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Legend

- Taxpayer =

- State A =
- State B =
- Corp A =
- Corp B =
- Corp C =
- Corp D =
- Corp E =
- Corp F =
- Corp G =
- Corp H =
- Bank A =
- Bank B =
- Equity =

LLC =

Dear :

This is in response to a request for a ruling dated April 6, 2010, and subsequent correspondence, submitted on behalf of Taxpayer by your authorized representatives. The ruling concerns the application of cooperative tax law to the transaction described below.

Taxpayer was incorporated in pursuant to the Cooperative Corporations Law of the State A. Taxpayer's primary and fundamental purpose has been and continues to be the marketing of crops grown by its members. Such marketing is conducted on a cooperative basis. All members of Taxpayer are growers of vegetables and/or fruits, or cooperatives the members of which are such growers. Taxpayer's fiscal year ends on the last Saturday in of each calendar year. It utilizes the accrual method of accounting for book and tax purposes. As of , Taxpayer represent that it was a tax-exempt farmers cooperative pursuant to section 521 of the Internal Revenue Code.

Prior to , Taxpayer owned an interest in Corp A, which processed fruits and vegetables supplied by Taxpayer's members. In , Corp A was sold, resulting in a capital gain to Taxpayer of approximately \$. Taxpayer is requesting a ruling that the capital gain is patronage source income under subchapter T of the Code.

On , Taxpayer acquired ownership of all of the common stock of Corp B. After the transaction, Corp B operated as a wholly-owned subsidiary of Taxpayer. The transaction in marked the culmination of a process which started in , when Corp C, a State B business corporation which functioned as a subchapter T cooperative, announced that it intended to sell all of its interest in the common stock of Corp B. Corp C's interest consisted of 99 percent of the Class B shares, which had voting control of the Board of Directors of Corp B, and approximately 14 percent of the publicly-traded Class A shares. With this announcement, Taxpayer was faced with the prospect of losing the market for its members' crops that Corp B had provided for over years. During the sale process, all of the likely bidders for the stock were deemed by Taxpayer's Board of Directors to be highly unlikely to continue the unique contractual relationship between Taxpayer and Corp B established in . During the bidding process conducted by Corp B and Corp C, the information furnished to potential buyers included a calculation by Corp B of the amount necessary for a successful bidder to terminate the contractual arrangements with Taxpayer. While Taxpayer did not agree with the calculation of the amount to be

paid to it upon termination of the contractual arrangements, it was apparent that the acquirer of Corp B could and likely would terminate such arrangements.

As a general rule, the crops provided to Taxpayer by its members are not the types of crops planted, cultivated, and harvested unless the member has an established market to which its crop will be sold. As such, the termination of the contractual relationship between Taxpayer and Corp B would have left Taxpayer's members with no stable, reliable market for their crops and would have ended the purpose for Taxpayer to exist, leading to its liquidation and dissolution. Confronted by this prospect, Taxpayer's Board of Directors, and subsequently its members, determined that they had no choice except to pursue ownership and control of Corp B if Taxpayer were to maintain a market for its members' crops. Ultimately, Taxpayer was successful in acquiring all of the outstanding capital stock of Corp B from funds raised through the placement of \$ of high yield notes issued by Corp B upon the closing of the acquisition and through an enhanced credit line from Bank A.

From through , Taxpayer operated Corp B in much the same manner as Corp B had operated prior to while controlled by Corp C, except that Taxpayer changed the company's name from Corp B to Corp D on . Through the sale of various assets and businesses which were not critical to the members of Taxpayer and through the sale of businesses which Corp D could not operate profitably, Taxpayer was able to reduce its bank debt over time and was able to operate Corp D profitably in most years.

As a business with primarily private label, food service, and industrial customers, and with only a handful of regional brands in its portfolio, Corp D faced the pressure of low profit margins, increased costs, limited opportunities for the growth of its businesses, and increased competition from other food processors, including those with significant national brands. Faced with these pressures, when the opportunity arose in the months before to acquire Corp E, which used the Corp A trademark to support its national branded frozen vegetable business, Taxpayer, through Corp D, became a bidder to acquire that business. Ultimately, on , Taxpayer successfully acquired the stock of Corp E, and Corp E was merged into Corp D.

The acquisition of Corp E came at a high price, involving both the transfer of business assets to Corp F, the owner of Corp E and the payment of cash. To finance the cash portion of the purchase price, Taxpayer and Corp D refinanced Corp D's bank debt, which was guaranteed by Taxpayer, through Bank B and issued \$ of high yield notes to repay the high yield notes issued in and to provide additional capital, all of which left Taxpayer and Corp D highly leveraged.

By , it became apparent to the management of Taxpayer and Corp D that additional capital was needed. Corp D's debt load threatened the viability of its food processing business. While not the sole customer for Taxpayer's members' crops, in

the late 1990's and early 2000's, Corp D purchased in excess of 90 percent of the crops marketed by Taxpayer. Because the necessary capital could not be raised by Taxpayer through its members or by adding new members, the Board of Directors of Taxpayer authorized the management of Taxpayer and Corp D to pursue opportunities with strategic partners or capital investments from private equity firms. Ultimately, on _____, Equity, a private equity firm, invested \$ _____ into Corp D as part of a refinancing of Corp D.

The structure of the _____ transaction with Equity involved three principal components. First, Corp D was reorganized as part of the refinancing transaction. LLC was formed as a State B limited liability company. LLC was owned in part by Equity, which contributed \$ _____ for a combination of _____ percent of the preferred units and _____ percent of the common units of LLC. Taxpayer contributed to LLC all of the common stock of Corp D in exchange for units in LLC which represented _____ percent of the common ownership of LLC. As such, the common stock of Corp D, which Taxpayer had acquired in _____, was converted to units in LLC, the indirect parent company of Corp D. Management of Corp D was provided a _____ percent interest in certain common units of LLC in exchange for contributions of cash and notes.

The governance of Corp D (which was reincorporated in State B as part of the refinancing), of its immediate parent company, Corp G (a newly-formed State B corporation), and of its indirect parent company, LLC, were controlled primarily through two agreements. These agreements established Equity's control of the Boards of Directors of Corp D and Corp G, and the management committee of LLC. Taxpayer was provided with _____ representatives on the Boards and management committee, which initially had _____ members but which were subsequently increased to include _____ members. Taxpayer representatives had insufficient voting power to set policy or direction for the business. Through a set of contractual rights set out in these agreements, Equity obtained the ability to sell Corp D's assets or stock, to sell the units of LLC, or to effect various other types of transactions (e.g., mergers, consolidations, and initial public offerings). The agreements entered into as part of the refinancing transaction with Equity marked the end from a practical perspective of Taxpayer's control over the ultimate disposition of Corp D's business.

Of critical importance to Taxpayer, the arrangements in place since _____ governing the supply of crops by Taxpayer to Corp D were largely maintained through a new supply agreement negotiated as part of the _____ refinancing transaction. Under the new _____-year supply agreement, Taxpayer was a preferred supplier of crops to Corp D, but Corp D had the ultimate decision-making authority on the types and quantities of crops it would purchase and the extent to which it would purchase those crops from Taxpayer. The methodologies for determining crop prices, the terms and schedules of payment, and the process for implementing raw product plans before each growing season were maintained in the new supply agreement largely as they had been in effect under the prior supply agreement. In addition, the new supply agreement required Corp D to use reasonable commercial efforts to have

the supply agreement, or appropriate portions of the supply agreement, assumed by a buyer of the business of Corp D, or by a buyer of any part of the business, if it were sold during the new agreement's ten-year term.

Thus, through the refinancing transaction, Taxpayer was able to avoid the potential financial failure which seemed imminent in and the first half of while also obtaining a long-term, stable supply arrangement for the benefit of the members of Taxpayer through the growing season.

During the time period from through , the business of Corp D continued to evolve under the control of Equity. The name of Corp D changed to Corp A on . Despite these business changes, the supply agreement entered into as part of the refinancing transaction served to maintain the markets for the crops of Taxpayer's members.

In mid- , Corp A announced that LLC had reached an agreement to sell all of the stock of Corp A to Corp H. This stock transaction closed on , and resulted in Taxpayer receiving a portion of the sale proceeds totaling approximately \$ for Taxpayer's units in LLC. As Taxpayer's tax basis in its investment in Corp A was approximately \$, Taxpayer recognized a gain for tax purposes of approximately \$ as a result of the sale of Corp A to Corp H.

The bylaws of Taxpayer at Article X, Section 4 provide for the allocation or distribution of any gain recognized from the disposition of Corp A. The bylaws provide that such gain is shared based upon a member's (or if required by applicable tax laws, a patron's) crop deliveries to Taxpayer from through the date of the transaction which results in the recognition of the gain.

Taxpayer, requests a ruling that the gain recognized by Taxpayer on , as a result of the sale of Corp A is patronage source income pursuant to subchapter T of the Code.

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 of subchapter T of the Code as part of the Revenue Act of 1962, Pub. L. No. 87-834 (1962 Act).

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. In its report accompanying the 1962 Act, 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).

A true patronage dividend that may be excluded from the income of a 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, regulations and rulings address the issues for cooperatives governed by subchapter T of the Code.

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, Inc. 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 situation, Taxpayer's original acquisition of the stock of Corp B and its subsequent operation of that business furthered Taxpayer's cooperative purpose. Taxpayer's percent ownership of Corp A changed as a result of the refinancing transaction involving Equity. The refinancing transaction was deemed necessary by Taxpayer's Board of Directors, and ultimately was approved by the members of Taxpayer, in order to assure that Corp A was sufficiently capitalized to continue in operation, thus preserving a long-term, stable market for the crops of Taxpayer's members. As part of the transaction, Taxpayer exchanged its percent ownership of Corp A for a percent interest in the common units of LLC.

As with the original acquisition in of the stock of Corp B, the refinancing transaction in was motivated by Taxpayer's goal of preserving a stable market for its members' crops. In and the first half of Taxpayer has represented that it

faced economic circumstances, because of a large debt load, which threatened its long-term viability. In refinancing Corp A in _____, Taxpayer obtained a capital infusion into Corp A. That capital investment stabilized the financial condition of Corp A. Further, Taxpayer achieved its cooperative purpose of providing a stable market for its members' crops, not only through a continuation of the marketing of its members' crops to Corp A, but also through the provisions of the _____-year supply agreement entered into as part of the transaction which served to assure that buyers of any businesses from Corp A would also become customers of Taxpayer to whom its members' crops could be marketed.

The sale of Corp A in _____ marked the end of Taxpayer's ownership of the assets originally acquired in _____. But at all times from _____ through the sale of Corp A, Taxpayer's ownership of Corp A (and its predecessors) served to provide a market for the crops of Taxpayer's members. Even with the sale of Corp A, the supply agreement terms obtained in _____ have resulted in a continuing market for the crops of Taxpayer's members, not only to Corp A but also to various other customers obtained by Taxpayer through the workings of the supply agreement.

Taxpayer has represented that its members supplied over _____ percent of the raw product purchases made by Corp A for processing. As that percentage exceeds Taxpayer's ownership interest, we can assume that the gain on the sale received by Taxpayer was attributable to its members business conducted with Corp A and, accordingly, all patronage sourced.

Thus, we rule as requested that the gain recognized by Taxpayer on _____, as a result of the sale of Corp A is patronage source income pursuant to subchapter T of the Code.

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 representatives.

Sincerely yours,

Paul F. Handleman

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