
Exempt Organizations; Proposed Examination Guidelines Regarding Rural Electric Cooperatives

Announcement 96-24

PURPOSE

The Internal Revenue Service has developed proposed examination guidelines for Exempt Organizations Internal Revenue Agents to use during the examinations of rural electric cooperatives. These guidelines are intended to provide a framework that agents can follow in conducting the examination. Because they address matters that may have a significant impact on rural electric cooperatives, the Service is soliciting public comments on them. The guidelines will be published in the Internal Revenue Manual.

BACKGROUND

These guidelines offer suggestions on issues, documents and techniques for examining rural electric cooperatives. They do not attempt to cover every issue that might arise in an examination. They are not intended to require examiners to exhaustively review all areas described in each rural electric cooperative examination.

PROPOSED EXAMINATION GUIDELINES

(12)20 Specific Examination Guidelines

(12)21 Rural Telephone Cooperatives [Reserved]

(12)22 Rural Electric Cooperatives

These guidelines offer suggestions on issues, documents and techniques for examining rural electric cooperatives. They do not attempt to cover every issue that might arise in an

examination. Conversely, some issues in these guidelines will not arise in every examination. Examinations of generation and transmission cooperatives and distribution and transmission cooperatives, for example, present different issues. Further, these guidelines are not intended to require examiners to exhaustively review all areas described in examining every rural electric cooperative. Examiners or case managers should use their professional judgment to determine the scope and depth of each examination.

(12)22.1 Introduction: Electric Utilities and Rural Electric Cooperatives

(1) Electric Utilities. Electric utilities (including rural electric cooperatives) were once monopolies. Now they confront many challenges including increased competition from their own consumers, independent power producers and other electric utilities. Electricity is becoming a commodity. Industry and government consumers demand electricity at the lowest cost and increasingly, if dissatisfied with rates from the local electric utility, they may build their own generating plants (and bypass the electric utility altogether) or purchase electricity from another electric utility (to be transmitted over the local utility's power lines (retail wheeling)). Other changes in economics and technology are challenging electric utilities. Demand for electricity is growing, only slowly, thereby holding down revenues (as are stranded investments). Further, it remains to be decided what role electric utilities will play in developing the information superhighway. Legislatures and regulatory agencies are responding to these questions.

(2) Trends. Industry analysts forecast several trends: more price wars between competing utilities, more mergers among electric utilities, (including generation and transmission cooperatives (G&Ts)); more joint ventures between cooperatives and other utilities to own and operate power generation plants; and more sharing of services. This environment will very likely generate new accounting and tax questions.

(3) Rural Electric Cooperatives. Rural electric cooperatives (cooperatives) provide electric power to members and other consumers. G&Ts construct and operate power plants (alone

or in arrangements with other utilities) and sell electricity at wholesale to their member distribution cooperatives, which in turn, sell electricity retail to consumers. Distribution cooperatives are members of G&T cooperatives. The distribution cooperatives purchase electricity from their G&T to furnish electricity to consumers. Each cooperative, in turn, may be a member of other cooperatives, including cooperative subsidiaries. To carry out their activities, G&Ts and distribution cooperatives acquire land and land rights (including easements, water and power rights, diversion rights, submersion rights). They own (or lease) and operate electric generating plant and transmission and distribution plant, office space, furniture and equipment. 7 C.F.R. § 1767.16. Cooperatives also contract for fuel, power supply and operate power plants jointly with other utilities. See GAO Reports *REA Borrowers' Investment in Cable and Satellite Television Services*, RCED-93-164 (1993); *Legislation Needed to Improve Administration of Tax Exemption Provisions For Electric Cooperatives*, GGD-83-7 (1983). On the history and background of rural electric cooperatives, see *Exempt Organizations Handbook*, "Local Benevolent Life Insurance Association, Mutual Ditch, Irrigation and Telephone Companies, and Like Organizations," ch. 12(00).

(4) Joint Ventures. G&Ts often join with other electric utilities to build and operate power generating stations. The joint venturers may own the station as tenants in common, operating the station and sharing its capacity and energy according to various operating agreements, station agreements and load management agreements. These joint ventures may raise issues bearing on the 85 percent test. See generally, *Specialized Industry Audit Guidelines—Public Utilities (Utilities Handbook)* § 240.

(5) Diversification. Cooperatives are diversifying, offering water management, sewage treatment, venturing into economic development, offering satellite television service and selling satellite reception equipment (and, less commonly, offering cable television service). Many cooperatives belong to the National Rural Telecommunications Cooperative (NRTC) which offers Rural TV programming on the satellite C-band. NRTC also plans to offer Direct TV (which uses different re-

ceivers) on the satellite Ku-band. Many of these satellite and cable television services are for-profit (noncooperative) businesses. GAO Report RCED-93-164.

(12)22.2 Overview—IRC 501(c)(12)

(1) Background on Electric Cooperatives. See *Exempt Organizations Handbook*, "Local Benevolent Life Insurance Association, Mutual Ditch, Irrigation and Telephone Companies, and Like Organizations," ch. 12(00); "Taxation of Cooperatives," ch. (45)10, *Utilities Handbook*, including Exhibits 200-2, Index of Revenue Rulings and 200-3 Index of Court Cases and *Examination Guidelines Handbook*, "Local Benevolent Life Insurance Association, Mutual Ditch, Irrigation and Telephone Companies, and Like Organizations—IRC 501(c)(12)," ch. (12)10.

(2) Requirements for Exemption. Mutual ditch or irrigation companies, mutual or cooperative telephone companies and like organizations are exempt from federal income tax under IRC 501(c)(12) if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses (the 85 percent test). To be exempt, cooperatives must be:

- (a) like organizations;
- (b) operate under cooperative principles; and
- (c) meet the 85 percent test.

(1) Like Organizations and Not Like Organizations. Rural electric cooperatives and cable television services operating on a cooperative basis are like organizations described in IRC 501(c)(12). Rev. Ruls. 67-265, 1967-2 C.B. 205; 83-170, 1983-2 C.B. 97. See also, *Exempt Organizations Handbook*, Chapter (12)33. The following are not like organizations:

(a) Cooperative organizations formed by electric cooperatives to finance their customers' purchases of electrical, water or plumbing appliances. *Consumers Credit Rural Electric Cooperative Corp. v. Commissioner*, 319 F.2d 475 (6th Cir. 1963);

(b) Cooperatives whose sole activity is selling electrical materials, equipment and supplies and furnishing equipment manufacturing,

testing and repair services, although all the members are cooperatives. Rev. Rul. 65-201, 1965-2 C.B. 170.

(c) Nonprofit automobile clubs furnishing travel and other services to members. *New Jersey Automobile Club v. United States*, 181 F. Supp. 259 (Cl. Ct. 1960), *cert. denied*, 366 U.S. 964 (1961);

(d) Housing cooperatives. Rev. Rul. 65-201, 1965-2 C.B. 170; and

(e) Organizations selling electrical materials, equipment and supplies and manufacturing, repairing or testing for members. Rev. Rul. 65-201, 1965-2 C.B. 170.

(2) Cooperatives Engaged in IRC 501(c)(12) and Non-IRC 501(c)(12) Activities. If a cooperative engages in activities described in IRC 501(c)(12) and in activities not described in IRC 501(c)(12), the examiner should determine whether the latter activities are insubstantial or are conducted incident to and in furtherance of IRC 501(c)(12) activities.

(3) Cooperative Principles. Cooperatives must operate according to the following principles:

(a) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership (unlike stockholders who earn a return on capital invested);

(b) democratic control by the members of the cooperative;

(c) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage) (unlike stockholders who own equal shares in a corporation's net worth, regardless of how much business they transact (if any) with the corporation); and

(d) operation at cost (not operating for profit or below cost).

Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 308 (1965), *acq.*, 1966-2 C.B. 6; *Mutual Fire Ins. Co. of Germantown, Inc. v. United States*, 142 F.2d 344 (3d Cir. 1944), *cert. denied* 323 U.S. 729 (1945); *Keystone Auto. Club Casualty Co. v. Commissioner*, 122 F.2d 886 (3d Cir. 1941), *cert. denied*, 315 U.S. 814 (1942). See generally, parallel provisions in IRC 521 and Treas. Reg. § 1.521-1.

(e) Cooperative Principles Applied to IRC 501(c)(12). Rev. Rul. 72-36, 1972-1 C.B. 151 holds that IRC 501(c)(12) cooperatives must comply with fundamental cooperative principles. Because a cooperative must operate at cost, it must not accumulate cash reserves exceeding its reasonable needs. Any unneeded funds must be returned to members as patronage dividends. The rights of members in the cooperative's patronage capital account (the balance sheet account approximating retained earnings) must be determined on the basis of members' patronage throughout their years of membership. The cooperative must at all times keep records of members' rights to these assets and make distributions accordingly when the cooperative retains a reasonable cash reserve, when a member withdraws from the cooperative and when the cooperative realizes gains on sale of appreciated assets prior to dissolution. Rev. Rul. 78-238, 1978-1 C.B. 161.

(f) Maintaining Exemption. A substantial departure from democratic ownership, operation and control may warrant revocation of exemption (e.g., activities that would constitute private inurement or impermissible private benefit as defined in IRC 501(c)(3)). Cf. *Keystone Auto. Club Casualty Co. v. Commissioner*, 122 F.2d 886 (3d Cir. 1941).

(12)22.3 The 85 Percent Member Income Test

(1) General Principles. The following rules apply:

(a) Annual Testing. The 85 percent test must be computed in each taxable year. A cooperative may fail the test one year but meet the test in a prior or subsequent year. Rev. Rul. 65-99, 1965-1 C.B. 242. The test is applied using the cooperative's method of accounting. Rev. Rul. 68-18, 1968-1 C.B. 271. See also IRC 451(f) and IRC 166 discussed at (12)22(16).

(b) Gross Receipts or Gross Income. (Safe Harbor Guidelines) Prop. Treas. Reg. § 1.501(c)(12)-2 (49 Fed. Reg. 1244 (January 10, 1984)) would have determined the income from sale of electricity by subtracting the cost of goods sold

(computed according to Treas. Reg. § 1.471-11) from gross sales. The preamble to the proposed regulations stated that the regulations would be effective for taxable years beginning after the date of publication of final regulations and that in prior years, cooperatives may continue to apply the 85 percent test using the method that they consistently used in the past. The proposed regulations were withdrawn (58 Fed. Reg. 25587 (April 27, 1993)). Under the Safe Harbor Guidelines, cooperatives may continue to use the method they have consistently used in the past. If the cooperative computes member income using the gross receipts method, the cooperative should use the same method to compute nonmember income.

(c) No Netting. Gross income derived from a transaction with a third party cannot be offset by amounts owed to that third party. Rev. Rul. 65-174, 1965-2 C.B. 169; Rev. Rul. 74-362, 1974-2 C.B. 131, *obsoleted in* Rev. Rul. 81-291, 1981-2 C.B. 131.

(d) No Reductions. Rents, dividends and interest must be included in gross income without reduction.

(2) Members vs. Nonmembers. Cooperatives may have several types of members. In general, members are those entitled to voice in management of the cooperative and to share in patronage capital. Rev. Rul. 78-238, 1978-1 C.B. 161. If the cooperative has more than one type or class of "members," ascertain which are members as defined in IRC 501(c)(12). A municipal corporation may be a member or nonmember. Rev. Rul. 68-75, 1968-1 C.B. 271. G&Ts may have members that are not distribution cooperatives.

(3) Classifying Income as Member or Nonmember Income. Each transaction for which income is realized must be classified as member income, nonmember income or excluded income. Member income is member-sourced and derived from activities conducted according to cooperative principles. IRC 501(c)(12); Rev. Rul. 72-36, 1972-1 C.B. 151; Rev. Rul. 78-238, 1978-1 C.B. 161; Rev. Rul. 80-86, 1980-1 C.B. 118. Common transactions include:

(a) Sale of Electricity. Income from sale of electricity may be member or nonmember income, de-

pending on the membership status of the purchaser/consumer.

(b) Power Pooling Arrangements and Power Interchange Agreements. These agreements may generate member or nonmember income. Payments received by a cooperative under an arrangement with a commercial power company to operate the cooperative's generator unit constitute income to be considered in calculating whether the cooperative meets the 85 percent test. The cooperative may contend that the arrangement is merely an interchange of power involving no income or revenue for either party. Rev. Rul. 65-174, 1965-1 C.B. 242.

(c) Income from sale and service of appliances to nonmembers who purchase no electricity from the cooperative is nonmember income, even if the sales are made through agents or subsidiaries. (See (12)22.4(2) for treatment as unrelated business taxable income.)

(d) Interest Income. Interest income is often nonmember income because the source/payor of the interest is a nonmember. Transactions yielding interest income include:

(1) Interest Income from the Installment Sale of an Office Building. This is nonmember income. Cf. Rev. Rul. 65-99, 1965-1 C.B. 242 (holding that a cooperative must account for gain on an installment sale of property to a nonmember as nonmember income on a year-by-year basis).

(2) Interest Income from Sale/Leaseback of Cooperative's Assets. Interest income received by an exempt cooperative in sale/leaseback transaction (including safe harbor leases described in former IRC 168(f)(8)) is nonmember income.

(e) Discharge of Indebtedness Income. This income may be nonmember income or excluded income. See (12)22.3(4)(c) and (12)22.3(3)(g).

(f) Rent. Leasing a power generating station to a nonmember utility from which the cooperative purchases power results in nonmember rental income. Rev. Rul. 65-174, 1965-2 C.B. 169. See below for qualified pole rentals.

(g) Original Issue Discount and Cancellation of Indebtedness Income

Resulting from Modification of Debt Instruments. Cooperatives enter into agreements under which the terms of their long-term debt are modified. For example, under section 12 of the Rural Electrification Act of 1936, REA is authorized to allow financially distressed cooperatives to defer principal and interest payments on REA loans. If a modification of the terms of a debt instrument occurs, it must be determined whether the modification is significantly material to constitute a deemed exchange of the debt instrument for a new debt instrument (with the modified terms) under IRC 1001. In general, a significant deferral of interest or principal payments constitutes a deemed exchange under IRC 1001.

(1) Original Issue Discount. If an IRC 1001 exchange occurs, original issue discount (OID) is created on the new debt equal to the difference between the IRC 1274 issue price of the new debt and the stated redemption price at maturity (SRPM) of the new debt. The SRPM of the new debt is equal to the stated principal (face) amount of the new debt plus any interest that is not paid on a current basis. The IRC 1274 issue price of the new debt is equal to the lesser of: (A) the face amount of the new debt and (B) the present value, as of the date of the modification, of all payments of principal and interest due on the new debt, calculated using a discount rate equal to the Applicable Federal Rate. OID on the new debt is amortized by the cooperative over the term of the new debt on a constant yield basis.

(2) Cancellation of Indebtedness Income. In addition, the cooperative recognizes cancellation of indebtedness income on the exchange to the extent the face value of the old (unmodified) debt (plus any unamortized premium and less any unamortized discount) exceeds the IRC 1274 issue price of the new debt. Discharge of indebtedness income will generally occur if the old debt bears an interest rate that is below the Applicable Federal Rate. Any discharge of indebtedness income is (nonmember) gross income in the taxable year realized. See also (12)22.3(4)(c) on discharge of indebtedness income on prepayment of

certain REA loans at a discount. For additional information on modification of debt instruments, contact the Office of the Assistant Chief Counsel (Financial Institutions & Products).

(h) Gains and Losses from Sale of IRC 1221, 1231, 1245 and 1250 Property. See *The Mountain Water Co. of LaCrescenta v. Commissioner*, 35 T.C. 418 (1960), *acq. on other issues*, 1961-2 C.B. 5; *Cate Ditch Co. v. United States*, 194 F. Supp. 688 (S.D. Cal. 1961); Rev. Rul. 65-99, 1965-1 C.B. 242 (gain on sale of office building). *Cf.* Rev. Rul. 74-84, 1974-1 C.B. 244.

(4) Exclusions from the 85 Percent Test. The following amounts are excluded in computing the 85 percent test in Treas. Reg. § 1.501(c)(12)-1:

(a) Sale of Excess Fuel at Cost. Sale of excess fuel, (an inventoriable item) at cost, yields no gross income and, therefore, does not enter into the 85 percent test. Rev. Rul. 80-86, 1980-1 C.B. 118.

(b) Qualified Pole Rentals. Qualified pole rentals are rental income from the right to use any pole (or other structure that supports wires) that the cooperative uses to provide electricity to members. IRC 501(c)(12)(C)(i), (D).

(c) Discharge of Indebtedness Income on Prepayment of Certain REA Loans at a Discount. Gross income includes income from discharge of indebtedness. IRC 61(a)(12). The amount of indebtedness discharged equals the face amount of the debt (adjusted for any unamortized premium or discount) minus any consideration given by the taxpayer to effect the discharge. Discount income is nonmember income. The effect on the 85 percent test of loan prepayment at a discount, however, depends on when the loans are prepaid:

(1) Prepayments Between 1986 and 1989. Cooperatives were permitted to prepay at a discount certain REA loans made pursuant to sections 306A, 306B or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987) (7 U.S.C. §§ 936a, 936b, 940a). OBRA 1986, Pub. L. No. 99-509 § 1101(a) and Continuing Appropriations for F/Y 1987, Pub. L. No. 99-591 § 101(m) (Title IV § 623); Food, Agriculture, Conservation and Trade

Act of 1990, Pub. L. No. 101-624 § 2387. However, TAMRA 1988 excludes from the 85 percent test discharge of indebtedness income realized from prepayment of loans from REA or any loans made or guaranteed by the United States (or any of its agencies or instrumentalities) after December 31, 1986 and before January 1, 1990. TAMRA 1988, Pub. L. No. 100-647 § 6203; S. Rep. No. 445, 100th Cong., 2d Sess. 411, *reprinted in* 1988 U.S.C.C.A.N. 4918-9; H. Conf. Rep. No. 1104, 100th Cong., 2d Sess., 211, 1988-3 C.B. 211.

(2) Prepayments in 1990 and Later Years. Cooperatives may again prepay certain REA loans at a discounted present value. REA Improvement Act of 1992, Pub. L. No. 102-428 § 2; 7 C.F.R. § 1786 (59 Fed. Reg. 13616 (Mar. 22, 1994)). Loan discounts probably range between 10 and 15 percent. Any discharge of indebtedness income realized from loan prepayments on or after January 1, 1990 is non-member income in computing the 85 percent test.

(5) Consequences of Failing the 85 Percent Test. If, in any taxable year, a cooperative fails the 85 percent test, it is a nonexempt cooperative and must file Form 1120. IRC 501(c)(4) does not apply. Rev. Rul. 57-494, 1957-2 C.B. 315, *nonacq. in United States v. Pickwick Elec. Mem. Corp.*, 158 F.2d 272 (6th Cir. 1946).

(12)22.4 Unrelated Business Taxable Income

(1) For an overview of IRC 511-514, see *Exempt Organizations Handbook*, "Taxation of Unrelated Business Taxable Income," ch. (35)00-(41)00 and annual Technical Instruction Programs. The following additional issues may also arise in examination of cooperatives:

(2) Sales and service of appliances for nonmembers who purchase no electricity from the cooperative are unrelated trade or business. Treas. Reg. §§ 1.501(c)(12)-1(a); 1.513-1(a), (d).

(3) Income from debt-financed investments may be taxable under IRC 514(a) (*e.g.*, arbitrage investments of REA loan funds). *Southwest Tex. Elec. Coop. v. Commissioner*, T.C. Memo. 1994-363 (1994); *Kern County Elec. Pension Fund v. Commissioner*, 96

T.C. 845 (1991), *aff'd* 988 F.2d 120 (9th Cir. 1993);

(4) IRC 1245 and 1250 depreciation recapture rules override IRC 512(b)(5). Treas. Reg. §§ 1.1245-6(b); 1.1250-1(c)(2);

(5) Payments from affiliated organizations or subsidiaries may be taxable under IRC 512(b)(13); and

(6) Qualified pole rentals are not income from unrelated trade or business. IRC 513(g).

(12)22.5 Other Code Sections Applicable in Examinations of Cooperatives

(1) IRC 446 and 481. Method of accounting issues and changes in methods of accounting arise in many examinations of cooperatives. There are numerous differences between book and tax. See *Utilities Handbook* §§ 320-322, 426, 430-438, 445 and discussion below. Note that a method of accounting (e.g., depreciation and capitalization) elected on Form 990 may not be changed without the consent of the Commissioner, irrespective of whether the cooperative files Form 990 or Form 1120 in a subsequent year. Treas. Reg. § 1.446-1(e).

(2) IRC 266. Cooperatives may elect to capitalize certain taxes and carrying charges (including interest) into the adjusted basis of property. An election may affect the amount of gain on a cooperative's sale of utility plant, affecting the 85 percent test. On elections and their consequences, see Treas. Reg. § 1.266-1; Rev. Rul. 90-38, 1990-1 C.B. 57.

(3) IRC 118.

(a) Contributions to the capital of a cooperative are not gross income to the cooperative. But contributions in aid of construction or any other contribution as a customer or potential customer are not contributions to capital. IRC 118(a), (b); Treas. Reg. § 1.118-1; *United States v. Chicago, B. & O. R. Co.*, 412 U.S. 401 (1973), 1973-2 C.B. 428; *Utilities Handbook* § 434.

(b) For taxable years beginning after December 31, 1985, IRC 118(b) was repealed. Consequently, contributions that a cooperative receives after December 31, 1985 to provide or encourage providing services or for the benefit of the contributor must be reported as income by the cooperative.

(4) IRC 269. If any person(s) acquire, directly or indirectly, control over a corporation and the principal purpose of the acquisition is to evade or avoid federal income tax by securing the benefit of a deduction, credit or other allowance, which the acquiring person(s) or the controlled corporation would not otherwise enjoy, then the Service may disallow the deduction, credit or allowance. IRC 269(a); Treas. Reg. § 1.269-1. "Allowance" is defined very broadly. Treas. Reg. § 1.269-1(a). IRC 269 may apply to cooperatives and/or their subsidiaries (e.g., in applying the 85 percent test, if a subsidiary is used as a conduit for sales to nonmembers).

(5) IRC 483 and 7872. Imputed interest rules on deferred payments or below-market loans receivable (e.g., installment sales) may affect the computation of interest income, the 85 percent test or unrelated trade or business taxable income.

(6) IRC 103. [Reserved].

(12)22.6 Deferred Compensation and Retirement Benefits

(1) Cooperatives may provide several types of deferred compensation or retirement benefits for their employees. These include qualified plans, and eligible and ineligible deferred compensation plans under IRC 457. For additional information on deferred compensation plans under IRC 457 contact the Office of Associate Chief Counsel (Employee Benefits & Exempt Organizations).

(2) Qualified Plans. A qualified plan is a funded, tax exempt plan. The employer makes contributions which are generally held in trust. In some cases, employees may also contribute. There is a wide variety of qualified plan types, including pension and profit-sharing plans. They are subject to numerous qualification requirements under IRC 401. A plan may (but is not required to) obtain a determination letter from a key district office. This letter would constitute a ruling that the plan met the qualification requirements in form. It would not assure that the plan met all of the requirements for qualification in operation.

(a) Qualified Plan Requirements. Qualified plans are subject to numerous and complex requirements governing discrimination in favor of highly compensated employees, lim-

itations on contributions and benefits, coverage of employees, participation levels, vesting, funding, portability, holding of investments, and other requirements.

(b) IRC 401(k) Plans. A qualified plan may include a "qualified cash or deferred arrangement," often called a "section 401(k) plan." A cooperative, unlike other tax-exempt organizations and state and local government entities, is allowed to maintain a qualified cash or deferred arrangement. See IRC 401(k)(4)(B) (last sentence). Under a qualified cash or deferred arrangement, an employee may choose whether to receive part of his or her compensation in cash or to have it contributed to the plan. The election most commonly takes the form of a salary reduction arrangement. The contributions are called "elective deferrals," and are limited to a dollar amount (\$9,240 in 1994), which is adjusted annually for changes in the cost of living. Elective deferrals are subject to a special nondiscrimination test called the actual deferral percentage test ("ADP test"), in which the average deferral percentage of highly compensated employees is compared to that of non-highly compensated employees. The plan is also subject to all of the requirements that generally apply to qualified plans, and to some special requirements.

(3) Nonqualified Plans. Any other plans, agreements, or arrangements deferring the receipt of compensation to some future date or event such as retirement or separation from service are nonqualified plans. There is a wide variety of nonqualified deferred compensation plans. These arrangements may be elective (including salary reduction) plans or nonelective plans. They may be defined benefit or defined contribution plans. They may be unfunded plans where the participants have only a contractual promise from the employer that future payments will be made and any assets held to make payments are reachable by general creditors of the employer or they may be funded plans where cash or other assets are transferred to a trust or other third party, such as an insurance company, for payment to participants at a later date.

(a) Unfunded Plans. The tax consequences of unfunded plans are

contained in IRC 457 and the regulations thereunder. An unfunded plan of a state or local government or an agency or instrumentality thereof, or of any other tax exempt organization is either (A) an eligible deferred compensation plan, or (B) an ineligible deferred compensation plan. The tax consequences differ significantly.

(1) Eligible Plans. Under IRC 457(a), participants in an eligible plan, defined in IRC 457(b), are taxed on deferred amounts when those amounts are paid or made available to plan participants following separation from service or in the event of a distribution for an unforeseeable emergency.

(2) Ineligible Plans. If the plan is not an eligible plan, plan participants are taxed when amounts are deferred unless there is a substantial risk of forfeiture. A “substantial risk of forfeiture” is defined by IRC 457(f)(3)(B) as existing if a “person’s rights to [the] compensation are conditioned upon the future performance of substantial services by any individual.”

(3) Participants. All employees of a state or local government or an agency or instrumentality thereof may participate in an IRC 457 plan. Only a select group of management or highly compensated employees, however, may participate in an IRC 457 plan maintained by a tax exempt employer. (This is necessary to maintain the plan’s exemption from the funding requirements of ERISA.)

(4) Maximum Deferrals. Each participant in an eligible IRC 457 plan may defer up to the lesser of \$7,500, or 33 $\frac{1}{3}$ percent of includible compensation (generally meaning taxable compensation) in a taxable year. This limit applies to both elective and nonelective deferred compensation. It is not indexed. Under a catch-up provision, a participant may defer up to \$15,000 in each of the last three taxable years before he or she reaches normal retirement age, but the increase over the normal limit is available only to the extent of unused portions of the limitations for previous years. All eligible IRC 457 plans of an employer are aggregated, and no individual may defer a total of more than \$7,500 (\$15,000 if the catch-up provision applies) in a taxable year

(even under plans of more than one employer). The same limits apply to a nonqualified defined benefit plan. This is a plan that specifies the benefit that a participant will receive in the future rather than the amount that will be added to his or her account each year. A defined benefit plan often fixes a benefit based on factors such as compensation and length of service, and usually provides a benefit in the form of an annuity or payments over a number of years. Benefits under a defined benefit plan do not depend on the performance of any investments acquired by the employer. Applying the limits to a nonqualified defined benefit plan is more difficult than applying them to a defined contribution plan. The benefit subject to the limit in any year is the present value of the increase in the participant’s accrued benefit during that year. This present value will usually be different for each participant, and will often change from year to year. Consult an actuary (in Employee Plans) for assistance in determining the present values. It is important to remember that the limit applies to increases in the participant’s accrued benefit on a year-by-year basis. A plan would not satisfy this requirement if it merely applied an aggregate limit (based on all of the participant’s service) to the total accrued benefit. If an employee participates in both a nonqualified defined benefit plan and a nonqualified defined contribution plan, the annual limit applies to the sum of (A) the present value of the increase in the accrued benefit under the defined benefit plan, and (B) the amount deferred under the defined contribution plan.

(5) Coordination of Deferrals. IRC 457(c) requires that deferrals under an eligible IRC 457 plan be coordinated with certain other plans such as IRC 401(k) plans. This means that elective deferrals by the employee under an IRC 401(k) plan are subtracted from the \$7,500 (or \$15,000 in a catch-up year) limit. As a result, an employee who elects any deferrals under an IRC 401(k) plan will only be able to defer \$7,500 (or \$15,000 in a catch-up year) under the combination of IRC 401(k) and 457 plans, even though a higher limit might be available under the IRC 401(k) plan alone.

(6) Plan Administration Consistent with IRC 457(b). A plan that is consistent with IRC 457(b), but that is administered in a manner that is inconsistent with the requirements of IRC 457(b), may lose its status as an eligible plan. If the employer is a state or local government or an agency or instrumentality thereof, the plan does not become ineligible until the beginning of the first plan year beginning more than 180 days after notification by the Secretary of the Treasury of the inconsistent administration. If the inconsistency is corrected before the first day of that plan year, the plan remains an eligible plan. This grace period for correcting administrative defects does not apply to an employer that is a tax exempt organization other than a government.

(b) Funded, Nonqualified Plans. A plan that is funded (*e.g.*, through a trust, annuity contracts, or other vehicle insulating the assets from the general creditors of the employer) but is not a qualified plan is not governed by either IRC 401 or IRC 457. The tax consequences of funded, nonqualified plans are contained in IRC 402(b), 403(c) and 83, which require that a participant recognize income when amounts are paid to a trust or insurance company unless there is a substantial risk of forfeiture as defined in IRC 83(c)(1) and the participant’s interest is nontransferable.

(4) Tax-Sheltered Annuity. An IRC 403(b) annuity, often called a “tax-sheltered annuity,” is an annuity contract that may be purchased by an IRC 501(c)(3) organization or educational institution of a state or local government for its employees. Custodial accounts for registered investment company stock (mutual funds) may also be treated as annuity contracts for purposes of IRC 403(b), if they meet certain requirements. Since a cooperative is neither an IRC 501(c)(3) organization nor an educational institution of a state or local government, it cannot maintain an IRC 403(b) annuity plan. Any plan of a cooperative purporting to be an IRC 403(b) plan would probably consist of either nonqualified annuity contracts or taxable custodial accounts or trusts, and would be a funded, nonqualified plan. Contact an Employee Plans specialist if you encounter such a plan.

(12)22.7 Employee Benefits

(1) Cafeteria Plans.

(a) Under present law, compensation generally is includible in gross income when actually or constructively received. An amount is constructively received by an individual if it is made available to the individual or the individual has an election to receive such amount. Under one exception to the general principle of constructive receipt, no amount is included in the gross income of a participant in a cafeteria plan described in IRC 125 solely because, under the plan, the participant may elect among cash and certain employer-provided qualified benefits.

(1) Qualified Benefits. In general, a qualified benefit is a benefit that is excludable from an employee's gross income by reason of a specific provision of the Code. Thus, employer-provided accident or health coverage, group-term life insurance coverage (whether or not subject to tax by reason of being in excess of the dollar limit on the exclusion for such insurance) and benefits under dependent care assistance programs may be provided through a cafeteria plan. However, a cafeteria plan may not provide qualified scholarships or tuition reduction (IRC 117), educational assistance (IRC 127), or miscellaneous employer-provided fringe benefits (IRC 132). In addition, a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement (IRC 401(k)).

(2) Cash or Qualified Benefits. Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. A salary reduction agreement is sufficient to satisfy the "cash" requirement of a cafeteria plan.

(3) Plan Requirements. A cafeteria plan must be in writing, must include only employees (including former employees) as participants and must satisfy certain non-discrimination requirements. An employer that maintains a cafeteria

plan is required to file an annual return relating to such plan.

(b) Employment Taxes. The cafeteria plan exception from the principle of constructive receipt generally also applies for employment tax (FICA and FUTA) purposes.

(2) Voluntary Employees' Benefit Associations (VEBAs). If the cooperative maintains a VEBA or taxable trust for payment of welfare benefits, it may be appropriate to include the VEBA in the examination. See *Exempt Organizations Handbook*, "Voluntary Employees' Benefit Associations," ch. 900.

(12)22.8 Employment Taxes

(1) General Considerations. Taxable compensation paid to employees may not be properly reflected on Forms 990, employment tax returns, or Forms W-2. Determine whether payments to individuals who are not employees are properly reported on Forms 1099. Determine whether the cooperative has properly classified its workers. Be alert to efforts to treat employees as independent contractors. For a list of the 20 common law factors indicating an employment relationship, see Rev. Rul. 87-41, 1987-1 C.B. 296. In any questionable situation, determine whether a Form SS-8 has been filed by the cooperative or the worker. See IRM 7(10)(16)4.8.

(2) Section 530. Be sure to raise employment tax classification issues. Under section 530 of the Revenue Act of 1978, a cooperative may be entitled to relief from employment taxes with respect to a particular worker if three requirements are satisfied: the cooperative must have filed all federal tax returns (including information returns) required to be filed on a basis consistent with treating the worker as not being an employee; the cooperative must not have treated any worker holding a substantially similar position as an employee for employment tax purposes after December 31, 1977, and the cooperative must have a "reasonable basis" for not treating the worker as an employee. Reasonable basis may exist if the cooperative's treatment of workers as independent contractors was in "reasonable reliance" on a past examination of the cooperative in which there was no assessment attributable to the treatment for employment tax purposes of individuals holding

positions substantially similar to the position held by the worker in question. The cooperative may be entitled to rely on a prior examination whether or not it was an employment tax examination. See Rev. Proc. 85-18, 1985-1 C.B. 518.

(3) Meal Allowances. See ISP Coordinated Issue: Meal Allowances (1994).

(4) Fringe Benefits.

(a) Overview. A fringe benefit is any property or service (or cash, under certain circumstances) that an employee receives from the cooperative in lieu of or in addition to regular taxable wages. If a benefit is not specifically excluded from gross income by the Code (e.g., IRC 79, 105, 106, 107, 117(d), 119, 127, 129, and 132), its value must be treated as compensation and reported as wages in Box 1 of the employee's Form W-2. See IRM 7(10)(16)9.81. In 1989, the Service issued final regulations under IRC 61 and 132, setting forth specific rules for valuing fringe benefits and for determining the applicability of the exclusions in IRC 132 (no-additional-cost services, qualified employee discounts, working condition fringes and *de minimis* fringes). Fringe benefits can take many forms. See the User's Guide to "More Basics: The Basics of Fringe Benefits", which was produced by the Office of Chief Counsel, IRS Technical TV (January 1994).

(b) Examination of Fringe Benefits. Perform the following procedures:

(1) Review a sampling or list of Forms 1099 and W-2 issued by the cooperative. Compare them with a sample of expense entries to determine if the cooperative is consistently and properly issuing Forms 1099 and W-2;

(2) If the cooperative has a plan whereby employees receive reduced rates for insurance or other services provided by suppliers to the cooperative, determine the extent of the cooperative's involvement and whether the reduced rates constitute a fringe benefit; and

(3) Determine whether the cooperative provides free or discounted parking to its employees. Under IRC 132(f), the fair market value of "qualified parking" in excess of the statutory exclusion is includable in

an employee's gross income and must be reported as wages in Box 1 of Form W-2. See Notice 94-3, 1994-1 C.B. 327, for more information.

(12)22.9 Excise Taxes

An excise tax is imposed on sales of coal taken from mines located in the United States and on certain fuels. These are issues which may arise in the examination of G&Ts. IRC 4121, 4081. The excise taxes on certain large vehicles and the highway use tax may arise in examinations of all cooperatives. IRC 4051, 4481. See generally, *Utilities Handbook* § 448; IRM 4700.

(12)22(10) State and Federal Regulation of Electric Cooperatives

(1) State Public Utility Commissions (PUCs). In approximately 21 states, the state public utility commission (PUC) regulates rates charged by electric cooperatives. These and other states may also restrict or regulate the non-utility investments of electric cooperatives (e.g., no loans from a cooperative to any affiliated companies without PUC approval). To ascertain if the cooperative is regulated by a PUC, see *Utility Regulatory Policy in the United States and Canada*, NARUC (1992). In these states, the cooperative's filings with the PUC and the PUC's orders may reveal information useful to the examiner (e.g., changes in billing procedures).

(2) Federal Energy Regulatory Commission (FERC). FERC regulates the rates, terms and condition of wholesale electric power sales and transmission services. Certain G&Ts file annual reports with FERC. (FERC Form 1). These reports are public information.

(3) Rural Electrification Administration (REA).

(a) Virtually all electric cooperatives finance their utility plant through loans from or guaranteed by REA. (Note: Although REA's name has been changed to Rural Utilities Service (RUS), these guidelines refer to "REA." Pub. L. No. 103-354 § 232 (1994)). G&Ts generally borrow from the Federal Financing Bank (FFB) or from private lenders with REA guaranteeing the loans.

(b) Loan Terms. G&Ts' interest rate equals Treasury's cost of funds

plus 1/8 percent. G&Ts also obtain financing through pollution control bonds. Distribution cooperatives generally obtain insured loans from REA. REA finances 70-90 percent of the loan amount, with other lenders (e.g., National Utilities Cooperative Finance Corporation (CFC)) financing the balance. The interest rate is a blended rate of 5 percent on the REA portion and market rate on the balance. The interest rate on other loans varies. 7 C.F.R. § 1714.2 *et seq.*

(c) Loan Origination and Documentation. Cooperatives submit loan proposals requesting REA financing for constructing new utility plant or replacing existing plant. REA lends only for construction of capital assets, not for maintenance or repairs. As a result, cooperatives generally have an economic incentive to classify disbursements as capital expenditures (as opposed to current expenses). Upon approval of the loan proposal, the cooperative executes a promissory note in favor of REA and executes the REA Mortgage. The cooperative deposits REA loan proceeds in a special trustee account and expends its own funds to construct the new plant. After REA reviews and approves the cooperative's documentation of construction expenditures, the cooperative may then withdraw the approved amount from the trustee account and deposit the funds in its own cash accounts.

(d) REA Oversight. To ensure repayment of loans, REA requires cooperatives to follow its Uniform System of Accounts and audit procedures (see below). REA holds a first mortgage on all the cooperative's property. The REA Mortgage requires the cooperative to submit detailed annual financial reports to REA including certified audits performed by independent certified public accountants (CPAs) and other reports. All reports are public information. If cooperatives do not comply with these (and other) requirements, REA may declare the loan in default, suspend all future lending to the cooperative and exercise other remedies reserved under the REA Mortgage. To insure that loan funds are used properly, REA field accountants review cooperatives' financial records, reports and financial

statements prepared by cooperatives' CPAs at least once every three years. These REA Field Reports are public documents.

(12)22(11) REA's Uniform System of Accounts

(1) Overview. REA requires detailed financial information and reporting on cooperatives' activities (e.g., corporate structure, reorganizations and acquisitions, investments in affiliated companies, extraordinary gains and losses). Cooperatives must keep detailed books of account using REA's Uniform System of Accounts (USoA), published at 7 C.F.R. § 1767 (58 Fed.Reg. 59822 (1993)), clarifying and modifying the prior USoA. The USoA is based on FERC's accounting system, with some modifications. Cooperatives must also follow REA Accounting Principles (Accounting Principles). 7 C.F.R. § 1767.41. Accounting Principles mandate the entries to book particular transactions and aid in understanding the proper accounting treatment of items. REA also publishes Accounting Interpretations on the USoA. Because many accounts and account numbers in the USoA from prior years remain unchanged, these examination guidelines (citing to the 1994 USoA) can generally be used to examine taxable years beginning before 1994.

(2) Recordkeeping and Accounting Requirements. Cooperatives must keep books of account and all supporting books, records, minute books, memoranda, etc. to support all entries in books of account. 7 C.F.R. § 1767.15. Cooperatives must use the accrual method of accounting (as defined in Generally Accepted Accounting Principles (GAAP)). 7 C.F.R. § 1767.15(k). Separate accounting records must be maintained for each power plant and for any other utility department (e.g., gas or water). 7 C.F.R. § 1767.15(l), (m).

(3) The USoA contains the following Accounts:

(a) Balance Sheet Accounts:	
100 - 199	Assets and Other Debits
200 - 299	Liabilities and Other Credits
300 - 399	Plant Accounts
433, 436 - 439	Retained Earnings Accounts

(b) Income and Expense Accounts:

400 – 432;	Income Accounts
434 – 435	(Net Income)
440 – 459	Revenue Accounts
500 – 599	Production, Transmission and Distribution Expenses
900 – 949	Customer Accounts, Customer Service and Informational, Sales and General and Administrative Expenses

(c) Note on Accounts. Most USoA nonbalance sheet accounts are paired Revenue Accounts and Expense Accounts. “Income Accounts” (generally, the less significant accounts), combine revenue and expense in a single account. Certain nonbalance sheet accounts show revenue and expense for transactions between different departments within the cooperative. As noted below, timing differences and permanent differences abound between REA accounting and income tax accounting. For these and other reasons, in conducting the examination, it may be necessary adjust the amounts shown on the financial statements.

(d) Exhibits. On closing operating and nonoperating revenue and expense accounts into patronage capital accounts at the end of the fiscal year, see Exhibit 12(20)–1, “Summary of Accounts Used in Connection with Recording Patronage Capital.” Exhibit 12(20)–2, “Applying the 85 Percent Test: Analysis of REA Uniform System of Accounts (Selected Revenue, Income, Expense and Balance Sheet Accounts)” illustrates the income tax treatment of certain USoA Accounts.

(e) There is insufficient space in these guidelines to explore all aspects of the USoA, GAAP, Generally Accepted Government Auditing Standards (GAGAS) relevant to examination of cooperatives. Review particular provisions relevant to the examination. Examiners may contact REA’s Technical Accounting and Auditing Staff with questions at (202) 720-5227.

(4) Entities Covered by Financial Statements. A cooperative’s financial statements must comply with FAS No. 94, “Consolidation of All Majority-

Owned Subsidiaries.” If the cooperative owns a majority interest in a subsidiary (as defined (12)22(21)), the cooperative must prepare consolidated financial statements including the subsidiary, together with supplementary schedules presenting a balance sheet and income statement for each subsidiary. REA Forms 7 and 12 must be prepared on an unconsolidated basis. Accounting Principle 404, Consolidated Financial Statements. The REA regulations contain sample financial statements (with accountants’ notes) for an electric cooperative. 7 C.F.R. §§ 1789.38; 1773 Appendix B, Exhibit 7.

(5) REA Regulations on CPAs’ Audits of REA Borrowers. The CPAs must prepare and submit the following annual reports to REA:

(a) Auditor’s Report (on the cooperative’s financial statements, including accountants’ notes and statements of cash flows);

(b) Report on Compliance with Applicable Laws and Regulations (as required by SAS No. 63, “Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance” and GAGAS);

(c) Report on Internal Controls; and

(d) Management Letter (including disclosure of material transactions with related parties (e.g., officers and directors) as required by SFAS No. 57, “Related Party Disclosures”).

7 C.F.R. §§ 1773.30–1773.34.

These reports and the management letter are public documents.

(e) See 7 C.F.R. § 1773 Appendix A for sample financial statements, auditor’s report, compliance report and report on internal controls. See 7 C.F.R. § 1773, Appendix C for a sample management letter.

(12)22(12) General Considerations in Examinations

(1) Coordinated Examinations. Examinations of cooperatives may use the coordinated examination procedures, where appropriate. See IRM 7(10)-(18)0. If an examination is of limited scope, the coordinated examination procedures may be followed to the extent they are useful, although the

examination has not been approved as a CEP case.

(2) Assistance from Other Functions. If, in connection with the examination of a cooperative, the case manager and the examiner believe that it is also necessary to examine an entity not under the jurisdiction of EP/EO Examination (e.g., a joint venture operating a power generating plant), they should request assistance from the function responsible for examining that entity.

(3) Employment Taxes. Follow the package audit procedures in IRM 7(10)44.5 and, as appropriate, the employment tax procedures in IRM 7(10)(16)0. For general instructions on handling employment tax examinations and assessments of additional tax on fringe benefits, see IRM 7(10)(16)9.81. See generally, *Utilities Handbook* §§ 447, 44(14).

(4) Compliance Checks. *Utilities Handbook* § 460 outlines compliance checks on certain issues (e.g., unlawful activities). Consider whether performing any of these procedures is appropriate.

(12)22(13) Initial Contact Items

(1) The examiner should consult the following for assistance in planning and conducting the examination:

(a) State Public Utility Commissions. If one or more PUCs regulate the cooperative, contact the PUC(s) concerning the cooperative’s filings and PUC orders.

(b) Federal Energy Regulatory Commission. Contact the Office of Chief Accountant at (202) 219-2600.

(c) Rural Electrification Administration. Contact the Director of Borrower Accounting at (202) 720-9450.

See *Utilities Handbook* § 240.

(12)22(14) Requesting the Assistance of Specialists

(1) Utilities Industry Specialist/Media/Communications Industry Specialist (cable television and direct TV). The Industry Specialists can assist the examiner with the following:

(a) identifying unique industry issues and Service position;

(b) giving insight into the economic conditions of the industry;

(c) describing accounting and business practices; and

(d) suggesting examination procedures and computer programs that may have potential application.

Utilities Handbook § 152; IRM 42(10)(14)0.

(2) VEBA (Voluntary Employees' Beneficiary Association) Industry Specialist. The Industry Specialist can assist with examination of VEBAs.

(3) Computer Audit Specialist. If the services of a computer audit specialist are necessary, obtain a description of the cooperative's hardware, software (including accounting software) and formats of files and records.

(4) Engineer. All cooperative returns with assets of \$10 million or over must be referred for engineering action. IRM 42(16)0, 7(10)25.1. This mandated referral overrides IRM 7(10)25.1(4). In examination of exempt and nonexempt cooperatives, the engineer is a valuable resource (e.g., tax exempt bonds, construction techniques, machinery and building design, repairs, depreciation, depletion and valuation of assets). The engineer should be involved in the early planning stages of the examination. See generally, *Utilities Handbook* § 154.

(5) Excise Tax Specialist. Examinations of cooperatives (particularly G&Ts) often raise excise tax issues which may require the use of an Excise Tax Specialist. *Utilities Handbook* §§ 158, 448; IRM 4700.

(6) Employee Plans Specialist. See IRM 45(10)0 for employee plans examinations.

(7) Tax Exempt Bonds. [Reserved]. See 7(10)7(11).4.

(12)22(15) Initial Document Requests

(1) Obtain and review the documents listed below to gain a basic understanding of the cooperative's activities, capital structure and related organizations:

(a) Documents to be Requested from All Electric Cooperatives:

(1) Articles of Incorporation (and all amendments);

(2) bylaws (and all amendments);

(3) a list of all the names and addresses of subsidiaries and associated companies (as defined in (12)22(21));

(4) names and addresses of all directors, trustees and officers of the cooperative and of all subsidiaries and associated companies;

(5) minutes of meetings of board of directors and of all board committees;

(6) annual reports, financial statements (including statement of cash flows and accountants' notes) and tax returns for all subsidiaries and associated companies (as defined in (12)22(21));

(7) REA Forms 7 Financial and Statistical Report, Operating Report — Financial, Form 12;

(8) REA Field Reports on the cooperative (from REA field accountants or engineers);

(9) any debt restructuring plan entered into between the cooperative and REA;

(10) Methods and Procedures Manual (procedures to record transactions);

(11) a chart of accounts correlating general ledger accounts to USoA Accounts;

(12) the cooperative's 85 percent test worksheets;

(13) the cooperative's policy book on patronage capital and patronage dividends;

(14) an analysis of income and expense;

(15) an analysis of deferred credits and deferred debits with supporting documentation (this analysis is required in 7 C.F.R. § 1773.34(h)).

(16) all reports filed with REA (including but not limited to: REA Forms 7, 12; audited financial statements (including statement of cash flows and accountants' notes)); auditor's report, compliance report, report on internal controls and management letter;

(17) all reports and other filings with PUCs and PUC orders (if applicable);

(18) all agreements between the cooperative and any subsidiary or associated company;

(19) qualified employee retirement plans: the official plan and trust documents, any determination letters issued to qualified plans, records of employer and employee contributions, account balances or accrued benefits and employee compensation;

(20) nonqualified deferred compensation plans: employee benefit plans and related documents (e.g., trusts, insurance contracts, private letter rulings), records of employer and employee contributions and account balances or accrued benefits;

(21) all other employee benefit plans: including accident and health plans, cafeteria plans and VEBAs, related documents (including any trust instruments); See *Exempt Organizations Handbook*, "Voluntary Employees' Benefit Associations," ch. 900;

(22) all arrangements for compensation of directors (including qualified and nonqualified deferred compensation plans). See also *Utilities Handbook* § 132; and

(23) a schedule of all funded reserves (including any trusts or VEBAs for payment of welfare benefits or postretirement benefits).

(2) Documents to be Requested from G&T Cooperatives:

(a) a list of the names and addresses of all members;

(b) all reports filed with FERC (including complete FERC Forms 1) (If the G&T jointly operates any generating station with another cooperative, public utility or government agency, also request complete FERC reports filed by the other entity or entities);

(c) all power delivery agreements (or power supply agreements) in effect during the years under examination;

(d) all power exchange or power pooling agreements;

(e) all power rate schedules in effect during the years under examination;

(f) representative sample invoices for excess capacity sales and for off-peak sales;

(g) for any jointly operated generating station (as defined above): all operating agreements, station agreements, load management agreement and all other agreements concerning a jointly operated station, income and expense analysis. In some circumstances, the examiner may also need to request all documents (including agreements and correspondence) concerning acquisition, construction and financing of such stations;

(h) Securities and Exchange Commission Forms 10-K filed by the cooperative (if applicable);

(i) the method used to compute patronage dividends;

(j) workpapers used to support claimed patronage dividends;

(k) notification letters to all members on allocations of patronage dividends; and

(l) tax exempt bonds. Contact Headquarters; Chief, Exempt Organizations Technical Branch 4.

(3) Documents to be Requested from Distribution Cooperatives:

Newsletters and other communications to members.

(12)22(16) Examination of Financial Statements and Reports to Regulatory Agencies

(1) Methods of Accounting. As noted, cooperatives must use the accrual method (as defined in GAAP, with modifications) for REA reporting. 7 C.F.R. § 1767.15(k). Although the basic principles are the same, the accrual methods for REA accounting and income tax accounting diverge. When this occurs, income tax accounting rules control. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979); Treas. Reg. § 1.446(e)-1; Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Proc. 92-20, 1992-1 C.B. 685. There are many differences between REA accounting and income tax accounting affecting the timing of income and expense, gain and loss and raising issues under IRC 61, 118, 451, 1001, 1231, IRC 446 and 481 for changes in methods of accounting. This may affect the 85 percent test in IRC 501(c)(12) and also IRC 461 and 512. *Utilities Handbook* §§ 320-322, 430-438.

(2) IRC 451(f). Accrual basis electric utilities must recognize income from sale of electricity to customers not later than the taxable year in which the electricity is provided. Utilities may not accrue income relying on when they read customers' meters or when they bill customers. IRC 451(f), effective for taxable years beginning after December 31, 1986. On IRC 481(a) adjustments resulting from IRC 451(f), see Pub. L. Nos. 99-514 § 821(b)(2), (3) and 100-647 § 1008(h). S. Rep. No. 313, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 3) 120-121; H. Conf. Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (Vol. 4) II-322-324. For prior law (cycle billing vs. budget billing), see Rev. Rul. 72-114, 1972-1 C.B.

124; *Utilities Handbook* § 432. Note that Account 173, Accrued Utility Revenue, unlike IRC 451(f), allows cooperatives to accrue (or not accrue) estimated revenue for electricity sold but not billed as of the end of the taxable year. As a result, adjustments to the cooperative's income may be necessary.

(3) Timing Differences Between REA Accounting and Income Tax Accounting.

(a) Distribution cooperatives generally use cycle billing or budget billing. Cycle billing is based on monthly meter reading and billing cycle. Budget billing is based on an annual projected budget; customers are billed a level amount monthly with an annual adjustment reflecting actual electricity consumption. Account 173, Accrued Utility Revenue. On billing methods, see Rev. Rul. 72-114, 1972-1 C.B. 124; *Utilities Handbook* § 432. Ascertain whether the cooperative accrues income consistently and in accord with IRC 451(f).

(b) Accounts 200.1, Memberships Issued; 252, Customer Advances for Construction or 208, Donated Capital may raise issues under the 85 percent test and IRC 118, 446 or 481. See Rev. Rul. 75-557, 1975-2 C.B. 33, *clarified in* Rev. Rul. 76-61, 1976-1 C.B. 12; *Utilities Handbook* §§ 434, 435.

(c) Amounts in Account 235, Customer Deposits typically represent a security deposit for electricity. *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990); Rev. Proc. 91-31, 1991-1 C.B. 566; Rev. Rul. 72-519, 1972-2 C.B. 32; *Utilities Handbook* § 435.

(d) The following Accounts may also affect the timing of income, expense, gain or loss: Account 229, Accumulated Provision for Rate Refunds; Account 449.1, Provision for Rate Refunds. See also, discussion of transfer of utility plant and other property.

(12)22(17) Analysis of Financial Statements and Accountants' Notes

(1) Information on the Cooperative and its Activities. Initial inquiries that may affect planning the examination include the following:

(a) Margin Stabilization Plans. If the cooperative is operating under

a margin stabilization plan, it will be necessary to reconstruct the cooperative's actual income and expense.

(1) Cooperatives must maintain certain financial ratios (*e.g.*, TIER (defined in (12)22(21)) of 1.00 for G&T cooperatives and 1.50 for distribution cooperatives), or their REA loans are in default. To more easily meet the required ratios, some cooperatives seek to average their margins in good and bad years through "margin stabilization." The cooperative selects a target margin (usually REA's required TIER of 1.00 or 1.50) by which income is to exceed expenses. The income shown in financial statements and in the financial reports to REA is the target margin, not the actual income and expense accrued in that year. In a good year, the cooperative books the excess of income over expense as a deferred credit; in a bad year, the operating loss is booked as a deferred charge. GAAP allows this, if certain conditions are met. SFAS No. 71, Accounting for the Effects of Certain Types of Regulation; No. 90, Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs; or No. 92, Regulated Enterprises—Accounting for Phase-in Plans. REA also allows margin stabilization plans if cooperatives meet certain requirements and disclose the plan in their financial statements. See 7 C.F.R. § 1718 (proposed regulations). The deferred charges and deferred credits should appear in Accounts 181-188, 251-253, 255 and 256.

(2) To check for margin stabilization plans, review REA correspondence and accountants' notes to financial statements. (Cooperatives may implement SFAS Nos. 71, 90 or 92 (the basis for margin stabilization plans) only with REA's prior written approval. 7 C.F.R. § 1767.13(d).) REA can verify whether it approved a cooperative's margin stabilization plan. See also REA Publication 201-1, TIER, line 88 (for distribution cooperatives). If TIER on line 88 is exactly 1.50, this may also indicate a margin stabilization plan.

(3) These plans raise issues with respect to the 85 percent test and Rev. Rul. 72-36. See *Technical Instruction Program for FY 1994*,

“Current Issues Affecting Certain Cooperatives and Like Organizations Described Under IRC 501(c)(12)”, 38, 47–49.

(b) Account 923, Outside Services Employed. Entries in this account may reveal payments to accountants, attorneys, appraisers, engineers and other consultants for special reports on financing, construction or rates.

(2) Cooperative Principles, 85 Percent Test and Unrelated Business Taxable Income.

(a) Operating Revenue from Sale of Electricity. A cooperative's electricity customers may vary: residential, commercial, industrial, agricultural, governmental consumers or other public utilities. Review Accounts 440–456 for the 85 percent test and possible unrelated trade or business. To classify sales to members and nonmembers, compare information on members to the persons the cooperative supplies electricity. For example, on Accounts 444, Public Street and Highway Lighting and 445, Other Sales to Public Authorities, ascertain whether the local, state or federal government agency is a member of the cooperative. Ascertain if commercial customers are members or nonmembers. Review Accounts 447, Sales for Resale (and all subaccounts) and 442, Commercial and Industrial Sales for member/nonmember income. (Late payment charges from government customers booked in Account 450, Forfeited Discounts, are not exempt under IRC 103. *Kurtz Bros. v. Commissioner*, 42 B.T.A. 561 (1940) and other authorities cited in *Utilities Handbook* § 437.) The total amount of the electric operating revenue accounts is entered in Account 400, Operating Revenue.

(1) Review Accounts 142, Customer Accounts Receivable; 142.1 Customer Accounts Receivable—Electric; 142.2 Customer Accounts Receivable—Other; 144.1, Accumulated Provision for Uncollectible Customer Accounts — Credit and Account 904, Uncollectible Accounts. *REA Accounting Course* at 214–215. Taxpayers must use the specific charge-off method in accounting for losses on bad debts. Tax Reform Act of 1986, Pub. L. No. 99–514 § 805(a), repealing IRC

166(c) (the reserve method), effective for taxable years beginning after December 31, 1986. Utilities are not barred from charging-off uncollectible accounts merely because they must continue to serve customers in arrears on their accounts. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II–314, 1986–3 C.B. (Vol. 4) 314–316. For the change in method of accounting from reserve to specific charge-off and IRC 481(a) adjustment, see Pub. L. No. 99–514 § 2835(d)(2). Analyze customer accounts for member/nonmember income.

(2) Account 555, Purchased Power, shows the cost of electricity purchased for resale and all net settlements for exchange of electricity (including economy power, off-peak power for on-peak power and spinning reserve capacity). The cooperative must maintain records showing, by months, the demands, demand charges, kilowatt-hours and prices under each purchase contract and the charges and credits under each exchange or power pooling contract.

(b) Income from Interest and Dividends. Review the following Accounts:

(1) Cash Accounts. Cooperatives must invest cash in income-producing accounts and should give primary consideration to safety and liquidity. 7 C.F.R. §§ 1715, 1789; REA Mortgage; REA Bulletin 1–7, General Funds (12/6/77). Review the cash accounts, trace earnings to the appropriate Revenue Accounts or Income Accounts, ascertain whether earnings are member or nonmember and trace to Form 990. See Accounts 131.1, Cash—General; Cash—Construction Fund—Trustee; 131.3 Cash—Installation Loan and Collection Fund (distribution cooperatives' loans to consumers for installation of appliances). For REA's rules on accounting for cash, see *REA Accounting Course* at 1–25.

(2) Other Investment Funds. Review Accounts 124, Other Investments; 125, Sinking Funds (if applicable); 126 Depreciation Fund; 128, Other Special Funds; 134, Other Special Deposits; 136 Temporary Cash Investments Trace investment income attributable to these Accounts to appropriate income Accounts and Form 990.

(3) CFC. Many cooperatives also borrow from the CFC and pay a membership fee to join CFC. Account 123.23 Other Investments in Associated Organizations. As part of the financing, they execute a subscription agreement with CFC and agree to purchase interest-bearing capital term certificates. These transactions are booked in Accounts 123.21, Subscriptions to Capital Term Certificates—CFC; 224.11, Other Long-Term Debt Subscriptions; 171, Interest and Dividends Receivable; 419, Interest and Dividend Income.

(4) Interest and Dividend Income. Analyze Accounts 171, Interest and Dividends Receivable and 419, Interest and Dividend Income.

(5) Interest Income from “Cushion of Credit Accounts.” Ascertain whether interest income from “cushion of credit accounts” is reported. Cooperatives with REA loans may deposit amounts in cushion of credit accounts at the U.S. Department of the Treasury. These accounts can only be used to pay principal and interest on REA loans. They earn interest at 5 percent (a fixed rate, not based on Treasury's changing cost of funds). When interest rates from other investments fall below 5 percent, cooperatives often increase deposits to their cushion of credit accounts. Transactions in cushion of credit accounts should be booked as follows: Deposits are debited to Account 222.6, Advance Payments Unapplied—LTD Debt and credited to Account 131, Cash. Interest income earned is debited to Account 419 and credited to Account 222.4. Cushion of credit payments (and interest) applied to REA loans are debited to Account 224.3, Long-Term Debt—REA Construction Notes and credited to Account 224.6. The interest earned on cushion of credit accounts should be recorded as interest income and never as a reduction of interest expense. See REA Bulletin 20–9; 320–12 Loan Payments and Statements; REA Bulletin 181–1. If necessary, the examiner can request a transcript of REA's loan receivable accounts for the cooperative and analyze deposits and accrued interest income applied to installments of principal and interest on REA loans.

(6) Notes Receivable. Review Account 141 for amount, timing and source of interest income.

(7) Premium Income. G&Ts using pollution control bond financing or cooperatives borrowing from FFB may have premium income. Cooperatives must maintain separate accounts for premium, discount and expense for each class and series of long-term debt. 7 C.F.R. § 1767.15(q). See Accounts 225, Unamortized Premium on Long-term Debt (amortized monthly under Account 429, (Amortization of Premium on Debt—Credit); Accounting Principle 624, Pollution Control Bonds. See Treas. Reg. § 1.61–12.

(c) Forgiveness of Indebtedness Income from Reacquisition of Long-Term Debt. When cooperatives reacquire or redeem their debt, under the USoA, the difference between the amount paid upon reacquisition and the face value (plus any unamortized premium less any related unamortized debt expense and reacquisition expense) less any unamortized discount, related debt expense and reacquisition expense attributable to the redeemed debt are booked in Account 189, Unamortized Loss on Reacquired Debt or Account 257, Unamortized Gains on Reacquired Debt. These amounts are amortized monthly over the remaining life of the old original debt (Account 428.1, Amortization of Loss on Reacquired Debt; Account 429.1, Amortization of Gain on Reacquired Debt—Credit). Accounting Principle 625, Prepayment of Debt. As stated above, for income tax purposes, discharge of indebtedness income is (nonmember) gross income in the taxable year realized unless TAMRA § 6203 applies. IRC 61(a)(12), 451, 501(c)(12)(C)(ii). Review Accounts 189, 257, 428.1, 429.1.

(d) Rental Income. Analyze Account 172, Rents Receivable and 418, Nonoperating Rental Income. Review Accounts 104, Electric Plant Leased to Others; 412, Revenues from Electric Plant Leased to Others; 413, Expenses of Electric Plant Leased to Others) for source and amount of rental income for the 85 percent test (including qualified pole rentals, if any) and unrelated trade or business taxable income. Qualified pole rentals are recorded in Account 454, Rent from Electric

Property. See *Utilities Handbook* § 44(12) on joint use of poles.

(e) Gains and Losses. The USoA rules on plant accounting and realization differ from the income tax rules on adjusted basis and realization:

(1) Accounting for Utility Plant. Utility plant is the largest asset account on the balance sheet. REA plant accounting differs radically from income tax accounting in many ways (e.g., acquisitions, retirements and depreciation reserves). *Utilities Handbook* §§ 230, 426.

(2) Work in progress appears in Account 107, Construction Work in Progress—Electric. 7 C.F.R. § 1767.16(a)–(d), (f)–(h) (detailed discussion of multiple expenditures covered). On booking additions and retirement of plant, see 7 C.F.R. § 1767.16(j); Account 102, Electric Plant Purchased or Sold; Accounts 301–399; Account 101, Electric Plant in Service. Some REA capitalization, basis and depreciation rules diverge from income tax accounting (e.g., Account 419.1, Allowance for Funds Used During Construction (imputed interest income for rate-making purposes only), booked to Account 101, must be eliminated to compute adjusted basis in utility plant). For equipment, see 7 C.F.R. § 1767.16(i). On basis and depreciation, see *Utilities Handbook* §§ 426, 445. The cooperative's CPA is required to test utility plant and depreciation accounts for additions, replacements, retirements and construction work in process. 7 C.F.R. § 1773.39. If appropriate, request the CPAs' workpapers.

(3) Transfer of Electric Plant and Other Property. When electric plant is transferred, the book cost of the transferred plant is debited to Account 102, Electric Plant Purchased or Sold (a suspense account) and credited to the appropriate plant account(s) and the accumulated depreciation amount (Accounts 108, 115, 119) (and any amount in Account 252, Customer Advances for Construction) are charged to those Accounts. This net amount, minus the consideration received for the transferred plant (less expenses of sale) is then credited to Account 102 and, if a "significant" amount, closed into Accounts 256, Deferred Gains from Disposition of Utility

Plant or 187, Deferred Losses from Sale of Utility Plant and amortized over five years (generally) in, respectively, Accounts 411.6, Gains from Disposition of Utility Plant and 411.7, Losses from Disposition of Utility Plant. Nonsignificant gains and losses are closed into Accounts 421.1, Gain on Disposition of Property or Account 421.2, Loss on Disposition of Property. 7 C.F.R. § 1767.16(e); *REA Accounting Course* at 296–297.

(4) Income Tax Accounting. Gains and losses from disposition or retirement of utility plant and other assets is included in gross income in the taxable year realized and recognized. IRC 1001, 1231, 451; Treas. Reg. § 1.167(a)–11(d) for pre-ACRS property. Review and reconcile activity in these Accounts with income tax accounting rules. *Utilities Handbook* §§ 433, 445.

(5) Gains and Losses on Transfers of Other Property. For other property (e.g., land or land rights), see Accounts 421.1, Gain on Disposition of Property or Account 421.2, Loss on Disposition of Property. 7 C.F.R. § 1767(e)(5). Accounting Principles 128, Sale of Property; 129, Gain or Loss on the Sale of an Office Building.

(f) Transfer of Clean Air Act Allowances.

(1) The Clean Air Act Amendments of 1990 (the Act). The Act established a system to issue emission allowances for airborne pollutants, implemented by the Environmental Protection Agency (EPA). Electric utilities (including G&Ts) are issued emission allowances authorizing the emission of a specified amount of airborne pollutants by the utility during a specified calendar year or later period. Starting in 1993, unused allowances may be sold, traded or held in inventory for use against emissions in future years.

(2) Accounting for Allowances. Account 158.1, Allowance Inventory, includes the cost of allowances owned by the G&T and not withheld by the Environmental Protection Agency. (See Account 158.2, Allowances Withheld, for treatment of withheld allowances.) Concurrent with the cooperative's monthly emission of sulfur dioxide, Account 158.1 is credited and Account 509,

Allowances, is debited. Separate subdivisions of the Account are maintained to separately account for allowances usable in the current year and those used in subsequent years. The records should be sufficiently detail to identify each allowance, its origin, and the acquisition cost, if any. The cost of allowances owned by the G&T, but withheld by the EPA, are included in Account 158.2. Upon release of the allowance for use by the G&T, inventory cost is transferred to Account 158.1.

(3) Gains and Losses. G&Ts may realize gains and losses from the disposition of allowances or options on allowances. Accounting treatment of dispositions of allowances under the USoA varies depending on whether the allowance is held for speculative purposes:

(a) Nonspeculative Gains and Losses. Gains on dispositions of allowances not held for speculative purposes are credited to either: (1) Account 254, Other Regulatory Liabilities, when there is uncertainty as to the existence of a regulatory liability or definite regulatory liability; or (2) Account 411.8, Gains from Disposition of Allowances. Losses that qualify as regulatory assets are charged to Account 182.3, Other Regulatory Assets. All other losses are charged to Account 411.9, Losses from Disposition of Allowances.

(b) Speculative Gains and Losses. Gains on disposition of allowances held for speculative purposes appear in Account 421, Miscellaneous Nonoperating Income. Losses are charged to Account 426.5, Other Deductions. Costs and benefits of exchange-traded allowance futures contracts used to protect a utility from the risk of unfavorable price changes (hedging transactions) are deferred in Account 186, Miscellaneous Deferred Debits, or Account 253, Other Deferred Credits. The deferred amounts are included in Account 158.1 in the month in which the related allowances are acquired, sold or otherwise disposed of. Where the costs or benefits of hedging transactions are not identifiable with specific allowances, amounts are included in Account 158.1 when the contract closes.

(4) Income Tax Accounting. Examine Account 158.1 to ascertain

gains and losses realized from disposition of air emission allowances. Rev. Proc. 92-1, 1992-2 C.B. 503, discusses the federal income tax consequences of the air emission allowance program. Contact the Office of the Assistant Chief Counsel (Income Tax and Accounting) for further assistance in determining the income tax consequences of transactions involving the sale or exchange of allowances.

(g) Associated (Affiliated) Companies and Subsidiaries. These Accounts may raise issues concerning the 85 percent test, operation as a cooperative, unrelated trade or business and employment taxes.

(1) A cooperative's investment in an associated company embraces corporations, joint ventures and funded deferred compensation plans. Cooperatives must keep accounts and records to accurately report transactions with subsidiaries. 7 C.F.R. § 1767.15(n). Accounting Principle 623, Satellite or Cable Television Services. The results of subsidiaries' operations appear on the cooperative's balance sheet in Accounts 123.11, Investment in Subsidiary Companies; 418.1, Equity in Earnings of Subsidiary Companies and 216.1, Unappropriated Undistributed Subsidiary. Accounting Principle 623, Satellite or Cable Television Services; FAS No. 94.

(2) Review Accounts 123, Investment in Associated Companies; 123.23, Other Investments in Associated Organizations; 136, Temporary Cash Investments; 145, Notes Receivable from Associated Companies; 233, Notes Payable to Associated Companies; 146 Accounts Receivable from Associated Companies; Accounts Payable to Associated Companies; 223, Advances from Associated Companies. These accounts show the book cost of investments in securities issued (or assumed by) each associated company and joint venture, the cooperative's investment advancements and any accrued interest on any debt. Amortization of discount or premium on interest-bearing investments is booked in Account 419, Interest and Dividend Income. Write-offs appear in Account 426.5, Other Deductions.

(h) Economic Development Loan Fund. Cooperatives are en-

couraged to participate in REA's Rural Economic Development Loan and Grant Program. REA provides interest-free loans or grants to cooperatives to promote rural economic development and job-creation projects, through revolving loan funds and pass-through grants. See 7 C.F.R. § 1703, Subpart B (including final regulations published in 59 Fed. Reg. 11702 (Mar. 14, 1994)); Accounts 131.12, Cash-General-Economic Development Loan Funds; 224.16, Long-Term Debt—REA Economic Development Notes Executed; 224.17, REA Notes Executed—Economic Development—Debit; Accounting Principle 626, Rural Economic Development Loan and Grant Program. Analyze activity in these accounts in connection with the 85 percent test.

(i) Miscellaneous. Entries in the following accounts may reveal member, nonmember or unrelated trade or business income:

(1) Accounts 105, Electric Plant Held for Future Use; 121, Nonutility Property or 389-399, General Plant (particularly Account 397, Communication Equipment) may suggest nonmember income and/or unrelated business (e.g., non-cooperative cable TV service dealing with nonmembers) See also, Accounting Principle 623, Satellite or Cable Television Services.

(2) Sale of Nuclear Materials (as opposed to reuse): Account 157, Nuclear Materials Held for Sale is debited for salvage value; Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies is credited. Any difference between salvage value and the amount realized is credited/debited to Account 518, Nuclear Fuel Expense.

(3) Make Ready Charges Received from Cable Television Companies. The cooperative and a cable television company (an affiliate or an unrelated firm) may agree to place lines, attachments or apparatus on the cooperative's poles for transmission of TV signals. See REA Bulletin, Joint Use Agreement With CATV Companies. To make ready the poles, the cooperative incurs labor and materials costs. Make ready charges may be booked in several ways: as a reimbursement (Accounting Principle 135, Account-

ing for Removal or Relocation of Electric Facilities Resulting from the Action of Others (*Reimbursement*)); as contract work (Account 415, Revenues from Merchandising, Jobbing and Contract Work) or as reductions in expenses (Account 142.2, Customer Accounts Receivable—Other (when the invoice is paid, cash is credited and maintenance and operation expenses are debited)).

(4) Sales of Timber, Sand and Gravel. See 7 C.F.R. § 1767.16(g)-(3). Account 421, Miscellaneous Nonoperating Income.

(3) Patronage Capital. Cooperatives must keep detailed records on names and addresses of members and a patronage capital ledger. Accounts 200; 201.1. See GAO Reports RCED 93-164; GGD-83-7.

(a) The Patronage Capital Cycle. As discussed above, cooperatives must operate on a cooperative (nonprofit) basis. The excess of operating revenues over operating expenses for each year is considered to be capital furnished by members (patrons). Such capital or margins is to be assigned to members on the basis of each year's margins. See Exhibit 12(20)-1. This is done as follows:

(1) At the end of each year, revenue and expense from sale of electricity (income and expense netted from Accounts 400-408; 412-414; 423-428; 431) are closed into Account 219.1, Operating Margins. Note: Accounts 219.1 and 219.2 cannot be used (unless adjusted) to check the 85 percent test because they reflect net income from operations and because the income accounts do not uniformly parallel member/nonmember classifications in IRC 501(c)(12).

(2) The balance in Account 219.1 is then transferred to Account 201.2, Patronage Capital Assignable. (If the amount in Account 219.1 is a deficit, the amount is not transferred to Account 201.2.) Patronage capital is assigned to individual members on the basis of patronage, pursuant to the cooperative's bylaws.

(3) After the margins are allocated to members, this amount is transferred from Account 201.2 to Account 201.1, Patronage Capital Credits.

(4) Nonoperating margins from other activities (Accounts 415-417; 417.1, 418-419; 419; 421, 421.1, 421.2, 422, 434-435) are closed into Account 219.2, Nonoperating Margins. If the cooperative's bylaws permit, nonoperating margins may be assigned to members. Accounts 219.1, 219.2, 219.3, Other Margins; 219.4, Other Margins and Equities—Prior Periods which are assignable to patrons (members) are transferred to Account 201.2 and 201.2 (as above).

(5) When the board of directors authorizes the return of capital credits to patrons, the amount authorized is transferred to Account 238.1, Patronage Capital Payable. See Accounting Principles 501, Patronage Capital Assignments; 502 Patronage Capital Retirements; 503 Operating and Nonoperating Margins; 504, Patronage Capital from G&T Cooperatives, 505, Patronage Capital Furnished by Other Cooperative Service Organizations.

(6) Forfeited membership fees appear in Account 208, Donated Capital. See Accounting Principle 506, Forfeited Membership Fees. Ascertain whether forfeitures are treated consistently with Rev. Rul. 72-36, Q&A 4.

(b) The cooperative's CPAs must analyze patronage capital accounts and a sample of membership transactions. 7 C.F.R. § 1773.43(b), (c).

(c) Electric cooperatives are not required to file Forms 1099 to report payments of patronage dividends. Treas. Reg. § 301.6044-2(b)(2)(iii).

(d) Review the patronage capital credits allocated to a distribution and transmission cooperative by G&T Cooperatives. Account 123.1, Patronage Capital from Associated Cooperatives.

(4) Unrelated Business Taxable Income. Entries in the following Accounts may suggest unrelated trade or business:

(a) Accounts 415, Revenues from Merchandising, Jobbing and Contract Work; 416, Costs and Expenses of Merchandising, Jobbing and Contract Work; 417 Revenues from Nonutility Operations (*e.g.*, cable TV or furnishing management or engineering services to others); 417.1, Expenses of Nonutility Oper-

ations; 418, Nonoperating Rental Income (net income from real property, equipment, intangibles (*i.e.*, from Nonutility Property in Account 121)); 421, Miscellaneous Nonoperating Income (net gain from disposition of investments (7 C.F.R. § 1767.15(q)); net income from timber sales (7 C.F.R. § 1767.16(g)(3)); net profit on certain contracts); 434 Extraordinary Income; 435, Extraordinary Deductions; 451, Miscellaneous Service Revenues. Accounting Principle 623, Satellite or Cable Television Services.

(b) Allocation of Expenses. Cooperatives must keep accurate records of payroll distribution by function. Because REA finances only capital items (new construction and replacement) but not operating expense, the USoA requires detailed allocations of labor and materials expense between these functions. These records may assist the examiner with allocating expenses under Treas. Reg. § 1.512(a)-1(c). 7 C.F.R. §§ 1767.15(i), (j); 1767.17; 1767.27 (Accounts 500-598); Accounts 163, Stores Expense Undistributed. Cooperatives often share facilities, equipment or labor between furnishing electricity and television services. GAO Report 93-164.

(5) Retirement or Pension Plans, Other Deferred Compensation Arrangements and Employee Benefits. The cooperative may maintain one or more qualified or nonqualified plans.

(a) Examination of Qualified Plans. Determine what plans a cooperative maintains, and the type of plan. Where necessary, seek the assistance of an Employee Plans Specialist for further analysis of the plans and to make sure that there are no problems with participation, discrimination, contributions or benefits levels, vesting, funding, portability, or the security of pension investments. Review Account 228.3, Accumulated Provisions Pensions and Benefits and any Account 128 sub-accounts, Other Special Funds—Deferred Compensation; Special Funds Reserve—Deferred Compensation. Accounting Principle 604.

(b) Examination of Non-qualified Plans. Seek the assistance of a deferred compensation specialist in the Office of Associate Chief Counsel (Employee Benefits & Ex-

empt Organizations) for further analysis of the plans. To review non-qualified deferred compensation plans and other employee benefits, see Accounts 128, Other Special Funds and Account 123, Investment in Associated Companies (and sub-accounts). See Accounting Principle 604, Deferred Compensation.

(6) Employment Taxes. Employment taxes paid and accrued appear in Accounts 236.3, Accrued U.S. Social Security Tax—F.I.C.A. (employer's share of F.I.C.A.); 408.2 Accrued U.S. Social Security Tax—Unemployment; 408.3, U.S. Social Security Tax—F.I.C.A.; 236.7, Accrued Taxes—Other; 408.7 Taxes—Other; 241.1, Tax Collections Payable—F.I.C.A. (employee's share of F.I.C.A. collected by employer). Purchase rebates received from materials and supplies vendors may be in the form of package travel arrangements. The board of directors decides who receives these benefits. The contra charge for the reduction in cost is posted to Account 926, Employee Pensions and Benefits (for employees) or to Account 930.2, Miscellaneous General Expenses (for directors and members). Accounting Principle 620, Purchase Rebates.

(7) Other Accounts to be Reviewed. For compliance with the 85 percent test and employment tax reporting, review Accounts 143, Other Accounts Receivable (amounts due from employees to be separately stated); 144.3, Accumulated Provision for Uncollectible Accounts, Officers and Employees—Credit; Account 904, Uncollectible Accounts, Account 920, Administrative and General Salaries (salaries, bonuses and compensation for officers and other employees not chargeable to a particular operating function). Compensation expense for operating functions appear in other expense accounts. Account 926, Employee Pensions and Benefits, shows current accrued expense for qualified employee retirement plans, nonqualified unfunded plans, life insurance, accident and health benefits, educational and recreational activities for the benefit of employees. On nonqualified deferred compensation plans maintained by the cooperative, Account 926 may reflect accrued employee benefit expense netted against investment income. The investment income is included in computing the 85 percent test. Accounting Principles 601, Employee Benefits; 602

Compensated Absences; 603, Employee Retirement and Group Insurance; 604, Deferred Compensation; 605, Life Insurance Premium on Life of a Borrower Employee; 606, Pension Costs; 607, Unproductive Time; 608, Training Costs, Attendance at Meetings, etc.; 627, Postretirement Benefits.

(12)22(18) Analysis of Statement of Cash Flows

Cooperatives' financial statements must include a statement of cash flows. FAS No. 95, "Statement of Cash Flows." The statement provides information on the cooperative's ability to generate positive cash flows, to pay patronage dividends and need to borrow funds. This statement may assist the examiner in assessing whether the cooperative operates according to cooperative principles (including the reasonableness of cash reserves). See sample statement of cash flows in 7 C.F.R. § 1789, Appendix A; *REA Accounting Course* at 270-281. Analyze the statement of cash flows (or, if a condensed statement of cash flows is used, a more detailed cash flows statement). If appropriate, request the underlying workpapers. See IRM 7(10)44.(10)4.

(12)22(19) COBRA Continuation Coverage

(1) If a cooperative maintains a group health plan, the plan may be subject to the COBRA continuation coverage requirements under IRC 4980B. Under those requirements, plans generally must make continuation coverage available to beneficiaries losing coverage under the plan due to certain events, such as termination of employment, death, or divorce. IRC 4980B imposes an excise tax for failures to comply with the COBRA continuation coverage requirements. The excise tax is generally \$100 per day for each beneficiary affected by the noncompliance. Two exceptions may apply to plans of cooperatives so that the excise tax of IRC 4980B would not apply.

(a) First, if the plan constitutes a governmental plan under IRC 414(d), then the excise tax would not apply.

(b) Second, if the employers maintaining the plan employ in the aggregate fewer than twenty employees (including independent

contractors eligible for coverage under the plan), then the excise tax does not apply.

(2) For more information on the excise tax of IRC 4980B, see the *COBRA Employee Benefit Continuation Coverage Examination User's Guide (January 1994)*.

(12)22(20) Nonexempt Electric Cooperatives

(1) Overview. If it is necessary to prepare a Form 1120 for any years under examination, seek assistance from the Utilities Industry Specialist (e.g., Schedule M adjustments, when utility plant is placed in service, MACRS, alternative minimum tax) from the Farmers' Cooperatives Industry Specialist (e.g., IRC 277) and, if appropriate, the Media/Communications Industry Specialist and the VEBA (Voluntary Employees' Beneficiary Association) Industry Specialist (IRC 501(c)(9), 419, 419A (including differences in calculations for IRC 419A and FAS No. 106). Many aspects of the USoA not covered in these guidelines (e.g., plant accounts and deferred taxes accounts) may be useful in preparing Form 1120. See also *Utilities Handbook Exhibits*.

(2) Patronage Deductions. Nonexempt cooperatives not subject to Subchapter T may exclude patronage dividends paid or allocated to patrons, according to their bylaws. Rev. Rul. 83-135, 1983-2 C.B. 149. Information from the cooperative will be needed to analyze patronage and nonpatronage income and expense (e.g., analysis of maturity of certificates of deposits.)

(3) IRC 277. Nonexempt electric cooperatives are subject to IRC 277, a method of accounting as defined in IRC 446. Treas. Reg. § 1.446-1(e)(2)(ii)(a); *Concord Consumers Hous. Coop. v. Commissioner*, 89 T.C. 105, 116 (1989); Rev. Rul. 90-38, 1990-1 C.B. 57.

(12)22(21) Definitions

(1) See 7 C.F.R. §§ 1767.10, 1773.2 for definitions used in the USoA. For convenience, certain definitions are reproduced here:

(2) "Associated (or affiliated) companies" are persons that are directly or indirectly (through one or more intermediaries) control or are controlled by,

or under common control with, the cooperative. 7 C.F.R. § 1767.10.

(3) “Control” means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a company, whether such power is exercised alone, through one or more intermediary companies, or in conjunction with or pursuant to an agreement and whether such power is established through a majority or minority ownership or through voting of securities; common directors, officers or stockholders; voting trusts, holding trusts, associated companies; contracts, or any other direct or indirect means. 7 C.F.R. § 1767.10.

(4) “Subsidiary company” is a company controlled by the cooperative through ownership of voting stock. 7 C.F.R. § 1767.10.

(5) Financial Ratios. REA tracks financial ratios on cooperatives’ operations. Some may interest examiners (e.g., net working capital in relation to reasonable cash reserves). See *REA Accounting Course* at 257–287. “TIER” (times interest earned ratio) equals:

$$\frac{\text{(patronage capital and margins)} + \text{(interest on long-term debt)}}{\text{interest on long-term debt}}$$

TIER appears on line 88 of REA Publication 201–1. Patronage capital and margins appear on line 50; interest on long-term debt on line 48. Example: Patronage capital and margins is \$600,000. Interest on long-term debt is \$500,000. TIER is 2.20:

$$\frac{(600,000 + 500,000)}{500,000}$$

(12)22(22) Additional References

(1) Internal Revenue Service:

- (a) Technical Instruction Program (1977—current).
- (b) ISP Coordinated Issue Papers.
- (c) *Exempt Organizations Handbook*.
- (d) *Specialized Industry Audit Guidelines—Public Utilities (Utilities Handbook)*.
- (e) “More Basics: the Basics of Fringe Benefits” and User Guide (Chief Counsel Technical TV) (1994).

(f) *COBRA Employee Benefit Continuation Coverage Examination User’s Guide* (January 1994).

(g) *Office of Chief Counsel Telephone Directory and Subject Matter Directory*, Document 7801 (including Utilities ISP, Media/Communications ISP, Farmers’ Cooperatives ISP and VEBA (Voluntary Employees’ Beneficiary Association) ISP).

(2) General Accounting Office:

- (a) *Generally Accepted Government Auditing Standards* (GAGAS or Yellow Book) (rules for required reports on electric and telephone cooperatives prepared by independent CPAs).
- (b) *Legislation Needed to Improve Administration of Tax Exemption Provisions For Electric Cooperatives*, GGD–83–7 (1983).
- (c) *REA Borrowers’ Investment in Cable and Satellite Television Services*, RCED–93–164 (1993).
- (d) To order GAO reports, call (202) 512-6000 or fax (301) 258-4066. The first copy is free. Additional copies are \$2.00.

(3) Federal Energy Regulatory Commission (FERC):

- (a) Uniform System of Accounts, 18 C.F.R. § 101 *et seq.*
- (b) *Glossary of Important Power and Rate Terms, Abbreviations and Units of Measurement*, Interagency Committee on Water Resources (Federal Power Commission 1965).

(4) Rural Electrification Administration:

- (a) Rural Electrification Act of 1936 (With Amendments as Approved Through December 17, 1993), Informational Publication 100–1 (1993) (chronology of amendments, text of statute and guide to provisions).
- (b) Uniform System of Accounts (Electric), 7 C.F.R. § 1767 *et seq.* (1994) (58 Fed. Reg. 59822 (1993)) (or see REA Bulletin 1767–B (1993)) (USoA).
- (c) Policy on Audits of REA Borrowers, 7 C.F.R. § 1773 (requirements for audit of cooperatives by independent CPA under GAAP and GAGAS).
- (d) Margin Stabilization Plans, Revenue and Expense Deferrals, and Refunds of Previously Recorded Revenues, 7 C.F.R. § 1718 (proposed regulations) (53 Fed. Reg. 44887 (1988)).

(e) Note on REA regulations: REA regulations are available in hard copy (Code of Federal Regulations, published annually) and on disk in ASCII. Contact the National Office for additional information.

(f) REA Forms 7 Financial and Statistical Report, Operating Report — Financial, Form 12.

(g) *Guide for Preparing Financial and Statistical Reports for Power Supply Borrowers and Electric Distribution Borrowers with Generating Facilities*, Bulletin 1717B–3.

(h) *Guide for Preparing Financial and Statistical Reports for Electric Distribution Borrowers*, Bulletin 1717B–2.

(i) REA Standard Mortgage.

(j) *A Brief History of the Rural Electric and Telephone Programs and Report of the Administrator*, Fiscal Year 1992 Informational Publication 100–7.

(k) *REA Financed Generating Plants*, Informational Publication 200–2 (1993).

(l) *1992 Statistical Report, Rural Electric Borrowers*, Informational Publication 201–1.

(m) REA Bulletins (selected):

(1) Evaluation and Enforcement of Internal Control of Borrowers’ Enterprises, 182–1 (1/10/65).

(2) Procedures for Computing and Recording Capital Credits, Section 1951, Issue 2 (7/64).

(3) Capital Credits—Consumer Benefits, 102–1 (Electric) (7/64, reprinted 7/28/74).

(4) General Funds, 1–7 (12/6/77) (cash management guidelines).

(5) Joint Use Agreement With CATV Companies (joint use of utility poles), 1726A–125 (9/17/93).

(n) REA Accounting Interpretations.

(o) *REA Telephone Directory*, Informational Publication 500–1.

(5) Graduate School, U.S. Department of Agriculture:

REA Borrower Accounting (Electric), Correspondence Program course guide (1991) (*REA Accounting Course*).

(6) National Association of Regulatory Utility Commissioners (NARUC):

(a) *Utility Regulatory Policy in the United States and Canada*, (1992) (guide to state rate regulation of electric cooperatives).

(b) To order NARUC publications, call (202) 898-2200 or fax (202) 898-2213.

(7) American Institute of Certified Public Accountants (AICPA):

(a) *Audit and Accounting Guide: Consideration of Internal Control Structure in a Financial Statement Audit* (1990).

(b) *Audit Risk Alerts* (matters of interest to CPAs in planning audits, issued annually).

(8) Treatises:

(a) J. Bonbright, *Principles of Public Utility Rates* (1988).

(b) R. Hahne, G. Aliff, *Accounting for Public Utilities* (1993).

(c) M. Reeser, *Introduction to Public Utility Accounting* (1984).

(d) Pacific Gas and Electric, *Resource: An Encyclopedia of Utility Industry Terms* (1984).

(e) *Glossary of Cable & TV Terms*, National Cable Television Association, A.C. Nielsen Co. (1981).

(f) M. Abrahamsen, *Cooperative Business Enterprise* (1976).

(g) I. Packel, *The Organization and Operation of Cooperatives* (4th ed. 1970).

(h) G. Bauernfeind, *Income Taxation: Accounting Methods and Periods* (1992).

(9) Periodicals:

(a) *The Cooperative Accountant*
National Society of Accountants
for Cooperatives.

(b) *Journal of Accountancy*
AICPA.

(c) *Electric Utility Week*
McGraw-Hill.

(d) *Electrical World*
McGraw-Hill.

(e) *The Energy Daily*
King Publications Group.

(f) *Fortnightly* (formerly *Public Utilities Fortnightly*) Public Utilities Reports.

(g) *Rural Electrification*
National Rural Electric Cooperative Association (NRECA).

(h) *NRECA's Power Supply Report*.

(i) *Rural Electric Newsletter*
NRECA.

(j) *Electric Power Alert*
Inside Washington Publishers.

(k) *Broadcasting & Cable*
Cahners Publishing Co./Reed
Publishing.

(l) *Cablevision*
Diversified Publishing Group.

(m) *Telecommunications Policy*
BRP Publications, Inc.

(12)22(23) Exhibits

Exhibit 12(20)-1, "Summary of Accounts Used in Connection with Recording Patronage Capital" (reproduced with the compliments of the Graduate School, U.S. Department of Agriculture, from the Correspondence Program course *REA Borrower Accounting (Electric)*, copyright (c) 1991).

Exhibit 12(20)-2, "Applying the 85 Percent Test: Analysis of REA Uniform System of Accounts (Selected Revenue, Income, Expense and Balance Sheet Accounts)."

Applying the 85 Percent Test: Analysis of REA Uniform System of Accounts (Selected Revenue, Income, Expense and Balance Sheet Accounts)¹

USoA	Account Name	Non-Member	Member	Excluded
411.6	Gains from Disposition of Utility Plant [1]		X	
411.7	Losses from Disposition of Utility Plant [1]		X	
411.8	Gains from Disposition of Allowances [1]		X	
411.9	Losses from Disposition of Allowances [1]		X	
412	Revenues from Electric Plant Leased to Others		X	
414	Other Utility Operating Income [2]	X	X	
415	Revenues from Merchandising, Jobbing and Contract Work	X	X	
418	Nonoperating Rental Income [2]		X	
418.1	Equity in Earnings of Subsidiaries [1]	X	X	
419	Interest and Dividend Income [2]		X	
419.1	Allowance for Funds Used During Construction [1]	N/A	N/A	N/A
421	Misc. Nonoperating Income [2], [4]		X	
421.1	Gain on Disposition of Property [1]		X	
421.2	Loss on Disposition of Property [1]		X	
428.1	Amortization of Loss on Reacquired Debt [1]		X	
429	Amortization of Premium on Debt — Credit [1]		X	
429.1	Amortization of Gain on Reacquired Debt [1], [4]		X	X
434	Extraordinary Income [2]		X	
440	Residential Sales [3]	X	X	
440.1	Residential Sales—Excluding Seasonal [3]	X	X	
440.2	Residential Sales—Seasonal [3]	X	X	
441	Irrigation Sales [3]	X	X	
442	Commercial and Industrial Sales [3]	X	X	
442.1	Commercial and Industrial Sales—1000 kVA or Less [3]	X	X	
442.2	Commercial and Industrial Sales—Over 1000 kVA [3]	X	X	
444	Public Street and Highway Lighting [3]	X	X	
445	Other Sales to Public Authorities [3]	X	X	
446	Sales to Railroads and Railways [3]	X	X	
447	Sales for Resale [3]	X	X	
447.1	Sales for Resale to REA Borrowers [3]	X	X	
447.2	Sales for Resale—Others [3]	X	X	
448	Interdepartmental Sales [1]	N/A	N/A	N/A
449.1	Provision for Rate Refunds [4]	X	X	
450	Forfeited Discounts [4]	X	X	
451	Misc. Service Revenue	X	X	
453	Sales of Water and Water Power	X	X	
454	Rent from Electric Property	X	X	X
456	Other Electric Revenue		X	
158.1	Allowance Inventory		X	

Legend:

[1]: This Account requires an adjustment for differences between regulatory and income tax accounting.

[2]: This Account combines revenue and expense.

[3]: This Account may require an adjustment to comply with IRC 451(f).

[4]: This Account may require an adjustment for other timing differences between regulatory and income tax accounting.

N/A: Not applicable.

¹This Exhibit is a general guide to the range of classification of USoA revenue and income accounts for purposes of IRC 501(c)(12)(A), (C). Some Accounts may contain member, nonmember or excluded income (alone or in combination), depending upon the nature of the transactions, the parties thereto and/or in what taxable year the transactions occurred.

PUBLIC COMMENTS

These proposed examination guidelines address specific issues relating to rural electric cooperatives. Because they address matters that may have a significant impact on these cooperatives, the Service is soliciting public comments on them.

Comments should be submitted in writing on or before June 14, 1996.

Comments should be sent to the following address:

Internal Revenue Service
Assistant Commissioner
(Employee Plans and Exempt
Organizations) Attn:
CP:E:EO:T:3, Rm. 6137
Washington, DC 20224

If warranted, after consideration of the comments received, the Service will schedule a public hearing to discuss

these proposed guidelines before they are finalized.

DRAFTING INFORMATION

The person to contact regarding this announcement is Edward Karcher of the Exempt Organizations Division. For further information you can contact Mr. Karcher on (202) 622-8120 (not a toll-free number).