23930

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Legislation Needed To Improve Administration Of Tax Exemption Provisions For Electric Cooperatives

Since electric cooperatives were first granted tax exemption in 1924, many of them have grown and changed. IRS has tried to recognize the wide diversity among electric cooperatives when administering tax exemption provisions. However, it has had difficulty doing so because of broad legislation which generally exempts all such cooperatives from paying taxes regardless of differences in their operations and activities, financial condition, size, or mix of consumers served.

GAO recommends administrative changes so that IRS can more effectively enforce existing tax exemption provisions. More importantly, GAO recommends that the Congress, using GAO's suggested alternatives as a guide, adopt a tax treatment which better recognizes the changing operations and present day environment of many electric cooperatives and their continuing need for assistance.

GAO/GGD-83-7
JANUARY 5, 1983

024295

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-207753

To the President of the Senate and the
Speaker of the House of Representatives

, This report discusses the growth and changes that have occurred in some tax-exempt electric cooperatives since they were first granted tax exemption in 1924. It also discusses the difficulty the Internal Revenue Service (IRS) has had in attempting to apply the broad tax exemption provisions of the Internal Revenue Code to differing present day cooperatives.

We made this review as part of our efforts to assess the adequacy and administrability of various tax exemption provisions in today's environment. Electric cooperatives are a major type of nonprofit business organization exempt under Section 501(c)(12) of the Internal Revenue Code.

Copies of the report are being sent to the Director, Office of Management and Budget; the Secretaries of Agriculture, Energy, and the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

LEGISLATION NEEDED TO IMPROVE ADMINISTRATION OF TAX EXEMPTION PROVISIONS FOR ELECTRIC COOPERATIVES

D I G E S T

Because electric cooperatives are exempt from Federal income taxes, GAO wanted to know whether the laws are adequate and whether they are being effectively administered by IRS. GAO found that since electric cooperatives were granted exemption almost 60 years ago, the operations of many cooperatives and the environment in which they do business have changed substantially.

In administering tax exemption, IRS has tried to recognize the changes in electric cooperatives. However, it has had difficulty doing so because of the broad nature of the statute. The law generally exempts all electric cooperatives regardless of differences in their operations and activities, financial condition, size, or mix of consumers served.

IRS needs to make administrative changes to better enforce existing tax exemption provisions. More importantly, the Congress, using alternatives suggested by GAO as a guide, should establish a tax treatment which better recognizes the changing operations and present day environment of many electric cooperatives and their continuing need for assistance.

MANY ELECTRIC COOPERATIVES HAVE CHANGED SUBSTANTIALLY

Originally, most electric cooperatives were small associations which distributed electricity to sparsely populated rural areas. These cooperatives were made exempt from Federal income taxes under section 501(c)(12) of the Internal Revenue Code, which provides exempt status to mutual or cooperative companies deriving their income principally from members.

(GAO/GGD-83-7)

JANUARY 5, 1983

Today, many electric cooperatives serve both rural and suburban areas and closely resemble investor-owned utility companies in their operations and activities. In 1935, only about 30 electric distribution cooperatives existed, the largest of which had 63 miles of line and just 350 members. As of 1981, 920 electric distribution and power supply cooperatives were in operation with an average of 2,020 miles of line and about 10,400 consumers. Moreover, electric cooperatives' total operating revenues grew from $230 million in 1950 to about $7.4 billion in 1981.

Some electric cooperatives have expanded their activities by forming subsidiaries and associations of cooperatives which generate power, provide financing, own and lease coal mining properties and facilities, procure fuel and supplies, and provide ancillary business services. Others have expanded through the acquisition of small investor-owned utilities and interests in jointly-owned power generation plants. (See pp. 9 to 21.)

Another indication of electric cooperative growth is that many cooperatives have been able to accumulate and retain substantial amounts of member equity or patronage capital--about $3.9 billion as of December 31, 1981. A basic cooperative operating principle is that cooperatives should provide service at cost and distribute any margins or savings to members in proportion to their business or patronage. Under this principle the actual refunding of members' patronage capital is a management decision based on an assessment of cooperative operating needs and planned growth. Some cooperatives are using equity management plans to assist in balancing their financial requirements with their need to return members' patronage capital. Others have no such plans or intentions to establish them. (See pp. 34 to 38.)

IRS HAS PROBLEMS ADMINISTERING TAX EXEMPTION PROVISIONS

In administering tax exemption, IRS has tried to consider the changes in electric cooperatives' operations and the environment in which

they do business. It has taken positions on tax exemption issues and has published requirements electric cooperatives must meet to qualify for exempt status. However, IRS has been hampered by the broad legislation which has not changed significantly since the 1920s and, thus, does not reflect differences in many present day cooperatives. (See pp. 42 to 44.)

IRS' compliance program centers on the one specific legislative criteria--the requirement that 85 percent or more of a cooperative's income be collected from members for the sole purpose of meeting losses and expenses. But even this requirement has proven difficult for IRS to administer and for electric cooperatives to comply with. IRS has not provided sufficient guidance for cooperatives to properly compute the member income test. Furthermore, in view of the significant amounts of tax-free nonmember income permitted under law--more than $160 million in 1981--it is questionable whether the 85 percent member income requirement is still the best way to assist small cooperatives. (See pp. 45 to 48.)

To facilitate IRS' administration of tax exemption, GAO recommends that IRS take certain actions, including providing more complete guidance on the computation of the member income test. (See p. 49.)

GAO RECOMMENDS ADOPTION OF A TAX TREATMENT WHICH BETTER RECOGNIZES CHANGES IN SOME ELECTRIC COOPERATIVES

Unlike Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives. Thus, despite changes in the operations and activities of some electric cooperatives, all cooperatives continue to benefit from tax exemption provided they meet the broad statutory requirements of section 501(c)(12) of the Internal Revenue Code.

GAO recommends that the Congress establish a tax treatment to better recognize the changes

in electric cooperatives' operations and activities. To this end, GAO proposes alternatives to the present law which would (1) modify electric cooperatives' nonmember income allowance, or (2) eliminate that allowance, and/or (3) apply tax rules already applicable to other types of cooperatives. GAO emphasizes that these alternatives, which would have an estimated revenue impact ranging from $2 million to $45 million, are by no means all inclusive. Rather, GAO suggests them as a framework for the Congress' consideration. (See pp. 54 to 56.)

AGENCY COMMENTS AND
GAO'S EVALUATION

The National Rural Electric Cooperative Association, IRS, and the Departments of Agriculture and the Treasury comments ranged from general agreement on administrative issues by IRS to total disagreement by NRECA. The Edison Electric Institute was also asked to comment but declined the opportunity. (See Apps. V to VIII.)

NRECA disagreed with GAO's conclusions regarding the changes in the circumstances which initially motivated Federal Government involvement in rural electrification and on the extent to which present day cooperative operations and activities have changed. In contrast, IRS stated that electric cooperatives are much different today. GAO reemphasizes that while the special circumstances and operating environment of some cooperatives may not have changed, those of others have changed substantially. Yet, tax exemption continues to apply across-the-board to all electric cooperatives and does not recognize differences in their operations. (See pp. 31 to 33.)

Agriculture and NRECA contended that the report does not recognize the need for electric cooperatives to retain member equity and that taxing cooperatives could affect their ability to build up equity levels. GAO recognizes that cooperatives need to retain equity capital to become self-sufficient but emphasizes that in accordance with cooperative operating principles, cooperatives are to return to members amounts

accumulated above reasonable business needs. GAO also believes that cooperatives could find equity management plans useful for assuring that a proper balance is achieved between building needed equity and returning patronage capital and suggests that REA encourage the use of such plans. (See pp. 40 and 41.)

GAO also points out that under its proposed alternatives, electric cooperatives generally would be taxed only on their nonmember income and that such taxes should have little impact on electric cooperatives' ability to build equity. Moreover, these tax treatments would better recognize the differences in present day electric cooperatives and would be a step towards more equitable taxation of the Nation's electric consumers. (See pp. 59 and 60.)

NRECA also disagreed with GAO's findings and conclusions concerning the problems and difficulties related to IRS' administration of the tax exemption provisions. In contrast, IRS essentially agreed with GAO in this regard. (See pp. 51 to 53.)

Treasury commented that GAO's proposed alternatives should have included the outright repeal of tax exemption. In this regard, Treasury questioned the need for any type of Federal subsidization of cooperatives and stated that GAO's report should have been expanded to cover all types of assistance to electric cooperatives. GAO points out that while the issues raised by Treasury merit consideration, they were not within the scope of GAO's review. (See pp. 8 and 59.)

Contents

CHAPTER		Page
DIGEST		
1	INTRODUCTION	1
	Electric cooperatives--how and why they began	3
	Tax exemption legislation affecting electric cooperatives	4
	Objectives, scope, and methodology	5
	Agency comments and our evaluation	8
2	OPERATIONS OF MANY ELECTRIC COOPERATIVES HAVE CHANGED SUBSTANTIALLY, BUT TAX EXEMPTION PROVISIONS HAVE NOT	9
	Many electric cooperatives' operations have changed substantially	10
	Rural development has fostered growth and change among electric cooperatives	14
	Electric cooperatives benefit from tax exemption and other Federal assistance	22
	Present day electric cooperatives' operations vary but tax exemption generally applies to all	26
	Conclusions	30
	Agency comments and our evaluation	31
3	MANY TAX-EXEMPT ELECTRIC COOPERATIVES ARE RETAINING SUBSTANTIAL MEMBER EQUITY--ANOTHER SIGN OF GROWTH	34
	Cooperative principles and practices concerning the distribution of year-end margins	34
	Electric cooperatives' have retained substantial patronage capital	35
	Government policies affect the distribution of members' patronage capital	38
	Conclusions	39
	Agency comments and our evaluation	40

		Page
CHAPTER		
4	IRS HAS PROBLEMS ADMINISTERING EXISTING TAX-EXEMPTION PROVISIONS FOR ELECTRIC COOPERATIVES	42
	Lack of specific legislative criteria has made it difficult for IRS to address the changes in electric cooperative activities	42
	IRS' compliance program lacks adequate criteria	45
	Conclusions	48
	Recommendations to the Commissioner of Internal Revenue	49
	Agency comments and our evaluation	49
5	ALTERNATIVES TO THE PRESENT TAX TREATMENT OF ELECTRIC COOPERATIVES WOULD BETTER RECOGNIZE THEIR CHANGING OPERATIONS	54
	Modification of the nonmember income allowance	54
	Elimination of the nonmember income allowance	55
	Application of Subchapter T rules to electric cooperatives	55
	Conclusions	56
	Recommendation to the Congress	57
	Agency comments and our evaluation	57
APPENDIX		
I	Summary of the thinking on cooperative principles by the Rochdale pioneers, selected cooperative students, and the International Cooperative Alliance	62
II	Growth in generating capacity for investor-owned, municipal, and co-operative utilities	63
III	Federal power agency electric sales--fiscal year 1978	64
IV	General Accounting Office Questionnaire for Study of Electric Cooperatives' Operations and Policies With Summary of Cooperatives' Responses	65

APPENDIX		Page
V	Letter dated July 26, 1982, from the National Rural Electric Cooperative Association	70
VI	Letter dated July 27, 1982, from the Commissioner of Internal Revenue	75
VII	Letter dated August 18, 1982, from the Department of the Treasury	82
VIII	Letter dated August 18, 1982, from the Department of Agriculture	92

ABBREVIATIONS

CFC	National Rural Utilities Cooperative Finance Corporation
GAO	General Accounting Office
IOU	investor-owned utility
IRS	Internal Revenue Service
KWH	kilowatt-hour
MWH	megawatt-hour
NRECA	National Rural Electric Cooperative Association
REA	Rural Electrification Administration
TVA	Tennessee Valley Authority

GLOSSARY

Term	Definition
Electric distribution cooperative	A cooperative which sells electricity at the retail level to member consumers.
Embedded interest rate	The average interest rate on long-term debt. That is, the interest paid on long-term debt divided by the average of long-term debt outstanding at beginning and end of year.
Equity management plan	A cooperative plan and/or program to achieve an equity level which allows for refunding patronage capital to members.
Equity-to-assets ratio	A ratio showing the relationship between a business' net worth and its total assets; that is, the proportion of the assets financed through owners' equity as opposed to borrowing.
Margins, net margins, year-end margins	Terms used by cooperatives to describe monies received from members and other operations in excess of costs and expenses. This is comparable to net income of for-profit businesses.
Megawatt-hour	The electrical unit which equals 1,000 kilowatt-hours.
Nonoperating margins	Margins earned from sources other than a cooperative's electric operations. Such margins include interest, dividends, royalties and gains on the sale of assets.

GLOSSARY

Term	Definition
Operating margins	Margins resulting from a cooperative's electric operations, including the sale of electricity to both members and nonmembers and rental of electric property.
Patronage capital, member equity	Terms used to describe margins retained by cooperatives from members. This is comparable to the owners' equity of a for-profit business.
Patronage refund, patronage dividend	Terms used to describe the distribution of annual net margins or net proceeds by cooperatives to members.
Power supply cooperative	An electric cooperative which generates and/or purchases electricity for sale to electric distribution cooperatives and other utilities. Also referred to as generation and transmission or G & T cooperatives.

CHAPTER 1

INTRODUCTION

Tax-exempt organizations have grown and changed since enactment of the tax exemption laws in the early 1900s. Today, these organizations impact on almost every level of social and economic activity in the country. The number and types of organizations seeking tax exemption have steadily increased over the years. Over 800,000 individual entities are exempt from Federal income taxes under section 501(c) of the Internal Revenue Code.

While the operations and activities of tax-exempt organizations have expanded and changed, many of the law's tax exemption provisions have remained virtually unchanged. This has placed increasing demands on the Internal Revenue Service (IRS) to interpret and apply these tax exemption laws to the modern day activities of exempt organizations. Over the years, top officials in the Department of the Treasury and IRS have expressed concerns about administering the tax-exempt provisions. In 1956 the Secretary of the Treasury stated in a letter to the tax committees of the Congress that:

> "The present statutes in the tax-exempt area place insuperable interpretative and administrative burdens on the Internal Revenue Service and create formidable problems for taxpayers and tens of thousands of organizations involved. The problems in this field are obviously involved, complicated, and difficult."

In 1966 the Commissioner of IRS stated in a letter to the President that:

> "The structure and scheme of the exemption statutes are basically unsuitable to a system of income taxation. The principal exemptions are set forth in vague language adopted at a time when corporate tax rates were between 1 and 2 percent. In some cases exemption was granted solely because anticipated revenues from certain organizations were insufficient to make taxation worthwhile. Although tax rates have increased greatly and exempt organizations have changed substantially in size, activities and revenue endeavors, the policy underlying these exemptions has not been reviewed in recent years."

Yet little attention has been given to overseeing IRS' administration of the Internal Revenue Code's exemption provisions or determining whether existing law is adequate and equitable in

view of current conditions. Given the steady growth in the number and types of organizations that have been granted tax-exempt status, we wanted to

--develop current information about the size, characteristics, and activities of various tax-exempt organizations; and

--assess IRS' effectiveness in administering and enforcing the various tax exemption provisions of the Internal Revenue Code.

This report examines how the tax exemption provisions for one type of nonprofit business enterprise--electric cooperatives--are being administered by IRS and discusses changes that have occurred in the operations and activities of electric cooperatives since they were first granted tax exemption. It also suggests alternatives to the present tax treatment of electric cooperatives for the Congress to consider.

This report focuses on issues similar to those addressed in other GAO reports on non-tax-related issues of electric cooperatives and farmers' cooperatives. One such report set forth, among other things, the need for farmers' cooperatives to adopt programs for refunding members' equity (monies received from members and other operations in excess of cooperative costs and expenses) that are fair to current and former members. 1/ Another report concluded that the Rural Electrification Administration (REA) needs to make policy changes to better evaluate rural electric distribution systems' need for subsidized loans. 2/ The report was critical of REA for not doing enough to encourage its borrowers to increase their equity levels so that they could qualify for private financing. A third report examined the policies and procedures followed by REA in guaranteeing and making insured loans to rural electric generation and transmission (power supply) cooperatives. 3/

1/"Family Farmers Need Cooperatives-But Some Issues Need to Be Resolved" (CED-79-106, July 26, 1979).

2/"Rural Electrification Administration Loans to Electric Distribution Systems: Policy Changes Needed" (CED-80-52, May 30, 1980).

3/"Financing Rural Electric Generating Facilities: A Large and Growing Activity" (CED-81-14, November 28, 1980).

ELECTRIC COOPERATIVES--HOW AND WHY THEY BEGAN

Cooperatives are legally and operationally different from for-profit enterprises because they act for, and are owned by, their members, not by an outside group of stockholders.

Cooperatives perform a wide range of business functions and services and can be classified in two major categories: (1) producer or marketing cooperatives, which act on behalf of members to process and market their products, and (2) consumer cooperatives, which purchase goods and supply services for their members.

Electric cooperatives are consumer-type cooperatives which came into being when the vast majority of rural areas were without electricity. In order to bring electricity to sparsely populated areas where it was uneconomical for private utility companies to operate, small associations of farmers formed cooperatives to distribute their own electricity.

Electric cooperatives differ from most other cooperative enterprises because they are quasi-public utilities which provide electricity to all consumers in their designated service areas. Unlike members of marketing and most other types of consumer cooperatives whose participation is voluntary, consumers residing in areas serviced by electric cooperatives generally must receive service from the cooperative or do without electricity.

The first electric cooperative was formed in the United States in 1914. By 1935 at least 30 cooperatives had started distributing electricity in previously unserved rural areas. These cooperatives, however, were able to service only about 11 percent of U.S. farms. The cooperatives were very small and made little progress in meeting the electric needs of the Nation's farmers because of the prohibitive cost of building electrical lines and the lack of financial resources.

The granting of tax-exempt status, discussed below, had little financial impact on electric cooperatives during the early years since what they needed most was start-up capital to build distribution facilities. The needed thrust was provided with the establishment of REA by executive order in 1935 and the enactment of the Rural Electrification Act in 1936. The act authorized REA to make loans for bringing electric service to the rural areas of the country.

With the infusion of capital, the rural electrification program rapidly took hold. By the end of 1936 nearly 100 cooperatives had signed loan agreements with REA. By 1950 nearly 1,000 electric cooperatives and public utility systems had received loans from REA and were providing electricity to more than three

million consumers. As the network of electric distribution cooperatives expanded across the country, they began to form member-owned power supply cooperatives (also referred to as generation and transmission or G & T cooperatives) to purchase bulk power and to build their own generating capability to reduce dependence on outside sources of power. The first power supply cooperative was formed in 1937; today 51 are in operation.

The Rural Electrification Act was amended in 1973 to, among other things, authorize REA to guarantee loans made by non-REA lenders for electric generation and transmission facilities. The REA loan guarantee program presently is the major source of long-term financing for power supply cooperatives. 1/

TAX EXEMPTION LEGISLATION AFFECTING ELECTRIC COOPERATIVES

Electric cooperatives are exempt from Federal income taxation under section 501 of the Internal Revenue Code which authorizes the tax exemption of various nonprofit organizations. Section 501(c)(12) extends exempt status to:

> "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 consists of amounts collected from members for the sole purpose of meeting losses and expenses * * *." (Underscoring added.)

Section 501 (c)(12) originated with the Revenue Act of 1916. That act provided tax-exempt status to, among other organizations, mutual or cooperative companies which derived their income solely from members. At that time corporations were subject to a 2 percent income tax. Although congressional intent for exempting cooperatives and like organizations is vague, the House Committee on Ways and Means report accompanying the 1916 act indicated that the negligible amount of tax that would be collected from these organizations did not justify the expense and annoyance of close administration. Another view, according to one authority on tax exemption, is that the Congress desired to assist small mutual and cooperative associations formed by struggling farmers and businessmen during this precarious economic period. 2/

1/Hereafter, reference to electric cooperatives will include both electric distribution and power supply cooperatives, unless specific identification is needed.

2/James J. McGovern, "The Exemption Provisions of Subchapter F," Tax Lawyer, Vol. 29, No. 3, Spring 1976.

IRS considers electric cooperatives to be "like organizations" within the context of section 501(c)(12). As a group, they represent about 80 percent of section 501(c)(12) organizations in terms of assets and revenues. The first electric cooperative was granted tax-exempt status in 1923 as a result of an administrative ruling by the Bureau of Internal Revenue (now IRS). The Bureau determined that the cooperative, a local mutual association formed to take over a bankrupt light and power company, was a like organization within the meaning of the law.

The Revenue Act of 1924 amended section 501(c)(12) so that only 85 percent, rather than 100 percent, of an organization's income had to be collected from members to be exempt from taxation. The legislative history indicates that the Congress wanted to help smaller companies financially by allowing them to earn some interest on idle funds.

The provisions of section 501(c)(12) relating to electric cooperatives remained basically unchanged from 1924 to 1980. The Tax Reform Act of 1969 imposed an income tax on the unrelated business income of certain exempt organizations, including companies exempt under section 501(c)(12). This tax applies only to income derived by an organization from a trade or business regularly carried on which is not substantially related to that organization's exempt function. Also, the Miscellaneous Revenue Act of 1980 amended the 85 percent member income requirement as it applies to mutual or cooperative electric and telephone companies. These companies, in determining whether they meet the 85 percent member income requirement, may now exclude any income from rental of poles, such as rental payments from cable TV companies and from other utility companies, and from the sale of telephone directory display listings.

IRS' Exempt Organizations Division is responsible for administering section 501 of the Internal Revenue Code. The Director of that Division reports to the Assistant Commissioner for Employee Plans and Exempt Organizations who in turn reports through the Associate Commissioner (Operations) and the Deputy Commissioner to the Commissioner. The Division, through various key IRS district offices which accept applications for tax exemption, determines whether organizations qualify for tax-exempt status and examines returns for compliance with the law.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to examine the characteristics and operations of electric cooperatives and IRS' administration of the tax exemption statutes to determine whether

- --electric cooperative operations and activities have changed since the granting of tax exemption,

--electric cooperatives are organized and operating in a nonprofit cooperative manner, and

--IRS can effectively administer the tax exemption provisions related to electric cooperatives.

To determine the kind and extent of changes that have occurred in electric cooperative operations, we compared past and current operating data for selected cooperatives. Our primary data base consisted of the 916 electric cooperatives holding REA loans as of December 31, 1979. These cooperatives comprised over 90 percent of the electric cooperative universe, and data on their operations is reported and published by REA. We also visited six electric cooperatives in four states to ascertain changes in their operations since they were granted tax exemption.

To determine whether electric cooperatives were organized and operating in a nonprofit manner, we needed criteria to distinguish cooperatives from other types of business entities. We used commonly accepted cooperative principles which embody the essential features of cooperative organization, ownership, and operation. The origin of these principles dates back to the establishment of the first permanent cooperative by the pioneers of Rochdale, England, in 1844. The principles, now commonly referred to as Rochdale principles, provide for

--open membership to all who can use the cooperative's service,

--democratic control with each member having one vote,

--limited return or interest on members' invested capital, and

--operation at cost by returning any net savings or margins to members on the basis of patronage in proportion to their business with the cooperative.

The Rochdale principles are the foundation for present day cooperative principles endorsed by the International Cooperative Alliance, the cooperative community, and scholars and authorities on the subject. (See App. I.)

Using the cooperative principles, we reviewed the financial statements and bylaws of 70 electric distribution cooperatives randomly selected from among 873 receiving loans from REA as of December 31, 1978. We also sent confidential questionnaires to 69 of the 70 cooperatives to solicit detailed information on their policies and practices, particularly with respect to the principle governing the treatment of patronage capital. (One cooperative was not solicited because it recently was included in the sample

of another GAO review.) Appendix IV contains a copy of the questionnaire with a summary of responses to each question. The sample, although representative of a cross section of electric distribution cooperatives, does not give precise estimates for the whole group. The sample was designed to assure that, 95 times out of 100, the percentage of all REA cooperatives having a particular policy would vary from the percentage reported in the sample by no more than 13 percent.

To more fully evaluate electric distribution cooperatives' policies and practices relating to the refunding of patronage capital, we reviewed patronage capital refund data for the electric distribution cooperatives receiving REA loans as of December 31, 1978, and 1979, respectively. We also reviewed IRS technical advice memoranda and recent court decisions concerning the treatment of patronage capital. Finally, we contacted officials at various State power commissions, TVA, REA, the Treasury Department, and IRS to obtain their comments and policies on the treatment of patronage capital.

To determine whether IRS can effectively administer tax exemption laws as they apply to electric cooperatives, we reviewed the policies, procedures, and practices used by IRS, including applicable tax legislation, revenue rulings, technical advice memoranda, and legal decisions. We selected 36 completed IRS compliance examinations of tax-exempt electric cooperatives to evaluate the nature, extent, and effectiveness of IRS' efforts. The examinations had been conducted in seven IRS district offices and covered tax years 1972 to 1977. The 36 completed examinations included 18 cooperatives examined by IRS out of our random sample of 70 electric distribution cooperatives that had received REA loans as of December 31, 1978, and 18 electric cooperatives we selected judgmentally on the basis of such characteristics as substantial nonoperating margins and high commercial and industrial sales. We also reviewed overall statistics on IRS' compliance and revocation efforts affecting tax-exempt electric cooperatives. In addition, we interviewed IRS headquarters officials in Washington, D.C.. and solicited opinions from electric cooperative managers on the effectiveness of IRS' administration of the tax exemption provisions.

Overall, we conducted work at Treasury, IRS, and REA headquarters in Washington, D.C. We visited electric cooperatives in four states, and contacted regulatory agencies in 19 States. We also contacted representatives of TVA, the Edison Electric Institute and the National Tax Equality Association, headquartered in Washington, D.C. We conducted our audit work during the May 1979 to March 1981 timeframe. We subsequently updated statistical information, where possible. Our work was performed in accordance with generally accepted Government auditing standards.

AGENCY COMMENTS AND OUR EVALUATION

The National Rural Electric Cooperative Association (NRECA), IRS, and the Departments of the Treasury and Agriculture commented on a draft of this report. (See Apps. V through VIII.) The Edison Electric Institute was asked to comment, but declined the opportunity.

In an August 18, 1982 letter, the Assistant Secretary of the Treasury (Tax Policy) implied that we had not gone far enough with our work because our list of alternatives did not include repeal of section 501(c)(12). In this regard, Treasury stated that the report did not (1) adequately explore the economic policy justification for Federal government intervention on behalf of electric cooperatives, (2) provide enough detail on the economic characteristics of electric cooperatives to evaluate the magnitude and effectiveness of tax exemption and other forms of Federal assistance, or (3) sufficiently quantify the interrelationship of these assistance programs. Treasury contended that if our review could have been expanded to more fully address these issues, the report's conclusion that remedial legislation is needed in the area of tax exemption could have been strengthened. Treasury further expressed the opinion that if the report could be expanded in this manner, the case for eliminating tax exemption of electric cooperatives, itself stronger than any of our alternatives, would be reinforced.

Although the issues raised by Treasury merit consideration, they were not within the scope of our review. As discussed above, our objectives were to determine whether electric cooperatives have changed since they were granted tax exemption and how effectively IRS is administering the tax exemption laws. To achieve these objectives it was not necessary to develop and use an economic model to evaluate all types of Federal assistance available to electric cooperatives. Rather, we assumed that the Congress originally wanted to help struggling nonprofit electric cooperatives and enacted tax exemption legislation to achieve that end. Similarly, since section 501(c)(12) applies to various mutual and cooperative associations and our work focused just on electric cooperatives, we do not have an adequate basis for incorporating Treasury's suggestion to include as one of our alternatives the repeal of the entire section.

CHAPTER 2

OPERATIONS OF MANY ELECTRIC

COOPERATIVES HAVE CHANGED SUBSTANTIALLY,

BUT TAX EXEMPTION PROVISIONS HAVE NOT

The operations of many electric cooperatives have changed significantly since these organizations were granted tax-exempt status almost 60 years ago. Initially, they were small, struggling associations which purchased and distributed electricity for their rural members. Today, most electric cooperatives are medium-sized utilities whose rates are, on the average, comparable to those charged by investor-owned utilities (IOUs) operated for profit in neighboring areas and in many urban centers of the country. They account for almost 10 percent of the Nation's electric revenues and provide service to more than 9 million rural and suburban residents, farms, and industries.

Some electric cooperatives have retained their rural, local character over the years. Others, however, spurred by rural economic development and growth and Federal assistance, have become large utility companies which closely resemble IOUs in their operations. In addition, as discussed in chapter 3, many electric cooperatives have been able to accumulate and retain substantial member equity.

As a result of these changes, the nature of current electric cooperative operations is diverse. Yet, unlike other assistance programs, tax exemption presently applies to all electric cooperatives regardless of differences in their operations, financial condition, size, or type of consumers served, provided they meet the broad statutory requirements of the law. As discussed in chapter 4, IRS has tried to recognize the changes in electric cooperatives in administering the tax exemption provisions of the Internal Revenue Code. However, it has not been able to effectively do so primarily because the exemption provisions are broad and do not recognize differences in electric cooperatives' present day operations or the environment in which they are operating. Changes are needed to facilitate IRS' administration of the existing provisions. Moreover, the Congress should evaluate alternatives to the current tax exemption provisions, such as those presented in chapter 5, which would better recognize the changing operations and present day environment of many electric cooperatives.

MANY ELECTRIC COOPERATIVES' OPERATIONS HAVE CHANGED SUBSTANTIALLY

The operations of many electric cooperatives have grown and changed since they were first formed to distribute electricity to rural areas of the country and since they were initially granted tax exemption. Some electric cooperatives continue to operate as when they began--small associations having several hundred farm members. Many, however, have grown to become medium-sized utilities which serve economically developed areas of the country. Still others have expanded their activities and have otherwise changed to the extent that they closely resemble for-profit IOUs.

Most electric cooperatives are medium-sized utilities

In 1935 only about 30 electric distribution cooperatives existed, the largest of which had 63 miles of line and just 350 members. As of 1981, 920 electric distribution and power supply cooperatives were in operation, each having an average of 2,020 miles of line and about 10,400 consumers, with many serving from 20,000 to more than 60,000. 1/ Total electric cooperative operating revenues grew from $230 million in 1950 to about $7.4 billion in 1981, and they had combined assets totaling nearly $35 billion as of December 31, 1981.

As shown in the following table, most electric distribution cooperatives have total assets of from $1 million to $20 million and annual operating revenues between $1 million and $10 million.

1/The 920 electric cooperatives--869 distribution cooperatives and 51 power supply cooperatives--include only active REA borrowers. There are also a number of former REA electric cooperative borrowers in operation; however, information on their operations and activities is not available at REA.

	Total assets as of December 31, 1979		Operating revenues Calendar year 1979	
	Number of cooperatives (note a)	Percent of total	Number of cooperatives (note a)	Percent of total
$ 999,999 and under	8	1	46	5
1,000,000 - 4,999,999	168	19	449	52
5,000,000 - 9,999,999	295	34	247	28
10,000,000 - 19,999,999	261	30	93	11
20,000,000 - 39,999,999	112	13	26	3
40,000,000 and over	23	3	6	1
Total	867	100	867	100

a/Financial data was not available for three distribution cooperatives holding REA loans as of December 31, 1979.

Over the years, some electric distribution cooperatives expanded their activities by forming associations of cooperatives and subsidiaries to generate and transmit electricity (power supply cooperatives); lease or purchase coal mining properties and facilities; procure fuels and supplies; and provide ancillary business services, including data processing, financing, and insurance.

Financially, power supply cooperatives are substantially larger than distribution cooperatives. As shown below, some have assets of more than $300 million and/or operating revenues exceeding $50 million.

	Total assets as of December 31, 1979		Operating revenues Calendar year 1979	
	Number of cooperatives	Percent of total	Number of cooperatives	Percent of total
$ 24,999,999 and under	5	11	15	32
25,000,000 - 49,999,999	7	15	9	20
50,000,000 - 74,999,999	4	9	8	17
75,000,000 - 99,999,999	2	4	9	20
100,000,000 - 199,999,999	7	15	4	9
200,000,000 - 299,999,999	4	9	1	2
300,000,000 - 499,999,999	8	17	-	-
500,000,000 and over	9	20	-	-
Total	46	100	46	100

Due to differences in the degree to which generation and distribution facilities are integrated, electric cooperatives are not directly comparable to municipal (State and local government-owned) and investor-owned utilities. The latter utilities are generally more vertically integrated than electric cooperatives. They generate as well as distribute electricity and some even own sources of fuel, such as coal mines. Yet on the basis of assets and revenues, most electric distribution cooperatives could be considered medium-sized utilities comparable in size to the smaller municipal systems and Class A and Class B IOUs, 1/ whereas many power supply cooperatives compare in size to larger municipal and medium-sized investor-owned utilities.

Electric cooperatives increasingly resemble investor-owned utilities

Although electric cooperatives are fundamentally different in capital structure from IOUs, they have become increasingly similar in other respects. Cooperatives are owned directly by their members and raise equity capital through the sale of memberships and retention of year-end margins. IOUs raise equity capital through the sale of stock to the public, and these investors, in turn, share in any profits earned by the companies. While this basic difference exists, it primarily affects the utilities' relative costs of capital. On the other hand, cooperatives and IOUs have grown increasingly similar with respect to their operations and activities.

Cooperatives, like IOUs, have service area monopolies in most States. Through the years, like IOUs, they have achieved a substantial level of vertical integration. As of December 31, 1981, electric cooperatives had invested over $1.3 billion in affiliated cooperative organizations which generate power, provide financing, own and lease coal mining lands, procure fuel and supplies, and provide other business services to their members.

In recent years, power supply cooperatives have added to their generating capacity by acquiring interests in IOU generating plants and participating in joint ventures with IOUs, municipal utilities, and other power supply cooperatives. In 1979 cooperatives had interests in 16 existing and 37 projected jointly owned power generation plant units. From 1968 to 1978 cooperatives increased their installed generating capacity by an average of 13.3 percent annually, as compared to 7.5 percent annual

---

1/The Federal Energy Regulatory Commission defines Class A utilities as those having annual operating revenues of $2.5 million or more. It defines Class B utilities as those having annual operating revenues of $1 million to $2.5 million.

growth for IOUs and 5.9 percent for municipal utilities. (See app. II for statistics showing growth in generating capacity by industry sector.) In 1981 cooperatives generated 77.2 million megawatt-hours of electricity, or about 52 percent of their total requirements. According to REA officials, these statistics only indicate that cooperatives are catching up with other sectors of the industry in securing a reliable source of power. Nonetheless, this expansion is a further indication of vertical integration and change from their original function of distributing electricity in sparsely populated rural areas.

Recent acquisition activity shows the competitive character of some electric cooperatives and their increasing resemblance to for-profit businesses. Since 1960, electric cooperatives have acquired 22 IOUs, whereas IOUs have acquired 4 electric cooperatives and unsuccessfully attempted to acquire 33 others. The most recent action at the time of our work involved the acquisition of an IOU located in a midwestern State by a subsidiary of an electric distribution cooperative. The distribution cooperative's subsidiary acquired the stock of the IOU in 1979 with funds borrowed from the National Rural Utilities Cooperative Finance Corporation (CFC), a tax-exempt finance cooperative owned by member electric cooperatives. An IOU had previously attempted to acquire the power company but dropped its efforts after a power supply cooperative filed an anti-trust complaint related to the proposed acquisition. As a result of the acquisition, the electric distribution cooperative has expanded its activities to include the sale of water and natural gas to retail consumers and the sale of electricity and natural gas to wholesale customers for resale.

In another recent action, an IOU in the northeast U.S. attempted to acquire a neighboring electric distribution cooperative. The acquisition was unsuccessful, in part, because only 81 of approximately 5,500 cooperative members voted 42 to 39 at their 1980 annual meeting not to meet with the IOU's management to discuss the merger proposal. In addition, according to information obtained from REA, another cooperative urged the president of the cooperative involved in the proposed acquisition to explore the possibility of acquiring the IOU. The cooperative indicated that financing could be arranged through CFC. It also pointed out that if the IOU became a cooperative it would no longer have to pay Federal income taxes and could receive the benefits of the Rural Electrification Act.

Although the above activities are not conclusive, they illustrate the resemblance of electric cooperatives to IOUs and indicate the economically competitive nature of some electric cooperatives today. An official of one cooperative we visited stated that electric cooperatives are becoming big businesses and that the emphasis of many cooperatives today is toward

profitability. Officials of another cooperative we visited said the major difference between their cooperative and an IOU is the lack of profit motive. Yet that cooperative had accumulated margins totaling over $13 million as of December 31, 1979, and had never made a patronage capital refund to its members since it began operations in 1940. Furthermore, as discussed in the next chapter, many cooperatives have accumulated large amounts of patronage capital and have not returned such capital to their members (See page 37.)

RURAL DEVELOPMENT HAS FOSTERED GROWTH AND CHANGE AMONG ELECTRIC COOPERATIVES

Rural economic growth and development has brought about growth and change in the service areas of many electric cooperatives. At the same time, it has helped to reduce the high cost of distributing electricity in many rural areas. In the last two decades, the average number of consumers served by each electric cooperative has nearly doubled and electric consumption levels have grown even more significantly. Today, the electric rates charged by rural electric cooperatives are comparable to those charged by IOUs serving neighboring areas and many urban centers of the country.

In recent decades, shifts in population and industrial activity have hastened the economic development of rural America and have affected the environment in which some electric cooperatives operate. Some areas serviced by rural electric cooperatives have become suburban in character as a result of spillover from growing metropolitan areas, such as Washington, D.C., and Atlanta, Georgia. Other areas have developed broader based economies and have a sizeable commercial and industrial base in addition to their agricultural activities.

In recent years, customers other than residential consumers (farm and nonfarm) have become increasingly important to electric cooperatives. In 1978, commercial, industrial, irrigation, and other users--rather than residential consumers--were the major customers of 157, or 18 percent, of the Nation's electric distribution cooperatives. The following table shows the percentage of electricity sold in 1978 to residential consumers by electric cooperatives reporting to REA.

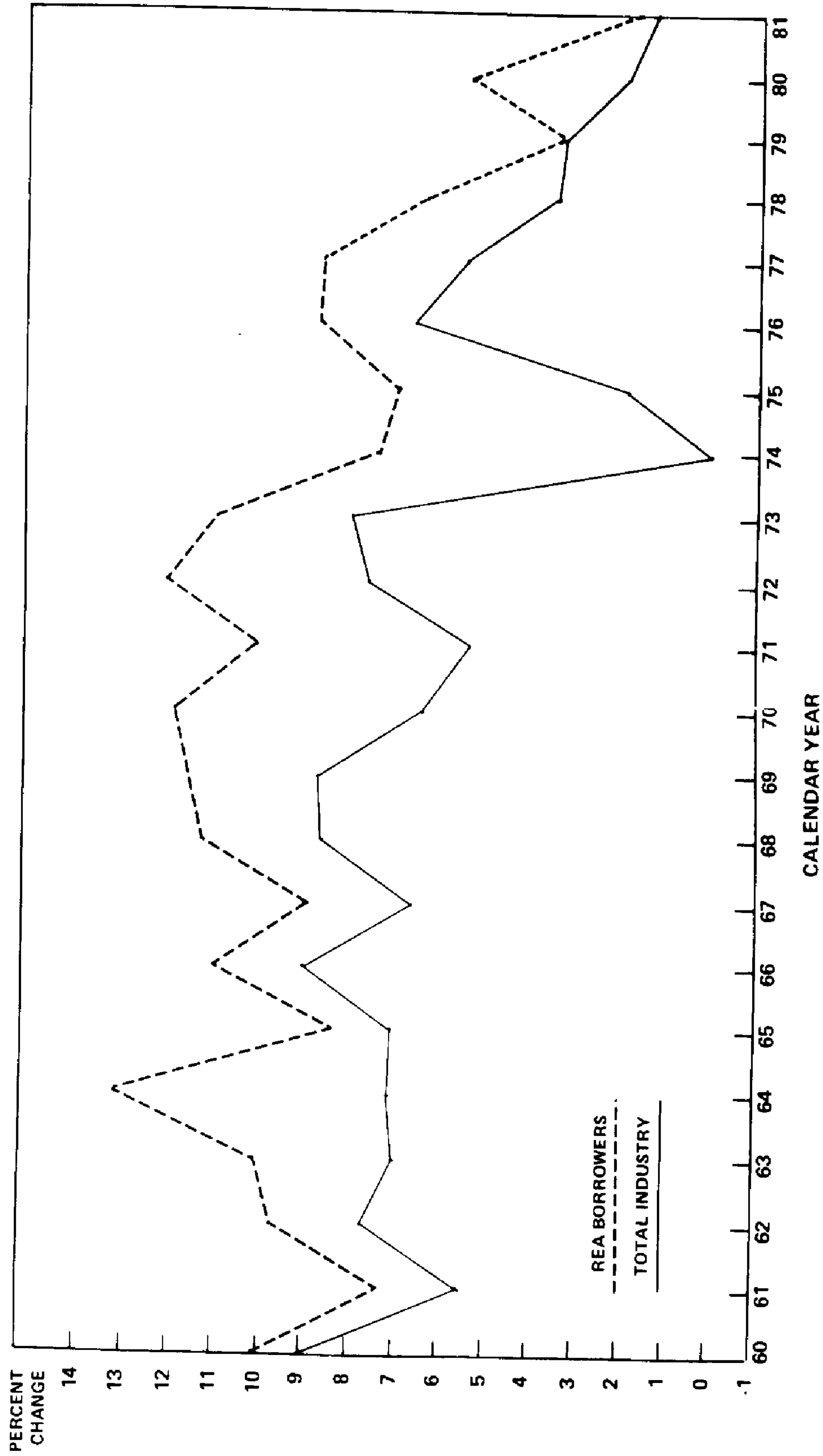
Percent of electricity sold to residential consumers	Number of cooperatives	Percent of total
90 - 100	143	17
80 - 89	234	27
70 - 79	160	18
50 - 69	174	20
less than 50	157	18
Total	868	100

As a result of this rural development, electric cooperatives have experienced rapid growth in electric demand. Since 1960 total cooperative sales of electricity have increased nearly seven-fold, growing from 25.4 million to 186.5 million megawatt-hours (MWH).1/ From 1960 to 1981, the average annual growth rate of electric cooperatives and other utilities borrowing from REA has been about 50 percent higher than that of the total U.S. electric utility industry. (See Fig. 1, p. 16.) In terms of electric sales, electric cooperatives accounted for nearly 10 percent of total U.S. electric revenues in calendar year 1980.

REA attributes this rapid growth in electric sales to the lack of adequate substitutes for electricity in many rural areas and the faster growth in population of rural areas. These reasons may also explain the growing size of electric cooperatives and the sharply increased levels of electricity consumption by residential, commercial, and industrial consumers of electric cooperatives.

1/Total MWH sales by cooperative distribution systems and MWH sales made to other than REA borrowers by cooperative power supply systems.

FIGURE 1
ANNUAL PERCENT CHANGE IN ELECTRIC SALES
TO ULTIMATE CONSUMERS



SOURCES: REA Bulletin 1-1
Edison Electric Institute Statistical Yearbook

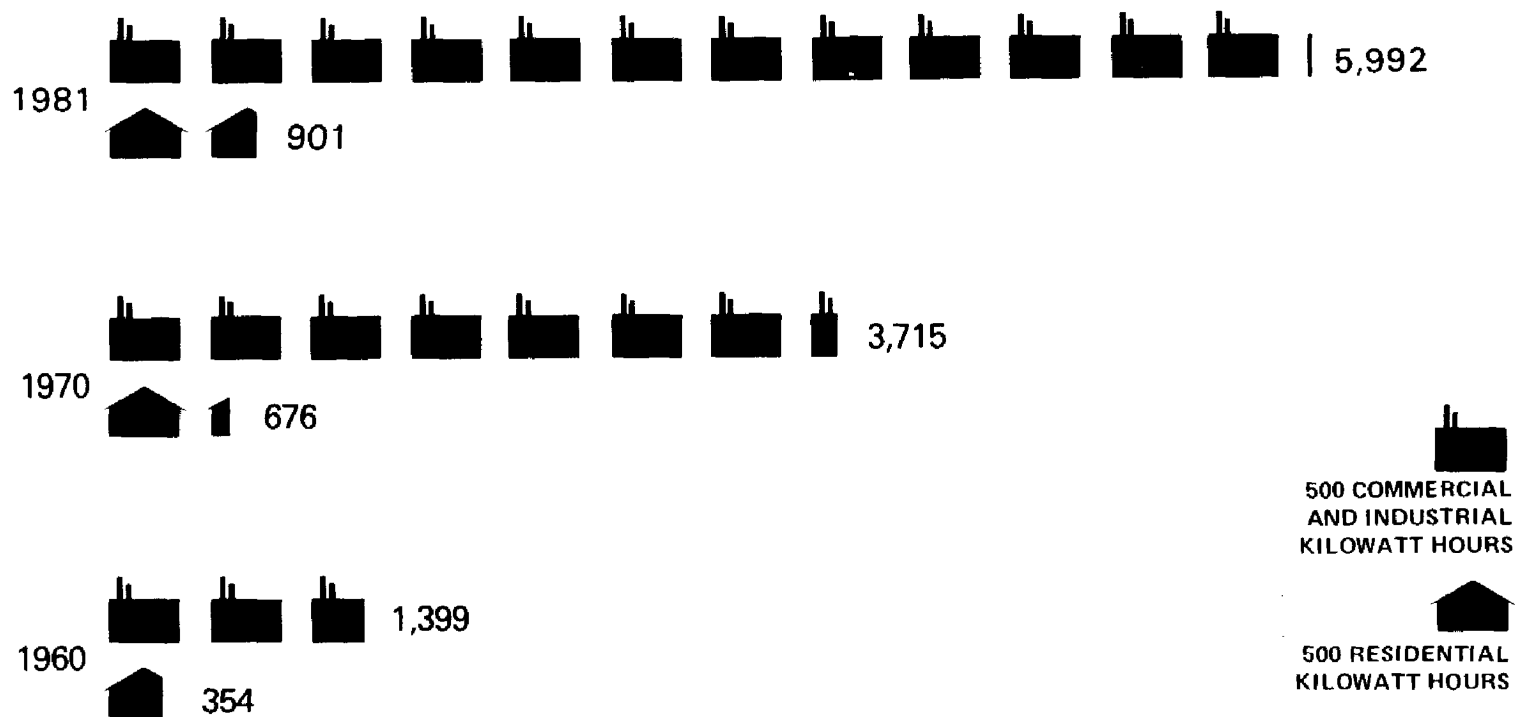
Although the number of electric distribution cooperatives has remained about the same since 1950, they have grown significantly over the last 20 years in terms of the number of consumers each serves. As shown below, in 1960 about 64 percent of electric distribution cooperatives had fewer than 5,000 consumers, and only 10 percent had 10,000 or more consumers. In 1981 about 37 percent of the cooperatives had fewer than 5,000 consumers, whereas, about 36 percent had 10,000 or more consumers. In 1981 the average electric distribution cooperative had 10,377 consumers (7,171 median) as compared to 4,980 consumers (3,847 median) in 1960. During this same period, the average number of consumers served per mile of line also increased by 48 percent from 3.3 consumers per mile in 1960 to 4.9 per mile in 1981.

	1960		1981	
Number of consumers	Number of cooperatives (note a)	Percent	Number of cooperatives (note a)	Percent
1 - 2,499	267	28	112	12
2,500 - 4,999	335	36	228	25
5,000 - 9,999	242	26	248	27
10,000 - 14,999	65	7	149	16
15,000 and over	28	3	189	20
Total	937	100	926	100
consumers per mile (average)		3.3		4.9
consumers per mile (median)		2.8		4.5

a/Figures include municipalities, public utility districts, and power supply cooperatives which borrow from REA (49 in 1960; 57 in 1981). The majority of these borrowers have fewer than 5,000 consumers.

In addition to serving growing numbers of consumers, electric cooperatives have experienced sharply increased levels of electric consumption by their residential, commercial, and industrial customers. From 1960 to 1981, the average monthly kilowatt-hour (KWH) consumption of electric cooperatives' residential consumers increased by 155 percent (from 354 to 901) and that of commercial and industrial consumers increased by 328 percent (from 1399 to 5992). (See Fig. 2, p. 18.)

FIGURE 2
AVERAGE MONTHLY KWH CONSUMPTION OF RESIDENTIAL AND COMMERCIAL/INDUSTRIAL CONSUMERS OF ELECTRIC COOPERATIVES



SOURCE: REA Bulletin 1-1

The recent growth in electric demand has represented a significant challenge to rural electric cooperatives. However, this growth in electric demand, together with Federal assistance in the form of REA loan programs, status as preference customers of Federal power agencies, and tax exemption (see pp. 22 to 26), has also enabled cooperatives in many rural areas to bring their electric rates in line with the rates charged by investor-owned utilities serving neighboring areas and urban centers of the country. Initially, due to the high costs associated with providing service to sparsely populated rural areas, electric cooperatives' rates were significantly higher than those of IOUs serving urban areas. Subsequently, electric cooperatives and other REA electric distribution borrowers reduced the average price of electricity sold to residential consumers in each year from 1948 to 1970. (See Fig. 3, p. 20.) Although the price of electricity has since risen markedly, residential consumers of REA borrowers have paid less per KWH than the industry average since 1961; and as of 1981, electricity cost these consumers 5.4 cents per KWH--about 40 percent more than it did in 1948.

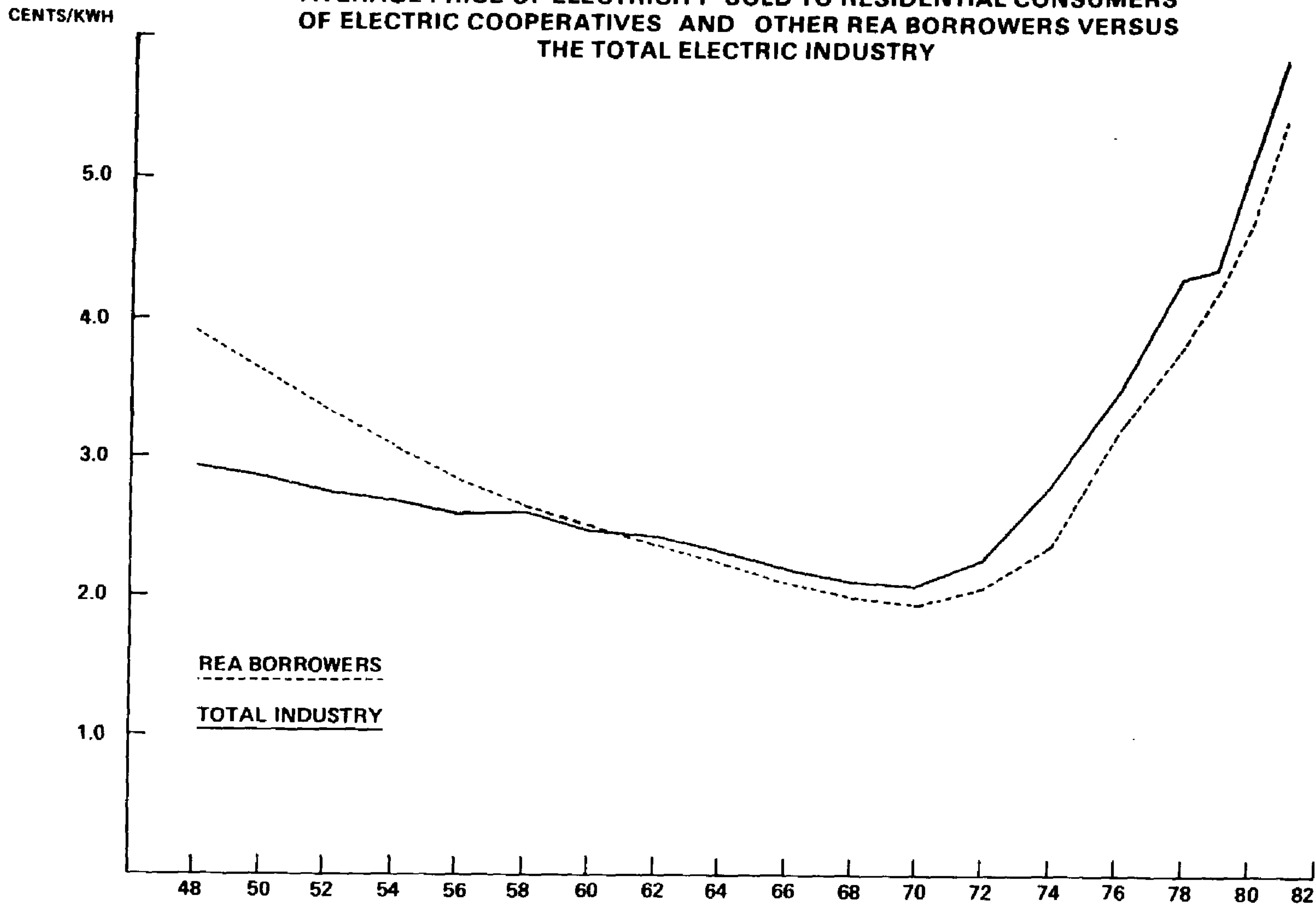


FIGURE 3
AVERAGE PRICE OF ELECTRICITY SOLD TO RESIDENTIAL CONSUMERS OF ELECTRIC COOPERATIVES AND OTHER REA BORROWERS VERSUS THE TOTAL ELECTRIC INDUSTRY

SOURCES: REA Bulletin 1-1
Edison Electric Institute Statistical Yearbook

On a national average, rural residents served by REA borrowers now pay less per KWH of electricity than do residential consumers of IOUs. In calendar year 1981, residential consumers of IOUs paid an average of 6.2 cents per KWH of electricity, or about 14 percent more than the average of 5.4 cents per KWH paid by residential consumers of REA borrowers.

The comparison below of U.S. average residential electric bills for REA borrowers as of January 1, 1981, with U.S. average bills for cities of 2,500 population or more showed that, on average, REA borrowers' rates are lower than those in U.S. cities. Further comparison showed that average electric rates of REA borrowers compare favorably to those of IOUs serving selected large cities, particularly at the higher levels of usage.

	250 KWH	500 KWH	750 KWH	1000 KWH
U.S. average-REA borrowers (note a)	$17.49	$29.07	$40.28	$51.28
U.S. average-cities of 2,500 population and more	17.76	32.61	43.99	58.12
Selected U.S. cities served by IOU's (note b)				
Atlanta	13.76	23.51	33.12	42.50
Boston	24.69	46.31	58.74	76.42
Chicago	17.95	34.85	41.14	56.41
Denver	16.22	29.71	43.20	56.68
Detroit	16.60	31.08	40.30	55.72
Houston	15.97	26.55	37.12	47.69
Los Angeles	17.02	34.03	51.05	68.06
New York	31.17	58.82	76.83	103.72
Philadelphia	19.34	38.68	50.80	70.21
Washington	14.12	26.95	36.50	49.34

a/ The average monthly usage for residential consumers of electric cooperatives was 901KWH in 1981.

b/ Several of these cities had different rates for summers and winter periods. For comparative purposes we used the lower winter rates. One city (Los Angeles) is served by a municipal utility.

As shown by the information presented above, the rural development process of the last several decades has stimulated growth and change in the areas serviced by many electric cooperatives. This change has brought about a reduction in the cost of electricity to the residents of these rural areas.

ELECTRIC COOPERATIVES BENEFIT FROM TAX EXEMPTION AND OTHER FEDERAL ASSISTANCE

Federal assistance has played a major role in bringing electric service to sparsely populated rural areas of the country. Over the years, electric cooperatives have benefited from Federal tax exemption, REA loan programs, and their status as preference customers of Federal power agencies.

Benefits accruing from tax exemption

In addition to making gross income from members tax-free, the tax exemption provisions permit electric cooperatives to earn tax-free up to 15 percent of such income from nonmembers. Nonmember source income consists of operating margins from the rental of electric property and sale of electricity to nonmembers; and nonoperating margins, including interest, dividends, royalties, and gains on the sale of assets. As shown below, nonmember income from sources other than cooperatives' electric operations, namely nonoperating margins, has increased from about $13 million, or 16 percent of net margins, in 1960 to $160 million, or 32 percent of net margins, in 1981. These nonoperating margins represent profit which, in some cases, reduces members' cost of electricity.

	1960	1970	1980	1981
	(000)			
Net margins	$84,130	$136,283	$377,234	$497,448
Nonmember income (note a)	13,241	22,065	114,620	160,260
As a percent of net margin	16%	16%	30%	32%

a/Exclusive of operating margins from nonmember sources not identifiable from REA records.

Electric cooperatives also benefit from tax-exempt status because they can retain members' patronage capital and do not have to pay a market rate of return on this equity capital. As exempt organizations they are prohibited by IRS from paying interest or dividends on patronage capital retained from their members. Further, such patronage capital can be retained to finance capital expansion programs. IOUs, on the other hand, must finance expansion from after-tax earnings and sales of stock to the public, and, when in a position, pay dividends on equity capital.

Because electric cooperatives are prohibited from paying interest on retained patronage capital and allowed to refund this capital on a discretionary basis, they incur a significantly lower cost of equity capital than do IOUs, and can retain a large portion of their year-end margins to finance expansion. In calendar year 1978, for example, electric cooperatives reporting to REA retained 86 percent of their year-end margins, whereas IOUs reporting to the Federal Energy Regulatory Commission were able to retain 21 percent of after-tax earnings. This is shown in the below comparison of net margins retained and refunded by electric cooperatives, and net income retained and paid out by investor-owned utilities.

Cooperative Accounting Terms	Cooperatives (note a) (000)	IOUs (note b) (000)	Comparable Private Utility Accounting Terms
Net year-end margins	$370,618	$8,716,708	Net income after taxes
Patronage capital refunds	51,397	6,877,691	Dividends declared on common and preferred stock
Addition to retained patronage capital	$319,221	$1,839,017	Addition to retained earnings and transfers to other accounts
Percent of net margins refunded	14%	79%	Percent of earnings paid out
Percent of net margins retained	86%	21%	Percent of earnings retained

a/ Based on CY 1978 operating results reported to REA by 869 electric distribution cooperatives and 46 power supply cooperatives.

b/ Based on CY 1978 operating results reported to the Federal Energy Regulatory Commission by 192 privately-owned electric utilities each having annual electric operating revenues in excess of $2.5 million.

Patronage capital refunds are not the same as dividends declared on common and preferred stock. Patronage capital refunds represent the return *of* capital retained from members, whereas dividends represent a return *on* capital invested by shareholders. Notwithstanding this distinction, these amounts represent cooperatives' and IOUs' respective annual payouts related to members' and investors' invested funds. Consequently, in substance, patronage capital refunds and dividends represent the respective costs of equity capital to electric cooperatives and IOUs.

Although electric cooperatives receive benefits from tax exemption, it should be pointed out that investor-owned and municipal utilities also receive certain Federal tax incentives and benefits. The tax benefits available to municipal utilities exceed those received by electric cooperatives. The tax benefits available to IOUs partially offset and defer their Federal income tax liabilities.

Municipal utilities, like electric cooperatives, are exempt from Federal income taxes. The income of public utilities is specifically excluded from Federal taxation under section 115 of the Internal Revenue Code. Furthermore, municipal utilities benefit from their ability to issue tax-exempt debt securities in that the interest received by investors is exempt from Federal income taxes. This benefit significantly reduces municipal utilities' cost of debt financing. In 1980, municipal utilities' long-term debt carried a 5.13 percent embedded rate of interest as compared to 8.17 percent for IOUs and 6.43 percent for cooperatives. 1/

IOUs benefit from Federal income tax provisions designed to encourage private investment in plant expansion and modernization. These tax incentives, available to all taxable businesses, include investment tax credits for qualifying capital expenditures, deferral of Federal income taxes through accelerated depreciation, and the ability to sell unused tax benefits under the safe harbor leasing provisions of Code section 168(f)(8). 2/ IOUs also benefit to some extent from the dividend reinvestment provisions of Code section 305(e). Under this section, investors can defer taxes on up to $1500 of dividends reinvested in qualified utility companies. Notwithstanding these tax benefits, in the 5-year period ended December 31, 1980, IOUs paid Federal income taxes totaling nearly $4 billion and deferred another $8 billion in taxes on income from their electric utility operations.

As of December 31, 1980, IOUs' accumulated deferred income tax liability totaled over $14.1 billion. This resulted mostly from the accelerated depreciation of investments in electric utility plants during the late 1970s. From 1976 to 1980 electric utility plant investment totaled $92.1 billion, as compared to

---

1/Based on interest paid on long-term debt in 1980 (including interest charged to construction) divided by average long-term debt outstanding at beginning and end of year.

2/The Tax Equity and Fiscal Responsibility Act of 1982 substantially reduced some of the tax advantages of the Internal Revenue Code's leasing provisions.

$58.5 billion from 1971 to 1975. As long as plant investment continues to grow in future years , IOUs will continue to defer these tax liabilities.

REA loan assistance

The REA loan program has been the principal means for channeling Federal assistance to rural electric cooperatives. Since it was established in 1935, REA has approved $15.6 billion in low-interest loans and $26.1 billion of loan guarantee commitments to electric cooperatives. As of December 31, 1980, direct REA loans and loans guaranteed by REA represented about 90 percent of cooperatives' total outstanding long-term debt of $21.5 billion. This long-term debt carries a 6.43 percent embedded rate of interest. IOU and municipal utility long-term debt, in comparison, carried embedded interest rates of 8.17 percent and 5.13 percent, respectively, in 1980.

We estimate that in 1980, as a result of REA loan programs, cooperatives saved nearly $340 million over the cost of private financing. 1/ Further, although future cooperative financings will undoubtedly bear higher rates of interest due to current economic conditions, a large portion of existing REA long-term debt is fixed at the low embedded rates through the maturity of the loans.

In a May 1980 report, we concluded that, although many rural electric distribution systems continue to need REA loan assistance, others could afford to obtain loans from private sources at reasonable rates and terms. 2/ In recognition of the differences among electric cooperatives, the report recommended that REA policies be revised to better evaluate each electric distribution system's needs for subsidized loans so that REA assistance could be directed to those systems with greater needs. The report also recommended that REA establish minimum equity goals (the portion of assets financed by equity as opposed to debt) for its electric distribution system borrowers and require those borrowers with lower levels of equity to increase their equity levels accordingly.

Preference power

Electric cooperatives also benefit from their status as preference customers of Federal power agencies. Under Federal

---

1/Based on electric cooperatives' long-term debt carrying the same 8.17 percent embedded rate of interest as carried by IOUs in 1980.

2/See footnote 2 on page 2.

marketing policies, electric cooperatives, publicly owned utilities, and certain other customers are given preference, or first right, to purchase low-cost Federal power. Electric cooperatives' and other REA borrowers' purchases from Federal power agencies have increased from 11.5 million MWH in 1960 to 39.9 million MWH in 1980.

As of fiscal year 1978, electric cooperatives received substantially larger power allocations than IOUs, but less than those of municipal utilities. (App. III shows the disposition and pricing of Federal power agency sales in fiscal year 1978.) The benefits of preference power are widely distributed among electric cooperatives, with 191 electric distribution systems in 21 States purchasing power directly from Federal power agencies and many more benefiting indirectly as members of the 20 power supply cooperatives in 19 States which also purchase Federal power.

The availability of Federal power has additional significance in that customers of Federal power agencies are not burdened with the capital financing requirements associated with replacing this federally generated power. As of September 30, 1978, the net utility plant assets of Federal power projects totaled $22.5 billion, of which $13.5 billion represented investments by the Government.

PRESENT DAY ELECTRIC COOPERATIVES' OPERATIONS VARY BUT TAX EXEMPTION GENERALLY APPLIES TO ALL

When electric cooperatives were first granted tax exemption almost 60 years ago, they were generally small associations limited to the costly task of providing electric service to farms and rural residents in sparsely populated areas. As a result of rural economic development, Federal assistance, and tax benefits, some electric cooperatives' operations and service areas have grown and changed to the point where cooperatives today vary greatly. However, the broad tax exemption provisions of the Internal Revenue Code have not changed significantly and still apply to all electric cooperatives.

The following five examples illustrate the diversity in present day cooperatives' operations and activities. The electric cooperatives discussed in examples 1 and 2 are small, member-controlled associations which distribute electricity predominately to rural farms and residents. They have refunded margins to their members and earned little income from nonmember sources.

Example 1

An electric distribution cooperative was formed in 1939 to bring electricity to its 694 members. By 1979 it

had grown to a size of 1,401 members, including 35 commercial and industrial customers. In 1979 it had operating revenues of $1.2 million, including $16,099 earned from nonmember sources, and had accumulated patronage capital totaling $1.1 million.

The cooperative has an equity management plan whereby it refunds members' patronage capital on a first-in, first-out basis on a 20-year cycle (see p. 37). It has consistently refunded patronage capital on an annual basis and has to date refunded more than $385,000 to its members. In addition, it has maintained a relatively high level of member participation. In a recent 5-year period, annual meetings were attended by an average of 249 members, with an additional 38 members voting by proxy.

Example 2

An electric distribution cooperative began operations in 1937 and, as of 1945, had 2,501 members. The cooperative has since grown to about 4,300 members, predominantly farm and nonfarm residential consumers. In 1979 the cooperative's operating revenues totaled $3.4 million, including $49,000 from nonmember sources. As of December 31, 1979, it had retained $4.2 million of patronage capital from its members.

Under the cooperative's equity management plan, members' patronage capital is refunded on a first-in, first-out basis and a 20-year cycle. It has consistently refunded patronage capital annually and to date has refunded about $2.1 million to its members. In addition, over a recent 5-year period, an average of 457 members attended the cooperative's annual meetings.

In contrast, the electric cooperatives discussed in examples 3 through 5 have expanded their business activities, earned substantial tax-free income from nonmember sources, and/or increased their commercial and industrial sales base. As a result, their operations and activities now seem to more closely resemble those of taxable companies.

Example 3

An electric distribution cooperative was formed in 1940 to provide electric service to its 3,500 members. It has since grown to approximately 28,500 members, including about 3,200 commercial and industrial customers who in 1979 accounted for 42 percent of the cooperative's electric sales. The cooperative had operating revenues of $19.9 million and

nonmember income totaling $207,000 in 1979. As of December 31, 1979, the cooperative had accumulated patronage capital of $13.9 million.

The cooperative has refunded no patronage capital since it began operations in 1940 because its power supply contract with the Tennessee Valley Authority (TVA) precludes refunding patronage capital other than through rate reductions. (See p. 38.) Over the next 10 years, the cooperative plans to collect an additional $11 million of patronage capital from its members to meet future capital requirements. Furthermore, with only from 10 to 29 members in attendance at its annual meetings during the years 1975-79, the cooperative did not achieve the attendance quorum set forth in its bylaws.

Example 4

A power supply cooperative formed in 1940 has expanded to the point that today a majority of its electric sales are to utilities other than its electric distribution cooperative members. The cooperative has expanded and restructured its business activities to permit the subsidization of its distribution cooperative members' cost of electricity with substantial tax-free income.

In calendar year 1979, the cooperative had operating revenues totaling $55.9 million and net operating margins of $4 million. It also earned $1.7 million in nonoperating margins, consisting principally of coal royalty income. Although the cooperative has not refunded patronage capital, it has credited $4 million from operating margins to both member and nonmember utilities. It has not credited patronage capital from nonoperating margins to members, but rather accumulates it for future contingencies. As of December 31, 1979, the cooperative had accumulated nonoperating margins totaling $5.9 million.

In 1972 the cooperative formed a taxable subsidiary power supply cooperative to assist in marketing its lignite coal resources and to provide its members with a future source of low-cost power. Under a long-term power sales agreement, the subsidiary presently sells all electricity it produces to an IOU and pays the parent cooperative royalties for the right to purchase coal. As of December 31, 1979, the subsidiary cooperative had paid the parent $3.6 million in coal royalties and $2 million in joint venture administration fees.

In addition, the cooperative has arranged its business activities in a manner which may affect its computation of member income. In 1970, the cooperative established separate

membership classes for its affiliated distribution cooperative members and for other utilities to which it sells electricity. The cooperative has issued 48 shares of stock to its 12 distribution cooperative members and 17 shares to its other members, which include 10 IOUs, 4 power generation cooperatives, and 3 municipal utilities.

Furthermore, the cooperative credited $1.6 million of patronage capital to its distribution cooperative members in 1979 even though the average price they paid for electricity was below the average total cost of production. It achieved this by allocating power from its lowest cost sources to its distribution cooperative members and power from its higher cost sources to the other utilities it serves.

Example 5

The electric sales of a power supply cooperative formed in 1966 and its four member distribution cooperatives are predominately to commercial and industrial rather than residential consumers. In 1979 the power supply cooperative generated 3.9 million MWH of electricity and purchased another 3.3 million MWH for resale to its four members. The cooperative had net operating margins of $6.9 million from its electric sales and nonoperating margins of $1.1 million earned from other sources. In turn, it credited, but did not refund, patronage capital from both operating and nonoperating margins to its four electric distribution cooperative members. An analysis of the distribution cooperatives' revenues and patronage capital credits is shown below.

	Electric distribution cooperative				
	A	B	C	D	Total
Revenues:					
Residential	$4,623,775	$ 8,288,242	$ 7,975,934	$ 5,349,238	$ 26,237,189
Commercial and industrial	1,548,113	3,942,087	62,117,386	43,630,171	111,237,757
All other	142,099	125,208	137,036	135,028	539,371
Total	$6,313,987	$12,355,537	$70,230,356	$49,114,437	$138,014,317
Patronage capital credited	$ 233,035	$ 111,309	$ 4,579,965	$ 3,148,557	$ 8,072,866
	(3%)	(1%)	(57%)	(39%)	(100%)

As can be determined from the above schedule, commercial and industrial consumers accounted for 81 percent of total revenues for the four distribution cooperative members in 1979. Further, the power supply cooperative credited $7.7 million of patronage capital or 96 percent of its net margins to the two distribution cooperatives having the bulk of commercial and industrial usage.

Tax exemption primarily benefits the cooperatives' commercial and industrial users since they receive a tax deduction for patronage capital included in their electric bills and credited to their accounts. Electric cooperatives are not subject to Subchapter T of the Internal Revenue Code, which taxes year-end margins at either the cooperative or member level. (See p. 55.) Thus, income taxes on these contributions to capital will be deferred until they are refunded in cash by the cooperatives and taken in as income by the commercial and industrial members.

The above examples show the divergent extent and nature of tax-exempt electric cooperatives' operations and activities today. Most electric cooperatives fall somewhere in between. Federal power and REA loan programs have been modified through the years to account for changing economic conditions and rural development needs and the corresponding changes in some cooperatives. In contrast, the tax exemption provisions governing electric cooperatives have not significantly changed since 1924. Unlike Federal assistance programs which can be targeted to those organizations needing assistance, tax exemption applies to all electric cooperatives meeting the broad statutory requirements without regard to their operations, financial condition, size, or type of consumers served.

CONCLUSIONS

The law conveying tax exemption on electric cooperatives has not changed significantly since it was enacted almost 60 years ago. Some cooperatives continue to operate much as they did when they were originally granted tax exemption. But other cooperatives have become larger, financially sound utilities whose rural and suburban service areas are no longer economically disadvantaged. Still others have expanded their business activities, dramatically increased their commercial and industrial electric sales, and earn substantial untaxed income from nonmember sources to the point where they more closely resemble taxable utility companies. Thus, the operations and activities of present day cooperatives are diverse. However, unlike direct Federal assistance programs which can be targeted to those organizations needing assistance, tax exemption applies to all electric cooperatives provided they meet the broad statutory requirement of the law.

AGENCY COMMENTS AND OUR EVALUATION

Agency comments concerning the changing operations of electric cooperatives were diverse. In a letter dated July 26, 1982, the Acting General Manager of NRECA disagreed with our report's conclusions on (1) the changes in the circumstances which initially motivated Federal government involvement in rural electrification and (2) on the extent to which present-day cooperative operations and activities have changed. On the other hand, in a letter dated July 27, 1982, the Commissioner of Internal Revenue stated that electric cooperatives are much different today.

Special circumstances of electric cooperatives

NRECA stated that while the special circumstances which initially motivated Federal Government involvement in rural electrification have changed to some extent, they are as significant and startling today as they were in 1936. To support its contention, NRECA pointed out that, on the average, (1) electric cooperatives in 1981 had the highest cost of new capital in the electric industry and their low embedded interest costs are rising because of the need to finance new generating plants; (2) electric cooperatives experience low consumer and revenue densities, as compared with other sectors of the industry; and (3) cooperatives' electric rates are higher than those of other utilities.

We disagree with NRECA's overall contention that the special circumstances faced by electric cooperatives in 1936 still exist today. In making its case, NRECA emphasizes the "average cooperative" but does not recognize the variances which make up that average. We acknowledge, as we point out in this chapter, that some cooperatives in NRECA's average statistics have probably retained their rural, local character and thus may continue to need assistance to provide electricity at reasonable rates. In contrast, however, there are many other cooperatives, such as those discussed in the examples on pages 27 to 30, which have come to more closely resemble their for-profit counterparts and earn substantial tax-free nonmember income.

With respect to NRECA's specific contentions on this issue, we could not address its point that electric cooperatives had the highest average cost of new capital in 1981 because comparative data for other industry sectors is not yet publicly available. However, embedded interest rate comparisons as of 1980 showed that electric cooperatives' embedded rates were, on average, lower than those of IOUs. As shown on page 25, electric cooperatives' long-term debt carried a 6.43 percent embedded rate of interest in 1980, as compared with 8.17 percent for IOUs and 5.13 percent for municipal utilities in the same year. We acknowledge that

electric cooperatives' embedded interest costs are rising due to the high cost of money. We calculated that cooperatives' embedded interest rate rose to 7.75 percent in calendar year 1981. However, it is reasonable to assume that the embedded interest costs of the other industry sectors are likewise rising in the current interest rate environment. Furthermore, a large portion of cooperatives' existing long-term debt is fixed at the low embedded rates through maturity of their REA loans.

We agree with NRECA's point that electric cooperatives generally have low consumer and revenue densities compared to other utilities. However, as pointed out in our May 1980 report on REA loan programs, 1/ the disadvantages of serving low-density areas are often offset by other factors, such as low power costs, which can have a positive effect on electric rates. In this regard, the report pointed out that as of mid-1977, 52 percent of REA borrowers charged lower residential electric rates, at average usage levels, than neighboring IOUs. Moreover, as shown on page 21 of this report, national average rates of REA borrowers as of January 1, 1981, were lower than those rates charged in cities of 2,500 population or more at all levels of electric usage, and compared favorably with those rates charged in selected large cities. Thus, it appears that for certain areas the disadvantages of lower consumer and revenue densities, as inferred by NRECA, are more than offset by other utility cost factors.

It should be pointed out that even if the electric rates charged by cooperatives are higher than those charged by other utilities, an argument can be made against tax exemption. To illustrate, Treasury, in its August 18, 1982, comments, stated that higher than average costs do not necessarily justify Government intervention on behalf of cooperatives serving low-density markets. According to Treasury, Government intervention is warranted only when sellers exercise monopoly power, and even in those cases the remedy should be public regulation or suit under the anti-trust laws, rather than the subsidization of competitors.

The operations of many electric cooperatives have changed substantially

NRECA stated that the operations and activities of electric cooperatives are essentially the same as they were in 1924--to provide electricity to their member consumers. It further said that the size of a cooperative has nothing whatsoever to do with

1/See footnote 2 on page 2.

its tax-exempt status and that the relevant factors are cooperative ownership and nonprofit operation. Although we agree that the purpose of electric cooperatives has remained the same--to provide electricity to members--we do not agree that the operations and activities of electric cooperatives in support of that purpose in 1924 were the same as they are in the present environment. As substantiated in this chapter, the operations and activities of many cooperatives have indeed grown and changed substantially since tax exemption was first granted almost 60 years ago.

In this regard, although we acknowledge that a cooperative's size per se is not a determining factor for tax exemption, increased size is certainly an indication of growth and change. As discussed on pages 10 to 14, some electric distribution cooperatives have expanded their activities through the formation of subsidiaries and associations of cooperatives. Others have expanded through the acquisition of small IOUs and investments in jointly-owned power plants.

One major factor, not mentioned by NRECA, which has contributed to the growth of and changes in many electric cooperatives is that their operating environment has changed. Since the 1920s and 1930s, rural economic development has brought about growth and change in the service areas of many electric cooperatives. Some service areas have become suburban in character as a result of spillover from growing metropolitan areas. The consumer mix of many cooperatives is also changing, as evidenced by the increasing importance of commercial and industrial customers. In contrast to the predominantly farm population served by electric cooperatives in earlier years, today nonresidential consumers, such as commercial, industrial and other business users, are the major customers of nearly 20 percent of the Nation's distribution cooperatives.

- - - - -

In summation, while the special circumstances and operating environment of some electric cooperatives may not have changed since the time they were first granted tax-exemption, those of others have indeed changed substantially. The operations and activities of many electric cooperatives have grown and changed to the point where today some large cooperatives closely resemble their for-profit counterparts and earn substantial tax-free income from nonmember sources. Despite these changes, tax exemption continues to apply across-the-board to all electric cooperatives and does not recognize differences in their operations. Thus, as discussed in chapter 5, we continue to believe that the Congress should adopt a tax treatment which better recognizes the changes that have taken place and the variances that currently exist.

CHAPTER 3

MANY TAX-EXEMPT ELECTRIC COOPERATIVES ARE RETAINING SUBSTANTIAL MEMBER EQUITY--ANOTHER SIGN OF GROWTH

Another indication of how electric cooperatives have grown since they were granted tax exemption is that many have been able to accumulate large amounts of patronage capital. At the end of 1981, electric cooperatives were holding about $3.9 billion in patronage capital belonging to their members.

A basic cooperative operating principle is that cooperatives should operate and provide services at cost and distribute any margins or savings to members in proportion to their business or patronage. 1/ Under the principle, actual distribution need be made to members only when patronage capital is deemed to be over and above that needed to finance cooperative operations and anticipated growth.

Some electric cooperatives have developed equity management plans that balance the financial requirements for their operations and planned growth with the need to refund members' patronage capital. Other electric cooperatives have no equity management plans and do not intend establishing them.

Some Federal and State agencies interacting with electric cooperatives have certain policies and procedures which affect the distribution of members' patronage capital. Also, as discussed in chapter 4, IRS currently has difficulty determining whether electric cooperatives are operating as cooperatives, particularly with respect to the retention and accumulation of members' patronage capital.

COOPERATIVE PRINCIPLES AND PRACTICES CONCERNING THE DISTRIBUTION OF YEAR-END MARGINS

A fundamental concept that sets tax-exempt cooperatives apart from other businesses is that cooperatives are to (1) operate and provide services at cost and (2) distribute to members in proportion to their business with the cooperative any margins or savings accumulated above reasonable business

---

1/Some cooperatives distribute margins to all patrons, members and nonmembers alike. Therefore, subsequent references to members in this chapter include both member and nonmember patrons.

needs. Under cooperative principles, the year-end margins of electric cooperatives represent the difference between revenues from members and other operations and costs and expenses. Rather than refunding margins to their members in cash, electric cooperatives generally credit members' patronage capital accounts and retain the margins to finance cooperative operations. This patronage capital contributed by cooperative members represents their equity interest in the cooperative's assets.

Those electric cooperatives which refund patronage capital to their members generally do so under either the first-in, first-out or percentage method. Under the first-in, first-out method, the patronage capital first contributed by members is first refunded. Refunds under the percentage method are based on the percentage of total patronage capital contributed by each member. The actual refunding of members' patronage capital is usually left to the discretion of a cooperative's management and board of directors, based on their assessment of the cooperative's financial condition and other factors such as cooperative growth.

ELECTRIC COOPERATIVES HAVE RETAINED SUBSTANTIAL PATRONAGE CAPITAL

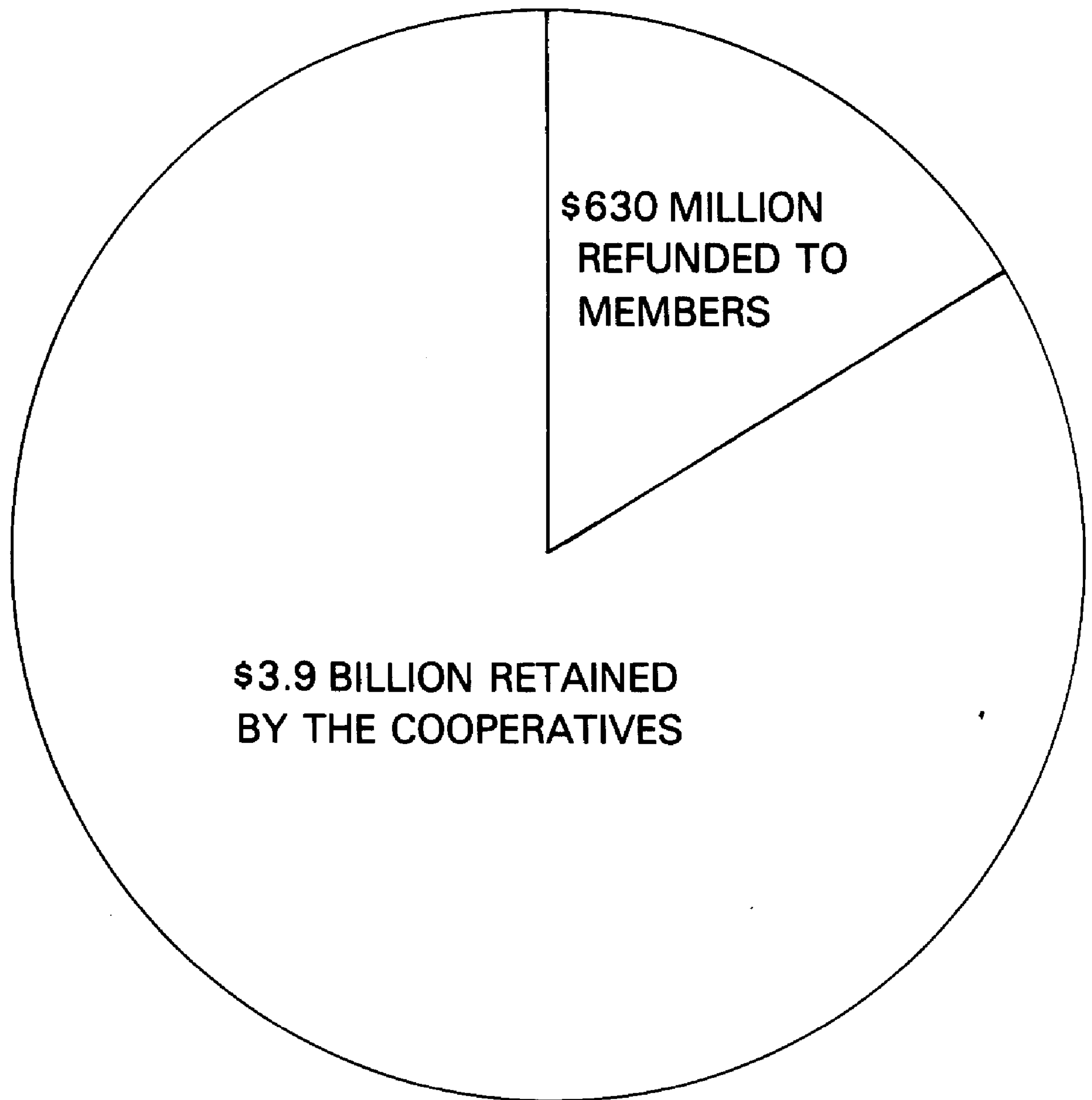
As of December 31, 1981, electric distribution cooperatives had collected over $4.5 billion of year-end margins from members and other operations. However, they had refunded only about $630 million to their members while retaining about $3.9 billion of this patronage capital. (See Fig. 4, p. 36.)

As of December 31, 1978, only about 2 percent of the 873 electric distribution cooperatives reporting to REA refunded more than 40 percent of the patronage capital received from their members, while about 48 percent returned 10 percent or less. The following table shows the percentage of patronage capital refunded by various electric cooperatives reporting to REA.

Percent of patronage capital refunded to members	Electric distribution cooperatives	
	Number	Percent
0 - 5	300	34
6 - 10	125	14
11 - 15	141	16
16 - 20	117	14
21 - 40	174	20
Over 40	16	2
Total	873	100

FIGURE 4

STATUS OF ELECTRIC DISTRIBUTION COOPERATIVE MARGINS AS OF DECEMBER 31,1981



About 20 percent, or 173 of the above electric cooperatives, had never returned patronage capital to their members. It should be pointed out, however, that about 4 percent, or 36 of the electric cooperatives, have operated on a nonprofit basis by setting their rates at or near cost and thereby have accumulated very little patronage capital.

To determine the patronage capital refund policies and practices of electric cooperatives, we sent questionnaires to 69 randomly selected distribution cooperatives. The median amount of patronage capital retained by the 64 electric distribution cooperatives responding to our questionnaire was $253 per member. One cooperative, however, had retained patronage capital averaging over $5,000 per member. As can be determined from the table below, over 50 percent of the cooperatives responding to our questionnaire had on their books outstanding patronage capital extending back more than 20 years. Further, nine of these cooperatives indicated that they do not refund patronage capital to any members, active or former.

Patronage capital outstanding		Electric distribution cooperatives	
Number of years		Number	Percent
over 40		2	3
31 - 40		9	14
21 - 30		22	34
11 - 20		30	47
10 or less		1	2
	Total	64	100

Forty of the 64 cooperatives indicated they had established equity management plans to, among other things, assure sufficient cash flow to finance cooperative operations and refund patronage capital on a predetermined cycle. These plans take into account, for example, cooperative rate structures, facility expansion, and loan requirements. Twenty-three of the 40 cooperatives had equity management plans under which members' patronage capital is consistently refunded on a 10 to 20-year cycle. Twenty-four of the cooperatives responding to our questionnaire did not have an equity management plan to assure cooperative members that their patronage capital would eventually be repaid. Nine of these had no intentions of setting up such a plan in the future. We believe such equity management plans could be useful to assist cooperatives in balancing the need to return members' patronage capital along with their other financial operating needs.

Forty-eight of the 64 cooperatives responding to our questionnaire said that their members influence management decisions regarding the refunding of patronage capital. We noted, however, that, on average, less than 7 percent of the members of the 48 cooperatives voted at annual meetings held during the period 1974-78.

GOVERNMENT POLICIES AFFECT THE DISTRIBUTION OF MEMBERS PATRONAGE CAPITAL

Certain Federal and State agencies interacting with tax-exempt electric cooperatives have policies and procedures that impact on the distribution of members' patronage capital. For example, REA loan provisions limit electric cooperatives patronage capital refunds, TVA allows patronage capital to be returned only through rate reductions, and State agencies generally do not require member patronage capital to be returned within a specific timeframe.

REA loan provisions limit patronage capital refunds

Since one of REA's primary concerns is the protection of the Government's loan interests, it does not require electric cooperatives to refund patronage capital. As a means to protect Government loan interests, REA limits the refunding of patronage capital through loan provisions for those cooperatives whose equity-to-assets ratio is less than 40 percent. Although REA advocates the refunding of margins when the equity-to-assets ratio exceeds 40 percent, it has not used its loan provisions to require that this be done. It should be pointed out here, however, that REA does have another policy which to some extent may encourage the payment of patronage capital refunds. Under this policy, cooperative general funds in excess of certain limits must be applied to funding plant additions, making advance payments on loans, or refunding members' patronage capital.

As of December 31, 1979, 262 of the 870 electric distribution cooperatives receiving REA loans had equity-to-assets ratios exceeding 40 percent. Of the 262, 149 made no general patronage capital refund in 1979. Of the 149 cooperatives, 48 had never refunded patronage capital, and 32 of the 48 had equity-to-assets ratios of more than 50 percent.

TVA allows patronage capital to be returned through rate reduction

TVA sells power to over 160 utilities, including 45 electric distribution cooperatives receiving REA loans. As of December 31, 1979, these electric cooperatives had retained patronage capital

totaling $336 million, and 10 of the 45 cooperatives had equity-to-assets ratios of more than 60 percent. TVA permits electric cooperatives it supplies with electricity to refund patronage capital only through across-the-board reductions of electric rates. TVA maintains that the basic purpose of the power provision of the TVA Act is to permit domestic and rural use of electricity at the lowest possible rate. Thus, its position has been that cooperative members realize a return on their capital contributions in the form of future rate reductions. IRS officials informed us that the Service has reviewed this method of refunding patronage capital and determined it to be in accordance with the basic requirements for cooperative operation as set forth by Revenue Ruling 72-36 (see p. 43).

State regulatory agencies do not require patronage capital distribution

At the time of our review, electric cooperatives were regulated by State agencies in 24 of the 46 States in which they were located. Only Iowa requires that patronage capital be returned to members within a stipulated timeframe. Although other States do not impose requirements on patronage capital refunds, some monitor refunds as part of their ratemaking processes.

Through inquiries made concerning the role State power agencies have in regulating electric cooperatives, we found that two distribution cooperatives in a midwestern State had not refunded patronage capital to their members in 1978 and 1979 even though the refund costs were included in their approved rates of return. The State power commission having jurisdiction over the cooperatives subsequently ordered that the refunds be carried out. According to one official of the power commission, electric cooperatives' patronage capital refunds are now being verified on a 2-year cycle.

Since this matter could be applicable to electric cooperatives not under State regulation and could have an adverse impact on cooperative members, we brought this matter to the attention of REA which is responsible for reviewing electric rates of electric cooperative borrowers. REA had not been verifying the cost of patronage capital refunds in the past. Recently, it instituted a requirement that patronage capital refund costs be verified during field office visits.

CONCLUSIONS

A further indication of the growth of present day electric cooperatives is that many have been able to accumulate significant sums of patronage capital and are currently holding about $3.9 billion in member equity.

Under cooperative principles, patronage capital is supposed to be refunded to members when it is deemed to be over and above that needed to finance cooperative operations and expansion. Some electric cooperatives have established plans that balance their financial operating needs and growth along with the need to refund members' patronage capital. Others, however, have no such plans or intentions to establish them.

Some Federal and State agencies interacting with electric cooperatives have certain policies and procedures which affect the distribution of members' patronage capital. Also, as discussed in the next chapter, although the Internal Revenue Code grants tax exemption to electric cooperatives primarily on the basis of their mode of operation, IRS has difficulty in determining whether electric cooperatives are retaining and accumulating members' patronage capital beyond reasonable business needs.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this report, the Secretary of Agriculture, in a letter dated August 18, 1982, stated that the draft was critical of electric cooperatives' member equity levels and does not recognize the need for cooperatives to retain patronage capital in order to become self-sufficient. In a letter dated July 26, 1982, the Acting General Manager of NRECA interpreted the report as directing electric cooperatives not to build up their equity levels. NRECA maintained that the report contradicts other Federal mandates and a prior GAO recommendation for electric cooperatives to increase their equity levels so that they could qualify for private financing. NRECA went on to say that the Congress has continuously examined the need for electric cooperatives to retain equity, and that it would be difficult to simultaneously increase equity levels and refund members' patronage capital.

We emphasize that it is not our intention to prevent electric cooperatives from building equity or to hinder them from obtaining private market financing. Rather, we recognize the need for cooperatives to retain equity capital from members in order to become financially self-sufficient. However, as nonprofit cooperative organizations, they are also obligated to return margins to members, either directly or through rate reductions, once accumulations exceed a level necessary to finance their operations and expansion needs.

The need for electric cooperatives to operate in a nonprofit manner is also recognized by NRECA. In its comments on our draft report, NRECA pointed out that ownership by consumer-members and nonprofit operations are relevant factors concerning the tax exemption of electric cooperatives. We fully agree. We also point out in the report that some electric cooperatives have been able to accomplish these objectives by establishing equity management plans. These plans enable cooperative managers to make better informed decisions regarding the adequacy of equity levels and the refunding or rotating of members' equity capital on a consistent and timely basis. Other cooperatives, however, have neither established such equity management plans nor have any intentions of doing so.

Consequently, we continue to believe that cooperatives should plan to systematically refund members' equity capital in accordance with cooperative operating principles. We also believe that REA can assist cooperatives in achieving these goals by encouraging those cooperatives not having equity management plans to establish them in the future.

In addition to being useful to cooperative management in determining the proper level of equity to be retained, equity management plans could also be useful for tax administration purposes. As we discuss in the next chapter, IRS has had difficulty in administering the tax exemption provisions of the Code applicable to electric cooperatives, especially in its attempts to deal with member equity issues.

CHAPTER 4

IRS HAS PROBLEMS ADMINISTERING EXISTING TAX EXEMPTION PROVISIONS FOR ELECTRIC COOPERATIVES

As previously discussed, many electric cooperatives' operations and service areas have changed since the tax exemption laws were enacted. IRS has tried to address these changing conditions in administering the tax exemption provisions of the Internal Revenue Code. However, these efforts have been hampered by broad legislation passed in the 1920s that does not reflect the variances in present day cooperative activities. As a result, IRS has had to focus on the only specific legislative criteria--the 85 percent member income requirement. However, even this requirement has been difficult for IRS to administer because of the complexity of present day electric cooperative activities and the absence of specific criteria for resolving certain issues relating to member and nonmember income.

The recommendations in this chapter are intended to facilitate IRS' administration of present tax exemption provisions. The Congress, however, needs to consider alternatives to the present tax treatment of electric cooperatives, such as those discussed in chapter 5, which would better recognize the changes in cooperatives' activities.

LACK OF SPECIFIC LEGISLATIVE CRITERIA HAS MADE IT DIFFICULT FOR IRS TO ADDRESS THE CHANGES IN ELECTRIC COOPERATIVE ACTIVITIES

The origin of section 501(c)(12) dates back to the Revenue Act of 1916, when the Congress granted tax exemption to a number of organizations, including certain mutual or cooperative companies of a purely local character which derived their income solely from members. The law was subsequently amended in 1924 so that, among other things, 85 percent rather than all of the companies' income had to be collected from members. Despite the changes that have occurred in the extent and nature of electric cooperative activities, the 85 percent member income requirement is basically the only specific legislative criteria available for IRS to use in administering the law.

IRS has attempted to address the changes in electric cooperatives' operations and activities by issuing technical advice memoranda applicable to individual cooperatives and public revenue rulings which interpret the law almost on a case-by-case basis. However, some of IRS' requirements lacked specific

criteria for implementation and administration. Some others have been successfully challenged by electric cooperatives in the courts.

In 1972, IRS issued a revenue ruling (Rev. Rul. 72-36), which consolidated and set forth its basic criteria and requirements for cooperative operation under section 501(c)(12). The ruling stated that:

--The rights and interests of members in net margins should be determined in proportion to their business with the organization.

--Funds can be retained in excess of those needed to meet current losses and expenses as long as they are not accumulated beyond the reasonable business needs of the organization.

--Records must be maintained as are necessary to determine, at any time, each member's rights and interests in the assets of the organization.

--Under an organization's bylaws, a member's rights and interests in the organization's assets cannot be forfeited upon withdrawal or termination of membership.

--Upon dissolution, gains from the sale of assets should be distributed to all persons who were members during the period the assets were owned by the organization.

Our review of all technical advice memoranda issued through 1979 showed that:

--IRS' requirement that records be maintained to determine each member's rights and interests in the assets of an organization can be satisfied merely through retention of billing records. IRS does not require electric cooperatives to maintain capital accounts for their members or even apprise members of amounts they have paid in excess of cost.

--Funds may be retained in excess of those needed to meet current losses and expenses, as long as they are not accumulated beyond the reasonable needs of the organization. However, IRS has no specific criteria for determining whether electric cooperatives are retaining patronage capital beyond reasonable business needs. Furthermore, as discussed in chapter 3, cooperatives are not required to maintain equity management plans, which would provide some indication of reasonableness.

IRS has had difficulty sustaining some of its decisions in the courts due to the broad language of section 501(c)(12). Electric cooperatives have successfully challenged IRS' positions in at least two Federal court districts.

The U.S. Court of Appeals for the Ninth Circuit affirmed a district court decision (Peninsula Light Co., Inc. vs. United States 552 F. 2d 878 (1977)) that the failure of an electric cooperative to credit or distribute its margins on a patronage basis and the forfeiture of the rights and interests of its members upon termination of membership were not grounds for revocation of its tax-exempt status. The court held that, as a nonprofit corporation owned by its members, each of whom had equal voting rights and an equal share in its assets, the electric cooperative need not operate on a patronage basis in order to qualify for exempt status under section 501(c)(12). It also indicated that the manner in which an electric cooperative treats surplus (retained margins) is not a proper IRS concern.

IRS has taken exception with this decision on the basis that it reflects a lack of understanding of the basic cooperative principles of at-cost operation (Rev. Rul. 78-238). In all other circuits, IRS continues to require tax exempt electric cooperatives to operate on a cooperative basis in accordance with Revenue Ruling 72-36.

In the second case, the U.S. Court of Appeals for the Sixth Circuit upheld a district court decision (United States vs. Pickwick Electric Membership Corp. 158 F. 2d 272 (1946)) that an electric cooperative qualified for tax exemption as a social welfare organization under section 101(8) even though it did not meet the section 101(10) requirement that 85 percent of its income be derived from members. 1/ The court ruled against the exclusive application of section 101(10), stating that "the "two exempt classifications are cumulative, not mutually exclusive." Id. at 276. IRS disagrees with this decision (Rev. Rul. 57-494), and maintains that an organization clearly described in section 101(10) which meets all the requirements for exemption under that section, except for the 85 percent income requirement, does not qualify for exemption under section 101(8).

These court decisions have hindered IRS' efforts to recognize the changing nature of electric cooperatives in its administration of section 501(c)(12).

1/Sections 101(8) and (10) were the statutory predecessors to sections 510(c)(4) and (12), respectively.

IRS' COMPLIANCE PROGRAM LACKS ADEQUATE CRITERIA

IRS' efforts to monitor and enforce compliance of established requirements for tax exemption under section 501(c)(12) have shown few results. IRS' enforcement of tax exemption requirements focuses on the one statutory criteria for exemption--that 85 percent or more of an electric cooperative's income be collected from members. But even this requirement has proven increasingly difficult for IRS to administer and for electric cooperatives to comply with.

IRS examinations have little impact

IRS' Exempt Organizations Division has responsibility for monitoring the compliance of more than 800,000 entities and organizations recognized as exempt from Federal income taxes under section 501(c) of the Internal Revenue Code. It does this primarily through examinations, which focus on the organizations' articles of incorporation, operating bylaws, minutes of directors meetings, reconciliation of tax return information with books of account, employment tax returns, analysis of income and expense accounts, and unrelated business activities. In examining organizations exempt under section 501(c)(12), one of IRS' main objectives is to determine whether 85 percent or more of a cooperative's income is collected from members.

Although no data was readily available relating specifically to electric cooperatives, during fiscal year 1979 IRS examined 22,371 exempt organization returns and recommended additional tax and penalties totaling $13.7 million. Of these totals, 501(c)(12) organizations accounted for only 275 returns and $5,066 in additional tax and penalties--an average of only $18 per return examined. This was exclusive of unrelated business income tax recommended deficiencies which are not identifiable by category of exemption from IRS records.

IRS and electric cooperatives have problems administering and complying with the 85 percent member income requirement

The 85 percent member income requirement was added to the law by the Revenue Act of 1924. It was intended to help small cooperatives financially by allowing them to earn some interest on their idle funds. As the requirement is presently administered, however, electric cooperatives can earn significant amounts of nonmember income--up to millions of dollars--yet continue to be

in compliance with the law. In addition, the member income requirement has become increasingly difficult for IRS to administer and for cooperatives to comply with.

The member income requirement may no longer be meeting its intended purpose

Electric cooperatives can earn substantial income from nonmember sources and still continue to meet the 85 percent member income requirement of the law. The requirement is applied on a gross income basis. That is, 85 percent or more of a tax exempt cooperative's gross income (gross receipts less cost of goods sold) must be collected from members. For those years in which less than 85 percent of an electric cooperative's gross income is earned from members, it foregoes tax exemption and is liable for Federal income tax on the total net income earned from nonmember sources. As of August 1980, IRS had suspended the tax-exempt member status of one electric cooperative for not meeting this requirement. (Other electric cooperatives may have been suspended but subsequently were reinstated to exempt status as of this date.)

As shown on page 22, electric cooperatives' nonoperating margins have increased in recent years and represent a substantial portion of their net year-end margins. The following table, based on calendar year 1979 operating results of selected cooperatives, illustrates that electric cooperatives can earn substantial amounts of income from nonmember sources and still qualify for tax exemption.

Power supply cooperatives	Gross income from members	Gross income (net margin) from nonmembers sources	Gross income from all sources	Percent of gross income from members
A	$19,572,639	$1,692,952	$21,265,591	.92
B	80,721,184	4,065,115	84,786,299	95
C	24,173,006	1,596,485	25,769,491	94
D	61,007,695	7,558,295	68,565,990	89
Distribution cooperatives				
A	$6,891,593	$446,077	$7,337,670	94
B	7,427,162	766,254	8,193,416	91
C	4,254,559	422,569	4,677,128	91
D	7,055,398	692,013	7,747,411	91

Source: REA Bulletin 1-1, 1979

Significant amounts of tax-free nonmember income are permitted under present law--as much as $4.1 million and $7.6 million in the above cited cases. Thus, given the growth in some electric cooperatives, we question whether the 85 percent member income requirement is still the best way to meet a purpose of the Revenue Act of 1924--to assist small companies financially by permitting them to earn some tax-free interest on their idle funds.

IRS needs to provide more guidance on the member income requirement

As the operations and activities of electric cooperatives have grown more complex, it has become more difficult for electric cooperatives to determine the percentage of gross income collected from members as opposed to nonmembers and for IRS to monitor compliance with the law. IRS could help this situation by providing more adequate guidance to its revenue agents and to electric cooperatives concerning how member and nonmember income percentages should be computed.

Much of IRS' guidance has been in the form of general counsel memoranda and technical advice memoranda which relate only to specific situations and, until recently, were not public information. For example, IRS has determined that:

--Income from members who have no voice in management and who receive no share in the net margins of the cooperative cannot be considered member income for purposes of the 85 percent requirement. (GCM. 35165, 1972)

--Gross income from the sale of electricity produced by a generating cooperative is to be determined by subtracting production costs (in accordance with the full absorption method of accounting) from gross receipts from its sale. (GCM. 37199, 1977)

IRS has not, however, addressed certain issues which affect the computation of member income. This is particularly important in view of the growth and changing activities of some electric cooperatives. These issues include:

--Whether patronage capital received from affiliated cooperatives should be treated as member income, nonmember income, or as an offset to the cost of goods and services purchased.

--Whether all income collected from members of a power supply cooperative should be treated as member income when it (1) has more than one class of members and (2) allocates its lowest cost power to one class of members and higher cost power to other membership classes in crediting patronage capital to members for year-end margins.

--Whether a power supply cooperative can issue more shares of voting stock to one membership class and fewer voting shares to other membership classes, yet consider the latter classes as members for purposes of the member income requirement.

Electric cooperatives are supposed to determine their compliance with the member income requirement as part of their annual filing of exempt organization returns (Form 990). However, in addition to inadequate guidance, the exempt organization return lacks the format and instructions necessary to properly compute the 85 percent member income test. In this regard, 10 of the 64 cooperatives responding to our questionnaire indicated that the exempt organization return needed to be improved, but they did not provide specific suggestions. Our analysis showed that this return needs to be reviewed for possible changes to better enable cooperative companies exempt under section 501(c)(12) to determine compliance with the member income requirement of the law. Specifically, the return or a supplemental schedule should provide the format and instructions necessary to properly account for member and nonmember income and compute the 85 percent member income test. IRS' Tax Forms Coordinating Committee, as part of its ongoing responsibilities, should examine the return from a compliance, as well as paperwork burden, standpoint to determine whether changes are warranted.

The lack of guidance has also made it difficult for IRS agents to compute the 85 percent test. Our analysis of 36 examinations which were conducted by 7 IRS district offices and covered tax years 1972 to 1977 showed that in 16, or about 44 percent of the examinations, IRS agents had conducted the test on a gross receipts rather than gross income basis. Moreover, our recomputation of the test showed that three electric cooperatives had collected less than 85 percent of gross income from their members and, therefore, should not have been tax exempt for the years under examination. During our review, the Exempt Organizations Division implemented a post-examination review process which should help identify future errors made in the computation of cooperatives' member income percentage. We still believe, however, that IRS needs to provide more specific guidance to help electric cooperatives account for their member and nonmember income for tax exemption purposes and to better enable its revenue agents to determine whether cooperatives are in compliance with the law.

CONCLUSIONS

Due to the lack of statutory criteria and the changes that have occurred in the operations and activities of electric cooperatives, IRS has had problems administering the tax exemption provisions of section 501(c)(12). IRS has tried to address this

changing environment by formulating positions on tax exemption issues and by publishing several requirements for nonprofit operation under section 501(c)(12). However, some requirements have not provided specific criteria for implementation and administration, and others have not been sustained in the courts.

Even the 85 percent member income requirement--the only specific criteria in the law--has become increasingly difficult for IRS to administer and for electric cooperatives to comply with. Moreover, in view of the significant dollar amounts of tax-free income permitted under law, it is questionable whether this requirement continues to meet its objective of assisting small companies financially by permitting them to earn small amounts of tax-free income. Notwithstanding, IRS needs to take some administrative actions, including providing better guidance to electric cooperatives, which will facilitate its enforcement of the 85 percent member income requirement.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that the Commissioner of Internal Revenue:

--Provide more complete guidance to assist electric cooperatives and other section 501(c)(12) organizations in complying with the 85 percent member income requirement of the law and to assist IRS examiners in determining compliance with this requirement. At a minimum, such guidance should address those issues that affect the computation of member and nonmember income.

--Direct the Tax Forms Coordinating Committee to examine the need for revisions to the exempt organization return (Form 990) and/or the need to include a supplementary schedule to provide the format necessary for section 501(c)(12) organizations to properly account for their member and nonmember income and compute the percentage of gross income collected from members.

AGENCY COMMENTS AND OUR EVALUATION

In a letter dated July 27, 1982, the Commissioner of Internal Revenue essentially agreed with our findings and conclusions concerning the problems and difficulties related to IRS' administration of the tax exemption provisions applicable to electric cooperatives. On the other hand, the Acting General Manager of NRECA, in a letter dated July 26, 1982, disagreed that (1) IRS has had difficulty administering the tax exemption of electric cooperatives because of broad legislation and (2) cooperatives earn substantial nonmember income.

IRS also stated that some electric cooperatives find it financially advantageous to forego exempt status; whereas, NRECA contended that some cooperatives are losing tax-exempt status because of nonmember sales.

Need for administrative guidance

IRS stated that it has already provided some guidance to its agents and electric cooperatives in determining how member and nonmember income should be computed in complying with the 85 percent member income test of the law. It further stated that it is in the process of giving additional guidance.

IRS acknowledged the results of our analysis of examinations conducted during tax years 1972 to 1977 and said that there was considerable confusion during this time about the proper method of computing electric cooperative member income. It stated it subsequently alerted field agents, through audit guidelines and training programs, that they should consider cost of goods sold in determining whether a cooperative has met the member income requirement. IRS also stated that its Chief Counsel's Office has established a regulation project to formulate how the cost of goods sold relating to the sale of electricity should be calculated in computing electric cooperatives' gross income. This project, however, does not address certain member/nonmember income issues, such as those which we discuss on pages 47 and 48. IRS commented that it attempts to keep its agents informed of issues and problems, like the ones we raised, as part of the post examination review program which it established in 1980.

IRS initially had reservations about whether the exempt organization return (Form 990) needs to be changed so that section 501(c)(12) organizations can account for member and nonmember income and compute the percentage of gross income collected from members. It said that the Form 990 already segregates member and nonmember income and that electric cooperatives are well aware of the 85-percent test and the need to distinguish member and nonmember income. It further said that since only a small percentage of organizations that file Form 990 are exempt electric cooperatives, it is important to make only those changes on the form that are essential. IRS did, however, agree to make revisions to the Form 990 instructions.

After receiving IRS' comments, we met with IRS officials and discussed specific difficulties that both IRS agents and the electric cooperatives were experiencing in complying with the 85 percent nonmember income requirement. IRS officials agreed to inquire into the specific issues we raised concerning the computation of member income to ascertain whether additional guidance is needed. They also agreed to consider expanding the scope of the above mentioned regulation project to include assessing

whether changes in the Form 990 format and/or an illustrative example are required.

Changes in electric cooperatives' tax status

Both IRS and NRECA commented on certain electric cooperatives losing their exempt status; however, their comments differed as to the reasons why. Our review of IRS records showed that as of August 1980, one electric cooperative had been suspended for not meeting the 85 percent member income requirement. NRECA stated that there are presently 13 power supply cooperatives which have either lost their tax exemption due to nonmember sales or expect to in the near future.

We could not confirm these figures with IRS. In its comments, however, IRS stated that recently certain electric cooperatives have decided that it is financially advantageous not to be exempt so that they can obtain the tax benefits afforded by the new (safe harbor) leasing rules prescribed by section 168(f)(8) of the Internal Revenue Code. It further stated that these cooperatives propose to intentionally violate a requirement of exemption so that they will no longer be under section 501(c)(12). IRS officials we met with subsequent to receiving IRS' comments said that several other cooperatives have recently sought technical advice on whether certain income is considered to be nonmember income. According to those officials, these cooperatives wanted confirmation in writing to assure that they would be suspended from exempt status if they entered into certain transactions. In this regard, REA also informed us that as of August 4, 1982, it had approved safe harbor leases for seven power supply cooperatives involving the sale of assets (which would be considered nonmember income) totaling nearly $1.9 billion.

IRS officials pointed out that electric cooperatives can forego tax exempt status in one year to take advantage of the safe harbor provisions and be reinstated in subsequent tax years if they again meet the requirements for exemption. It should be noted, however, that the recently enacted Tax Equity and Fiscal Responsibility Act of 1982 substantially reduced some of the tax advantages of the Internal Revenue Code's leasing provisions.

IRS has difficulty administering tax exemption provisions

NRECA disagreed with our conclusions that IRS has experienced difficulty in administering tax exemption provisions for electric cooperatives because of the broad exemption legislation. NRECA maintained that IRS already possesses sufficient authority to prevent the excessive accumulation of equity. It also stated that the unrelated business income tax provisions of the Code assure that taxes are paid on cooperatives' income from activities which fall outside their exempt function. In this connection, it

noted that electric cooperatives have little nonmember income, and stated that the 85 percent member income test assures that the bulk of electric cooperatives' business is conducted with members.

With regard to NRECA's disagreement with our conclusion about problems caused by the broad tax exemption legislation, we believe the evidence available clearly demonstrates that IRS has indeed had difficulty in (1) addressing the changes in electric cooperative operations and activities by issuing technical advice memoranda and public revenue rulings, (2) determining the reasonableness of electric cooperatives' equity accumulations, and (3) administering the 85 percent member income requirement of the law. Moreover, as discussed in Chapter 1, both IRS and Treasury have expressed concerns about the structure and scheme of broad exemption statutes which have placed increased interpretive and administrative burdens on IRS in attempting to apply these laws to exempt organizations' modern day activities.

Although NRECA stated that IRS has sufficient authority to prevent excessive equity accumulations, neither we nor IRS share this opinion. IRS officials we met with after receiving IRS' formal comments informed us that the Service has experienced considerable difficulty in determining the reasonableness of electric cooperatives' equity accumulations. They also pointed out that tax-exempt electric cooperatives could accumulate members' equity funds indefinitely, so long as these funds are reinvested in the business. Furthermore, cooperatives are not required to maintain equity management plans or to apprise members of the amounts of equity capital they have contributed, provided records are available to determine members' interests in the event of liquidation.

IRS stated in its July 27, 1982, letter that unless the Congress provided precise guidelines for determining the reasonableness of cooperatives' member equity accumulations, such determinations would continue to pose an administrative burden on IRS and the cooperatives. It should be noted in this regard that some cooperatives presently have equity levels ranging from 75 percent to more than 90 percent of assets. Yet, IRS has no specific criteria for determining the reasonableness of electric cooperatives' accumulation of members' equity; and to date, IRS has found no accumulations of member equity to be unreasonable.

We agree with NRECA's statement that the 85 percent member income test assures that the bulk of electric cooperatives' business is conducted with members. However, we emphasize that under the

85 percent member income provision, electric cooperatives are permitted to earn substantial dollar amounts of nonmember income and still qualify for tax exemption. We further emphasize, as discussed on pages 45 to 48, that IRS has problems administering this provision. Electric cooperatives earned about $160 million in nonoperating margins during 1981, not including operating margins from nonmember sources. In view of the significant dollar amounts of tax-free income permitted under the law, as illustrated by the examples cited on page 46, we continue to question whether the 85 percent member income requirement is still the best approach for meeting the Congress' intent of assisting small companies financially by permitting them to earn some tax-free interest on their idle funds.

CHAPTER 5

ALTERNATIVES TO THE PRESENT TAX TREATMENT OF ELECTRIC COOPERATIVES WOULD BETTER RECOGNIZE THEIR CHANGING OPERATIONS

Tax exemption provides an indirect tax subsidy to electric cooperatives and their members. Under the provisions of section 501(c)(12), electric cooperatives are permitted to earn substantial untaxed income from nonmember sources which subsidizes cooperative members' cost of electricity. Unlike other Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives.

Many electric cooperatives are still small associations which continue to need assistance in order to provide electricity to rural areas at rates comparable to those charged in urban areas. Others have substantially changed in character or have progressed to the point where they closely resemble their taxable counterparts. Yet, all electric cooperatives continue to benefit from tax exemption, provided they meet the broad requirements of the law.

The recommendations in chapter 4, if adopted, should enable IRS to better administer the existing tax exemption provisions of the law. However, the Congress should consider alternatives to the present tax treatment of electric cooperatives and adopt treatment which would better recognize the changes in their operations and the present day environment in which they operate. To this end, this chapter presents several alternative tax treatments which would (1) modify electric cooperatives' nonmember income allowance, (2) eliminate that allowance, or (3) apply tax rules applicable to other cooperative businesses. These are by no means all inclusive, but are suggested as a framework for the Congress' consideration.

MODIFICATION OF THE NONMEMBER INCOME ALLOWANCE

One alternative would be for the Congress to provide limited tax assistance to electric cooperatives by replacing the present 85 percent member income provision of the law with a nonmember income exclusion. For example, if a $50,000 exclusion were established, electric cooperatives could exclude the first $50,000 of nonexempt function income from their taxable income. In 1979, 498, or more than half of the tax-exempt electric cooperatives, earned nonoperating margins of less than $50,000. Thus, adopting

this tax treatment would be in line with the purpose of the 85 percent member income requirement, that is, to assist cooperatives financially by permitting them to earn small amounts of tax-free nonmember income.

ELIMINATION OF THE NONMEMBER INCOME ALLOWANCE

The Congress could restructure tax exemption to apply only to electric cooperatives' income from the sale of electricity to members. Nonmember income, such as dividends, interest, rents, and royalties, would be taxed at normal corporate rates. This tax treatment already applies to homeowners' associations exempt under section 528. Revising section 501(c)(12) in this manner would discontinue the subsidization of members' service costs with tax-free income from nonmember sources.

The Treasury Department estimated in 1977 that taxing electric cooperatives' nonmember income would have little revenue impact. Treasury estimated that minus investment tax credits, tax revenues would have been less than $2 million in 1977. However, electric cooperatives' nonmember income has tripled between 1977 and 1981, going from about $45 million to over $160 million, and this could warrant an upward revision in Treasury's estimate.

APPLICATION OF SUBCHAPTER T RULES TO ELECTRIC COOPERATIVES

Subchapter T of the Internal Revenue Code (sections 1381 to 1388) could be amended to cover electric cooperative companies presently exempt under section 501(c)(12). Application of these rules to electric cooperatives would have little impact on cooperative members who purchase electricity for residential or nonbusiness purposes, but it would eliminate the tax benefit received by the cooperatives' commercial and industrial members.

The Revenue Act of 1962 established Subchapter T to assure that cooperative income is taken into account by either the members or the cooperatives for income tax purposes. Subchapter T tax treatment presently excludes mutual or cooperative companies exempt under section 501 as well as certain other nonexempt cooperative companies. Under Subchapter T, cooperatives are permitted to deduct both cash and noncash patronage refunds from their gross income under certain conditions detailed in the law. The principal condition is the consent of members to include the full amount of patronage refunds in their taxable income. This condition does not apply to refunds attributable to personal, living, or family expenses. Therefore, residential and nonbusiness members are unaffected by Subchapter T.

Exclusion from Subchapter T, as is presently the case, can provide a tax benefit to the cooperatives' business members since they receive a tax deduction for that part of their electric bill which is a contribution to capital (patronage capital credited to members but retained by the cooperative). Income taxes on these contributions to capital are presently deferred until patronage capital is refunded in cash and taken in as income by the members. This is different from the tax treatment of other businesses which are not permitted a tax deduction for contributions made to capital.

If Subchapter T were extended, electric cooperatives' net margins attributable to businesses would be taxed at either the cooperative or member level. In order to be deductible by the cooperative, net margins would have to be allocated as "qualified patronage dividends" to members who would be required to take the dividends into account as income in the year allocated, rather than when actually paid. If net margin allocations did not qualify under Subchapter T, they would be taxable income to the cooperatives.

This alternative would place electric cooperatives' commercial and industrial members on a more equal footing with similar consumers serviced by taxable utility companies. A disadvantage to the cooperatives, however, is that under the present provisions of Subchapter T they would be required to refund at least 20 percent of their year-end margins in cash.

The Treasury Department has estimated that, if electric cooperatives were subject to Subchapter T rules, about $30 million additional income tax revenue would have been collected in 1977. Using the Treasury Department's model, but substituting more current figures, we estimate this amount would have increased to about $45 million in 1981.

CONCLUSIONS

Tax exemption, as presently structured, applies across-the-board to all electric cooperatives regardless of the extent and nature of their operations and activities. Yet, many cooperatives have progressed to the point where they closely resemble their for-profit counterparts and earn substantial tax-free income from nonmember sources which subsidizes their members' cost of electricity. In view of this, we believe the Congress should evaluate alternative tax treatments and adopt one which would better recognize the changing operations of electric cooperatives and their continuing need for assistance in today's environment. Such alternatives might include, but need not be limited to:

--Providing limited tax assistance to cooperatives by replacing the 85 percent member income provision with a nonmember income exclusion.

--Eliminating the nonmember income allowance which permits cooperatives to earn untaxed income from nonmember sources.

--Making Subchapter T rules applicable to electric cooperatives.

Although the revenue impact resulting from the adoption of tax exemption alternatives may not be significant, there are the additional considerations of tax equity and the credibility and administrability of the tax exemption laws. These nonmonetary considerations should also be weighed in assessing the relative merits of the alternative tax treatments presented in this chapter.

Finally, it should be noted that section 501(c)(12) also exempts other mutual or cooperative companies, such as mutual ditch or irrigation companies, and cooperative telephone companies, which are in many ways similar to electric cooperatives. Our review did not specifically address these organizations. Given their common characteristics, however, it may be beneficial for the Congress, in re-examining the tax treatment of electric cooperatives, to broaden its inquiry to cover all companies exempt under section 501(c)(12).

RECOMMENDATION TO THE CONGRESS

Recognizing the changes that have occurred in the extent and nature of electric cooperatives' operations since they were granted tax exemption, we recommend that the Congress, using alternatives in this chapter as a guide, establish a tax treatment which better addresses electric cooperatives' present operating environment.

AGENCY COMMENTS AND OUR EVALUATION

IRS, NRECA, and the Departments of the Treasury and Agriculture provided comments relating to the alternative tax treatments we proposed for the Congress' consideration. In a July 26, 1982, letter, the Acting General Manager of NRECA contended that in view of recent changes in tax laws favorable to investor-owned utilities, we, in essence, have singled out electric cooperatives as the only segment of the electric utility industry to be subject to Federal income taxes. We grant that our work was focused on electric cooperatives. However, the Assistant Secretary of Treasury (Tax Policy), in an August 18, 1982, letter, not only

questioned continued Federal subsidization of electric cooperatives but also suggested that the alternatives we provided to the Congress should have included repeal of tax exemption as it applies to all types of mutual and cooperative associations covered under section 501(c)(12).

Both the Secretary of Agriculture, in an August 18, 1982, letter, and NRECA raised concerns over the effects of taxing electric cooperatives on their ability to build up equity levels. Also, the Commissioner of Internal Revenue in a July 27, 1982, letter, and the Secretary of Agriculture pointed out potential problems with using equity levels as a statutory basis for tax exemption.

Taxation of electric cooperatives is not discriminatory

NRECA indicated in its comments that municipally-owned utilities have historically been exempt from taxation and that, over the past few years, the Congress has revised the Internal Revenue Code to offer IOU's complete freedom from Federal income tax liability. NRECA further held that we had singled out electric cooperatives to be the only segment of the electric utility industry to be subject to Federal income tax and that to do so was illogical. We disagree with NRECA's contentions.

As NRECA correctly points out in its comments, the Economic Recovery Tax Act of 1981 changed the Internal Revenue Code as it relates to the investor-owned sector of the electric utility industry. We do not agree, however, that this act has offered investor-owned utilities complete freedom from Federal income tax liability.

The 1981 act expanded investment tax credits and depreciation deductions for all U.S. businesses and provided new safe harbor rules for transferring these tax incentives to other companies through leasing transactions. The act also offered taxpayers deferral of taxes for dividends reinvested in qualified public utilities. The full impact of these tax provisions will not be realized until the mid-1980s, and the act's impact on the Federal income tax liabilities of IOUs is not yet known. Moreover, the Tax Equity and Fiscal Responsibility Act of 1982, as signed by the President on September 3, 1982, scaled back the expanded investment tax credits and depreciation writeoffs enacted in 1981, and substantially reduced the benefits of the leasing provisions of the law.

As discussed on page 24, in the 5-year period ended December 31, 1980, IOUs paid Federal income taxes totaling nearly $4 billion and deferred another $8 billion in taxes on income from electric operations. According to a January 1982 study by the

Congressional Research Service, IOUs had an industrywide effective Federal income tax rate of 11.5 percent. 1/ In view of this and the undetermined impact of recent tax laws on the Federal income tax liabilities of IOUs, we cannot concur with NRECA that electric cooperatives have been singled out by anyone as the only industry segment subject to Federal income taxes. However, we have amended our conclusions in this chapter to recognize that it may also be beneficial for the Congress to include in its reassessment of electric cooperatives' tax treatment other mutual or cooperative companies subject to section 501(c)(12).

In contrast to NRECA's charge that it is being singled out for taxation, Treasury commented that our alternatives should have included a proposal to repeal Code section 501(c)(12) and thus eliminate tax exemption. As discussed in chapter 1, however, the scope of our study was limited to a review of electric cooperatives' operations and activities. Consequently, we do not have an adequate basis for recommending repeal of section 501(c)(12) which also applies to various other mutual and cooperative organizations.

Taxation would not undermine cooperatives' efforts to build equity

In its comments, NRECA stated that to subject to Federal income tax those cooperatives that have increased equity levels in response to the mandates of the Congress and the Executive Branch seems grossly contradictory. Similarly, the Department of Agriculture indicated that should electric cooperatives be required to pay income taxes, they will have fewer internally generated funds available for new plant construction and that this could create pressure for additional low interest REA loans, the cost of which may exceed any tax revenues collected.

Under the alternative tax treatments we presented for consideration by the Congress, electric cooperatives would be subject to Federal income taxes only to the extent of their income from nonmember sources. Electric cooperative income collected from members would remain exempt from taxation under all the alternatives, including Subchapter T tax treatment. As discussed on pages 55 and 56, the estimated annual revenue impact of the tax alternatives ranges from about $2 million under one alternative to $45 million under another alternative, compared with electric cooperatives' 1981 net margins of $497 million.

1/"The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry," January 15, 1982, Congressional Research Service, Library of Congress, Washington, D.C.

In addition, the bulk of such Federal income taxes would be borne by those electric cooperatives having significant amounts of income from nonmember sources. It does not seem equitable for consumers of IOUs to be burdened with Federal income tax paid by their utility companies, while at the same time contributing taxfree income to electric cooperatives as is happening in the situation described in example 4 on page 28. In this example, a power supply cooperative subsidizes its members' cost of electricity with tax-free income from electric sales to IOUs.

Thus, we do not believe the alternative tax treatments recommended in this chapter contradict other Federal mandates, or that Federal income tax collections from electric cooperatives would significantly affect their ability to build equity. Rather, we believe the alternatives provide a means of better recognizing the variances in the operations of many electric cooperatives and of better focusing tax exemption. In addition, these alternatives represent a step towards more equitable tax treatment of the Nation's electric consumers.

The use of equity levels as a basis for tax exemption could have unintended effects

As one of the alternatives presented in a draft of this report sent to various agencies for comment, we proposed that section 501(c)(12) could be amended to better focus on those cooperatives continuing to need assistance by establishing criteria and parameters to determine the need for assistance. We specifically proposed that electric cooperatives' equity-to-assets ratios or accumulations of member equity could be used as indicators of financial stability and need for tax exemption, and that an accumulated earnings tax could be imposed on those funds retained beyond a cooperative's reasonable business needs.

IRS and the Department of Agriculture pointed out that the use of equity-to-assets ratios as a criteria for tax exemption may have the adverse effect of encouraging electric cooperatives to make greater use of borrowed funds. Thus, adoption of this alternative could result in increased demand for REA loans at an increased cost to the Government. IRS further commented that it currently experiences difficulty in determining the reasonableness of cooperative equity accumulations, and that the adoption of a tax treatment based on equity accumulations would be an administrative burden unless the Congress provided precise guidelines for making such determinations. However, even if such guidelines could be provided, this basis, like the equity-to-assets ratio, could encourage greater use of borrowed funds.

Therefore, while we continue to believe that the equity-to-assets ratio and accumulations of member equity are viable measures for assessing a cooperative's financial strength and stability, we acknowledge the possible unintended effects of using equity as a statutory basis for tax exemption. Accordingly, we dropped this alternative from the final report.

SUMMARY OF THE THINKING ON COOPERATIVE PRINCIPLES BY THE ROCHDALE PIONEERS, SELECTED COOPERATIVE STUDENTS, AND THE INTERNATIONAL COOPERATIVE ALLIANCE

Rochdale pioneers	Edwin G. Nourse	Ward W. Fetrow	Henry H. Bakken	Marvin A. Schaars	International Cooperative Alliance
Profits divided pro rata on purchases	Savings distributed as patronage refunds	Sharing savings in proportion to patronage	Service at cost	Service at cost	Earnings belong to members
One person, one vote in government	Democratic control	Democratic control	Democratic representation	Democratic control	Democratic control (one person, one vote in local cooperatives)
Capital provided by members and at a fixed rate	Limited returns capital	Limited returns on capital	Deemphasis of capital	Limited interest on equity capital	Limited interest or none on shares of stock
Percentage of profits allocated to education	-	-	Promotion of education	Promotion of education	Education of members, employees, and public
Equality of sexes in membership	-	-	Selective vs. open membership and political, religious, and racial neutrality	Selective vs. open membership and political and religious neutrality	Voluntary membership no restrictions as to race, political views, and religious beliefs
-	Increased efficiency	-	-	Striving for business efficiency	-
-	-	-	Commodity and functional specialization	Single vs. multiple commodity operation	-
-	-	-	Control and ownership of marketing facilities and service installations	Control and ownership of market facilities	-
			-		Cooperation among cooperatives on local, national, and international levels

Source: Cooperative Business Enterprise, Martin A. Abrahamsen, PH.D., p. 52

APPENDIX I

GROWTH IN GENERATING CAPACITY FOR INVESTOR-OWNED, MUNICIPAL, AND COOPERATIVE UTILITIES

(Installed generating capacity in megawatt hours)

As of Dec. 31	Investor-owned utilities	Percent increase	Municipal utilities	Percent increase	Cooperative utilities	Percent increase
1967	203,580		18,049		3,019	
1968	220,766		19,429		3,434	
Increase	17,186	8.4	1,380	7.6	415	13.7
1969	240,078		20,035		4,318	
Increase	19,312	8.7	606	3.1	884	25.7
1970	262,675		20,941		5,162	
Increase	22,597	9.4	906	4.5	844	19.5
1971	288,301		21,992		5,470	
Increase	25,626	9.8	1,051	5.0	308	6.0
1972	314,353		23,049		6,704	
Increase	26,052	9.0	1,057	4.8	1,234	22.6
1973	346,476		24,956		7,288	
Increase	32,123	10.2	1,907	8.3	584	8.7
1974	376,122		27,324		7,474	
Increase	29,914	8.6	2,368	9.5	186	2.6
1975	399,036		28,787		9,136	
Increase	22,914	6.1	1,463	5.4	1,662	22.2
1976	415,504		30,602		9,947	
Increase	16,468	4.1	1,815	6.3	811	8.9
1977	438,385		33,291		10,889	
Increase	22,881	5.5	2,689	8.8	942	9.5
1978	453,647		34,426		11,635	
Increase	15,262	3.5	1,135	3.4	746	6.9

Source: 1978 Statistical Year Book of the Electric Utility Industry, p. 6, Table 25, Edison Electric Institute.

FEDERAL POWER AGENCY ELECTRIC SALES - FY 1978

	Cooperatives	Municipals	IOUs	Other (note a)	Total
Tennessee Valley Authority					
KWH sales (000)	21,190,000	55,326,000	175,000	41,255,000	117,946,000
Revenue per KWH (¢)	2.00	1.97	2.22	1.93	1.96
Bonneville Power Administration					
KWH sales (000)	6,493,000	10,395,000	13,566,000	46,057,000	76,511,000
Revenue per KWH (¢)	0.40	0.35	0.49	0.30	0.35
Bureau of Reclamation					
KWH sales (000)	8,617,000	8,583,000	5,334,000	32,747,000	55,281,000
Revenue per KWH (¢)	0.72	0.63	1.18	0.30	0.50
Southwestern Power Administration					
KWH sales (000)	2,533,000	1,543,000	518,000	745,000	5,339,000
Revenue per KWH (¢)	0.88	0.78	1.24	0.67	0.86
Southeastern Power Administration					
KWH sales (000)	2,918,000	1,125,000	93,000	3,285,000	7,421,000
Revenue per KWH (¢)	0.79	0.60	12.89	0.37	0.73
Totals					
KWH sales (000)	41,751,000	76,972,000	19,686,000	124,089,000	262,498,115
Revenue per KWH (¢)	1.33	1.56	0.77	0.85	1.13

a/Includes sales to other Federal agencies for own use and resale (44.3 billion KWH); to ultimate consumers (52.8 billion KWH); and to state and district agencies (26.9 billion KWH).

U.S. GENERAL ACCOUNTING OFFICE
QUESTIONNAIRE FOR STUDY OF ELECTRIC COOPERATIVES' OPERATIONS AND POLICIES (note a)

INTRODUCTION

This questionnaire is being used to gather information for a GAO study of the operations and policies of electric cooperatives. It asks for information on equity redemption policies and practices with respect to general and special retirements of patronage capital, and comments on complying with, and IRS' administration of, tax-exemption provisions.

Most of the questions can be answered by simply checking a box or entering a small amount of written information.

• This questionnaire is numbered to aid us in our follow-up efforts and will not be used to identify your organization with your responses in any report which we issue.

Throughout this questionnaire, there are numbers printed within parentheses to assist our keypunchers in coding responses for computer analysis. Please disregard these numbers.

A pre-addressed return envelope has been enclosed with the questionnaire. We ask that the questionnaire be completed and returned in that envelope within 5 days of receipt. If you find it difficult to complete and return the questionnaire that promptly, or if you have any questions about the questionnaire or the review, please call either Mr. Andrew F. Macyko at (212) 264-0746 or Mr. Daniel C. Harris at (202) 376-0023.

In the event that the return envelope is misplaced, the return address is:

U.S. General Accounting Office
Room 6126
Attention: Bill Johnston
441 G. Street, N.W.
Washington, D.C. 20548

Thank you for your cooperation.

Card 1
/ / / (1-2)
/1/ (3)

I. COOPERATIVE'S FIRST YEAR OF OPERATION

In this section we are interested in obtaining statistics on electric cooperative assets, revenues, sales, and membership for the first year of operation or the earliest year records are available.

1. When was the first year of the cooperative's operation?

   First year of operation: 19/ / / (4-5)

2. Please provide the following figures for the cooperative's first year of operation or for the earliest year records are available for all of the following information:

   1. Please indicate year used below.

      19/ / / (6-7)

   2. Total assets and other debits

      $/ / / / / / / / / / (8-15)

   3. Total investments in associated organizations including other property and investments

      $/ / / / / / / / (16-21)

   4. Total operating revenues and patronage capital

      $/ / / / / / / / / (22-28)

   5. Total megawatt hour sales

      $/ / / / / / (29-33)

   6. Total megawatt hour sales to residential consumers (farm and non-farm)

      $/ / / / / / (34-38)

   7. Total members of the cooperative

      / / / / / / (39-43)

II. POLICIES REGARDING PATRONAGE CAPITAL

In this section we are interested in obtaining information on cooperative equity redemption policies and the maintenance of patron accounts.

3. Does the cooperative maintain capital credit accounts for each of its patrons? (44)

		Response Percentages
1. /59/ Yes	(Go to 5)	92
2. /5/ No	(Continue)	8
		100

a/Summarizes responses of 64 randomly selected electric distribution cooperatives answering our questionnaire. Percentages shown are rounded.

4. If no, what records are maintained to reflect each patron's interests in the cooperative's assets? (Check one.) (45)

   1. /2/ Consumer ledger
   2. /2/ Billing record
   3. /_/ No record
   4. /1/ Other (please specify) ____________

5. How does the cooperative treat non-operating margins? (Check all that apply.) (46-49)

   1. /56/ Allocates the same as operating margins
   2. /16/ Applies to prior year deficits
   3. /3/ Doesn't allocate; makes no disposition
   4. /3/ Other (please specify) ____________

III. POLICIES REGARDING GENERAL RETIREMENTS OF PATRONAGE CAPITAL

In this section we are requesting information on how cooperatives retire patronage capital, their equity management plans, the administrative cost impact of annual capital credit retirements, and the amount of unclaimed general retirements.

6. What method does the cooperative use to retire general capital credits outstanding? (Check one.) (50)

   Response Percentages

   1. /47/ FIFO — 74
   2. /6/ Percentage method — 9
   3. /2/ Other (specify) ______ — 3
   4. /9/ Not applicable (Cooperative does not retire capital credits.) (Go to question 9.) — 14

   Total — 100

7. Please indicate below the most recent year in which the cooperative used FIFO, the percentage method or any other method to retire general capital credits outstanding. (Enter the year for each method. If not used, LEAVE BLANK.)

Method	Year Used	
1. FIFO	19/_/_/	(51-52)
2. Percentage	19/_/_/	(53-54)
3. Other (specify)	19/_/_/	(55-56)

8. What year does outstanding patronage capital extend back to?

   19/_/_/ (57-58)
   (year)

9. Does the cooperative have an equity management plan? (59)

   Response Percentages

   1. /40/ Yes (Continue) — 63
   2. /24/ No (Go to question 11.) — 37

   Total — 100

10. For which of the following does your equity management plan provide? (Check all that apply; then go to question 13.) (60-63)

    1. /26/ A revolving cycle for patronage capital retirements. (Please specify duration of cycle.)

       /_/_/
       (year(s))

    2. /31/ Guidelines to meet mortgage requirements
    3. /22/ Rate guidelines to assure that the cooperative's cash flow is sufficient to retire patronage capital
    4. /16/ Consistent retirement of patronage capital; e.g., yearly, every three years, etc. (Please specify.)

    ____

    (GO TO QUESTION 13.)

11. Does the cooperative have plans to use an equity management plan in the future? (64)

    1. /15/ Yes (Continue)
    2. /9/ No (Go to question 13.)

12. If yes, in what year will the cooperative initiate use of an equity management plan? (65-66)

    19/_/_/
    (year)

13. To what extent, if any, would each of the following items result from retiring patronage capital on a consistent fixed revolving cycle? (Check one column for each row.)

		Very great extent (1)	Great extent (2)	Moderate extent (3)	Some extent (4)	Little or no extent (5)	
	1. Higher administrative costs	2	4	25	22	11	(67)
a/	2. Member recognition	5	19	25	10	4	(68)
a/	3. Increase cost of capital	12	23	10	15	3	(69)
	4. Higher rates	12	23	15	7	7	(70)
a/	5. Other (please specify) 1-no response						(71)

14. By what percentage are/would administrative costs increase by retiring capital credits annually? (Check one.) (72)

1. /3/ 0%
2. /32/ 1 - 2%
3. /16/ 3 - 4%
4. /9/ 5 - 7%
5. /2/ 8 - 10%
6. /2/ Other (please specify) ______%

15. Which of the following procedures does the cooperative use to account for general retirements made to patrons you were unable to locate? (Check one.) (73)

	Response Percentages
1. /4/ Put in a cooperative educational fund	6
2. /33/ Forward to the State under the State escheat laws	52
3. /25/ Other (please specify) ______	39
2 - no response	3
	100

16. What is the cumulative amount of unclaimed general retirements, as of December 31, 1979?

$/ / / / / / / /
(74-79)

17. To what extent, if at all, do cooperative members influence capital credit retirements? (Check one.) (80)

	Response Percentages
1. /6/ Very great extent	10
2. /4/ Great extent	6
3. /23/ Moderate extent	36
4. /15/ Some extent	23
5. /15/ Little or no extent	23
1-no response	2
	100

Card 2
/ / /
(1-2)
/2 /
(3)

IV. POLICIES REGARDING SPECIAL RETIREMENTS OF PATRONAGE CAPITAL AND MEMBERSHIP TERMINATIONS

In this section, we would like to know what the cooperative's policies are concerning membership terminations.

18. For each category of membership terminations listed below, please indicate whether or not the following policies are applicable. (Check yes or no for each membership category, for each policy.)

Policy	Membership Terminations: Deceased member estates		Members leaving the service area		Members terminating membership (other) (specify)		Trustees of bankrupt corporations		
Does the cooperative:	1 Yes	2 No	1 Yes	2 No	1 Yes	2 No	1 Yes	2 No	
1. Retire capital credits?	40	24	3	61	2	62	7	57	(4-7)
2. Discount patronage capital retired?	7	57	0	64	0	64	0	64	(8-11)
3. Immediately retire total patronage capital?	19	45	0	64	0	64	4	60	(12-15)
4. Immediately retire patronage capital at a discounted rate?	5	59	0	64	0	64	0	64	(16-19)
5. Retire patronage capital only per retirement cycle?	20	44	42	22	40	24	37	27	(20-23)
6. Require forfeiture of patronage capital?	0	64	0	64	0	64	1	63	(24-27)
7. Require forfeiture of equity interests in the assets of the cooperative?	2	62	0	64	0	64	0	64	(28-31)

Card 3
/ / /
(1-2)
/ /
(3)

19. For active and inactive members, indicate the amounts of funds retained by the cooperative, as of 12/31/79. (Fill in an amount for each type of funds retained. If not applicable, write NA in the appropriate box.)

(Enter dollar amount in thousands of dollars; e.g., if $10,000, enter 10.)

Policy	Membership: Active (1)	Inactive (2)	Total (3)	
1. Capital retained	$	$	$	(4-15)
2. Discounted portion of capital retained	$	$	$	(16-27)

20. For active and inactive members, indicate the number of patrons from whom the cooperative has retained funds, as of 12/31/79. (Fill in the number of patrons from whom funds were retained. If not applicable, write NA in the appropriate box.)

(Enter number of patrons in hundreds; e.g., if 3,700 patrons, enter 37.)

Policy	Membership: Active (1)	Inactive (2)	Total (3)	
1. Capital retained				(28-39)
2. Discounted portion of capital retained				(40-51)

21. What does the cooperative do with the discounted portion of capital retained? (Check all that apply.) (52-56)

1. /0/ Used to cover administrative costs of retirements
2. /2/ Put in a special reserve account
3. /2/ Returned to equity
4. /1/ Other (please specify) ____________
5. /55/ Not applicable

V. INTERNAL REVENUE SERVICE ADMINISTRATION OF TAX-EXEMPT PROVISIONS FOR ELECTRIC COOPERATIVES

22. To what extent, if at all, does the cooperative have problems in complying with tax exemption provisions? (Check one.) (57)

			Response Percentages
1. /0/	Very great extent	(continue)	
2. /1/	Great extent	(continue)	2
3. /6/	Moderate extent	(continue)	9
4. /5/	Some extent	(continue)	8
5. /52/	Little or no extent (Go to question 24.)		81
			100

23. Please state problems in compliance and describe the nature and extent of these problems. (Attach additional sheet(s) if you need more space.) (58)

____

____

____

24. In your opinion, to what extent, if any, could IRS improve administration of tax-exemption provisions? (Check one.) (59)

			Response Percentages
1. /1/	Very great extent	(continue)	2
2. /4/	Great extent	(continue)	6
3. /5/	Moderate extent	(continue)	8
4. /6/	Some extent	(continue)	9
5. /47/	Little or no extent (Go to question 26.)		73
1 - no response			2
			100

25. Please describe how IRS could improve administration of tax-exemption provisions. (Attach additional sheet(s) if you need more space.) (60)

____

____

____

BY-LAWS

26. Please attach a current copy of your by-laws. (61)

COMMENTS

27. If you have any additional comments on any question in the questionnaire or related topics, please write your comments below. (Attach additional sheet(s) if you need more space.) (62)

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036/202-857-9500

July 26, 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

This is in response to your letter of June 23, 1982, inviting the National Rural Electric Cooperative Association (NRECA) to comment on a draft GAO report entitled Many Tax-Exempt Electric Cooperatives Have Changed: Legislation Is Needed to Better Focus And Administer Tax Exemption (GAO/GGD-82-83). As we read it, your Draft Report recommends that under certain circumstances rural electric cooperatives should pay Federal Income Tax.

In our judgment, the substance of the Draft Report is grounded on a number of misconceptions concerning the purpose and structure of the Rural Electrification program and the electric cooperatives established to effectuate that purpose.

The special circumstances which initially motivated Federal government involvement in rural electrification have perhaps changed in degree, but they remain as significant and startling in 1982 as they were in 1936. Electric cooperatives experience strikingly low consumer and revenue densities compared with investor-owned and publicly-owned utilities. Rural electric cooperatives serve only 4.7 consumers per mile of overhead distribution line compared to 35.8 consumers per mile for investor-owned utilities and 77.5 consumers per mile for publicly-owned utilities. The revenue per mile for rural electrics is $3,370, whereas the investor-owned utilities receive $42,007 and the publicly-owned utilities receive $68,128. The average cost of capital for electric cooperatives in 1981 was the highest in the industry, 13.5%, and their embedded interest cost is rising rapidly because of their need for new generating plants which of

Anderson
Page 2
July 26, 1982

necessity are being built with high cost money. Nationwide, the retail rates of electric cooperatives are 12% higher on the average than those of other utilities. These statistics provide clear and convincing evidence of the adverse conditions under which rural electric systems operate in 1982. The GAO Draft Report apparently fails to consider these statistics on which the justification for continued Federal support of rural electrification is grounded.

The Draft Report first focuses on the size and operations of rural electric cooperatives, asserting that they "have grown from small struggling associations formed to purchase and distribute electricity to their rural members to larger utility companies closely resembling investor-owned utilities in their operations and activities." NRECA submits that the size of a cooperative has nothing whatever to do with its tax exemption. The operations and activities of these systems are essentially the same as they were in 1924: to provide electricity to their consumer members. The relevant factors are that the cooperative is owned by its consumer-members and operates in a non-profit manner. Rural electric cooperatives have operated from their inception in this manner and continue to do so. Even though size is not relevant to the issue of tax exemption, rural electric cooperatives are small compared with investor-owned utilities. The average IOU serves 307,057 consumers whereas the average rural electric cooperative serves 9,745 consumer-owners. Under no circumstances can even G&Ts be considered comparable in size to large investor-owned utilities, as alleged in the draft report on Page 10. Certainly rural electric cooperatives are larger than they were in 1924, but so are virtually all successful businesses in America today.

We strongly object to the patently erroneous statement made in the Cover Summary of the Report that IRS has experienced difficulty in handling electric cooperatives because of "broad legislation which generally exempts all such cooperatives from paying taxes regardless of the differences in their operations and activities, financial condition, size, or type of consumers served." This cavalier evaluation of the applicable law is about as far from actuality as it is possible to get. The unrelated income tax provisions of the Code assure that taxes are paid by electric cooperatives on activities which fall outside the scope of usual electric utility business. The 85% member income test provided for in the Code assures that the bulk of the business of these cooperatives is conducted with their member-owners. In fact, contrary to implications of the Draft Report, rural

Anderson
Page 3
July 26, 1982

electric cooperatives have little nonmember income -- less than 4% nationwide. There are individual cases where some systems, generally cooperatives engaged in the generation and transmission of bulk wholesale electricity (G&Ts), have substantial nonmember income sales, and, for that reason, have lost their tax exempt status. There are presently at least 13 G&Ts which have either lost their tax exemption due to nonmember sales or expect to in the near future, contrary to the representation of the Draft Report that only one system has lost its tax exempt status.

Second, the Draft Report appears to question the member equity levels of rural electric cooperatives. There is, in fact, reason to be concerned with these levels, but contrary to the Report's conclusions, the reason for concern is that equity levels are too low. Actually, an impartial study of the equity levels of rural electric cooperatives could hardly conclude that these levels are excessive. The weighted average equity level for all rural electric cooperatives, including distribution and G&T systems, is 14.7%. Since rural electric cooperatives are not vertically integrated -- that is, the power supply functions and distribution functions are not generally within the same organization, as is true for investor-owned systems - rural electric equity levels must be viewed as a combination of both G&T and distribution equity. The G&Ts, which generally have low equity levels (3.0%), must rely on the financial health of their distribution system member-owners for their own fiscal stability.

Section 1 of the 1973 amendments to the Rural Electrification Act of 1936 (P.L. 93-32), (7 USC 930), the committee reports on P.L. 93-32, and the policy of every REA Administrator since 1973, and some who served prior to 1973, urge electric cooperatives to reduce their dependence on Federal assistance for investment capital and to raise progressively more such capital in the commercial money markets. Electric cooperatives throughout the country have responded by organizing their own non-Federal supplemental financing vehicle, the National Rural Utilities Cooperative Finance Corporation (CFC), through which they have borrowed several billion dollars of non-Federal debt capital. Commercial money lenders view equity as a critical measure of a borrower's ability to repay and, therefore, as an important indicator of how much money to loan and how much interest to charge. For this reason, the REA Administrator has joined CFC in asking electric cooperatives to raise retail rates as necessary to maintain equity levels adequate to attract non-Federal investment capital at reasonable rates of interest. To suggest now that those electric cooperatives which have acted

Anderson
Page 4
July 26, 1982

responsibly and tried to be responsive to the mandates of Congress and the Executive Branch of the Federal Government by building equity should, as a result, be subject to Federal income tax seems to us grossly contradictory. If this suggestion were not of itself sufficiently contradictory, the instant Draft Report expressly takes note of another GAO report which urges electric cooperatives to increase equity levels, and is "critical of REA for not doing enough to encourage its borrowers to increase their equity levels so that they could qualify for private financing."(See Rural Electrification Administration Loans to Electric Distribution Systems: Policy Changes Needed CED-8-52, May 30, 1980)

We suggest that the United States General Accounting Office decide whether its collective wisdom dictates that electric cooperatives should decrease their equity or increase it. We further suggest that it would be difficult to simultaneously move in both directions.

NRECA further submits that, contrary to the representations within the Draft Report, Congress has continuously examined and does understand the need of electric cooperatives to retain capital and build equity. The fact that there is no mandate that margins be returned in cash to the member-owners is not an oversight. The Tax Code as presently implemented by the IRS does adequately protect consumer-owners. The GAO Draft Report itself notes that under 501 (C)(12) cooperatives' retention of funds is governed by technical advice from the IRS stating that, "Funds may be retained in excess of those needed to meet current losses and expenses, as long as they are not accumulated beyond the reasonable needs of the organization" (emphasis added). Clearly the IRS believes that it already possesses sufficient authority to prevent the accumulation of "excess" equity.

Finally, and of major significance, we point out that in the four years which have been consumed in developing this Study to draft stage, the Congress, with full Administration concurrence and approbation, has revised the Internal Revenue Code to offer complete freedom from Federal income tax liability to the investor-owned segment of the electric utility industry (Economic Recovery Tax Act of 1981). Indeed, even the reinvested common stock dividends of the investor-owned companies are tax exempt to many stockholders. We do not quarrel with these benefits accorded to the power companies. They, like electric cooperatives, need and are deserving of Federal help in meeting their service responsibilities. Historically, municipally owned electric util-

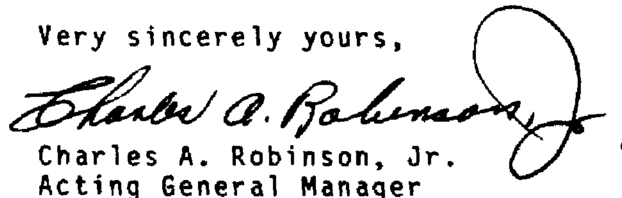
Anderson
Page 5
July 26, 1982

ity systems also have been exempt from Federal income tax liability. We most respectfully suggest that the concept of rural electric cooperatives being singled out as the only segment of the electric utility industry subject to payment of Federal income taxes is wholly illogical; especially so considering the statutory Federal purpose served by these cooperatives and the continuing Federal Assistance to them flowing from the Rural Electrification Act of 1936.

In summary, it is our judgment that the continued movement of Federal policy toward relieving all segments of the electric utility industry from Federal income taxes has so changed the context in which this Study was initiated four years ago as to strip it of any legitimate purpose. We also point out that electric cooperatives are not unique or even unusual as tax exempt organizations. Any business organization, regardless of size or type of ownership is tax-exempt so long as it meets the test of non-profit operation. Moreover, we urge upon the Comptroller General an understanding that electric cooperatives are being urged by their non-Federal sources of investment capital, by REA, and by the GAO itself, to raise equity levels rather than to reduce them as implied by the Draft Report.

In view of the foregoing considerations we urge that the instant study be terminated.

Very sincerely yours,



Charles A. Robinson, Jr.
Acting General Manager

CAR:mmm

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JUL 27 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter of June 23, 1982, requesting comments on your draft report, "Many Tax Exempt Electric Cooperatives Have Changed; Legislation Is Needed to Better Focus and Administer Tax Exemption." These electric cooperatives are currently exempt under section 501(c)(12) of the Internal Revenue Code.

Your report concludes that legislation is needed because section 501(c)(12) is anachronistic. You also recommend that we take certain administrative actions to provide more guidance to the public and our agents.

We neither oppose nor recommend adoption of the proposed legislation since these matters involve tax policy issues that are under the authority of the Treasury Department.

The administrative guidance you suggest is primarily concerned with how an electric cooperative computes its gross income for purposes of the 85 percent test of section 501(c)(12).

We have already provided some of the guidance that you suggest and we are in the process of giving additional guidance. Also, as a result of one of your suggestions, we plan to revise the instructions to the Form 990, Return of Organization Exempt from Income Tax.

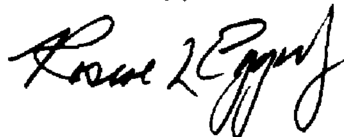
Attached is our analysis of your report that explains in detail the views and comments expressed in this letter.

In view of our comments, expressed in this letter and in the attached analysis, we would encourage your staff to meet with Service representatives before making your report final.

Thank you for giving us an opportunity to comment on your draft report.

With kind regards,

Sincerely,



Attachment
Analysis of GAO Report

Department of the Treasury Internal Revenue Service

ANALYSIS OF GAO REPORT

We have prepared this analysis of your report in order to provide details of the comments made in our cover letter.

Your report describes the growth of electric cooperatives over the past 60 years and explains how they are different from those in existence when Congress originally provided for their exemption from federal income tax in 1916. You observe that, as presently structured, tax exemption provides an indirect subsidy to electric cooperatives and unlike Federal assistance programs that can be directed to those organizations having a continuing need for assistance, tax exemption applies across-the-board to all electric cooperatives whether or not they continue to need such assistance.

Therefore, your report states that certain changes should be made to limit tax exemption to those electric cooperatives that need it. To accomplish this objective you make alternative legislative recommendations. You also recommend that we take certain administrative actions in order to provide sufficient guidance to the public and our agents. At the outset we would like to make clear that we take no position agreeing or disagreeing with the facts, analyses, observations and conclusions of your report other than as expressed herein.

Your report places great emphasis on the importance of exemption to electric cooperatives, but at least some electric cooperatives evidently do not agree. Recently, some electric cooperatives have decided that it is financially advantageous for them not to be exempt so that they can obtain the tax benefits afforded by the new leasing rules prescribed by section 168(f)(8) of the Code. Generally, the lease of property used by an exempt organization will not qualify as a section 168(f)(8) transaction. These cooperatives propose to intentionally violate a requirement of exemption so that they will no longer be described under section 501(c)(12).

With reference to legislative recommendations, your report suggests the following:

1. Use equity-to-assets ratios to identify cooperatives that need tax exemption assistance.

2. Where the reasonableness of a cooperative's accumulated member equity is a criterion for continued tax exemption, provide a means for assisting the IRS in making a determination of what is reasonable.

3. Impose an accumulated earnings tax on electric cooperative funds retained beyond reasonable business needs.

4. Provide limited tax assistance to cooperatives by replacing the 85 percent member income provision with a nonmember exclusion.

5. Eliminate the nonmember income allowance that permits cooperatives to earn untaxed income from nonmember sources.

6. Make subchapter T rules applicable to electric cooperatives.

We neither oppose nor recommend adoption of the proposals you suggest. In any event, it is the Treasury Department, as you are well aware, that must speak to issues of proposed legislation involving tax policy. We have, however, some general comments that we hope will be helpful.

With reference to the use of equity-to-assets ratios to identify those cooperatives that need tax exemption, the purpose of this test would be to deny exemption to cooperatives that have achieved financial stability, but the test would not prevent cooperatives from expanding their operations with borrowed funds and may even encourage them to do so. Thus, a cooperative could borrow its way into exemption. This seems inconsistent with one of the conclusions of your report that the expansion of electric cooperatives in certain ways is undesirable.

With respect to recommendations #2 and #3, we believe that unless Congress provided precise guidelines, determining what is reasonable would be disputable and would not relieve the administrative burden on both the IRS and the electric cooperatives.

As to the need for legislation, we agree that many electric cooperatives are much different today than they were in the early 1900's. However, Congress has not seen fit to restrict their activities. In fact, twice within the past four years section 501(c)(12) has been amended with a liberalizing rather than a restricting effect, particularly with regard to the 85 percent member income requirement.

Your report states that as the operations and activities of electric cooperatives have grown more complex, it has become more difficult for electric cooperatives to determine what constitutes member and nonmember income. According to the report, we need to provide more guidance to our revenue agents and to electric cooperatives as to how member and nonmember amounts should be computed. This has reference to a basic requirement for exemption that, in the language of section 501(c)(12), 85 percent or more of the income consist of amounts collected from members for the sole purpose of meeting losses and expenses. This 85 percent member income test is a gross income test and it is applied on the basis of annual accounting periods. See Rev. Rul. 65-99, 1965-1 C.B. 242 and Rev. Rul. 80-86, 1980-1 C.B. 118.

Your report states that much of the IRS guidance has been in the form of general counsel memoranda (GCM's) and technical advice memoranda, neither of which was available to the public until recently. GCM's issued after July 4, 1967, have been or will be made available to the public although they cannot be relied upon. Page 47 of the report cites the holdings of two GCM's as examples of the need to provide more guidance to revenue agents and electric cooperatives:

> (1) Income from members who have no voice in management and who receive no share in the net margins of the cooperative cannot be considered member income for purposes of the 85 percent requirement.
>
> (2) Gross income from the sale of electricity produced by a generating cooperative is to be determined by subtracting production costs (in accordance with the full absorbtion method of accounting) from gross receipts from its sale.

One of the most effective means to educate revenue agents and the general public is through the publication of revenue rulings and revenue procedures. The IRS has been regularly publishing revenue rulings pertaining to section 501 (c)(12) and possibly we can increase our efforts in this area. However, as to the two above examples, the first, we believe, is covered in Rev. Rul. 72-36, 1972-1 C.B. 151, which specifically states that as a requirement for exemption under section 501(c)(12) the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. Thus, income from a person who did not share in the savings of a cooperative would be nonmember income whether or not that person had the right to vote.

As to the second example, which states that gross income from the sale of electricity is determined by subtracting production costs from gross receipts, our Chief Counsel's office concluded in 1977 that cost of goods sold has to be taken into consideration when electricity is sold in order to determine the amount of gross income derived from the sale. The precise method of determining and calculating what constitutes the cost of goods sold in the case of generating electricity has not been formulated because of unique problems in this area.

Accordingly, our Chief Counsel's Office has established a regulation project through which we can solicit public comment as to how the cost of goods sold should be calculated when the regulation is published in proposed form.

Your request also states that you made an analysis of some examinations conducted by IRS agents covering tax years 1972 to 1977 and that in about 44 percent of the examinations, the 85 percent requirement was determined on a gross receipts rather than on a gross income basis.

In addition, pp. 47-48 of the report states that the IRS has not addressed certain issues that affect the computation of member income. We understand that these issues were observed in the course of your review of Forms 990 in connection with the examinations referred to above. During the years 1972 to 1977 there was considerable confusion about the proper method of computing membership income with respect to electric cooperatives. As stated above, the purpose of the regulation project is to formulate a method of computing gross income with respect to the sale of electricity and to have the benefit of public comment before finalization.

However, we have already alerted our field agents to consider the cost of goods sold in determining whether a cooperative has met the 85 percent member income requirement. This has been done through audit guidelines (IRM 7(10)69) and our Continuing Professional Education (CPE) Program. Audit guidelines, which are instructions to IRS revenue agents, are published in the Internal Revenue Manual. Our CPE program is conducted annually and is published in booklet form. We also direct your attention to the fact that both the CPE booklet and our audit guidelines are available to the general public. The 1980 CPE booklet included an article on section 501(c)(12) which stated that in determining gross income in the case of electric cooperatives the cost of goods sold should be deducted from gross receipts, and it reported that the National Office has a study (the regulation project) aimed at determining what items are included in the cost of goods sold with respect to the sale of electricity.

With reference to those issues that pp. 47-48 of the report states our agents failed to address, we realize that it is essential to keep our agents apprised of potential problems and new developments. We have attempted to establish uniform application of the Service position in this area through various instructional materials for our employees including our audit guidelines and our CPE program. In addition, we established a post review examination program in 1980 in which a sampling of examinations conducted in the field is sent to the National Office for review. This review program is intended to locate and call attention to issues that were overlooked or not properly developed, and it explains how those issues should be developed in the future.

Your report also has suggestions with respect to the annual information return, Form 990, that is filed by most organizations exempt under section 501(c). Page 48 of the report states as follows:

> " Electric cooperatives are supposed to determine their compliance with the member income requirement as part of their annual filing of exempt organization returns (Form 990). However, in addition to inadequate guidance, the exempt organization return lacks the format and instructions necessary to properly compute the 85 percent member income test. In this regard, 10 of the 64 cooperatives responding to our questionnaire indicated that the exempt organization return needed to be improved, but they did not provide specific suggestions. Our analysis showed that this return needs to be redesigned so cooperative companies exempt under section 501 (c)(12) could better determine compliance with the member income requirement of the law. Specifically, the return should segregate member and nonmember income and include a format for computing the 85 percent member income test."

The Form 990 already provides lines for segregating member and nonmember income. Line 85(a) on page 4 of the form provides a space for listing member gross income and line 85 (b) has a space for nonmember gross income.

Dividing line 85(a) by the total of lines 85(a) and (b) produces the percentage of member gross income. Exempt 501(c)(12) electric cooperatives are well aware of the 85 percent test and the need to distinguish member and nonmember income. The entries for lines 85(a) and (b) should be readily ascertainable from the cooperative's books and records.

We note that 54 of the 64 cooperatives that responded to your questionnaire thought the Form 990 was adequate and the 10 who thought it could be improved, either could not or would not, make any suggestions. We have an ongoing program to encourage suggestions from the public on ways to improve our public use forms and welcome suggestions on how the Form 990 might be improved. However, please keep in mind that the Form 990 is filed by different types of organizations. Our statistics indicate that for the most recent filing period about 405,000 organizations were required to file Form 990. Of these, slightly more than 4,900 were section 501(c)(12) organizations of all types. Because such a small percentage of organizations that file Form 990 are exempt electric cooperatives, it is important to make only those changes on the form that are essential. However, if the final regulations dealing with the cost of goods sold indicate more information is needed to determine compliance with the 85 percent requirement, appropriate changes in the Form 990 and/or accompanying instructions will be made.

On the other hand, as a result of your suggestions we will revise the instructions to the Form 990 advising that electric cooperatives must deduct the cost of goods sold from gross receipts in computing gross income. This change is consistent with the changes made in our audit guidelines and the our 1980 CPE booklet, mentioned above.

GAO Note: Page references have been changed to correspond to the final report.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

AUG 18 1982

Dear Mr. Anderson:

This is in response to your letter of June 23 forwarding for comment a copy of the proposed draft report, "Many Tax-Exempt Electric Cooperatives Have Changed: Legislation Is Needed To Better Focus and Administer Tax Exemption." I understand that Treasury staff have arranged to meet with Mr. Harris to discuss technical matters of data and presentation so I will restrict my comments to three general questions bearing on the Report's legislative recommendations. These are discussed in greater detail in the enclosed staff memorandum.

First, there is the question why the list of options does not include simple repeal of section 501(c)(12). In its present state, the Draft Report does not include either a coherent description of the case for Federal government intervention in aid of electric cooperatives or a critical evaluation of popular arguments in support of such aid--furtherance of the "cooperative movement", providing electric service to rural areas, etc. In view of the multiplicity of claims to Federal government support from all segments of society, absent a cogent argument there are national benefits to be derived from particular aid programs that are worth at least as much as they cost Federal taxpayers, serious consideration should be given to withdrawing support for these programs.

Second, the Draft Report does not portray the structure and operations of electric cooperatives in sufficiently detailed functional accounts as are required for an evaluation of the significance of tax exemption as an aid to electric cooperatives and to estimate their budget deficit impact. The "worth" of tax exemption in terms of lowered cost per unit of power delivered, or of higher cost absorbed, is neither estimated in the Report, nor is it derivable from the data presented.

Finally, inasmuch as tax exemption is but one of a battery of interrelated Federal aids to electric cooperatives, the others having to do with preferential financing and access to subsidized Federal power, policy evaluation would be greatly improved if the relationships among these aids and their cumulative worth to members of electric cooperatives were made more explicit and quantified. In turn, recognition of the implicit costs in the Federal budget of these extensive aids might provide Congress a basis for considering more varied, significant and effective curtailment options than those enumerated in the Report.

As in the past, we offer our comments constructively and in a cooperative spirit. Since we all share an interest in improved budgetary policymaking, I can assure you our staff stands ready to assist yours in any technical capacity they might find useful.

Sincerely,

John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. William J. Anderson
Director
General Government Division
General Accounting Office
Washington, D.C. 20548

Enclosure

Staff Memorandum
Comments on GAO Proposed Draft Report, GAO/GGD-82-83

A reading of the GAO Draft Report, "Many Tax-Exempt Electric Cooperatives Have Changed: Legislation Is Needed To Better Focus and Administer Tax Exemption," (GAO/GGD-82-83) discloses three analytical and empirical omissions which, if they could be overcome, would substantially strengthen the Report's conclusion that remedial legislation is called for not only in the area of tax exemption, but also in other Federal programs in aid of electric cooperatives. In brief, these omissions are: an exploration of the economic policy justification for Federal government intervention on behalf of electric cooperatives; sufficiently detailed specification of the economic characteristics of electric cooperatives necessary for an evaluation of the magnitude and effectiveness of tax exemption or other forms of aid to these organizations; and a more complete quantification of the interrelated aids to electric cooperatives in the form of subsidized financing and preferential access to subsidized Federal power.

First, implicit in the statement of Report objectives, "to determine whether electric cooperative operations and activities have changed since the granting of tax exemption, [and if] electric cooperatives are organized and operating in a non-profit cooperative manner...." (pp.5-6), is the notion that the provision of Federal government assistance to these forms of business organization is responsive to a "need" the satisfaction of which with the aid of Federal resources is in the public interest. This is recognized in the Report Digest statement:

> Unlike Federal assistance programs which can be directed to those organizations having a continuing need for assistance, tax exemption currently applies across-the-board to all electric cooperatives whether or not they continue to need such assistance. (p.iii.)

The body of the Report, however, fails to make clear either the characteristics of electric cooperatives that originally qualified them for Federal assistance or, more important, how that assistance was justified. There is no obvious impediment in the laws of the United States, including the Internal Revenue Code, to the organization of cooperatives. A cooperative is simply an incorporated voluntary association of individuals organized to achieve specified objectives agreed to by the incorporators. A cooperative differs from an ordinary corppration in only a few respects which, while they may be of significance to the stockholders (cooperative members), have no apparent public policy interest. In a cooperative, there is a close correspondence between the shareholder-members and the customers of the activity to be engaged-in (consumer coop), or its suppliers (producers' coop), whereas, in an ordinary corporation, there is little or none of this correspondence; in a cooperative, exercise of ownership control is on the basis of one vote per shareholder-member, but rarely other than one vote per share held in the case of ordinary corporations. Provided shareholders agree to the terms of their association and the objectives of the association are not _per se_ illegal, there is no _a priori_ reason why public policy should favor one form of incorporation over another. If one form is, in fact, superior in the sense it results in lower-cost production and/or higher incomes for its shareholders, individuals may be relied on to adopt that form without benefit of government preference.

Moreover, cooperatives engage in activities that are indistinguishable from those of other forms of business organization. Thus, there is no justification for government intervention on behalf of cooperatives on the ground they face "externalities" or "market-failure"; if such conditions confront the cooperatives, they also confront their competitors who should receive equal subsidy. Nor is this observation subject to qualification in the case of electric cooperatives by reason of

their original organization to provide their members electric power distribution services not then available from established power companies. Presumably, if dispersed agricultural families and establishments had been willing to pay a high enough price for service, power companies would have been pleased to provide it. While the initiative of the organizers of rural electric cooperatives in providing their members power, and possibly at lower cost, is commendable, their doing so requires no more reward than the savings earned and enjoyed by the shareholder-member families and businesses served. Nor does the fact that the cost of distributing electric power to low-density markets is higher than average justify government intervention on behalf of cooperatives serving such markets. A fundamental principle of systems of voluntary market exchange is that purchasers must be prepared to pay sellers a price sufficiently high to cover the costs incurred in production. Unless there is evidence that prices determined in markets are too high because existing sellers exercise monopoly power, there is no justification for government intervention to reduce prices purchasers must pay for service. And, if monopoly is a cause of high prices, the remedy is civil suit under the anti-trust laws, or public control of the monopoly, as in the case of public utilities, not the subsidization of competitors.

It follows that, unless a well-reasoned justification for government intervention on behalf of electric cooperatives can be adduced by authors of the Report, the list of legislative recommendations in Chapter 5 is incomplete. The list should also include an option to repeal section 501(c)(12), for the 4 options presented all imply Federal subsidy to electric coops was and continues to be justified, if only on a more restricted basis.

The second comment applies in the event proponents of aid to electric cooperatives are able to present a persuasive justification for their cause. For this case, the role of tax

exemption in providing justifiable aid needs to be better defined in the Report. The aim of a Federal subsidy to electric cooperatives can only be to subsidize the sale of electric power by these organizations, whether the subsidy actually results in lowered selling prices or is absorbed by inefficient operations of the subsidized entity. From this perspective, a special tax rule, such as that provided in section 501(c)(12), can be quantified only in the context of a specification of the economic accounts of the activity affected. That is, however an electric power distributing system is legally organized, it will have to employ labor and capital and purchase goods and services from other firms to make electric service available to its customers. It will incur these costs of service and, in turn impose charges on its customers for the services rendered.

The technical summary of the operations of an activity is called a "product-income statement" which closely resembles the financial accounting income statement for a corporation as follows:

Corporation Product/Income Statement

Sales..............................quantities sold, times prices at which sold; hence "value of product", or simply "product"

less: cost of sales

labor costs.............quantities of labor, times wage rates; hence the labor share of product, or labor "income"

purchases from other firms.................quantities times prices; hence the share of "value product" produced by other activities

equals: operating income........the share of gross product attributable to capital; gross capital income

less: depreciation..............the (estimated) value of capital used-up in producing current product, or capital consumed in production

equals: net return to capital...the capital share of net product, or "capital income"

less: interest paid creditors...the share of capital income attributable to holders of debt claims against corporation assets

equals: corporation income......the share of capital income attributable to holders of equity claims against corporation assets

less: corporation income tax (if taxable)............corporation income, times a schedule of rates

equals: "net corporation income"..................net corporate income distributable to equity claimants, taxable to them, if distributed

It is apparent from the product-income statement that:

(a) Whether or not a corporation's income is taxable, the corporation can readily be operated as "non-profit", provided that its shareholders are willing to hold shares that yield them nothing. Thus, there is nothing in the taxability of

cooperatives that conflicts with the logic of the cooperative principle that the shareholders will be satisfied by receiving their return in the form of lower product prices. Whether this is a generally valid principle is not of concern here; the point is that there is no impediment in the tax laws, or any other laws, to the (non-profit) operation of a corporation by its shareholders that must be overcome by legal exemption from tax.

(b) Whether, and the degree to which, tax exemption of a corporate entity benefits its owners--shareholder-customers in the case of cooperatives--depends on:

1) The relative importance of capital in total costs of production. The larger the ratio of operating income--the gross return to capital--to total sales or product, the more significant will be corporation income tax exemption.

2) The relative importance of debt in financing the entity's capital stock. The higher the debt ratio, the lower will be the corporation (equity) share of enterprise capital income, and the less significant will be corporation income tax.

Unfortunately, the Report does not present sufficiently comprehensive income statement and balance sheet data to permit the reader to determine the economic significance of section 501(c)(12) exemption for electric cooperatives.

Which leads to the third and final comment. The Report properly notes that electric cooperatives have enjoyed borrowing subsidies and preferential access to low-cost (subsidized) power generated at Federal facilities. The borrowing subsidy administered by REA since the mid-thirties actually has two dimensions: the rates charged have been below those that private firms engaged in the same activity would pay, as the Report notes (pp. 25); and the leniency of Federal lending authority has

permitted electric cooperatives to operate with far higher debt ratios than is customary in the industry of which they are a part. For example, in 1975, cooperatives reporting to the REA displayed an aggregate debt equal to 75 percent of reported net assets, yielding an equity ratio of only 25 percent. That same year, investor-owned utilities (IOUs) reporting to FERC (then FPC), displayed an equity ratio of 47 percent, nearly twice that of REA cooperatives. Since cooperatives not only enjoyed below-market interest rates but also were permitted to finance a much larger fraction of their plants with debt, the borrowing subsidy was much larger than $320 million for 1979, as estimated 1/ in the Report (p. 25). At the same time, this aspect of the borrowing subsidy diminishes the importance of tax-exemption, as noted above.

With respect to preferential access to subsidized power although the Report includes data on Federal agency sales of subsidized power to cooperatives, it does not provide supporting information to quantify the relative importance of this form of Federal aid to coops. Lacking an estimate of this form of Federal subsidy to electric cooperatives, the full magnitude of Federal aid is grossly understated, impairing the empirical basis for Congressional review of the battery of aids it has provided for electric cooperatives.

In summary, there appears to be no *a priori* economic or tax policy justification for Federal aid to electric cooperatives in the form of exemption from the Federal corporation income tax. If there is, nevertheless, a justification for Federal aid to these organizations, three questions must be addressed: How much Federal budget aid is justified? Is the budget aid provided in preferential lending and access to subsidized power equal to, less, or more than the cost that can be justified? And, if more aid is justifiable, does exemption from corporation income tax provide this in an efficient manner, or should better-designed

---

1/This figure was changed to $340 million for 1980.

subsidies be provided? If the Report could be expanded to more fully address these questions, the case for eliminating tax exemption of electric cooperatives, itself stronger than any of the legislative recommendations, would be reinforced.

GAO Note: Page references were changed to correspond to the final report.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

August 18 1982

Mr. Henry Eschwege
Director
Community and Economic Development Division
U.S. General Accounting Office
Washington, D.C. 20508

Dear Mr. Eschwege:

This is in reply to your letter of June 23, 1982, requesting comments on the GAO draft of a proposed report to Congress entitled "Many Tax-Exempt Electric Cooperatives Have Changed: Legislation is Needed to Better Focus and Administer Tax Exemption." Although the draft report does not address any recommendations directly to REA/USDA, we believe that there are several specific areas that warrant comment.

The basic directions suggested by the draft report could produce unintended effects that would be in conflict with the Congressional policy toward rural areas and the rural electric program in particular. The result would be additional cost to the Government.

- The draft report presents an option that would base tax exemption on low equity/asset ratios. We believe that the majority of the cooperatives would take this option. Such an approach would make it more difficult and costly for rural electric cooperatives to obtain private market financing.

- The draft report states that a basic principle of cooperatives is to "provide services at cost and distribute any margins or savings." The general tone of the report is critical of rural electric systems with high equity/asset ratios and thus relatively large amounts of retained patronage capital. The draft report does not recognize that retained patronage capital is needed for electric cooperatives to become self-sufficient. This is inconsistent with Congressional policy as stated in the 1973 amendment to the Rural Electrification Act: ..."rural electric and telephone systems should be encouraged and assisted to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations and other sources."

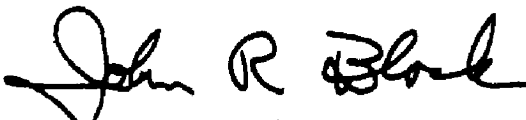
- The impact of the draft report's proposals on the demand for REA loan funds is not addressed. If cooperatives reduce their equity/asset ratios and also pay taxes they will have fewer internally generated

Mr. Henry Eschwege 2

funds available for construction of new plant needed to serve consumers. This will likely create pressure for additional low-interest (currently 5 percent) REA loans at significant cost to the Government. These additional costs could exceed the tax revenues, if any, that may be collected from electric cooperatives.

As requested in your transmittal letter, the above comments concern the substance of the findings discussed in the draft report. In order to resolve technical matters that require clarification and revision, it is recommended that a meeting be held with REA staff.

Sincerely,



John R. Block
Secretary

(268077)

*U.S. GOVERNMENT PRINTING OFFICE : 1982 0-361-843/12

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".