Part I

Section 501.--Exemption From Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(c)(12)-1: Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

Rev. Rul. 2002-55

ISSUE

How the 85 percent member income test of § 501(c)(12)(A) of the Internal Revenue Code is applied in the situation described below.

FACTS

A is a corporation formed for the purpose of providing telephone services to members. A operates according to cooperative principles. A is recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(12). Membership in A is available to any person. A's members reside in a certain geographic area of State X. B is a taxable corporation formed for valid business purposes. A owns 100 percent of the stock of B. B does not operate on a cooperative basis. B is not a member of A. B distributes $5x to A as a dividend (as defined in § 301) to A. B files Forms 1120.

In the year in question, A's income is derived as follows: $90x from its members for telephone services, $5x as a dividend received from B, and $5x from interest income earned on A's bank accounts.

LAW

Section 501(c)(12)(A) 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 in any year consists of amounts collected from members for the sole purpose of meeting losses and expenses.

A corporation is a separate taxable entity for federal income tax purposes if the corporation is formed for valid business purposes, and is not a sham, an agency or instrumentality. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Commissioner v. Bollinger, 485 U.S. 340 (1988).

ANALYSIS

An organization seeking exemption under § 501(c)(12) must satisfy two requirements. First, it must be a benevolent life insurance association of a purely local character, mutual ditch or irrigation company, mutual or cooperative telephone company or a like organization. Hence, an organization must conduct activities that are permitted under § 501(c)(12) and must be operated on a cooperative basis.

Second, the organization must receive 85 percent or more of its income in any year from members for the sole purpose of meeting losses and expenses incurred from services provided to members. The 85 percent member income test requires that the income be (1) derived from members and (2) used to pay for services listed in § 501(c)(12). See § 1.501(c)(12)-1(a) of the Income Tax Regulations and Consumers Credit Rural Electric Cooperative Corp. v. Commissioner, 37 T.C. 136 (1961), *aff'd in pertinent part*, 319 F.2d 475 (1963).

In order to maintain tax exemption under § 501(c)(12), the cooperative must compute the 85 percent member income test in each taxable year. The cooperative may fail the 85 percent member income test one year but satisfy the test in a prior year or subsequent year. See Rev. Rul. 65-99, 1965-1 C.B. 242. Hence, the 85 percent member income test requires a cooperative exempt under § 501(c)(12) for any taxable year to combine all sources of income not otherwise excludable under § 501(c)(12)(B) or (C) and calculate whether more than 15 percent of that income is derived from nonmembers. The cooperative is not tax exempt in any taxable year if more than 15 percent of its income is derived from nonmembers. A cooperative has the burden of proof to establish that it satisfies the 85 percent member income test for each taxable year. See also Nonprofits' Insurance Alliance of California v. United States, 32 Fed. Cl. 277 (1994) (income tax exemptions are matters of legislative grace which the courts have consistently strictly construed).

In the situation described, A must establish that not more than 15 percent of its income is derived from nonmember sources for the taxable year in question. Assuming that B is recognized as an entity separate from A for federal income tax purposes under Moline Properties, the income of B is not included for purposes of determining whether A satisfies the 85 percent member income test. However, any payments A received from B are included in the calculation of the 85 percent member income test. Because B is not a member of A, the dividend A receives from B for the year in question is nonmember income for purposes of the 85 percent member income test. Further, even if B were a member of A, the dividend is not member income because it is not payment for the sole purpose of meeting losses and expenses incurred for telephone services provided to B by A.

A's total income for the year in question is $100x, $90x (90 percent) of which is derived from members. $10x (10 percent) of the total income for the year in question is derived from nonmembers, $5x from B and $5x from A's interest bearing bank accounts. A satisfies the 85 percent member income test for the year in question.

HOLDING

A is exempt from federal income tax under § 501(c)(12) for the taxable year in question because more than 85 percent of its income is derived from members.

EFFECTIVE DATE

This revenue ruling is effective for taxable years beginning after December 31, 2002. However, taxpayers may rely on this revenue ruling for prior periods.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Seto, TE/GE Division, Exempt Organizations. For further information regarding this revenue ruling contact Michael Seto on (202) 283-9465 (not a toll-free call).