

Internal Revenue Service

Department of the Treasury

Number: **200042013**
Release Date: 10/20/2000
Index Number: 1381.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
PLR-106609-00 CC:PSI:5

Date:
July 20, 2000

LEGEND

Coop =

INC =

State A =

State B =

b =

c =

d =

e =

Dear

This is response to your request dated February 21, 2000, for a ruling that after completing the corporate merger described herein, the surviving corporation will be an organization “operating on a cooperative basis” within the meaning of section 1382(a)(2) of the Internal Revenue Code.

Coop has been in operation since *b* without any major changes to its corporate structure. Coop’s Board and membership have recently determined, however, that the Coop needs to revise its governance structure to accommodate its membership growth. This restructuring will consist of merging Coop with and into INC, an entity formed by Coop for the sole purpose of becoming the surviving corporation in the merger. The purpose of the merger is to change the statute under which the association is formed and reduce the size of the Board of Directors.

Coop currently has *c* members. The purpose of the Coop was and remains chiefly to purchase, warehouse, sell and distribute on behalf of its members *d*. Coop was incorporated as an agricultural cooperative marketing association under the State A Cooperative Marketing Act and has continually operated under that Act since its formation.

The Coop is governed by a Board of Directors. Each member appoints one director and one alternate. Consequently, Coop has a Board consisting of *c* directors. The vast majority of Coop's members are *e* distribution cooperatives which provide retail service to customers.

Coop's principal business activities are, at best, only tangentially related to the State A Cooperative Marketing Act which generally applies to the agricultural business. Accordingly, Coop wishes to re-form under an enabling statute that more closely fits its business activities. Because of its rapid growth to *c* members, and consequently *c* directors, Coop has found it difficult to conduct effective board meetings. The sheer size of the Board makes it difficult to hold effective and meaningful discussions of relevant issues. The geographic dispersion of the membership also makes it difficult to attract a sufficient number of members to form a quorum. Further, as the Board continues to grow with each new member, Coop fears that apathy will grip the Board and directors will not educate themselves on the important issues facing Coop. For these reasons, Coop proposes to reduce the size of the Board of Directors. To accomplish this, Coop has determined that it would be best for it to re-form under the State B Cooperative Act and reduce the Board to nine members. Coop's Directors and members unanimously approved the proposed transaction on January 7, 2000.

The State B Cooperative Act permits associations to operate on a cooperative basis and engage in a wide range of business activities including the power to purchase, warehouse, distribute and sell *d*. It will also allow the members and directors to vote at meetings using telecommunications which will help with efficiencies.

To reduce the size of the Board of Directors to a manageable level, INC's Bylaws provide for a nine member Board, using an odd number to prevent gridlock. Six directors will be nominated by the Coop's State A members, and three nominated by the Coop's members outside of State A. (This approximates the number of members located in these different geographic areas: 63.8% of Coop members are State A members and will nominate 66.7% of the Board.) Nominees are then elected by a vote of the entire membership.

The use of districts was determined to be necessary to ensure that the members outside of State A are given representation of their interests and viewpoints. Coop's original membership was exclusively from State A and it is only in recent years that membership has grown outside of State A. Because of the continued high concentration of membership in State A, using districts consisting of State A and non-State A members makes the most practical sense. Currently, Coop's non-State A members rarely attend Board or member meetings because they generally have less patronage equity invested and because they tend to be located farther from Coop's principal offices. Coop anticipates the three directors nominated by the non-State A members will attend meetings thereby strengthening the non-State A members franchise and equalizing the distribution of actual voting strength.

Based on the foregoing, Coop and INC request a ruling that the surviving corporation after completion of the reorganization will be "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the Code.

Section 1381 of the Code provides that subchapter T shall apply to "any corporation operating on a cooperative basis . . ." (with certain exceptions not here relevant). Section 1.1381-1(a) of the Income Tax 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., 1966-1 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. (See also I. Packel, The Organization and Operation of Cooperatives, 107-107 (4th Ed. 1970); Frost v. Corporation Commission, 278 T.C. 515 (1929)).

Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remain in the hands of the members/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, 72-1 USTC 9465 at 84,613-614 (CA-5 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 association are required to make periodic allocations of the same among the members in proportion to their active participation as workers. Puget Sound, at p. 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 and mutual 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 a deduction from the gross income of any cooperative to which part I 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 notice of allocation" as meaning a written notice of allocation which is not described at section 1388(c) or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year.

Section 1.1385-1(d)(1) of the regulations states that in determining the amount to be included in a patron's gross income with respect to a patronage dividend received as property, property shall be taken into account at its fair market value when received.

Section 1382(d) of the Code provides, in part, that the payment 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.

Subordination of Capital

Neither Coop nor INC have any nonpatron investors, nor do they plan to accept any nonpatron investors. Consequently, after the reorganization INC, like Coop, will be controlled by its member-patrons who will also be the sole beneficiaries of any financial benefits of its operation.

Numerous provisions of INC's Articles of Incorporation and Bylaws ensure that it will meet the requirement of subordination of capital. For example, INC's Articles and Bylaws both have provisions that mandate that it operate on a cooperative basis for the benefit of its members. To ensure that control of INC remains in the hands of its member-patrons, its Bylaws also mandate that each of its members shall have one and only one vote on any matter subject to voting of the members and, unless otherwise provided, the vote of the majority shall control. The Bylaws further provide that only three corporate actions require greater than majority vote: (i) amendment to the Articles of Incorporation; (ii) approval of a merger, sale, dissolution or liquidation; and (iii) amendment of any Bylaw which "affects the nomination, election, compensation or other remuneration paid (or the disclosure thereof) Directors." Each of these corporate actions has potentially far-reaching implications for the rights of the individual members and are, therefore, matters that should not be approved without broad consensus among the membership. Consequently, it is not inappropriate that the Bylaws require a vote of "two-thirds of the entire membership" to approve such significant changes in the operation of INC.

In addition to the mandate to operate on a cooperative basis, the Articles specifically provide that patrons shall be entitled to both any dividends that are paid and to any net proceeds that are distributed after dissolution on the basis of the “quantity or value of business done with or for the Patron.”

Democratic Control

As noted, the principle of democratic control envisions an organization “organized according to a model of widely-based participatory democracy in which all members are able to exercise a franchise of equal strength.” Etter Grain, supra. INC’s Bylaws provide that each member shall be entitled to one, and only one, vote on all matters subject to a member vote. As noted, only 3 serious corporate issues require a super-majority. The utilization of districts to nominate directors as part of the process of reducing the size of the Board of Directors as described earlier will not violate the democratic control principle because: (i) nomination approximates the membership in each district; and (ii) once nominated, nominees are elected by majority vote of the entire membership. This will ensure that the newest members will have significant and proportional representation and no person will serve as a director without the support of the majority of members.

Operation at Cost

INC’s governing documents ensure that the net earnings or savings are distributed to the patrons in proportion to the “quantity or value of business conducted with” them, thereby ensuring that it is operated at cost.

Based solely on the documents submitted and the forgoing discussion of the facts and law we conclude that the surviving corporation after completion of the reorganization will be “operating on a cooperative basis” within the meaning of section 1381(a)(2) of the Code.

No opinion is expressed or implied on any other provision of law, particularly on whether the reorganization qualifies under subchapter C of the Code.

This letter is addressed only to the taxpayer that requested it. Section 6110(k) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
/s/WALTER WOO
Senior Technician Reviewer
Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)