

C&A COOPERATIVE TAXATION BRIEF

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Discounted Capital Credits and the Member Income Test: The Creation of a New Equity Account

Cooperatives have been given conflicting guidance from the IRS concerning the proper treatment of discounting of capital credits. Specifically, some pronouncements indicate that the discount (i.e., the difference between face value and present value) should be treated as non-member income under Section 501(c)(12), while others state it is not gross income at all. These widely differing results put cooperatives in a difficult position in deciding whether to implement a discounting program.

In a private letter ruling issued earlier this month, the IRS ruled that a telephone cooperative's discounting program did not generate gross income. The ruling is significant because, otherwise, the income could potentially be classified as non-member income. An unexpected increase in non-member income could cause a cooperative to fail the Member Income Test, rendering the cooperative as a taxable entity.

Background

The cooperative at issue provide telephone services to members on a cooperative basis. It complies with Section 501(c)(12) in all respects, including the three traditional cooperative principles. It previously allocated excess margins on a 25-year cycle, on hybrid basis consisting of FIFO and LIFO.

To strengthen its balance sheet, the cooperative sought to implement a discounting program. The program would accelerate the retirement of capital credits by discounting them to present value, calculated using the Wall Street Journal Prime Interest Rate plus 2 percent. Members would receive the discounted value in the



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form of cash payments. Unlike many programs, this program is not voluntary to members.

Another key factor is that the discount will be transferred to a special equity account in the name of the members. These equity accounts would not earn any rate of return or entitle the members to additional voting rights. Unlike the traditional capital credit accounts, these equity accounts would be payable only upon liquidation or dissolution of the cooperative.

While the ruling indicates "members retain a continuing property right" in the new equity account, it does not give more guidance on which members retain such rights. Though it is not clear from the ruling, presumably, the member whose capital credits are discounted would retain an interest in the discount. (This would be consistent with prior rulings.)

The Ruling

The IRS ruled that the discounting program designed by the cooperative (i) would not violate cooperatives principles and (ii) would not result in gross income to the cooperative.

In support of its ruling, the IRS analogized the proposed transaction to the capitalization of a stock corporation. Generally, taxable corporations do not recognize gain or loss when they issue stock in exchange for money or property. This corporate capitalization is similar to the transaction proposed by the cooperative in that members effectively contribute the discount, which they would otherwise be entitled to at some point in the future, in exchange for the new equity interest. The IRS believed that after the transaction, "nothing has changed -- the separate [equity] accounts are simply an organizational tool."



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Implication

The ruling is important because most prior guidance from the IRS was either conflicting or specifically refused to address the issue of the Member Income Test. Though cooperatives cannot rely on private letter rulings, this ruling may provide some level of comfort to those cooperatives which are considering a discount program.

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