

[Exemptions]

[Federal income tax exempt status issued by IRS &/or as declared by Taxpayers]

26 U.S. Code § 501 (c)(12)



501(c)(12) — Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, etc.



Part 7. Rulings and Agreements

Chapter 25. Exempt Organizations Determinations Manual

Section 12. Organizations Exempt Under IRC 501(c)(12)

7.25.12 Organizations Exempt Under IRC 501(c)(12)

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7.25.12.1 (08-09-2006)

Technical Overview

1. IRC 501(c)(12) exempts the following organizations from federal income tax:
 - benevolent life insurance associations of a purely local character
 - mutual ditch or irrigation companies
 - mutual or cooperative telephone companies
 - mutual or cooperative electric companies
 - "like organizations"
2. The phrase "of a purely local character" applies only to benevolent life insurance associations and organizations like them.
3. To qualify for and maintain exemption under IRC 501(c)(12), all of the organizations described in (1) above must receive 85 percent or more of their income from members for the sole purpose of meeting losses and expenses each year.
4. Organizations that meet the requirements of IRC 501(c)(12) may apply for exemption from federal income tax on Form 1024.
5. Contributions to organizations that are exempt under IRC 501(c)(12) are not deductible as charitable contributions on the donor's income tax return.
6. For more information regarding examination issues, see IRM 4.76.20.

7.25.12.1.1 (08-09-2006)

Legislative History

1. In 1916, Congress established exemption from federal income tax for mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations. 1916 Revenue Act, P.L. 64-271, sec. 11(a)(10), 39 Stat.766 (1916).
2. In 1924, Congress extended exemption from federal income tax to benevolent life insurance associations of a purely local character and reduced the member income from 100 percent to 85 percent. Revenue Act of 1924, ch. 234, sec. 231(10), 43 Stat. 283 (1924).
3. In passing the Miscellaneous Revenue Act of 1980, Congress added IRC 501(c)(12)(C), which specifically listed electric cooperatives as exempt under this Code section for the first time and permitted them to exclude qualified pole rentals from the 85-percent member income test. Miscellaneous Revenue Act of 1980, P.L. 96-605, section 106(a), 94 Stat. 3523 (1980).
4. In 1988, Congress permitted mutual or cooperative telephone and electric companies to exclude income derived from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 from the 85-percent member income test. Technical Miscellaneous Revenue Act of 1988, P.L. 100-647, section 2003(a)(2)(C)(ii), 102 Stat. 3598 (1988).
5. Effective for taxable years beginning after October 22, 2004, and before January 1, 2007, Congress amended IRC 501(c)(12) to exclude income received by a mutual or cooperative rural electric company from any open access transaction, any nuclear decommissioning transaction, or any asset exchange or

conversion transaction, for purposes of determining whether such cooperative meets the income test for tax-exempt status (i.e., 85 percent of income collected from members of cooperatives for the sole purpose of meeting losses and expenses of providing services to members). American Jobs Creation Act of 2004, P.L. 108-357, sections 319(a),(b), 118 Stat. 1470 (2004).

6. Congress passed the Energy Policy Act of 2005, eff. Aug. 8, 2005, P.L. 109-58, Title XIII, Subtitle A, sections 1304(a),(b), 119 Stat. 997, eliminating the January 1, 2007, sunset provision for treatment of income derived from open access and nuclear decommissioning transactions and income from load loss transactions, thereby making the income-exclusion provision described above in paragraph (5) permanent.

7.25.12.2 (08-09-2006)

Regulatory Overview

1. State and federal agencies regulate mutual or cooperative telephone or electric companies. Recordkeeping and reporting requirements vary.
 - A. The Federal Communications Commission regulates and oversees interstate and international communications by radio, television, wire, satellite, and cable. More information is available at <http://www.fcc.gov/aboutus.html>.
 - B. The Federal Energy Regulatory Commission (FERC) regulates interstate transmission of electricity, natural gas, and oil. It reviews rates for wholesale sales, examines proposed mergers and acquisitions, and seeks to ensure the integrity of electrical power grids. More information is available at <http://www.ferc.gov/default.asp>.
 - C. State public utility commissions regulate instate services and rates. The National Association of Regulatory Utility Commissioners has links to state regulators at <http://www.naruc.org/displaycommon.cfm?an=7>.
 - D. The Department of Agriculture's Rural Utilities Service (RUS) provides financing for utility plants, expansion, and updating technology in rural areas. More information is available at: <http://www.usda.gov/rus/index2/aboutus.htm>
The RUS implementing regulations are in 7 CFR, Chapter 17, section 1710.

7.25.12.3 (08-09-2006)

Requirements for Exemption Under IRC 501(c)(12)

1. In order to qualify for exemption under IRC 501(c)(12), an organization must:
 - Meet the organizational and operational requirements that apply to one of the types of organizations described in the Code, regulations derived thereof and revenue rulings, and
 - Receive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses.

7.25.12.4 (08-09-2006)

Requirements for Benevolent Life Insurance Associations

1. The phrase "of a purely local character" applies only to benevolent life insurance associations and organizations that are similar to them. An organization of purely local character is one that confines its business activities to a particular community, place, or district, irrespective of political subdivisions. Treas. Reg. 1.501(c)(12)-1(b).
2. The organization must confine its operations to a single identifiable locality. In 1928, the Court of Claims held that a reciprocal or interinsurance exchange that operated in 27 states was not an organization of a purely local character. Hardware Underwriters v. United States, 65 Ct. Cl. 267 (1928), *cert. den.*, 278 US 645 (1928).

3. An organization is not purely local in character if only the borders of a state limit its activities. Treas. Reg. 1.501(c)(12)-1(b). A life insurance organization that operated under a state permit that empowered it to do business in any county within 75 miles of its home office, but also issued policies to residents outside that area, did not qualify as an exempt organization. Rev. Rul. 64-193, 1964-2 C.B. 151.
4. The requirement that business activities must be purely local is satisfied if members reside in the local area at the time of application. In 1983, the Service ruled that a benevolent life insurance company that did not terminate members' life insurance coverage when they moved out of the local area was tax-exempt. Rev. Rul. 83-43 1983-1 C.B.108.

7.25.12.5 (08-09-2006)

Requirements for Mutual Ditch, Irrigation, Cooperative Telephone or Electric Companies, and "Like Organizations"

1. Ditch and irrigation companies, telephone companies, electric companies, and "like organizations" that seek exemption under IRC 501(c)(12) must be organized and operated as mutual or cooperative organizations. The terms "mutual" and "cooperative" have no legal distinction for purposes of section 501(c)(12). The U.S. Tax Court defined "cooperative" as follows:
"A cooperative is an organization established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor. The means of production and distribution are those owned in common and the earnings revert to the members, not on the basis of their investment in the enterprise, but in proportion to their patronage or personal participation in it."
Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1966), *acq.* 1966-2 C.B. 6.
2. The court described the organizational and operational cooperative principles as follows:
 - A. **Democratic Control.** The organization must periodically hold democratically conducted meetings with members. Election of officers must be on a one member, one vote basis. Meetings must have a quorum of members in attendance or voting by proxy.
 - B. **Operation at Cost.** The organization must allocate all excess operating revenues (excess of revenue over expenses) among the members.
 - C. **Subordination of Capital.** The organization must ensure that those who contribute capital neither control the operations nor receive most of the pecuniary benefits. The organization will meet this requirement by ensuring that the members control and own the savings or monetary benefits rather than the shareholders or equity investors.
3. The Service sets out additional organizational and operational cooperative requirements that an organization must meet for exemption under IRC 501(c)(12). Rev. Rul. 72-36, 1972-1 C.B. 151. These requirements are:
 - A. The organization must keep adequate records of each member's rights and interests in its assets.
 - B. The organization must distribute any savings to members in proportion to the amount of business done with them based on the "operation at cost" principle.
 - C. The organization must not retain more funds than it needs to meet current losses and expenses.
 - D. The organization cannot forfeit a member's right and interest in the organization upon termination of membership.
 - E. Upon dissolution, the organization must distribute the gains from the sale of any appreciated assets to all persons who were members during the period that the organization owned the assets, in proportion to the amount of business done by the members during that period.

7.25.12.5.1 (08-09-2006)

Mutual or Cooperative Characteristics—Examples

1. An association organized and operated on a cooperative basis to produce and market the worker-members' products and to allocate profits to the worker-members was found to be exempt. Puget Sound Plywood, Inc. v. Commissioner, supra.
2. A mutual water company's articles of organization required its members, in the event of dissolution, to turn over their total interests without charge to the local government. This requirement is consistent with the principles of mutual operation and does not preclude exemption under IRC 501(c)(12). Rev. Rul. 73-453, 1973-2 C.B. 185.
3. In 1978, the Service announced that it would not follow the Ninth Circuit's decision in Peninsula Light Co., Inc. v. U.S., 552 F.2d 878 (9th Cir. 1977). The decision recognized an organization that never operated on a patronage basis as exempt under IRC 501(c)(12). Its charter provided each member with an equal share in the organization's assets and, upon dissolution, divided its assets equally among the current members. Rev. Rul. 78-238, 1978-1 C.B. 161.
4. A mutual ditch company operated in a manner that was consistent with the provisions of state law before Congress enacted legislation that provided for exemption from federal income tax. It qualified for exemption even though it did not satisfy all the requirements in Rev. Rul. 72-36. Since there were no major changes in the applicable federal tax provisions in the intervening years, the Service believed that Congress intended that mutual ditch and irrigation companies that operate in such a manner would qualify for exemption. Rev. Rul. 81-109, 1981-1 C.B. 347.
5. The fact that all of its members may be exempt under IRC 501(c)(12) does not alone qualify an organization for exemption. Consumers Credit Rural Electric Cooperative Corp. v. Commissioner, 37 T.C. 136 (1961), *aff'd on exemption issue*, 319 F.2d 475 (6th Cir. 1963).

7.25.12.6 (08-09-2006)

"Like Organizations"

1. The Code provides that an organization may qualify for exemption from federal income tax under IRC 501(c)(12) if it is "like" a benevolent life insurance association, a mutual ditch or irrigation company, or a telephone or electric company.
2. "Like organizations" engage in activities similar in nature to organizations listed in IRM 7.25.12.4 and IRM 7.25.12.5. Rev. Rul. 65-201, 1965-2 C.B. 170.

7.25.12.6.1 (08-09-2006)

Examples of "Like Organization" Activities

1. **"Like" Benevolent Life Insurance Associations.** An activity that is similar to providing life insurance is providing cash benefit for burial and funeral expenses. Thompson v. White River Burial Association, 178 F. 2d 954 (8th Cir. 1950).
2. **"Like" Electric Cooperatives.** Activities or services that are similar to providing electricity to members include:
 - water and sewer services (see Rev. Rul. 67-265, 1967-2 C.B. 205, *updating and restating* I.T. 1671, II-1 C.B. 158 (1923), and Rev. Rul. 2002-54, 2002-2 C.B. 527)
 - cable television service (see Rev. Rul. 83-170, 1983-2 C.B. 97)
 - natural gas service (see Rev. Rul. 2002-54, supra)
The rationale is that these services are public utility-type services that have been traditionally regulated by a state, political division, public utility commission, or other similar body of a state,

or an agency or instrumentality of the United States. Such services also require extensive delivery infrastructure, the construction of which necessitates large capital investment. See Rev. Rul. 2002-54, *supra*.

3. **"Like" Telephone Cooperatives.** Activities or services that are similar to providing telephone service include:
 - a two-way radio service for the use of members (see Rev. Rul. 57-420, 1957-2 C.B. 308) The rationale is that these services, like telephone service, allow members to communicate with others. See Rev. Rul. 57-420, *supra*.
4. **"Like" Ditch and Irrigation Cooperatives.** An activity that is similar to providing ditch and irrigation services is constructing and maintaining structures to prevent erosion of river banks. Rev. Rul. 68-564, 1968-2 C.B. 221.

7.25.12.6.2 (08-09-2006)

Activities Not Within the Meaning of "Like Organization "

1. Providing bus services is an activity not exempt under IRC 501(c)(12). Rev. Rul. 55-311, 1955-1 C.B. 72.
2. Promoting automobile safety and furnishing road side and trip planning services are activities not exempt under IRC 501(c)(12). New Jersey Automobile Club v. United States, 181 F.Supp. 259 (Ct.Cl.1960), *cert. den.*, 366 U.S. 964 (1961).
3. Financing the purchase of appliances and equipment is an activity not exempt under IRC 501(c)(12). Consumers Credit Rural Electric Cooperative Corp. v. Commissioner, *supra*.
4. Selling electrical materials, equipment, and supplies, and furnishing equipment for manufacturing, repair, testing, and other services are not activities exempt under IRC 501(c)(12). Rev. Rul. 65-201, 1965-2 C.B. 170.
5. Selling tanked propane is not an activity exempt under IRC 501(c)(12). Rev. Rul. 2002-54, 2002-2 C.B. 527.

7.25.12.7 (08-09-2006)

Unrelated Business Income Tax

1. IRC 511(a)(1) imposes a tax on unrelated business income earned by organizations described in IRC 501(c)(12), except as described in (2) below. The criteria to determine whether an activity conducted by a section 501(c)(12) organization is an unrelated business are in section 511 *et seq.* These criteria are whether the activity is a trade or business, whether it is regularly carried on, and whether it is unrelated within the meaning of IRC 513.
2. Income earned by electric cooperatives from activities described in IRC 501(c)(12)(H) is excluded from the definition of unrelated business taxable income. See IRC 512(b)(18).
3. Interest earned on debt-financed income is subject to tax under section 511. Southwest Tex. Elec. Coop. v. Commissioner, T.C. Memo 1994-363 (1994).

7.25.12.8 (08-09-2006)

The 85-Percent Member Income Test

1. A cooperative exempt under IRC 501(c)(12) must receive 85 percent or more of its income from members. The 85-percent member income test requires that the income be
 - derived from members and

- used to pay for services listed in IRC 501(c)(12)
Rev. Rul. 2002-55, 2002-2 C.B. 529; see Rev. Rul. 2002-54, *supra*, Treas. Reg. 1.501(c)(12)-1(a), and Credit Rural Electric Cooperative Corp. v. Commissioner, *supra*.
2. The 85-percent member income test is computed each tax year. If in any year the member income falls below 85 percent of the total income received that year, the organization is no longer exempt under IRC 501(c)(12) for that tax year and must file a corporate tax return. Rev. Rul. 65-99, 1965-1 C.B. 242.
 3. When an organization uses the accrual method of accounting, it will use the same method to compute the 85-percent member income test. Rev. Rul. 68-18, 1968-1 C.B. 271.
 4. Electric cooperatives do not have to subtract the cost of goods sold from gross sales to calculate the 85-percent member income test. Prior to 1998, the Service's position was that an electric cooperative must deduct the cost of goods sold for purposes of calculating the 85-percent member income test. See Rev. Rul. 80-86, 1980-1 C.B. 118. This position was proposed for formal adoption in Prop. Treas. Reg. 1.501(c)(12)-2 (49 Fed. Reg. 1244, 1984). The proposed regulation was withdrawn. See 58 Fed. Reg. 25587 (April 27, 1993). Under the safe harbor guidelines, electric cooperatives may continue to use the method they have consistently used in the past. Ann. 96-24, 1996 I.R.B. 35, (12)22.3(b).
 5. A benevolent life insurance company is not entitled to exemption if it issues policies for stipulated cash premiums, or requires advance deposits to cover the cost of the insurance and maintains investments from which it gets more than 15 percent of its income. However, if an organization makes advance assessments for the sole purpose of meeting future losses and expenses, and retains the balance of the assessments remaining at the end of the year to meet losses and expenses or returns it to members, it may be entitled to exemption. Treas. Reg. 1.501(c)(12)-1(a). The Court of Claims has held that:
"...[T]he income of the association did not consist solely of assessments, dues, and fees collected from members. It had income from large investments in certificates of deposits and United States bonds, and this income, as stated, was deposited and commingled with the general fund of the association in the bank and used for paying expenses. It was income derived from investments. Certainly there is at least a grave doubt as to whether the plaintiffs come within the exemption, and it must be held that they are not entitled to be exempted."
Hardware Underwriters v. United States, *supra*.

7.25.12.8.1 (08-09-2006)

Included Income, Excluded Income, and Non-Income Items

1. A cooperative must take income from all sources (except as provided below) for computation under the 85-percent member income test, including capital gains from the sale of assets where the gain arises from an incidental disposition of assets upon dissolution. Mountain Water Co. of La Crescenta v. Commissioner, 35 T.C. 418 (1960), *acquiescence on other issues*, 1961-2 C.B. 5; Cate Ditch Co. v. U.S., 194 F.Supp. 688 (D.Cal.1961).
2. When an electric cooperative leases power facilities to a nonmember power company, and the nonmember power company furnishes electric energy to the cooperative members, the payments are not an "interchange of power." Rather, they are rental payments that the cooperative must include in income to determine whether it meets the 85-percent member income requirement for exemption from federal tax. Rev. Rul. 65-174, 1965-2 C.B. 169.
3. A government grant is not income and is treated as nonshareholder contribution to capital. Hence, such a grant is not included as income for purposes of computation under the 85-percent member income. In order to be treated as a grant, the income:
 - must become a permanent part of the transferee's working capital structure,

- may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee,
 - must be bargained for,
 - must result in benefit to the transferee in an amount commensurate with its value, and
 - must ordinarily, if not always, be used in or contribute to the production of additional income and its value assured in that respect. United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401 (1973); Rev. Rul. 93-16, 1993-8 C.B. 26.
4. Telephone cooperatives will apply the 85-percent income test without taking into account any income received or accrued from:
- Another telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the IRC 501(c)(12) telephone company. IRC 501(c)(12)(B)(i).

Example:

In one year, a cooperative telephone company receives \$85X from its members for telephone calls, \$15X interest income, and \$20X in credits. Other long distance telephone companies give the credits, under long distance interconnection agreements, for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative members (whether the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements). The cooperative telephone company will calculate the member income fraction without taking into account, either in the numerator or the denominator, the \$20X credits received from the other telephone companies. Treas. Reg. 1.501(c)(12)-1(c); Rev. Rul. 81-291, 1981-2 C.B. 131.

- Qualified pole rentals. IRC 501(c)(12) (B)(ii).
 - The sale of display listings in a directory furnished to members of the mutual or cooperative telephone company. IRC 501(c)(12)(B)(iii).
 - The prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936. IRC 501(c)(12)(B)(iv).
 - Charging third parties such as inter-exchange carriers, local exchange carriers, or other exchange carriers for billing and collecting intrastate, interstate, or international revenues. FSA 199906034 (1999). This Field Service Advice changed the Service's position and reflected its acquiescence to the U.S. Tax Court's decision in Golden Belt Telephone Association, Inc. v. Commissioner, 108 T.C. 498 (1997). See AOD 1998-18 I.R.B. 4 (1998); see also, Notice 92-33, 1992-2 C.B. 363.
5. Electric cooperatives will apply the 85-percent income test without taking into account any income received or accrued from:
- **Qualified pole rentals.** IRC 501(c)(12)(C)(i).
 - **Nondiscriminatory open access transactions** (other than income received or accrued directly or indirectly from a member) such as the provision or sale of electric energy transmission services or ancillary services under an open access transmission tariff approved or accepted by FERC, or under an independent transmission provider agreement approved or accepted by FERC. See IRC 501(c)(12)(C)(ii),(iii).
 - **Nuclear decommissioning transactions.** IRC 501(c)(12)(C)(iv). The term "nuclear decommissioning transaction" is defined as any transfer into a trust, fund, or instrument

established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear power plant or nuclear power plant unit, or any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs, or any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs. IRC 501(c)(12)(F).

- **Asset exchange or conversion transactions.** IRC 501(c)(12)(C)(v). The term "asset exchange or conversion transaction" means any voluntary exchange or involuntary conversion of any property related to generating, transmitting, distributing, or selling electric energy by a mutual or cooperative electric company, the gain from which qualifies for deferred recognition under IRC 1031 or IRC 1033, but only if the replacement property acquired by the company constitutes property which is used or to be used for generating, transmitting, distributing, or selling electric energy or natural gas. IRC 501(c)(12)(G).

7.25.12.8.2 (08-09-2006)

Member vs. Nonmember

1. Members are those who have the rights to elect the governing board of the cooperative and be involved in the operations of the organization. Many kinds of entities and individuals may be members of organizations exempt under IRC 501(c)(12). Government agencies may be members of IRC 501(c)(12) organizations. Rev. Rul. 68-75, 1968-1 C.B. 169. An organization that is exempt under section 501(c)(12) may have members that are exempt under that section. See e.g., Consumers Credit Rural Electric Cooperative Corp. v. Commissioner, supra.
2. Below are some examples of types of member income or nonmember income for purposes of the 85-percent member income test:
 - A. Income from the sale and service of appliances to nonmembers who do not purchase electricity from the cooperative is nonmember income, whether the sale is made through a third party or subsidiary. Treas. Reg. 1.513-1(a), (d).
 - B. Interest income from the sale of an office building is nonmember income. Rev. Rul. 65-99, 1965-2 C.B. 242.

7.25.12.9 (08-09-2006)

Current Issues

1. Some current issues are described below.

7.25.12.9.1 (08-09-2006)

Redemption of Capital Credit Accounts at a Discount

1. Many cooperatives keep savings in reserve for improvements, expansion, and unexpected expenses. They create capital credit accounts that show pro-rata savings per member. When finances permit, cooperatives may redeem these accounts. Some cooperatives have asked to redeem the accounts at a discount rather than face value. Discounted redemption programs raise two issues:
 - A. Whether the difference between the face value and the discounted amount is income for purposes of the 85-percent member income test—
The difference is treated as income for purposes of the 85-percent member income test.
 - B. Whether discount redemption programs violate any cooperative principles—
A capital credit redemption program may jeopardize two cooperative principles: (1) a member's rights and interest in the assets of the cooperative cannot be forfeited if his or her membership ends; and (2) on dissolution, a cooperative must distribute any gains from the sale of its assets to all members while the cooperative owned the assets. The Office of Exempt Organizations, Rulings

and Agreements, in coordination with the Office of Chief Counsel, has issued multiple private letter rulings to the effect that an electric cooperative's program that creates capital accounts and retires capital credit accounts at a discount does not violate cooperative principles.

7.25.12.9.2 (08-09-2006)

New Services

1. Below is a list of activities that the Service has determined administratively to be exempt under IRC 501(c)(12). See IRM 7.25.12.6.1, above.
 - A. **Telecommunications.** Many telephone cooperatives are offering new telecommunications services such as:
 - wireless or cellular phone services
 - Internet access
 - paging
 - home security monitoring
 - medical alert and environmental monitoring servicesThe rationale is that providing a communications capability to members on a cooperative basis is an exempt activity similar to a two-way radio system. See Rev. Rul. 57-420, 1957-2 C.B. 308.
 - B. **Direct Satellite Television.** The Service has determined that this service is an activity exempt under IRC 501(c)(12). The rationale is that, like cable television, it is regulated to some extent by state governmental units.

7.25.12.9.3 (08-09-2006)

Other Issues

1. For information on the following issues—
 - Providing multiple services, see IRM 4.76.20.8(1);
 - Issuance of shares of non-voting, interest-bearing stock, see IRM 4.76.20.8(2).

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