a fifth category, "like organizations," which is not defined in the Code or the regulations. So,

the activities of an organization are crucial in determining qualification for exemption under I.R.C. 501(c)(12).

A. Benevolent Life Insurance Activities

Providing life insurance to members is an I.R.C. 501(c)(12) activity if restricted to "a purely local character," meaning that the cooperative's business is confined to a particular community, place, district, or locality, irrespective of political subdivision. Section 1.501(c)(12)-1(b) of the regulations. An insurance association can conduct business in several political subdivisions (such as counties) if these political subdivisions constitute a locality or community. The locality restriction does not require it to terminate membership if a member moves out of the locality in which it operates. Rev. Rul. 83-43, 1983-1 C.B. 108.

Rev. Rul. 64-193, 1964-2 C.B. 151, held that "a purely local character" did not include an insurance association doing business within a 75-mile radius of a home office that included three separate large metropolitan areas. Rev. Rul. 64-193 reasoned that "purely local character" implies a single locality, not three large metropolitan areas. Similarly, in Huff-Cook Memorial Burial Assn. v. United States, 327 F.Supp. 1209 (W.D. Va. 1971), the court held a life insurance company that solicited business in three states was not of a purely local character, so it did not qualify for exemption under I.R.C. 501(c)(12). *See also*, Hardware Service Co. v. United States, 6 A.F.T.R. 7408 (Ct. Cl. 1928).

Whether a benevolent life insurance organization satisfies this condition is an issue of facts and circumstances. Factors that indicate a life insurance company is not of a purely local character include members in several localities or soliciting business in several cities or nationwide.

B. Mutual Ditch or Irrigation Activities

Mutual ditch or irrigation companies are cooperatives that operate a ditch or irrigation water system. The Code and regulations do not define ditch or irrigation, but the common meaning of both is to bring, channel, or control water to or away from land.

C. Telephone and Electric Activities

I.R.C. 501(c)(12)(A) provides for the exemption of cooperatives that provide telephone services. Telephone services include both local and long distance services.

I.R.C. 501(c)(12)(C) provides for the exemption of cooperatives that provide electricity to members. Providing electric services does not include financing purchases of electrical, water, or plumbing appliances. *See* Consumers Credit Rural Electric Coop.

Corp. v. Commissioner, 37 T.C. 136, 143 (1961), aff'd 319 F.2d 475 (6th Cir. 1963). Also, Rev. Rul. 65-201, 1965-2 C.B. 170, held that neither selling electrical materials to members nor furnishing, repairing, or testing equipment are providing electric services or like activities within the meaning of I.R.C. 501(c)(12).

D. Activities of "Like Organizations"

Rev. Rul. 65-201, 1965-2 C.B. 170, stated that "like organizations," is limited by the kinds of organizations specified in I.R.C. 501(c)(12). The term includes mutual or cooperative organizations engaged in activities similar in nature to the benevolent life insurance or public-utility type of service or business customarily conducted by the specified organizations in the statute. The Service and courts have analyzed diverse activities to determine if they are "like" or similar to the activities specifically described in I.R.C. 501(c)(12).

(1) Burial and Funeral Benefit Association

The Eighth Circuit Court of Appeals held providing burial and funeral benefits are within the definition of "like activities" similar to providing benevolent life insurance, Thompson v. White River Burial Association, 178 F.2d 954 (8th Cir. 1950).

(2) Ditch or Irrigation Services

Rev. Rul. 68-564, 1968-2 C.B. 221, held constructing and maintaining structures or improvements to prevent erosion of riverbanks are activities like those of ditch or irrigation companies. Rev. Rul. 68-564 concluded that building and maintaining improvements to prevent erosion is similar to ditch or irrigation activities, which reclaim or preserve land for useful purposes.

(3) Water and Sewer Services

Rev. Rul. 67-265, 1967-2 C.B. 170, held providing water and sewer services are like activities within the meaning of I.R.C. 501(c)(12), as water and sewer services are public-utility services similar to services provided by the organizations specified in I.R.C. 501(c)(12)(A). Rev. Rul. 67-265 does not mention state or federal public utility regulation as a requirement for like organizations.

(4) Current Issues - Telecommunication Services

Many cooperatives provide local and long-distance telephone services. However, new technology has greatly changed the nature of electronic communication, and increased the uses that can be made of traditional telephone wires or wireless systems. Telephone cooperatives have expanded with the rest of the industry. Many telephone

cooperatives offer new telecommunication services including wireless or cellular phone services, Internet access, paging services, home security monitoring, medical alert services, and environmental (energy consumption, temperatures, *etc*.) monitoring. These services allow member-patrons to communicate with others by voice, writing, or other forms of communication. For example, home security monitoring allows a member-patron to be informed when there is a dangerous situation at his or her home or business. Medical alert and environmental monitoring services are similar.

Rev. Rul. 57-420, 1957-2 C.B. 308, concluded that the activities of an organization that provides and maintains a two-way radio system for its members are similar to those of a cooperative telephone company. By providing communication capability to members on a cooperative basis the organization served the same purpose as the organization described in Rev. Rul. 57-240 and traditional telephone cooperatives under I.R.C. 501(c)(12)(A).

(5) Current Issues - Direct Satellite Television Service

Like telecommunication technology, paid television service has also changed. Many I.R.C. 501(c)(12) cooperatives are beginning to offer a new kind of paid television service, direct satellite television, to members and patrons. This raises the issue whether direct satellite television service is a like activity under I.R.C. 501(c)(12).

Rev. Rul. 83-170, 1983-2 C.B. 97, held that a cooperative providing cable television to its members could qualify for exemption as a like organization under I.R.C. 501(c)(12). Rev. Rul. 83-170 equated the term "like organization" with a public utility or a public-utility type service. It compared cable television to public utilities and considered state law regulating cable television as an indication it is a public utility. The current EO position is that this rationale is applicable to direct satellite television service. So, a cooperative that provides direct satellite television may qualify for exemption as a like organization under I.R.C. 501(c)(12).

(6) Current Issues - Energy Services

(a) Natural Gas

I.R.C. 501(c)(12)(C) specifically provides for exemption of electric cooperatives. Many I.R.C. 501(c)(12)(C) cooperatives have started providing natural gas to their members, usually by pipeline. The Service considered whether distributing natural gas is a like activity in PLR 9715045 (Jan. 16, 1997). PLR 9715045 cited Rev. Rul. 67-265 and Rev. Rul. 83-170, supra, which held the definition of "like organization" includes providing public-utility type services. On the facts of this case, including that natural gas is a regulated commodity usually provided by public utilities, the Service concluded the organization was engaged in a like activity.

(b) Propane Gas

Many I.R.C. 501(c)(12) electric cooperatives have expanded their energy services to include distribution of propane gas. Both small business enterprises and public utility companies supply propane to customers. Additionally, there is some economic regulation of propane at the federal level. See Propane Education and Research Act of 1996, P.L. 104-284, 110 Stat. 3370 (1996). The Service is studying whether distributing propane gas is a like activity. So, any request by an I.R.C. 501(c)(12) cooperative for approval to distribute propane should be suspended pending resolution of this matter.

(c) Sales of Certain Energy Equipment

Many I.R.C. 501(c)(12) electric cooperatives also sell energy equipment, including fuel cells, micro-turbines, surge protectors and water filtration devices. Fuel cells and micro-turbines are portable power generators that permit on-site electricity generation. These power generators usually use propane as a fuel source. Surge protectors protect the user from variations of electricity or power "spikes" that can destroy computers, televisions, household appliances, or other electric equipment. Water filtration devices remove particles from drinking water. The Service is studying if selling equipment can be a like activity. (Note that Rev, Rul. 65-201, 1965-2 C.B. 170, held that sales of electrical equipment are not like activities and, therefore, not described in I.R.C. 501(c)(12)(A)). Any request for approval to sell equipment should be suspended pending resolution of this issue.

10. Eighty-Five Percent Member Income Test

A cooperative exempt under I.R.C. 501(c)(12) must receive 85 percent or more of its income from members. Member income is member-sourced and derived from I.R.C. 501(c)(12) activities conducted according to cooperative principles.

The 85 percent member income test is computed annually. An I.R.C. 501(c)(12) cooperative may be exempt in one year but lose exemption in another if it does not derive 85 percent or more of its income from members. Rev. Rul. 65-99, 1965-1 C.B. 242, provides that if a cooperative continues to meet the other requirements of I.R.C. 501(c)(12), it need not reapply for recognition of exemption to be considered exempt in years it meets the member income test.

The member income test considers only income received or accrued in the annual accounting period. Rev. Rul. 68-18, 1968-1 C.B. 271. For background information, *see* Topic I, CPE 1980, Current Technical Issues: Electric Cooperatives and Cooperative Telephone Companies Described in I.R.C. 501(c)(12).

In applying the member income test, each item of income is classified as member income, nonmember income, or excluded income. Before applying the member income test on an item of receipt, it must first be considered income.

A. Gross Receipts and Gross Income

I.R.C. 501(c)(12) and the regulations do not define income. Rev. Rul. 74-362, 1974-2 C.B. 170, states that the term means "gross income" for purposes of the 85 percent member income test. Rev. Rul., 80-86, 1980-1 C.B. 118, defined "gross income" as gross receipts less cost of goods sold, trade discounts, allowances of goods sold, and refunds on returned goods. Thus, it held an I.R.C. 501(c)(12) electric cooperative that used natural gas to power its generators need not include income from its sales, at cost, of excess natural gas. *See* Topic D, 1994 CPE, Current Issues Affecting Certain Cooperatives and Like Organizations Described Under I.R.C. 501(c)(12), which discusses gross receipts versus gross income.

B. Non-Income Items

Many I.R.C. 501(c)(12) cooperatives receive grants from state or federal agencies. A government grant is treated as a contribution to capital, which under I.R.C. 118(a) is not income, if it meets the following conditions from Rev. Rul. 93-16, 1993-1 C.B. 26:

- The grant must become a permanent part of working capital;
- The grant must not be compensation for specific quantifiable services;
- The use of the grant is subject to conditions imposed by the grantee;
- The grant must benefit the corporation commensurate with its value; and
- The grant must ordinarily be employed to generate additional income.

The member income test does not apply if the grant meets these conditions. All facts and circumstances must be examined to determine if a particular grant satisfies these conditions.

C. Member Income and Nonmember Income

The member income requirement has two prongs. First, it must be collected from the cooperative's members. Second, it must be paid for services described in I.R.C. 501(c)(12). This two-pronged analysis comes from I.R.C. 501(c)(12)(A), which requires that member income be collected to meet losses and expenses from I.R.C. 501(c)(12) activities. For example, commercial bank X is a member of telephone cooperative Y. X, like all other members, pays Y for telephone services in an amount proportional to the services it uses. Y also deposits its reserves in interest-bearing accounts at X. Under the two-prong analysis, X's payments for telephone services are member income for the 85

percent member income test but the interest payments are not. Although X is a member of Y, it does not pay the interest for services described in I.R.C. 501(c)(12).

Non-member income is income, for example, interest, from nonmember sources. Rev. Rul. 65-174, 1965-2 C.B. 169, held rental income is non-member income, and Rev. Rul. 65-99, 1965-1 C.B. 242, held income from installment sales of assets is non-member income. Non-member income also includes income from patrons who are not members of the cooperative. For example, a telephone cooperative may provide telecommunication services to both members and nonmembers. The income from members is member source but the income from nonmember patrons is not. If nonmember patronage income exceeds 15 percent in a tax year, the telephone cooperative would lose exemption for that year.

D. Excluded Income

An I.R.C. 501(c)(12) cooperative can exclude certain kinds of income from the member income test computation.

(1) Qualified Pole Rentals

Many I.R.C. 501(c)(12) electric and telephone cooperatives rent their electric or telephone poles. For example, an electric cooperative may allow a telephone or a cable television company to use its poles in return for rent. I.R.C. 501(c)(12)(B)(i) and (C)(i) specifically exclude "qualified pole rental income" from the member income test computation. What are qualified pole rentals? For purposes of I.R.C. 501(c)(12), they are poles or pole structures that:

- Support one or more wires used by the electric or telephone cooperative to provide electrical or telephone service; and
- Are rented to support wires used to provide electrical, telephone, or other communication services.

(2) Billing and Collection Services of Telephone Cooperatives

I.R.C. 501(c)(12)(B)(i) states that income from "communication services" to members is excluded from the 85 percent member income test. Many I.R.C. 501(c)(12) telephone cooperatives administer billing and collection of fees for nonmember long distance carriers that provide long distance telephone service to their members. In Notice 92-33, 1992-30 I.R.B. 15, the Service announced that billing and collection services are nonmember income and must be included in computing the member income test. For background information, *see* Topic E, CPE 1994 at p. 40.

In Golden Belt Telephone Cooperative v. Commissioner, 108 T.C. 198 (1997), the Tax Court held billing and collection are communication services, because the Federal Communication Commission had interpreted that phrase to include them. The Service, in an Action on Decision, 1998-18 I.R.B. 4, acquiesced in the result but disagreed with the court's reasoning. The Service reasoned that billing and collection are communication services excluded under I.R.C. 501(c)(12)(B)(i) because they are a step in completing long-distance telephone calls for members.

(3) Income Derived from Directory Listings

Many I.R.C. 501(c)(12) telephone cooperatives sell display space in the telephone directories furnished to their members. I.R.C. 501(c)(12)(B)(iii) excludes this income from the 85 percent member income test.

E. Current Issues in Applying the 85 Percent Member Income Test

(1) Income from Prepayment of Rural Utilities Service Loans

Many I.R.C. 501(c)(12) electric and telephone cooperatives financed their capital improvements or expansion by borrowing funds from the federal Rural Utilities Service (RUS, formerly Rural Electrification Administration). RUS loans could be retired at a discount if they were paid before the end of the loan period.

Under I.R.C. 61(a)(12), income includes prepayment of indebtedness at less than face value. The difference between the discounted amount and face value of an RUS loan would be nonmember income for purposes of I.R.C. 501(c)(12)(A). I.R.C. 501(c)(12)(B)(iv) and (C)(ii) excluded this income in computing the 85 percent member income test, but only for RUS loans repaid after 1986 but before 1990. Section 6203 of the Technical and Miscellaneous Revenue Act of 1988. Topic K, CPE 1989, Recent Legislation, Part II, Technical and Miscellaneous Revenue Act of 1988 (TAMRA), section 5., at p. 157 provides background information on this legislation. Therefore, I.R.C. 501(c)(12) cooperatives must treat any discount realized from partial or complete prepayment of RUS loans made after December 31, 1989, as nonmember income in computing the 85 percent member income test.

(2) Redemption of Accounts at Discount

As discussed in section 8C of this article, many cooperatives want to redeem capital credit accounts at a discount. The cooperative pays a portion of the account to the member-patron and credits the difference between the amount paid and the account's face value to an equity account in the name of that member or former member. The discounted amount of a particular patronage account is not a patronage savings or dividend because it is not paid by the amount of business done with the member-patron.

This raises the issue whether the difference between the stated value and the discounted amount paid on a patronage account is income the I.R.C. 501(c)(12) cooperative must include in computing the 85 percent member income test.

The Service position is that a taxable cooperative realizes income by redeeming capital accounts at a discount because of the tax benefit the cooperative receives in the discounted redemption. The tax benefit rule provides that a recovered item (for example, a deduction) that produced an income tax benefit in a prior year must be included in income in the year it is recovered. (The recovered item may be excluded from income if its initial use as a deduction did not produce tax savings.) The tax benefit rule corrects the inequity that results if subsequent events show a deduction taken in a prior year could not have been taken if all relevant facts had been known at that time. *See* United States v. Bliss Dairy, Inc., 460 U.S. 370, 383-384 (1983).

An I.R.C. 501(c)(12) cooperative will not usually receive a tax benefit by redeeming capital. If a cooperative maintains its exempt status in each year and has no unrelated business income, then it takes no deductions. Therefore, it has no tax benefit to recapture in a subsequent year. As the tax benefit rule is the basis for recognizing income from discounted capital redemptions, there is no income if there was no tax benefit. As there is no income, these redemptions are ignored for purposes of the 85 percent member income test.

(3) Aggregating Gross Receipts of I.R.C. 501(c)(12) Cooperatives and Their Subsidiaries

I.R.C. 501(c)(12) cooperatives engage in many different business activities through subsidiaries. First, a subsidiary may provide the parent's members I.R.C. 501(c)(12) services that the parent does not itself provide. Second, a subsidiary may carry on business with nonmembers on a non-cooperative basis. Third, a subsidiary may conduct business activities unrelated to the parent's exempt purposes. A non-cooperative subsidiary does not adversely affect an I.R.C. 501(c)(12) cooperative's exempt status if the additional services are described in I.R.C. 501(c)(12) (for example, electric or communication services) and the cooperative continues to meet the 85 percent member income test. However, the second and third uses may jeopardize the parent's exempt status (see section 11, below, on unrelated business activity).

Parent-subsidiary activities raise the issue whether a subsidiary's gross income should be combined with its parent's to compute the 85 percent member income test. The Service and the Department of Treasury are studying this issue, which is an item on the 2001 IRS-Treasury Business Plan. The issue was raised in TAM 1999908038, which considered an I.R.C. 501(c)(12) telephone cooperative that owned and controlled a cable television subsidiary that was not a cooperative. The cable subsidiary served a geographic area larger than the area the parent telephone cooperative served. As a result,

some subsidiary customers were not members of the parent. However, neither the parent nor its subsidiary could identify which subsidiary customers were or were not members of the parent, or what part of the subsidiary's gross income was derived from members or nonmembers of the parent.

TAM 1999908038, relying on Rev. Rul 60-575, 1967-2 C.B. 134 (concerning an I.R.C. 521 farmers' cooperative), concluded that the cooperative and its subsidiary must combine their gross income calculate the 85 percent member income test. As a result, the parent derived less than 85 percent of its income from members and was not exempt in the year in question. However, as of this writing, this issue has not been finally resolved, as formal guidance has not been issued.

11. Interrelationship Among Unrelated Business Activity, the Activities Test and the 85 Percent Member Income Test

A. Unrelated Business Activities and the Activities Test

Most I.R.C. 501(c)(12) cooperatives only conduct activities described in I.R.C. 501(c)(12). For example, a telephone cooperative may only provide telephone or other "like" services, or an I.R.C. 501(c)(12) electric cooperative may provide only electricity. However, some I.R.C. 501(c)(12) cooperatives provide both I.R.C. 501(c)(12) services and services not described in I.R.C. 501(c)(12). For example, an I.R.C. 501(c)(12) electric cooperative may also sell and service electric appliances. This raises issues of both exemption and unrelated business income tax (UBIT). The activities test, UBIT test, and the 85 percent member income test must be applied separately to the activities or income of the I.R.C. 501(c)(12) cooperative.

(1) Exemption

As described in section 9, above, an I.R.C. 501(c)(12) cooperative must conduct activities described in I.R.C. 501(c)(12) to qualify for and maintain exemption. I.R.C. 511(a)(2) provides that organizations described in I.R.C. 501(c), including I.R.C. 501(c)(12) organizations, are subject to UBIT. Therefore, an I.R.C. 501(c)(12) organization can conduct some unrelated activities, but may jeopardize its exempt status by conducting more than an insubstantial amount of unrelated (or non-I.R.C. 501(c)(12)) activities. Whether a particular activity is more than insubstantial is factual. For example, factors to consider in determining if an electric cooperative's appliance sales were are more than insubstantial would include whether the gross income from appliance sales and service is insignificant compared to the gross income from providing electricity; and whether the resources, personnel, and time devoted to appliance sales and service are insignificant compared to resources devoted to distributing electricity. These factors are not exclusive or exhaustive.

An I.R.C. 501(c)(12) cooperative with substantial non-I.R.C. 501(c)(12) activities can still avoid jeopardizing its exempt status by showing that its non-I.R.C. 501(c)(12) activities are incident to, and further its I.R.C. 501(c)(12) services. This determination is also factual. Factors to consider in the electric cooperative example discussed earlier might include whether the appliance sales and service are provided only to members; and whether this activity is usual for electric utilities.

These standards apply to the issue of exemption I.R.C. 501(c)(12). Even if an activity does not affect exemption, it may still be subject to UBIT under I.R.C. 511, as discussed in the next subsection.

(2) UBIT Issue

I.R.C. 511 imposes a tax on the unrelated business taxable income of most I.R.C. 501(c) organizations, including I.R.C. 501(c)(12) cooperatives. I.R.C. 512(a)(1) provides that unrelated business taxable income is the gross income derived by any organization described in I.R.C. 501(c) from any unrelated trade or business regularly carried on. The criteria to determine whether an activity is an unrelated business are in I.R.C. 511 and seq., not I.R.C. 501(c)(12). These criteria are whether the activity is a trade or business; whether it is regularly carried on; and whether it is unrelated within the meaning of I.R.C. 513. This last criterion is determined by standards in section 1.513-1(d)(1) of the regulations.

B. Unrelated Business Activity and the 85 Percent Member Income Test

As described in section 10 of this article, an I.R.C. 501(c)(12) cooperative must receive 85 percent of or more of its income from members. So, each item of income, whether from an I.R.C. 501(c)(12) activity or an unrelated activity, must be included in computing the 85 percent member income test.

The following examples illustrate this interrelationship. X is an electric cooperative exempt under I.R.C. 501(c)(12). It provides electricity to its members, but also operates a bar exclusively for members. If the bar activity, which is obviously unrelated, is not substantial, it will not jeopardize X's exempt status. But, the income from the bar is subject to UBIT because it is a regularly carried on business activity that is not substantially related to X's exempt purpose. The cooperative must also include the bar income as nonmember in computing the 85 percent member income test, as it was not derived from services described in I.R.C. 501(c)(12) (see subsection 10C, above, for a discussion of member income). If the bar income exceeds 15 percent in a tax year, X would lose its I.R.C. 501(c)(12) exempt status for that tax year.

Unrelated taxable income is usually nonmember income for purposes of the 85 percent member income test. Nonmember income, however, is not necessarily subject to

UBIT. In the example described in section 10C, the interest income the I.R.C. 501(c)(12) telephone cooperative received from the bank, a member of the cooperative, though not member income for purposes of the 85 percent member income test, would not be subject to UBIT because of the exception to UBIT for interest income.