

**DESCRIPTION OF H.R. 4220,
THE “WATER AND AGRICULTURE TAX REFORM ACT OF 2015”**

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on September 14, 2016

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 4220, the “Water and Agriculture Tax Reform Act of 2015,” on September 14, 2016. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4220, the “Water and Agriculture Tax Reform Act of 2015”* (JCX-82-16), September 13, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

A. Modify Tax Exemption Requirements for Mutual Ditch or Irrigation Companies

Present Law

Under section 501(c)(12), certain mutual or cooperative organizations are exempt from Federal income tax under section 501(a), provided that certain requirements are satisfied. These organizations include: (1) benevolent life insurance associations of a purely local character; (2) mutual ditch or irrigation companies; (3) mutual or cooperative telephone companies; and (4) like organizations of organizations described in (1), (2), or (3).²

To qualify for exemption under section 501(c)(12), at least 85 percent of the organization's income must consist of amounts collected from members for the sole purpose of meeting losses and expenses.³ The 85-percent test is applied on a year-by-year basis. If an organization fails to satisfy the test for a year, it does not qualify for exemption for that particular year; it may, however, continue to qualify for exemption for any year for which the 85-percent test is satisfied. Present law includes special rules regarding the treatment of certain specific types of income under the 85-percent test for mutual or cooperative electric and telephone companies, but not for other types of organizations described in section 501(c)(12).⁴

The IRS takes the position that mutual or cooperative organizations described in section 501(c)(12) also must comply with fundamental cooperative principles.⁵ Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to

² In general, the cooperative tax rules of subchapter T (sections 1381-1388 of the Code) apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, certain tax exempt organizations (such as those described in section 501(c)(12)), and certain utilities), including tax-exempt farmers' cooperatives (described in section 521(b)). Except for section 521 tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative. Sec. 1382. The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative. Unlike subchapter T cooperatives, a section 501(c)(12) mutual or cooperative organization generally is exempt from Federal income tax, but pays tax on certain income derived from trade or business activities unrelated to the organization's exempt purposes (unrelated business taxable income, or UBTI).

³ Sec. 501(c)(12)(A).

⁴ See secs. 501(c)(12)(B)-(H).

⁵ See Rev. Rul. 72-36, 1972-1 C.B. 151.

generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost). Regarding the requirement of democratic control, the IRS has stated that the election of officers must be on a one member, one vote basis (not, for example, in proportion to share ownership in a corporation).⁶

Description of Proposal

The proposal provides that certain income received or accrued by a mutual ditch or irrigation company, or by a like organization to a mutual ditch or irrigation company, generally is not taken into account for purposes of applying the 85-percent-of-member-income test. The rule applies to income received or accrued from: (1) the sale, lease, or exchange of fee or other interest in real and personal property, including interests in water; (2) the sale or exchange of stock in a mutual ditch or irrigation company (or a like organization to a mutual ditch or irrigation company) or contract rights for the delivery or use of water; or (3) the investment of proceeds from sales, leases, or exchanges under (1) or (2).

Notwithstanding this general rule, any such income that is distributed or expended for expenses (other than for operations, maintenance, and capital improvements) of the mutual ditch or irrigation company or like organization is treated as non-member income for purposes of the 85-percent test in the year in which it is distributed or expended. For this purpose, “expenses (other than for operations, maintenance, and capital improvements)” include expenses for the construction of conveyances designed to deliver water outside of the mutual ditch or irrigation company or like organization system.

The proposal also provides a special rule for mutual ditch or irrigation companies (and like organizations to mutual ditch or irrigation companies) regarding organization governance. Under this special rule, where State law provides that such a company or organization may be organized in a manner that permits voting on a basis that is pro rata to share ownership on corporate governance matters, an organization's qualification as a mutual ditch or irrigation company (or a like organization to a mutual ditch or irrigation company) is determined without taking into account whether its member shareholders have one vote on corporate governance matters per share held in the corporation. This portion of the proposal, however, shall not be construed as giving rise to an inference regarding the requirements for organizations other than mutual ditch or irrigation companies (or like organizations to mutual ditch or irrigation companies).

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

⁶ See, e.g., I.R.M. sec. 7.25.12.5 (Rev. August 9, 2006) (citing *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1966), *acq.*, 1966-2 C.B. 6).

B. Estimated Revenue Effect

Fiscal Years											
[Millions of Dollars]											
<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2017-21</u>	<u>2017-26</u>
-3	-4	-4	-4	-4	-4	-4	-4	-4	-5	-18	-40

NOTE: Details do not add to totals due to rounding.