AHC COOPERATIVE TAXATION BRIEF

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Supporting Mutual Ditch and Irrigation Companies is Insufficient for Section 501(c)(12) Exemption

The Service recently denied exemption to an organization that sought exemption under Section 501(c)(12) as a mutual ditch and irrigation company. The organization failed to satisfy several requirements for exemption under Section 501(c)(12). The ruling provided an insight into the various requirements for exemption as mutual companies and how these requirements differ from those applicable to electric and telephone cooperatives.

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Background

The organization is a supporting organization for mutual ditch and irrigation companies. It holds an annual conference and workshop to increase awareness of dam and canal safety, construction, and technology. It also publishes newsletters, conducts focus groups, and intends to perform lobbying activities concerning issues and topics relevant to mutual ditch and irrigation companies.

Exemption Requirements

After reviewing the fundamental requirements for exemption under Section 501(c)(12), the Service determined that the organization failed to satisfy several of the requirements. The requirements for exemption include (i) the Organizational and Operational Test, (ii) the Activities Test, and (iii) the Member Income Test.

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Under the first test, the applicant is required to be organized and operate as a cooperative or mutual company. This includes implementing the cooperative principles set forth in federal tax case law, plus those regulatory requirements explicitly identified by the Service. The regulatory requirements include:

- Determining rights and interest of members in proportion to patronage;
- Retaining only a reasonable amount of reserves;
- Adequate recordkeeping;
- No forfeiture of members' dissolution or termination rights; and
- Appropriate allocation of dissolution gains.

The Service noted that, with respect to mutual ditch and irrigation companies, only some of the regulatory requirements will apply. In a prior revenue ruling, the Service pronounced that a mutual company qualified for exemption under Section 501(c)(12) even though it did not satisfy all regulatory requirements. It allowed two key exceptions for the mutual company at issue: (i) if a member failed to pay an assessment, the company could place and foreclose on a lien on the member's stock and cause forfeiture of that member's interest; and (ii) upon dissolution, only current members would receive distribution of the company's dissolution gains.

These exceptions appeared to be significantly limited by the particular facts of that ruling. The mutual company at issue was formed before enactment of the earliest tax legislation pertaining to mutual ditch and irrigation companies. And the company operated in accordance with state law governing such companies, but it failed to satisfy the two regulatory requirements noted above.

In the recent exemption ruling, the Service continued to uphold the two regulatory exceptions for mutual companies. It explicitly stated, "You would be relieved of the need to meet the last two [regulatory requirements] if you were a mutual ditch company operating in the traditional manner consistent with the provisions of [State] law."

Despite Regulatory Exceptions, Exemption Still Denied

Unfortunately for the organization, it was not operated in the traditional manner of mutual companies. In fact, it did not satisfy any of the case law or regulatory requirements. Among other things, it was not operated on a mutual or cooperative basis; its members' interests were not determined by patronage; there were no provisions requiring return of net margins; dissolution gains were to be distributed to certain other organizations and not to members; and it could not show how the Member Income Test would be satisfied.

Perhaps most obviously, it did not perform activities of a mutual ditch and irrigation company. While it provided certain support services to such companies, it did not perform ditch and irrigation services itself. Such indirect exemption has been denied before and was denied in this exemption ruling.

Based on the numerous failures to satisfy basic cooperative and mutual company principles, along with long-standing regulatory requirements, the Service denied exemption under Section 501(c)(12).

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