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Legend:

Taxpayer or cooperative =

LLC =

Country A =

INC =

D =

b =

c =

d =

State B =

State C =

Dear :

This is in response to a ruling request dated December 16, 2003, submitted on behalf of Taxpayer. The ruling concerns the issue of whether Taxpayer will be “operating on a cooperative basis” within the meaning of subchapter T of the Internal Revenue Code under the facts as fully described below.

Taxpayer (including its wholly-owned LLC subsidiary) is a cooperative organization organized and to be operated in the U.S. Taxpayer's member/patrons (the "GrowerCos") are three Country A companies which are themselves owned by approximately D produce growers (the "D growers"). The D growers currently market their crops in Country A through a grower-owned D company named INC. It is planned that the Taxpayer will be responsible for marketing and distributing the GrowerCos' crops on behalf of the D growers in the United States. The crops to be marketed include b, c, and d. Most of the D growers specialize in producing one of these three types of produce; however, certain growers may be engaged in the production of more than one type of produce.

Each GrowerCo will deal solely in one of the three crops and will be owned only by the D growers who specialize in that crop. With respect to D growers producing more than one type of produce, each will hold one share of voting stock in the GrowerCo representing their predominant crop. They will not hold voting stock in any of the other GrowerCos they may participate in as nonvoting patrons. In its role as a member/patron of the Taxpayer cooperative, each GrowerCo will advance and protect the interests of its constituent grower-members, while joining with the other GrowerCos to pursue a cooperative marketing strategy through the Taxpayer on behalf of their respective members.

Taxpayer will establish its own marketing and distribution facilities in the US through the LLC. In Country A, INC will coordinate the initial allocation of crops between Country A distribution and US distribution in exchange for a fee to be collected from the D growers. With respect to crops allocated by INC to the US market, the GrowerCos authorize their members, the D growers, to each sell its respective US-bound crops at an arm's-length fair market value transfer price directly to Taxpayer FOB shipping point in Country A. Using the employees and facilities to be acquired and developed by LLC, Taxpayer will then market and distribute the crops in the US market on a cooperative basis and distribute its net earnings as patronage dividends to the GrowerCos.

## PROPOSED STRUCTURE

The D growers are primarily unrelated closely-held corporations whose farming activities are conducted in Country A. GrowerCos A, B, and C (collectively the "GrowerCos") are Country A corporations wholly resident in Country A. Each GrowerCo is owned by a group of D growers who produce the same crop. GrowerCo A's owners all produce b, GrowerCo B's owners all grow c, and GrowerCo C's owners all grow d. Each GrowerCo represents the unique interests of its constituent grower-owners in dealing with Taxpayer for the purpose of marketing their crops on a cooperative basis.

Taxpayer is a general partnership organized under the laws of State B. The Taxpayer will make an election under section 301.7701-3(a) of the Income Tax Regulations (the "Regulations") to be taxed as an "association," effective as of the date

of the partnership's organizations. After such election, taxpayer will be taxed as a corporation for US federal income tax purposes and operate on a cooperative basis under Subchapter T of the Code. All of Taxpayer's sales and marketing activities will be carried out by a wholly-owned Limited Liability Company (LLC) organized under the laws of the state of State B, which it is represented will be a disregarded entity for US federal income tax purposes. The GrowerCos are establishing their initial ownership interests in Taxpayer in proportion to projected sales of their respective constituent member-growers' crops to Taxpayer. It is intended that ownership of Taxpayer by the GrowerCos will be maintained in alignment with the sale of each produce type handled by the cooperative. Voting control of Taxpayer is on a one-member, one-vote basis.

## OPERATIONS

Taxpayer will conduct sales and marketing activities in the US through its wholly-owned LLC. Since LLC will sell the crops to US customers for its own account and not as an agent for the GrowerCos or the D growers, it will also bear all risks incident to the sale; e.g. credit risk, inventory risk, market risk, etc. Using its own permanent employees and permanent facilities located in the United States, LLC will acquire and take delivery of crops in Country A for resale to the US market. The GrowerCos will authorize the D growers to deliver crops allocated by INC to the US market directly to LLC. Title to the crops allocated by INC will be passed by the D growers to LLC when it takes delivery of the produce. LLC will acquire the crops for an arms-length price reflecting fair market value and the risk borne by LLC. The crops will be delivered to LLC on an FOB shipping point basis, so title for the crops will transfer to LLC in Country A. The Taxpayer, but not the GrowerCos, will engage in a trade or business within the United States.

## FINANCIAL RESULTS

The books and records of the cooperative (including the LLC) will be kept on the accrual method of accounting. The cooperative's principal office is located in State B, and its returns will be filed with the Internal Revenue Center in State C. The cooperative has adopted a fiscal year ending December 31. The cooperative's business will be a US trade or business subject to tax in accordance with the provisions of Subchapter T of the Code. Taxpayer will report its income, gains and losses annually on Form 990-C, Farmers' Cooperative Association Income Tax Return.

The cooperative will be obligated to account on a patronage basis to all its GrowerCo patrons on an annual basis for all amounts received from business conducted with or for the D growers, as authorized and arranged by the GrowerCos. The patronage dividend will be such that all amounts of net profit before tax earned by the cooperative in the form of patronage income in any fiscal year shall be distributed to the members of the cooperative in proportion to the patronage of each patron in that fiscal year calculated according to volume and/or value of produce shipped to or through the cooperative by each of its member-patron GrowerCo's constituent grower-

shareholders. All patronage dividends distributed will be distributed to the patrons, i.e., the GrowerCos, in cash or qualified written notices of allocation as permitted by section 1382(b) of the Code.

Pursuant to the partnership agreement of the cooperative, the amount of capital, if any, furnished by each patron shall at the end of each fiscal year be clearly reflected and properly credited in the appropriate record to the capital account of each member. The cooperative shall, within 8-1/2 months after the close of each fiscal year, notify each member of the capital so credited to the member's account. The notice shall be in the form of a written notice of allocation or per-unit retain certificate.

The cooperative's partnership agreement provides that, upon dissolution, after all debts and liabilities of the cooperative basis have been paid, all partnership shares redeemed, and all capital furnished patronage shall have been retired without priority on a pro rata basis, distribution of any remaining assets shall be made on a patronage basis to all member patrons on the basis of the amount of patronage conducted by them and/or their constituent D grower-members to the extent practicable.

Under the terms of the partnership agreement, any entity that applies for and is accepted to membership in the cooperative, by such act alone, consents that the amount of any distributions with respect to that member's patronage, occurring after acceptance for membership status, which are made in written notices of allocation (as defined in section 1388 of the code), will be taken into account by the GrowerCo-member at the stated dollar amount in the manner provided in section 1385(a) of the Code in the taxable year in which such written notices are received by the member.

On an annual basis, Taxpayer's members, i.e., GrowerCos A, B, and C, will allocate to their D grower-shareholders each grower's share of the GrowerCos's earnings from patronage refunds and any nonpatronage earnings allocated and distributed by taxpayer to the GrowerCos. The amount to be allocated by the GrowerCos to each grower will be based on each grower's patronage with the taxpayer cooperative. Any dividends distributed by the GrowerCos to their respective grower-shareholders will be based on the amount allocated annually to each grower.

## Business Reasons For The Transactions

### A. COUNTRY A GROWERS' HOLDING COMPANIES ("GrowerCos")

For the purpose of facilitating the sale of each of three types of produce in the US, the GrowerCos are organized so that each GrowerCo is owned by the growers of a specific produce type and each GrowerCo will be a member-patron of taxpayer, a US cooperative.

The GrowerCo structure will allow for a straightforward cooperative structure (as the taxpayer cooperative will have three members instead of having each D grower as a

separate member) without compromising the goal that each constituent grower will have proper representation in the cooperative conducting US marketing activities on its behalf.

The GrowerCo structure will facilitate pooling of costs by type of produce and will also allow for the accounting by type of product to be captured in a single legal entity.

The GrowerCo structure will also facilitate the addition or retirement of growers from the structure. Without the GrowerCo structure, the growers would have to deal with the taxpayer directly and (1) it is generally easier and preferable for the Country A growers to deal with a Country A corporation as opposed to a US partnership in connection with the retirement or addition of a grower-shareholder, and (2) the addition or retirement of growers will not affect or complicate the membership structure of the taxpayer cooperative.

Incident to the management strategy and operating efficiencies described above, the GrowerCo structure will permit patronage income to ultimately flow back to the D growers more effectively from a Country A income tax perspective.

## B. TAXPAYER COOPERATIVE AND LLC

Under the proposed structure, a general partnership has been established under the laws of State B. Each GrowerCos is a partner in the general partnership. The partnership will be governed by its general partners, the GrowerCos, on a one-partner one-vote basis without regard to a partner's interest in the partnership. In addition, each member of the board of directors will be elected by partners holding a majority of the partnership interests.

The partnership will elect under the entity classification rules to be treated as an association taxable as a corporation for US federal income tax purposes. The taxpayer's intent is to operate on a cooperative basis and thus subject to tax under Subchapter T of the Code.

The taxpayer, through its wholly-owned State B LLC, will conduct sales and marketing activities in the US for produce grown by the D growers. It is represented that the LLC is disregarded as an entity for federal income tax purposes.

In this case, operating as a cooperative organization (including the LLC as a disregarded entity) is the structure most consistent with the long-term objective of the D growers as it gives them a better presence in the US for marketing their produce. It will also facilitate sales by permitting the Taxpayer to hire US personnel and establish US storage and distribution facilities.

It is anticipated that on a long-term basis, the taxpayer cooperative may also market produce produced by non-Country A growers (e.g. US growers and Mexican

growers). The parent partnership/LLC subsidiary structure will provide more flexibility for introducing different products to the business, possibly on a for-profit basis without involving the existing members or their cooperative relationship, by just adding a new member to the LLC or by adding a new LLC which could handle the US sales and marketing activities for non-D grower produce. The parent/LLC subsidiary structure permits the D growers to preserve the cooperative solely for the benefit of the GrowerCos and the D growers. Using the LLC also facilitates the segregation of risks incident to produce sales (e.g. credit risk, inventory risk, and market risk, etc.) if new sources of produce are introduced by establishing a new LLC under the cooperative.

From a Country A perspective, the parent partnership/LLC subsidiary structure permits a more efficient flow through of patronage earnings from the cooperative to the GrowerCos.

Taxpayer requests a ruling that taxpayer, including LLC, will be “operating on a cooperative basis” within the meaning of section 1381(a) (2) of the Internal Revenue Code, and will be treated as a cooperative under Subchapter T of the Code.

#### STATEMENT OF LAW

Section 1381 of the Code provides that Subchapter T shall apply to “any corporation operating on a cooperative basis...” (with certain exception not here relevant). Section 1.1381-1(a) of the Regulations states that Subchapter T of the Code “applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of business done with or for patrons.”

In *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), acq. 19661 C.B. 3, three principles are described as fundamental to cooperative operation: 1) subordination of capital; 2) democratic control by the members; and 3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor.

Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative’s business remains in the hands of the member/patrons of the cooperative rather than with nonpatron equity investors in the cooperative. The purpose of this limitation is to insure that the gains that accrue to the cooperative from the business that it transacts with its patrons will largely or completely inure to the benefit of those patrons rather than to its stockholders. To be operating on a cooperative basis, a cooperative must limit the financial return with respect to its equity capital. *Puget Sound*, 44 T.C. at 308. Stated differently, a cooperative may not be operated for the purpose of paying a return on equity investments.

Democratic control of the cooperative, as envisioned in *Puget Sound* at 308, is typically achieved by voting on a one-member, one-vote basis. The principle of

democratic control was further discussed in *Etter Grain Co. v. United States*, 462 F.2d 259, 263 (5th Cir. 1972), in which the court noted that section 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, “envision(s) the exempt association organized according to a model of a widely-based participatory democracy in which all the members are able to exercise a franchise of equal strength.” Each member must have a single vote regardless of the size of its investment or the amount of business it does with the corporation.

The requirement of operation at cost is met if the cooperative’s net earnings or savings are distributed to the cooperative’s patrons in proportion to the amount of business conducted with them. This requirement relates to:

the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, Bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the associations are required to make periodic allocations of the same among the members in proportion to their active participation as workers. *Puget Sound*, at 308.

Rev. Rul. 70-481, 1970-2 C.B. 170, holds that a corporation supplying services to its members at cost and making distributions to each member based on the value of business done with each member was “operating on a cooperative basis” within the meaning of section 1381(a)(2) of the Code.

Rev. Rul. 72-36, 1972-1 C.B. 151, states that in accordance with fundamental cooperative principles, the rights and interests of the members in the savings of a cooperative should be determined in proportion to their business with the cooperative. With respect to liquidating distributions, the Service has stated that the cooperative principle of operation at cost requires that a cooperative’s Articles of Incorporation or Bylaws obligate the cooperative to distribute its remaining assets upon liquidation to both its current and former members in proportion to the value or quantity of business that each did with the cooperative over some reasonable number of years.

Section 1382(b) (1) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation or other property with respect to patronage occurring during such taxable year.

Section 1382(b) (1) of the Code and section 1.1381-2(b) (1) of the regulations provide, in pertinent part, that there is allowed as deduction from the gross income of any cooperative to which part 1 of Subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends to the extent that such amounts are paid in money, qualified written notices of allocation, or other property

(other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90 day after the close of the payment period for the taxable year.

Section 1382(d) of the Code provides, in part, that the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or done for such patron. Section 1388(a) (2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a) (3) of the Code provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the corporation from business done with or for its patrons. That section further provides that “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons. Section 1.1382-3(c)(2) of the Regulations states that income derived from sources other than patronage means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association.

Section 301.7701-2(b) (2) of the Regulations provides that a partnership that elects to be taxed as an association is treated as a “corporation” for all federal tax purposes.

## ANALYSIS

Concerning the requirement of subordination of capital, taxpayer does not have any nonpatron investors, nor does it plan to accept any nonpatron investors. The partnership agreement contemplates that taxpayer will operate on a cooperative basis for the benefit of its members. In addition, after dissolution, distribution of the remaining assets will be made to all member patrons on the basis of their amount of patronage with taxpayer. Concerning the requirement of democratic control, taxpayer’s partnership agreement provides that each member shall be entitled to a single vote with majority rule controlling. Concerning the requirement of operation at cost, net earnings are distributed to the patrons in proportion to the quantity and value of business conducted with them thereby ensuring that it is operated at cost.

At the Country A level, the shares of each GrowerCo are held only by D growers. There are no non-grower investors nor do they plan to accept non-grower investors as shareholders. The articles of the GrowerCos provide that each D grower is limited to one voting share in his respective GrowerCo. In the case where a particular grower

produces more than one type of produce, the grower is permitted to hold a voting share only in the capital stock of the GrowerCo handling the grower's predominant crop. Accordingly, the democratic control requirement is also maintained at the GrowerCo level. Concerning the requirement of operating at cost, even though the directors of the GrowerCos have discretion with respect to the timing of distributions, the GrowerCos must, on an annual basis, allocate to each D grower its share of the patronage refunds from the taxpayer included in the GrowerCo's earnings. The amount allocated will be based on each grower's patronage, and dividends to be paid to each grower will be based on the amount so allocated on a patronage basis.

With respect to taxpayer's election under section 301.7701-2(b)(2) of the Regulations to be taxed as a corporation, Subchapter T applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons. As noted above, Taxpayer will conduct business as a cooperative and allocate patronage dividends to patrons on the basis of the patronage-based business done with or for such patrons. Accordingly, taxpayer should be taxed as a cooperative pursuant to Subchapter T of the Code.

Based solely on the representatives provided, Taxpayer, including LLC, will be "operating on a cooperative basis" within the meaning of section 1381(a) (2) of the Internal Revenue Code, and will be treated as a cooperative under Subchapter T of the Code.

This ruling is directed only to the taxpayer that requested it. Under section 6110 (k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to Coop.

Sincerely yours,

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Branch 5  
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