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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5-PLR-141267-01
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This is in response to a request for rulings dated July 23, 2001, submitted on behalf of Taxpayer by its authorized representative.

The Taxpayer was formed as a corporation under the State A Business Corporation Code in *b* and has operated on a cooperative basis consistent with subchapter T of the Code since that time. The Taxpayer develops software for its Shareholder/Members - rural electric cooperatives (more commonly referred to as electric membership corporations or "EMCs"). The software assists the EMC-members in (a) tracking and billing the sale and use of electricity and other goods and services provided to customers by the EMCs; (b) operating distribution systems, and (c) managing the Members' maintenance and service activities. The Taxpayer also may invest in or enter into joint ventures with other companies to develop for, and/or market software to, EMCs. Although the Taxpayer may sell goods and services to patrons who are not members, it is anticipated that revenues from non-member patrons will always remain well below 50 percent of all revenues.

The Taxpayer currently has 161 Members in 26 states. The EMC Shareholder/Members themselves have from 3,000 to 125,000 customers each (more than 3.5 million total). At present, democratic control is effected by having each Shareholder/Member nominate one Director and one alternate Director (i.e., 161 of each), with the alternate substituting for the respective Director when necessary. Both the Directors and the Shareholder/Members meet on an annual basis. An Executive Committee of the Board of Directors, consisting of nine Directors elected by the Shareholder/Members, meets several times annually.

Due to the geographic dispersal of Members, attendance at the annual meetings of Shareholder/Members and Directors has generally been around 35% in recent years. (The latter meet immediately after the former, so the same representative attends both meetings. A minimum quorum of one-third is required by State A. Attendance is much higher from EMCs located in relative proximity to the Taxpayer's headquarters, where Member and Director meetings generally are held. As the Taxpayer continues to grow, it is expected that the participation of the more geographically-distant Shareholder/Members and Directors in the governance of the Taxpayer may become even more unbalanced, concentrating effective control more and more in the hands of those Shareholder/Members better able to attend meetings - unless regional representation is permitted and encouraged and/or methods of voting that do not require attendance at meetings are permitted.

In order to encourage better regional representation of Shareholder/Members in the establishment of the cooperative's policies, while increasing the efficiency of the Shareholder's Board of Directors, the Shareholder/Members propose reducing the Taxpayer's current Board from one hundred sixty-one (161) to nine (9) Directors. The goal is to have one Director represent each of the 9 regions into which the Shareholder/Members will be divided. Regions are based on state boundaries. Continuity on the Board would be encouraged by implementing staggered three-year terms for Directors. The current Executive Committee of the Board of Directors would be eliminated.

The Shareholder/Members' preferred method for electing Directors is to have one Director elected solely by the Members in each of the 9 regions, pursuant to procedures established by the Board. Initially, the number of Members in each region will range from 15 to 24. Interim vacancies on the Board would be filled by a special election held by the Members in the region the former Director represented, with such electee to serve until the next annual election of Directors, at which time the remaining or new term of that directorship would be filled as provided above.

Any Director could be removed by a majority vote of the Shareholder/Members in the region that the Director represents, but such removal could be over-ridden by a majority vote of all Shareholder/Members.

It is also proposed that Shareholder/Members be permitted to vote on all matters presented to a vote of Shareholder/Members by written consent (ballot) in lieu of a meeting, as well as by proxy. The purpose of both procedures is to encourage more wide-spread participation of the membership in voting on matters submitted to Shareholder/Members. Proxy voting in cooperatives has previously been approved by the Service. Rev. Rul. 75-97, 1975-1 C.B. 167. Shareholder voting by written consent (i.e., by ballot) is permitted under State A, and unanimous written consent is not required, if so provided in the corporation's articles. The statute provides that the number of ballots cast in favor of a motion be "not less than the minimum ... necessary to authorize or take the action at a meeting at which all shareholders entitled to vote were present and voted."

In summary, the Taxpayer's Shareholder/Members would like to reduce their Board of Directors to 9 Members, have the option of electing Directors by regions; and have an alternative to face-to-face meetings. All three proposals have been approved by the Taxpayer's Executive Committee, but have not yet been submitted to shareholder approval.

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), acq., 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: (1) subordination of capital; (2) democratic control by the members; and, (3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor. (See also I. Packel, The Organization and Operation of Cooperatives, 107-107 (4th Ed. 1970); Frost v. Corporation Commission, 278 T.C. 515 (1929)). It is the principle of democratic control that is in issue herein.

The principal of democratic control envisions an organization "organized according to a model of a widely-based participatory democracy in which all of the members are able to exercise a franchise of equal strength." Etter Grain Co., 72-1 USTC ¶9465. Each member must have a single vote regardless of the size of its investment or the amount of business it does with the cooperative. Democratic control should depend on the control that the shareholder/members of a cooperative actually exercise. However, if, as is presently the case with the Taxpayer, actual shareholder/member voting is weighted toward a few geographic groups, the shareholder/members (and their constituent cooperative members) do not each "exercise a franchise of equal strength".

As discussed above, the Taxpayer's Articles and Bylaws provide that each Member shall be entitled to one, and only one, vote, and both the Bylaws and Articles of Incorporation contain general provisions mandating that the organization operate on a cooperative basis. However, in order to reduce the Board to a more efficient size, and yet ensure that the Shareholder/Members from certain geographic regions do not exercise dominant control by being better able to participate in meetings of Directors and Shareholder/Members, the Taxpayer proposes the following:

a. to reduce the Taxpayer's Board of Directors to 9 Directors.

b. to provide for the election of one Director by each region; and

c. to both permit voting on any matter submitted to a Shareholder/Member vote by ballots in lieu of a meeting, in addition to permitting proxy voting at meetings.

The Taxpayer proposes dividing Shareholder/Members into nine (9) geographical regions. The Board would consist of 9 members and be divided in three classes, with three Directors elected each year for three-year terms (after a two-year transition period). The primary officers of the Taxpayer would be elected by the Board. The Board and the management of the Taxpayer must present all

Shareholder/Members with a detailed statement of operations at least annually. Therefore, all Shareholder/Members are kept informed of the Taxpayer's operations.

State A law provides that the articles or bylaws may prescribe qualifications for directors. Taxpayer's Bylaws provide that Directors must be:

> an employee or director of a rural electric membership corporation organized under an electric membership corporation act or comparable act of the respective state of organization, a general cooperative, act, or pursuant to general corporation laws but operated as a cooperative.

In State A, vacancies on boards of directors may be filled by the shareholders, the directors, or as set forth in the articles or bylaws.

As provided in the Taxpayer's Articles, the Taxpayer proposes that its Board of Directors be reduced to 9 Members. At present each of the 161 Shareholder/Members appoints one Director and one alternative Director. However, due to the geographical disbursal of the Shareholder/Members, those closest to the Taxpayer's headquarters, where board and Shareholder/Member meetings are held, have much higher attendance and, as a consequence, a greater and disproportionate voice in and control over the Taxpayer's business affairs. By implementing the election of Directors by regions, the 9 Directors would effect a more equal regional representation on the Board, and would provide a body that is much more efficient in discussing and implementing policies for the Taxpayer's business operations, than has been the case with a board of more than 150 directors.

The articles of incorporation of a State A corporation may authorize the election of all or a specified number of directors by the holders of one or more authorized classes of shares or series. Therefore, voting for directors by regions is legal in State A. The Taxpayer's Articles provide that shareholders be divided into 9 regions, and each Director would be elected only by the Shareholder/Members in the region that the Director represents. Within each voting group, Directors must be elected by a plurality of the votes cast, with a quorum of at least half of the votes in each case (i.e., each region). The proposed regional voting would require greater Member participation in the election of Directors, with at least half of the Members participating. Presently, one-third of the entire membership constitutes a quorum for the election of Directors.

Election of Directors by regions would assure greater regional diversity on the Taxpayer's Board - not favoring Shareholder/Members from particular geographic regions. Since Members wold be more universally represented, democratic control would be maintained – and even enhanced. Each Shareholder/Member in each region would have one non-weighted vote, for the election of a Director from that region.

In applying the principles of democratic control to a federated cooperative, it is appropriate to consider that the ultimate beneficiaries of the federated cooperative are the members of the member cooperatives. Providing for equal regional representation of Shareholder/Members would be consistent with democratic control, both for the Taxpayer's Shareholder/Members, and for their constituent members.

Notwithstanding any provisions of a corporation's articles or bylaws, under State A law, certain actions may only be taken by a majority vote of all the shareholders. These include (i) approving a director's conflicting interest transaction (a transaction in which a director or a related party would have a beneficial interest); (ii) amendment of a corporation's Articles of incorporation, in which case each amendment must be proposed by the board, with all shareholders voting on the proposal, although certain minor amendments to the Articles may be undertaken by the Board alone, (iii) approval of a plan of merger, again after proposal by the board, (iv) the sale of all or substantially all of a corporation's assets and (v) the corporation's voluntary dissolution . All of these shareholder rights would continue after the proposed transactions. Moreover, any amendment of the Taxpayer's Bylaws, if voting is by proxy, would require the affirmative vote of a majority of all shares. Consequently, on matters that would have the most significance on the Taxpayer and its operations, the majority votes of all the Shareholder/Members (not just a plurality) would still be required.

State A law permits voting by proxy. Moreover, State A law permits action to be taken by shareholders without a meeting in two ways: (i) if the action is taken by all the shareholders entitled to vote on the action (i.e., unanimous written consent); or (ii) if so provided in the articles of incorporation, by one or more written consents, provided that written consents are received from a sufficient number of shareholders (members) to constitute a quorum, and the requisite majority of the written consents are in favor of the action (i.e., at least a quorum votes by written ballot, and a majority of those voting approve the action). The shareholders (members) must be provided with whatever material they would be provided at an actual meeting, and the written consent must be received within a 60-day window, from first to last received, to be valid, during which 60 days, any written consent may be withdrawn. Voting by consent has the same legal effect as voting at a meeting. If action is taken by fewer than all shareholders (i.e., the decision is not unanimous), notice of the action taken must be provided to the remaining shareholders within ten (10) days of the final vote.

Currently, one-third of the shareholder-members (excluding proxies) constitute a quorum for a meeting of the Taxpayer's Shareholder/Members, the minimum required pursuant to State A law. However, the Taxpayer's Bylaws may only be amended (i) by a majority vote of shareholders represented at any meeting held with proper notice at which a quorum is present, or (ii) by not less than a majority of the entire membership if proxy voting is used. However, either the Shareholder/Members or the Board have authority to change any bylaw in conflict with applicable law.

Thus, with balloting, a quorum would still be required, as would individual voting (one member, one vote). The 60-day window, between the receipt of the first and last ballots, would provide ample opportunity for the Shareholder/Members to contemplate and discuss any proposed action, and to submit their votes in an orderly manner.

In Rev. Rul. 75-97 the Service stated that proxy voting is consistent with democratic control in a cooperative. The U.S. Tax Court has ruled that "[t]he fact that petitioner's shareholders may vote by proxy is akin to voting by absentee ballot" and was held to be not inconsistent with democratic control by those shareholders. Thwaites Terrace House Owners Corp. v. Commissioner, T.C. Memo. 1996-406 (1996). If voting by proxy is not inconsistent with democratic control, then voting by ballot, which is "akin" to voting by proxy, should not be inconsistent with democratic control as well.

Voting by ballot is at least as democratic as voting by proxy, as each Shareholder/Member would cast its own vote, rather than relying on the actions of its representative. Moreover, the Taxpayer's Shareholder/Members would have 60 days during which to discuss proposed actions and alternatives among themselves. Votes could be changed during the 60-day window. Finally, Shareholder/Members may be more likely to return a ballot than to have a direct representative or the holder of a proxy attend a face-to-face meeting, held at a geographic distance.

Voting by ballot would encourage greater participation by the Shareholder/Members in the Taxpayer's affairs. While currently a majority (more than half) of a quorum of 1/3 (i.e., one vote more than 1/6 of the Taxpayer's total membership) can make shareholder decisions at a meeting, balloting would likely result in much greater participation in the democratic process, as physical attendance at meetings would no longer be necessary. Communications have changed greatly since the days of the Rochdale Cooperative discussed in Puget Sound (and even since the decisions in Puget Sound and Etter Grain), including the widespread use of telephone conferencing, faxes and e-mails. Face-to-face meetings are no longer necessary for effective democracy. Since State A law requires a 60-day period between when the first and last ballots are counted, balloting likely would encourage both greater discussion of proposed actions among Shareholder/Members and greater participation by the Shareholder/Members in each decision, than are the cases with meetings lasting an hour or so at a location that may not be convenient for many Members and their representatives.

In summary, having face-to-face meetings should not be a requirement of democratic control for a cooperative in this modern age, with geographically-dispersed shareholders and widespread communication networks. Voting by written ballots, no less than voting by proxy, preserves, and may actually enhance, democratic control and is consistent with Code Subchapter T. In the spirit of Etter Grain, balloting would likely result in the Taxpayer's Shareholder/Members exercising franchises of more equal strength.

Accordingly, base solely on the foregoing we rule that:

1. Reducing the Taxpayer's Board from 161 Directors to 9 elected Directors is consistent with the cooperative operating under democratic control within the meaning of subchapter T.

2. The election of one Director by the Shareholder/Members in each of 9 regions is consistent with the cooperative operating under democratic control within the meaning of subchapter T.

3. Voting on all matters presented to the membership by written ballots in lieu of a meeting is consistent with the cooperative operating under democratic control within the meaning of subchapter T.

This ruling is directed only to the taxpayer who requested it. Pursuant to section 6110(k) of the Code, it may not be used or cited as precedent.

Sincerely yours,
Walter Woo
Senior Technician Reviewer
Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

cc: