

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200907014**
Release Date: 2/13/2009

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

Index Number: 1381.02-00

, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-129968-08
Date:
October 23, 2008

Legend:

Taxpayer =

State A =

Sub =

Area =

Coop A =

Corp A =

Corp B =

Dear :

This is in response to a request for a ruling dated June 16, 2008, submitted on behalf of Taxpayer by your authorized representative. The ruling concerns the application of cooperative tax law to a transaction described below.

Taxpayer was incorporated in as a nonprofit rural telephone cooperative pursuant to State A Revised Statutes. In , Taxpayer was granted an

exemption under section 501(c)(12) of the Internal Revenue Code and has since filed as an exempt organization using Form 990, *Return of Organization Exempt from Income Tax*. Taxpayer has remained tax exempt for every year until . Since , Taxpayer has filed a *U.S. Corporation Income Tax Return, Form 1120*. Taxpayer has a wholly-owned taxable subsidiary, Sub for which it annually files a *U.S. Corporation Income Tax Return, Form 1120*.

Taxpayer's Amended Bylaws discuss its operation as a cooperative as follows:

Democratic Control. Article III, Section 5 of Taxpayer's Bylaws allows only one vote per member in corporate governance matters and that all questions shall be decided by a vote of the majority of members voting in person.

Subordination of Capital. Article VII, Section 1 of Taxpayer's Bylaws dictates that the organization will be operated on a non-profit basis. Further, that provision prohibits payment of dividends or interest on capital furnished by Taxpayer's patrons.

Operation at Cost. Article VII, Section 2 of Taxpayer's Bylaws dictates that the Cooperative's net savings from the provision of telephone services belongs to its patrons. Further, that Section requires Taxpayer to pay to all patrons the excess paid by them over cost in furnishing of telephone services. All such amounts credited to the equity account of the patron have the same status as though they were paid to the patron in pursuance of a legal obligation to do so, and the patron had them furnished Taxpayer the corresponding amount as an equity contribution.

Other Margins. To the extent that Taxpayer earns margins from non-patronage activities, those margins shall be retained by Taxpayer, Article VII, Section 2.

Vested Members Rights. Article II, Section 1 of Taxpayer's Bylaws defines the property rights of members and former members in the event of dissolution of Taxpayer. It states that upon dissolution, after all debts and liabilities of Taxpayer have been paid and patronage capital retired or redeemed in accordance with the Bylaws, the remaining property and assets of Taxpayer shall be distributed to members and former members in the proportion which the aggregate patronage of each member bears to the historic patronage of the organization.

To understand the facts relative to the transaction at issue, it is first necessary to consider the members and the region that Taxpayer serves. Taxpayer provides telephone service to residential and business members in Area. The Area is very rural and agrarian, and many of Taxpayer's owner-members depend on agribusiness either directly or indirectly for their livelihood.

The population in Taxpayer's service area is sparse, with the location of its members thinly spread over a large area. By comparison to the average telephone company with approximately 130 access lines per square mile, Taxpayer's territory has only about 15.5 access lines per square mile. This extremely low density of its service territory greatly

increases the difficulty of Taxpayer providing telecommunications infrastructure to support new technology.

In the early 1980s, cellular telephone service began to emerge as the next technological breakthrough for the telecommunications industry. In order to foster development of the cellular market, the Federal Communications Commission (FCC) divided the available radio spectrum in each market into two channel blocks. One block was set aside for development by wireline telephone companies and the other for non-wireline companies. In markets where there was more than one applicant for a network construction permit, lotteries were used to select applications.

Because each initial network construction permit holder was given 5 years from the date of authorization to build and expand its cellular system within its market, the FCC system insured a temporary duopoly in every service area. During this 5-year fill-in period, no applications from anyone other than the permit holder were accepted within the market on the holder's channel block without its consent. Any remaining area within the market not covered by the permit holder was considered an "unserved area."

After observing the early successes of providers of analog wireless telephone service in major metropolitan markets, Taxpayer's management and Board of Trustees reached several conclusions. First, wireless technology was bringing about a revolution in the communications business; its potential was almost unlimited in rural areas where a greater number of people work outdoors instead of office buildings. Equally important, cellular technology had the potential to undermine the continued economic viability of Taxpayer if it was brought to the members by a competing organization.

The fear was that a significant amount of members might abandon land-line service in favor of cellular telephones. Growing "foreign" cellular telephone penetration in Taxpayer's service area could cause an ever-shrinking base of members to support the fixed costs of a wire-based system. In other words, it would be a "death spiral" for Taxpayer. To protect the organization and its members from this unacceptable risk, Taxpayer's Board concluded that Taxpayer had to invest in the cellular technology when the FCC opened the licenses for rural areas.

In a partnership of Taxpayer, a neighboring telephone cooperative, Coop A, and an investor-owned telephone company, Corp A, acquired State A RSA License No. 1 and developed the cellular telephone service in Area.

Through the years of operation a significant number of Taxpayer's members subscribed to its cellular services offered by the State A RSA No. 1 Partnership. Taxpayer experienced operating losses from the partnership in the first several years and then it took several more years to recover those losses. By Taxpayer included income from the RSA partnership in member allocations for the year and has done so ever since.

During the same timeframe, Digital Subscriber Line technology allowed multiple uses of a “twisted pair” copper telephone wire. As a consequence, the risk of obsolescence of Taxpayer’s existing plant in service was somewhat mitigated.

By Taxpayer’s Board was satisfied that there was sufficient and diverse cellular telephone coverage to serve its members’ needs and Taxpayer needed to redeploy capital to fully develop its conversion from “twisted-pair” copper line to a fiber optic system. Accordingly, Taxpayer reached an agreement with Corp B on to sell Taxpayer’s percent interest and rights with respect to the State A RSA No. 1 Partnership for \$. The sales transaction closed on . At the closing date, Taxpayer’s tax basis in the partnership assets was \$.

Based on this transaction, Taxpayer anticipates being a nonexempt cooperative for tax year . Predicated on the information set forth herein, Taxpayer requests the following ruling:

The income realized by Taxpayer in the sale of its general partnership interest in State A RSA No. 1 Partnership constitutes “patronage-sourced” income which may be excluded from its gross income when allocated to Taxpayers’ patrons by a true patronage dividend.

In the event a rural telephone cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) of the Code no longer applies until such time as the cooperative again satisfies the requirements for exemption. During any taxable period, the rules applicable to the telephone cooperative depend on the reasons why it failed its exemption tests. If exemption was lost because the company failed to operate on a cooperative basis, then it will be taxed under the same rules applicable to for-profit corporations. Alternatively, if the cooperative becomes taxable because it failed the so-called 85-percent-income test imposed by section 501(c)(12), then the organization will be taxed as a cooperative.

While the requirements of Subchapter C of the Code regarding corporate distributions and adjustments and other provisions are generally applicable to nonexempt cooperatives, these entities are distinguished from other types of corporations by a specific body of tax law. The scheme of taxation for nonexempt cooperatives was developed from the administrative pronouncements of the Service and decision of the judiciary over a fifty-year period. These rules for tax treatment of most nonexempt cooperatives and their patrons were finally codified with the enactment Subchapter T of the Code as part of the Revenue Act of 1962. Pub. L. No. 87-834 (H.R. 10650).

With passage of Subchapter T, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative’s patrons were defined. However, section 1381(a)(2)(C) of the Code states that Subchapter T is not applicable to organization engaged in furnishing electric energy, or providing telephone service to persons in rural areas. According to the Senate Finance Committee Report accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under “present law.”

In its report accompanying the legislation, the Senate Finance Committee described “present law” as follows:

“Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative’s taxable income only if they are paid during the taxable year in which the patronage occurred or within the period in the next year elapsing before the prior year’s income tax return is required to be filed (including any extensions of time granted).” S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

Under this earlier body of tax law applicable to nonexempt telephone cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to their members/patrons. Further, under pre-1962 cooperative rules, the term “paid” means paid in cash or paid by notice of allocation. See also Rev. Rul. 83-135, 1983-2 C.B. 149 (A taxable cooperative not subject to the provisions of Subchapter T of the Code may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws).

While Subchapter T does not control the taxation of nonexempt telephone cooperatives, its foundations rest upon pre-1962 cooperative tax law. As a result, there are certain basic parallels between the tax treatment of nonexempt utility cooperatives and treatment of other cooperative organizations under Subchapter T. Therefore, to extent that Subchapter T reflects cooperative taxation as it existed prior to 1962, it is instructive resolving certain issues facing rural telephone cooperatives. This is because Congress stated that in enacting Subchapter T it was merely codifying the long common law history of cooperative taxation (with the exception of ensuring at least one annual level of tax at the cooperative or patron level. See S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962)) and, arguably, the case law post-enactment is merely a continuation and refinement of the pre-enactment common law. This is particularly true with respect to defining certain terms such as “operating on a cooperative basis” and “patronage income.”

Perhaps the most succinct definition of the term “cooperative” for Federal income tax purposes was provided by the U.S. Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3. The Tax Court said:

“Under the cooperative association form or organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as co-workers, in proportion to the amounts of their active participation in the cooperative undertaking.”

The Tax Court went on to describe three guiding principles at the core of economic cooperative theory as:

“(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members’ active participation in the cooperative endeavor.” 44 T.C. at 308.

The mechanism by which telephone cooperative achieve operation at cost is the patronage dividend (or capital credit). Since the payment of patronage dividends (and operation at cost) is so critical to achieving cooperative status as defined by *Puget Sound*, it is important to analyze this issue.

Rural telephone cooperatives perform a final accounting at year-end to determine the net margin derived from their members’ patronage during the course of the year. Then, the excess over cost collected from members is returned to them by a capital credit allocation based on each member’s patronage. Those capital credits are typically “paid” by allocations of capital credit certificates or notices of allocation, rather than in cash. The capital credits retained form the foundation for the organization’s equity capital.

A true patronage dividend that may be excluded from the income of a rural telephone cooperative must meet the three tests set forth in *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp 201 (N.D. Ia. 1949), and *Pomeroy Cooperative Grain Co. v. Commissioner*, 31 T.C. 674 (1958), *acq.*, AOD 1959-2 C.B. 6. Those tests are:

1. It must be made subject to a preexisting legal obligation;
2. the allocation must be made on the basis of patronage; and
3. the margins allocated must be derived from the profits generated from patrons’ dealings with the cooperative.

Although the Code does not provide specific guidance as to what constitutes patronage-sourced income for a nonexempt telephone cooperative, regulations and rulings address the issues for cooperatives governed by Subchapter T of the Code. While not directly applicable to taxable utility cooperatives per se, arguably they reflect the correct analysis with respect patronage income of cooperatives subject to pre-1962 law.

The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax “ordinary” (i.e., non-farmer) cooperatives for:

“non-operating income...not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis.” S. Rep. No. 781, 82d Cong. 1st Sess. (1951).

In response to that guidance of Congress, the Service promulgated regulations distinguishing nonpatronage income from that which is patronage derived.

Section 1388(a)(3) of the Code specifies that a patronage dividend must be “determined by reference to the net earnings of the organization from business done with or for its patrons.” That section further provides that the term “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers “to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.”

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers’ cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers’ cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative’s marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit

banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The Court held that the relation of income activity to the cooperative's business was too tenuous.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In *Farmland Industries v. Commissioner*, 78 T.C.M. 846, 864 (1999), *acq.*, AOD 2001-03 (citing *Cotter & Co. v. United States*, 765 F.2d 1102, 1106 (1985); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988, 993 (8th Cir. 1982); *Certified Grocers of Cal., Ltd. v. Commissioner*, 88 T.C. 238, 243 (1987); *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459 (1986)), the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision, the Court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons." 78 T.C.M. at 870.

In *Land O'Lakes, Inc., supra.*, the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

In the instant case, Taxpayer believed that investing in cellular technology was a correct decision for its members as a matter of providing the best available service and thwarting any potentially disastrous competition. As a matter of risk aversion, Taxpayer joined with Coop A and Corp A in a general partnership for the joint construction and operation of the State A RSA.

After Taxpayer's Board was satisfied that cellular telephone service was universally available to all of its members, it decided to sell Taxpayer's cellular partnership interest and redeploy that capital to the very expensive fiber optic installation (another patronage activity).

Taxpayer's initial investment and subsequent divestment of its cellular partnership interest were both directly related to and facilitative of the cooperative's overall patronage business purpose of providing telecommunications services.

Accordingly, based solely on the foregoing, we rule that the income realized by Taxpayer in the sale of its general partnership interest in State A RSA No. 1 Partnership constitutes "patronage-sourced" income which may be excluded from its gross income when allocated to Taxpayers' patrons by a true patronage dividend.

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 your authorized representative.

Sincerely yours,

/s/ Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: