Rev. Rul. 65-174, 1965-2 C.B. 169

An electric generation and transmission cooperative entered into a lease-operating agreement with a commercial electric power company whereby the commercial company leases, operates and maintains the cooperative's electric generator unit and provides electric energy to the cooperative's members all of which are nonprofit membership distribution cooperatives. The commercial company pays the cooperative a monthly rental equal in amount to the installment payments on the loan which financed the construction of the unit plus an additional amount to cover the cooperative's administrative expenses. The cooperative, in turn, pays the commercial company for the electric energy furnished its cooperative members for distribution.

Held, amounts received by the cooperative from the commercial company under such circumstances constitute income which must be considered in determining whether the cooperative meets the 85 percent member income provision of section 501(c)(12) of the Internal Revenue Code of 1954 for purposes of exemption from Federal income tax.

Advice has been requested whether amounts received by an electric cooperative pursuant to a lease-operating agreement, under the circumstances described herein, constitute income to be considered in determining whether the cooperative meets the 85 percent member income requirement for exemption from Federal income tax as an organization described in section 501(c)(12) of the Internal Revenue Code of 1954.

The organization in question was incorporated, under State law, as a cooperative, nonprofit, membership corporation to generate, transmit and distribute electric energy to its members which are nonprofit electric membership distribution cooperatives.

The cooperative contracted to purchase all of the electric power it could obtain from the United States Bureau of Reclamation. However, this source of supply was not adequate to serve the requirements of its member cooperatives. It therefore borrowed funds from the Rural Electrification Administration (hereinafter referred to as REA) to finance the construction of an electric generating unit to supply the additional electric power needed by its member cooperatives. It then entered into a long term lease-operating agreement with a commercial electric power company (hereinafter referred to as Company) in order to place the unit in production.

Under the terms of the agreement, Company will operate and maintain the unit from its own plant and pay the cooperative rent in an amount determined by the interest and principal payments on the REA indebtedness, plus 100x dollars per month for administrative and related expenses. The agreement further provides that Company shall sell and deliver to the cooperative all electric energy which it shall request up to a maximum of the

rated capacity output of the unit and that Company shall have the use of any surplus or remaining power of the plant. When the low-cost power of the Bureau of Reclamation becomes available to the cooperative in sufficient quantity to meet the needs of its members, it will not be obligated to take power from the generating unit leased and operated by Company, and Company will have such power available for its own use.

The cooperative contends that, notwithstanding the terms used in the agreement, there is no 'sale' of power by Company to it, nor is there any 'rent' received by the cooperative from Company; that the arrangement is, in effect, an arrangement recognized in the power industry as an 'interchange of power'; that this type of arrangement involves no income or revenue for either party, and is treated in the Federal Power Commission's Uniform System of Accounts as an item concerned in the cost of producing power; that the result of the arrangement merely is that each party bears the cost of generation and transmission of the power it furnishes to the other party; that the money each party obtains from the other is merely to be set off against the money it pays, any difference being entered into its costs of generation as a plus or minus figure, increasing or decreasing its cost of producing power; and that the money received in this interchange arrangement does not enter into the income accounts of the parties.

Section 501(c) of the Code describes certain organizations exempt from Federal income tax under section 501(a) of the Code, and reads, in part, as follows:

> (12) * * * 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.

It is clear from the above-described terms of the agreement that it is a straightforward lease-operating agreement. Company operates the power unit rented from the cooperative and sells the electrical energy produced therefrom. The cooperative receives energy from, but delivers no energy to Company. Thus, there is no interchange of power effected within the contemplation of the Federal Power Commission's Uniform System of Accounts, since the cooperative does not both deliver to and receive energy from Company. Following the procedures and concepts of the Uniform System of Accounts, the payments received by the cooperative from Company are considered to be rental income.

Based on the foregoing, it is concluded that amounts received by the cooperative from Company pursuant to the lease-operating agreement are income which must be considered in determining whether the cooperative meets the 85 percent member income requirement for exemption from Federal income tax under section 501(c)(2) of the Code.