



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **200728045**
Release Date: 7/13/2007

UIL: 501.12-02

Date: April 18, 2007

235524/EO

Contact Person:

Identification Number:

Telephone Number:

Legend

X =

Y =

Z =

Holdings # 1 =

Holdings # 2 =

Holdings # 3 =

m =

n =

Dear _____ :

This refers to your ruling request under section 501(c)(12) of the Internal Revenue Code (the Code).

The information submitted indicates that you are exempt under section 501(c)(12) of the Code. Since incorporation, you have functioned and been operated as a rural cooperative telephone exchange serving your members. You currently serve approximately m members.

In 1981, the Bell System introduced Calling Card Service which requires essentially all local exchange telephone carriers such as you to provide information relating to their line numbers to a computerized Data Base Administrative System (DBAS). You and many other smaller rural telephone service providers did not have the resources, personnel or technology to develop an independent DBAS in serving their members. A number of independent local exchange carriers (ILECs) joined together and formed X, a corporation, to develop and provide DBAS to their owners and their members. Only ILECs were permitted to own stock in X. You found that your members increasingly demanding the types of services available in X, and in 1988 you joined X by acquiring the required one share of Class A common stock and n shares of Class B common stock representing the number of subscriber lines that you had at the time.

Since becoming a shareholder, you have contracted with X in obtaining services that you are obligated to provide to your members as a local exchange carrier. These services include signal system, credit card, alternate billing, billing and collection, and line information data base service.

In 1993, X granted a two-for-one stock split on Class A shares held by shareholders. Also, X has undergone several changes, including mergers with and acquisitions by other companies. In these changes, your shares of stock in X were exchanged with the shares of stock of the changed company. In 1994, X reorganized into a holding company named Holdings #1. In 1995, Holdings # 1 merged with a telecommunication company, resulting in the formation of Holdings # 2, a publicly traded company. In 1996, Holdings # 2 was acquired by Y. In 2000, Y was acquired by Holdings # 3. In 2001, Holdings # 3 was acquired by Z.

You have represented that since your original investment to purchase ownership of X, you did not invest any additional cash or other property to ultimately own your current investment in Z. Also, while the company has transformed from X to Z, its original purpose remained the same, in providing database management, billing services, general administrative services, revenue administration services and other services for the benefit of cooperative telephone companies and their members. In addition, you have not terminated any of your contracted services with Z since becoming a shareholder.

You have requested the following ruling:

- (1) The income generated from the sale of stock of Z constitutes patronage-sourced income, which may be excluded from your gross income when allocated to your patrons as patronage dividends.

LAW

Section 501(c)(12)(A) of the Code provides exemption from income tax to include mutual or cooperative telephone companies. Exemption is recognized only if 85 percent or more of a cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Rev. Rul. 69-576, 1969-2 C.B. 166, holds that the classification of an item of income either as a patronage or nonpatronage source is dependent on the relationship of the activity generating the income to the cooperative. If the income is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing or service activities, the income is from patronage sources. However, if the income producing activity does not actually facilitate the accomplishment of the cooperative's marketing, purchasing or service activities, but merely enhances the overall profitability of the cooperative, the income is from nonpatronage sources.

Rev. Rul. 74-160, 1974-1 C.B. 245, held that interest income realized from loans made by a nonexempt cooperative engaged in the manufacture and sale of plywood to its chief supplier was patronage-sourced income. The loans were necessary to permit the supplier to finance equipment to carry out its business operation. Without the loans, the supplier would not have been able to supply the cooperative. The Rev. Rul. reasoned that the interest income is patronage-sourced income because the loans actually facilitated the accomplishment of the

cooperative's activities in that it enabled the cooperative to obtain necessary supplies for its operations.

In *Farmland Industries, Inc. v. CIR*, 78 T.C.M., 846, a nonexempt agricultural cooperative sold its shares of stock in three taxable corporations. The court held that income and losses from the sale of stock in the three corporations were patronage-sourced. The court found that the business of each of the three corporations was closely and directly related to petitioner's cooperative business of supplying petroleum products to its patrons, and that the formation and operation of each of the corporations facilitated the cooperative enterprise.

Other court cases have found that the direct relationship between the purpose of a cooperative business and its reasons for investing in a subsidiary were dispositive on the question of whether income received from the subsidiary was patronage-sourced. In *Astoria Plywood Corp. v. United States*, 79-1 U.S.T.C. 9197 (D. Or. 1997), the court found that the income derived by a plywood and veneer workers' cooperative from the cancellation of a lease on a veneer plant was patronage-sourced, because the production of veneer was an integral part of the cooperative's business. In other words, the reason the cooperative leased the property to begin with had nothing to do with investing in real estate and everything to do with making veneer. Similarly, in *Linnton Plywood Assoc. v. United States*, 410 F.Supp. 1100 (D.Or. 1976), the court held that the dividends received by a plywood workers' cooperative from a glue supplier corporation which the cooperative helped organize in order to supply its adhesive needs, were patronage-sourced income, since glue is essential for the manufacture of plywood, and the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

ANALYSIS

Rev. Rul. 69-576 sets the guidelines in classifying whether any income or losses derived therefrom is patronage or nonpatronage-sourced. If the cooperative's ownership of the stock actually facilitates the accomplishment of the cooperative's marketing, purchasing or service activities, then the income derived from its sale is patronage-sourced. See *Farmland Industries, supra*. See also Rev. Rul. 74-160, *supra*, which held that a cooperative's receipt of income from loans that facilitated the accomplishment of the cooperative's activities is patronage-sourced income. See also *Astoria Plywood Corp.* and *Linnton Plywood Assoc., supras*, where the direct relationship between a cooperative's exempt purpose and its reasons for investing in another entity was dispositive in determining that the income received from the other entity was patronage-sourced income.

Our analysis indicates that you invested in what was then X primarily to obtain services that you were obligated to provide as a local exchange carrier for the benefit of your members. These services would have been significantly more expensive, and potentially cost-prohibitive if you would have developed the services on your own. Since becoming a shareholder, you have continued obtaining needed services from Z. Therefore, we conclude that your investment in X, that became Z, is facilitating the accomplishment of your exempt activities.

Accordingly, based on the foregoing facts and circumstances, we rule as follows:

- (1) The income generated from the sale of Z stock shall constitute patronage-sourced income, which may be excluded from your gross income when allocated to your patrons through patronage dividends.

This ruling is conditioned on the understanding that there will be no material change in the facts upon which it is based. We express no opinion as to the tax consequences of the transactions under other provisions of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative. A copy of this letter should be kept in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437