

Dear _____ :

This is in response to a ruling request dated January 27, 2005, submitted on behalf of Taxpayer by your authorized representative. The ruling concerns whether patronage distributions paid in money during the payment period for patronage occurring during a taxable year when Taxpayer was operating on a cooperative basis qualify as patronage dividends under section 1382(b) of the Internal Revenue Code when the distributions are paid after the Taxpayer ceases operating on a cooperative basis. The facts of Taxpayer's transaction are fully described below.

Taxpayer, a non-exempt cooperative under Subchapter T, was founded in a and, according to Taxpayer, is the leading processor and marketer of b in the United States. Taxpayer is owned by approximately c grower-members who control acreage accounting for d percent of the aggregate b production. Taxpayer currently employs approximately e employees and generated net revenues of approximately \$f for its fiscal year ended g. Taxpayer's overall method of accounting is the accrual method. The tax returns for the year ending h will be filed using the overall accrual method with the cash advance method for inventories.

Taxpayer's primary purpose has been to process and market b produced and delivered by its members and to return the proceeds of sales, less expenses, on the basis of the quantity or value of products marketed for members. Taxpayer's processing and marketing of b on behalf of members on a cooperative basis constitutes Taxpayer's patronage business. The operations for its patronage business involve the marketing of i primarily to United States and international consumers for cooking and baking and to other food manufacturers for use in their own food products. In recent years, Taxpayer also has purchased a variety of other j and sold an extensive selection of non-b products. This non-b business is the Taxpayer's non-patronage business.

Taxpayer's non-patronage business has experienced significant growth . Taxpayer's non-patronage revenues have grown from \$k, or l percent of net revenues for the fiscal year ended m, to over \$n, or o percent of net revenues for the fiscal year ended g. Taxpayer's non-patronage net revenue grew p percent between the fiscal years ended m and g, accounting for about _____ of Taxpayer's growth in net revenue over that period of time. Non-patronage revenue has accounted for more than q percent of Taxpayer's net revenue in each of the last r fiscal years.

Taxpayer intends to convert from a State A cooperative marketing association to a State B corporation, and to issue stock to current members, pursuant to a vote and offering that is subject to a registration statement filed with United States Securities and Exchange Commission (the "Conversion"). After effectiveness of the registration statement for the Conversion, Taxpayer will solicit the votes of grower-members to approve the Conversion. According to Taxpayer, the reasons for the Conversion are to

provide owners liquidity of their equity interests and to raise capital for business growth. At a special meeting, Taxpayer's grower-members will vote on whether to approve the Conversion, contingent upon simultaneous closing of Taxpayer's initial public offering of securities ("IPO").

In the Conversion, grower-members' property rights in Taxpayer will be exchanged for newly-issued shares of common stock of a newly-formed State B corporation through a merger. The State B corporation, which is currently a subsidiary of Taxpayer, will survive the merger and will be the issuer of the common stock that is offered to the public in the IPO. Taxpayer anticipates that this vote will occur in t and that the IPO will occur in u. Under this corporate structure, Taxpayer will be able to offer stock ownership to outside or non-grower investors.

Beginning on v, Taxpayer will no longer be operating on a cooperative basis. From this date forward Taxpayer will be operating solely under Subchapter C. The payment structure for the crop pool closing in the year ending h provides for payments in the 8½ month period following the year-end h. These cash payments will be made by the State B corporation in satisfaction of Taxpayer's obligations under its bylaws in effect prior to v.

Taxpayer requests a ruling as to the consequences of patronage distributions paid in money during the payment period by Taxpayer subsequent to the Conversion for patronage occurring during its taxable year ending h when Taxpayer was operating on a cooperative basis within the meaning of section 1381(a)(2) of the Code. Taxpayer represents that the Conversion plan involves a mere change of identity of Taxpayer under section 368(a)(1)(F). Under the Conversion plan, Taxpayer has formed a wholly-owned subsidiary. Newly-issued stock of subsidiary will be issued in exchange for the cooperative member's property rights as a result of the merger of Taxpayer into subsidiary. Taxpayer expects the effective date of the reorganization to be v. For its fiscal year ending h, Taxpayer is obligated under its current bylaws to make patronage distributions to its members. The payments would be paid in money as required by Taxpayer's bylaws.

Taxpayer requests a ruling that it should be allowed a deduction under section 1382(b)(1) of the Code in Taxpayer's fiscal year ending h in the amount of money paid during the payment period in satisfaction of Taxpayer's patronage obligations.

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 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."

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 1.1382-2(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 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) 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.

ANALYSIS

At the time that the State B corporation makes the payments to the member-growers of Taxpayer for the patronage income earned by Taxpayer during Taxpayer's fiscal year ending h, Taxpayer will have merged into the State B corporation and the State B corporation will not be operating on a cooperative basis. Under its bylaws, Taxpayer is obligated to make payments to its members of patronage income. The payments will be paid in money as required by Taxpayer's bylaws. Taxpayer's patrons will receive checks for money equaling the patronage income within the payment period specified in section 1382(d) of the Code.

Section 1388(a)(1) of the Code defines a "patronage dividend" as an amount paid to a patron by a cooperative on the basis of the quantity or value of business done

with or done for the patron. Although a literal reading of section 1388(a) would seemingly preclude classifying the payments by the State B corporation as patronage dividends because Taxpayer is not making the payments, we do not believe that the mere change in identity created by a section 368(a)(1)(F) reorganization should prevent Taxpayer from taking deductions for those patronage dividends for the taxable year it was operating on a cooperative basis.

Accordingly, based solely on Taxpayer's facts and representations, including the representation that Taxpayer is a Subchapter T cooperative and that the Conversion qualifies as a reorganization under section 368(a)(1)(F) of the Code, in determining the taxable income for Taxpayer's timely filed return ending h, distributions that are paid by the State B corporation during the payment period specified in section 1382(d) in money for patronage occurring during Taxpayer's taxable year ending h will qualify as patronage dividends under section 1382(b)(1).

This ruling is directed only to the taxpayer that requested it. No opinion is expressed whether the Conversion is a reorganization qualifying under section 368(a)(1)(F) of the Code or whether Taxpayer is operating on a cooperative basis under Subchapter T. Under section 6110(k)(3) this ruling 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 your authorized representative.

Sincerely yours,

Susan Reaman
Chief, Branch 5
Office of Associate
Chief Counsel
(Passthroughs and Special
Industries)