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Refer Reply To:

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Date:

November 29, 2001

Legend

Coop =

State A =

Service =

Sub =

b =

Dear :

This is in response to your request for rulings dated July 5, 2001, submitted on behalf of Coop by your representative.

Coop was incorporated in as a corporation not for profit under the State A Revised Statutes. Coop was formed to serve its member credit unions by: (1) providing the means by which the credit unions could offer their members credit cards without incurring substantial new labor costs; and, (2) arranging for a service center to provide services related to insurance and maintenance of credit cards. In short Coop was formed to provide credit unions the economies of scale necessary to participate in the credit card business.

In Coop modified its Bylaws to operate on a cooperative basis with respect to its members. Also, it modified the Bylaws of Service, its wholly owned subsidiary, to directly operate on cooperative basis with Coop members. In January 2001 with the consent of the members of both organizations, Coop and Service merged because the compelling need for separate operations no longer existed. Since the members of both cooperatives were identical, it was determined that a combined operation would be more efficient to operate and administer.

In 1999, Coop's Board of Directors made the decision to offer to its members collection services on delinquent credit card accounts. Again, this service was offered to its members as means to achieve economies of scale. Prior to that, Coop had to

engage private collection agents to recover funds on those accounts.

A significant issue that Coop had to consider is liability that may be associated with collection services activities on delinquent accounts. Because of many abuses of private collection agents documented over the years, Congress enacted the *Fair Debt Collection Practices Act* (Act). That legislation was intended to prohibit certain types of collection activities and provided for punitive measures. Under the Act a significant number of individual and class action lawsuits have resulted with substantial damages awarded in some cases.

While Coop has every intention of complying with the provisions and spirit of the Act, it could not eliminate the possibilities of spurious claims arising from its collection efforts. Accordingly, the cooperative concluded that the collection operations would have to be placed in a wholly-owned and controlled subsidiary. In as much as this activity would be conducted exclusively for the benefit of Coop's members, it was established as a not-for-profit corporation.

That corporation, Sub filed for incorporation on September 29, 1999 with the State A Secretary of State. As stated in the preamble to Sub's Bylaws, effective as of January 1, 2000, the entity it is to be "operated as a one-Member cooperative for the benefit of the Member's patrons."

Sub commenced operations on January 1, 2000 for the purpose of providing credit card collection services to Coop's members. Coop's members request collection services from that cooperative. Then, Coop submits those requests to Sub, which performs the services requested and remits the net proceeds collected to Coop. Following that, Coop remits the net proceeds to its members. To the extent that any amounts are retained during the next year, following the close of the fiscal year Sub will make patronage dividend payments to Coop.

In its year of operations Sub lost approximately \$b. Though Coop has yet to file its consolidated Form 1120, *U.S. Corporation Income Tax* return for tax year 2000, it intends to consolidate Sub with Coop and offset the parent's patronage income with the patronage losses realized by Sub.

For purposes of allocating costs and patronage dividends to members, both Coop and Sub compile actual revenue by credit union and utilize an activity-based cost accounting system to determine the cost of supporting each credit union's card program. With Sub, it is expected that a majority of costs will be assigned on this direct basis. The remaining costs will be allocated among members using a dollars-of sales methodology. Once these costs assignments have been made, the margins for each members can be calculated.

In Article II, Paragraph 6, of Sub's Bylaws, the stockholder (Coop) is:

"entitled to vote in accordance with the terms and provisions of the certificate of incorporation and these by-laws shall be entitled to one vote, in person or by

proxy.”

Pursuant to Article III, Paragraph 2 of those Bylaws, there are five directors that are to manage the affairs of the Corporation. The first Board of Directors was appointed by Coop’s Board of Directors, which is democratically elected on a one member, one vote basis by Coop’s members. As replacements are required on Sub’s Board in the future, Coop’s Board of Director’s will following procedures set forth in Article III of Sub’s Bylaws for nomination and election of new Directors.

Article V of Sub’s Bylaws prescribes operation at cost and defines the treatment of the member’s capital. Paragraph 1 of that Article states:

“The corporation shall at all times be operated on a cooperative, service-at-cost basis for the benefit of the Member. The term “Member” means Coop”

In Paragraph 2 of that Article requires that:

“... the Member will through its patronage furnish capital for the Corporation. In order to induce patronage and to assure that the Corporation will operate on a service-at-cost basis, the Corporation is obligated to account on a patronage basis to its Member for all amounts received and receivable from the furnishing to these services in excess of operating costs and expenses properly chargeable against the type of service furnished. All such amounts in excess of operating costs and expenses at the moment they are furnished by the Member are received by the corporation with the understanding that they are provided by the Member as capital.”

Additionally, that Paragraph provides:

“The Corporation is obligated to make payments of all such amounts in excess of operating costs and expenses as patronage dividends in cash or by credits to a capital account for the Member. At least twenty percent (20%) of the annual patronage dividend must be paid to the Member in cash. The books and record of the Corporation shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by the Member is clearly reflected and credited in an appropriate record to the capital account of the Member.”

Also, that Paragraph states that:

“Patronage dividends may be paid in cash or by credits to a capital account for the Member, or as otherwise provided in Article V, Sections 2 and 3 of the Bylaws, based upon the value of its participation; margins available in allocation will be the Corporation’s patronage margin as determined for federal tax reporting purposes. No interest or dividends shall be paid with respect to membership certificates or revolving fund certificates. With eight and one-half (8-1/2) months following the end of the Corporation’s fiscal year or by filing of the Corporation’s federal income tax return, whichever is earlier, the Member will be notified in writing as to the amount of its patronage divided paid in cash and paid in

revolving fund certificates or other written instruments.”

The Paragraph goes on to say that amounts credited to the capital account of the Member will have the same status as though they had been paid in cash pursuant of a legal obligation to do so and the Member had then furnished Sub corresponding amounts for capital.

Paragraph 3 of Article V directs Sub’s Board of Directors to establish polices for the redemption of revolving fund certificates previously allocated in payment of patronage dividends. In the discretion of the Board and based on the financial condition of Sub, such patronage capital can be retired on a first-in, first-out basis.

Paragraph 4 of Article V requires Sub to account to Coop for all patronage and identify all transactions conducted for Coop’s members. Pursuant to Paragraph 5 of Article V, Coop consents that:

“the amount of any distributions with respect to its patronage occurring after September 29, 1999, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by the Member from the Corporation, will be taken into account by the Member at its stated dollar amounts in the manner provided in 26 U.S.C. 1385(a).”

In Paragraph 6 of Article V, Sub and Coop acknowledge that Sub’s Articles of Incorporation and Bylaws are a contract between the two corporations. Further, the paragraph defines the term “Member” to mean Coop.

Article VI of Sub’s Bylaws prescribe the terms for dissolution of the corporation and treatment of the property interests of the member. It states:

“Upon dissolution or liquidation of the Corporation, after all outstanding debts and obligations have been paid, revolving fund certificates have been redeemed, and all common stock redeemed at par value, any remaining savings of the Corporation will be distributed to the Member and the interests of the Member’s patrons shall be identified based on such patrons’ historic participation in the cooperative. Such distributions will be calculated by multiplying the remaining savings of the Corporation by the ratio of each of Member patrons’ cumulative cooperative patronage to the Corporation’s total patronage, all calculated since commencement of cooperative operations.”

To coordinate with the Bylaws of Sub, Coop modified its Bylaws to accommodate the allocation of patronage income received by it from the subsidiary. Under Article VI, Paragraph 6.07 of Coop’s Bylaws, the following is provided:

“To the extent that the Corporation receives patronage dividends from Sub based on transactions conducted for the Corporation’s member credit unions, the Corporation shall allocate and distribute such dividends to its member credit unions in proportion to such members’ participation in and receipt of services

from (i.e., patronage of) Sub.”

In other words, Coop is obligated to allocate to its patrons the patronage dividends received from Sub based on the participation of each Coop patron in Sub’s services. For this purpose participation is defined in terms of dollars of business conducted.

Coop’s management has also made the following responsibilities:

1. The Articles of Incorporation for Sub are a true copy.
2. The Bylaws of Sub are a true copy.
3. The Bylaws of Coop are a true copy.
4. Sub accounts for Coop’s annual patronage (and that of Coop’s members) using an activity based cost system. The majority of costs are allocated to Coop (and ultimately to Coop’s members) directly using the cost assignment model. Remaining costs are assigned to Coop (and its members) using an allocation method based on dollars-of-sales.
5. All references to “the Member’s patrons” in the Bylaws of Sub mean Coop’s members. Coop does not serve nonmembers 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.

In various situations the Service has examined the purpose of a cooperative's subsidiary to determine eligibility for exemption under section 521 of the Code. To determine compliance with the provisions of section 521, the Service has applied a "look through" principle to federated cooperatives for many years. *See, for example*, Rev. Rul. 69-575, 1969-2 C.B. 134. Though Coop is not an exempt farmers' cooperative under §521, the look-through principle can be equally applied to it to determine the status of Sub and its relationship with Coop.

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.

Cooperatives are distinguished from ordinary business corporations by how they allocate and distribute their earnings. In an ordinary business corporation, net earnings are shared by investors based upon the capital they invest in the business. In a cooperative, net earnings are shared by patrons on a patronage basis.

Rev. Rul. 93-21, 1993-1 C.B. 188, and Rev. Rul. 72-602, 1972-2 C.B. 511, state that "in order to be considered 'operating on a cooperative basis' under section 1381(a)(2) of the Code, the taxpayer must have a sufficient membership to form a mutual joinder of interest in the risks and benefits of the organization . . ."

In the instant case, Sub's Articles and Bylaws fulfill the requirements of cooperative operation.

Accordingly, based solely on the above we conclude that

1. Sub is a corporation operating on a cooperative basis under section 1381(a)(2) of

the Code.

2. Sub's payment of patronage dividends to Coop will qualify for deduction by Sub under the provisions of sections 1382(b) and 1388(a) of the Code.

3. Patronage dividends received by Coop from Sub will be patronage income to Coop.

4. Coop's method of allocating patronage dividends received from Sub to its ultimate patrons is deemed to be equitable under the requirements of cooperative income tax law.

In accordance with a power of attorney filed with this ruling request, a copy of this ruling is being sent to your authorized representative.

This ruling is directed only to the taxpayer who requested it. Pursuant to section 6110(k) of the Code, it may not be used or cited as precedent.

Sincerely yours,
Walter Woo
Senior Technician Reviewer
Branch 5
Office of the Associate Chief
Counsel (Passthroughs and Special Industries)

cc: