<u>COOPERATIVE TAXATION BRIEF</u>

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Federated Telecommunications Cooperative Denied Exemption

The IRS has rejected an organization's application for exemption under Section 501(c)(12), even though the organization was organized under a state's cooperative statute and provided services to telecommunications cooperatives. The ruling demonstrates that organizations must carefully review all requirements for exemption – statutory, common law, case law, and regulatory.

<u>Factual Background</u>

The organization ("Organization") was organized under a state's telephone cooperative statute. Organization provided gateway and policy-control services to its members, all of which provided telecommunication services to the public ("Members"). Organization's gateway service provides Members with access to the worldwide 4G broadband network. Organization's policy-control service ensured that Members' customers received the fastest possible connect times and the highest possible quality.

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Members may qualify for one or more of four classes of membership: Founding Members, Charter Members, Full Members, and Associate Members. Only Full Members had the right to vote. Only Founding Members get to vote on or appoint directors, but Full Members may remove directors by a majority vote. In addition, upon termination of membership, Members release their right to Organization's property and assets.

Failure to Qualify For Tax-Exemption Under Section 501(c)(12)

The IRS denied tax exemption to Organization on the following bases:

- Organization did not operate as a cooperative because it did not satisfy the subordination-of-capital principle.
- Organization did not perform "like" activities.
- Organization failed the Member Income Test because its Members did not qualify as "members" for purposes of Section 501(c)(12).

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Subordination of Capital

Subordination of capital means that a cooperative must vest the members with the power to elect or appoint directors. Organization's bylaws vested the power to elect or appoint directors solely in Founding Members. Founding Members, Charter Members, Full Members, and Associate Members had no right to vote or appoint directors.

The IRS also noted that, upon termination of membership, Members forfeit their rights of membership.

Activities Test

To qualify under Section 501(c)(12), an organization must perform activities like "mutual or cooperative telephone companies." The IRS recognized that telephone cooperatives which provide broadband service to customers qualify as "like" organizations. These organizations qualify because they facilitate communication between their members and others.

In contrast, Organization did not facilitate communication between Members and others. Instead, its services facilitated communication between its Members' customers (who are non-members) and others. Accordingly, the IRS found, Organization was not a "like" organization.

This aspect of the IRS's ruling is troublesome. The IRS imposed a standard based on one Revenue Ruling that could cause some federated telecommunications cooperatives difficulty. Federated telecommunications cooperatives are created to assist smaller telecommunications cooperatives in providing services to their member-customers.

Clearly, Organization was providing utility-like services, which historically has been the focus of the Activities Test under Section 501(c)(12). Under the current ruling, the IRS seems to limit the scope of qualifying activities to those not normally provided by federated telecommunications cooperatives.

Member Income Test

As a third basis to deny tax exemption, the IRS ruled that Organization did not satisfy the Member Income Test. While Organization's income was primarily generated from its Members, the IRS ruled that such Members did not qualify as "members" under the Member Income Test. The IRS has previously ruled that to qualify as "members" under the Member Income Test, members must have the right to vote for or appoint directors and vote at membership meetings.

In this ruling, the IRS determined that only Founding Members who are also Full Members had both the right to vote for or appoint directors and the right to vote at membership meetings. Income from other classes of membership did not receive such rights. Accordingly, income from all classes except Founding-Full Members was non-member income for purposes of the Member Income Test. Organization was unable to show that income from Full-Charter Members equaled 85% or more.

Conclusion

The current ruling is mostly consistent with prior rulings. Yet the IRS's rationale concerning the Activities Test may cause some concern among telecommunications cooperatives.

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David is a member of the firm's cooperative and construction practice groups. He started his career as a C.P.A. and auditor for electric cooperatives, electric membership corporations, and energy-related taxable cooperatives. After attending law school, he worked as an international tax consultant at Deloitte Tax LLP until joining Autry, Horton & Cole, LLP. As part of his cooperative law practice, David advises electric, telephone, agricultural, Subchapter T, and other cooperatives on their cooperative tax and corporate questions, power-supply transactions, governance, and various cooperative law issues.

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