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LEGEND:

Taxpayer =

State A =

b =

c =

Association 1 =

Association 2 =

Dear

This is in response to a request for a ruling dated May 31, 2011, submitted by your authorized representative. The ruling requests that Taxpayer will continue to be a corporation operating on a cooperative basis within the meaning of section 1381(a)(2) of the Internal Revenue Code after the alignment transaction described below.

Taxpayer is a corporation operating on a cooperative basis organized under State A law. Taxpayer was formed in . It was reorganized on a cooperative basis in . At that time, Taxpayer received a private letter ruling (PLR 9235011, dated May 21, 1992) confirming its status as a nonexempt cooperative subject to the provisions of subchapter T of the Code.

Taxpayer is a cooperative serving b hospitals. Currently, the members of Taxpayer are b hospitals. Taxpayer's members share data, knowledge and buying power to reduce costs and improve clinical and operational performance in b hospitals. The principal activities Taxpayer engages in on behalf of its members are:

- Group purchasing. Taxpayer provides group purchasing and supply chain management services ("group purchasing") for its members and their affiliates. Through Taxpayer, members and their affiliates have access to the c contract portfolio and to contracts that Taxpayer has itself negotiated with vendors. These contracts cover a broad array of medical, surgical, pharmaceutical and other products and services that Taxpayer's members require to operate their b hospitals.

  During 2010, members and their affiliates purchased approximately of products and services under these contracts.

  Under the contracts, Taxpayer's members typically place orders directly with the vendors, the vendors ship directly to them and bill them directly, and the members pay the vendors directly.

  The contracts provide for favorable pricing. They also usually require vendors to pay administrative fees to c (in the case of the c contracts) and to Taxpayer (in the case of the Taxpayer contracts). By virtue of the agreement that provides Taxpayer's members with access to the c contracts, Taxpayer shares in administrative fees paid by vendors to c with respect to purchases made by Taxpayer's members and their affiliates under the c contracts.

- Insurance services. In addition, Taxpayer provides insurance advisory and agency services ("insurance services") to its members and their affiliates. Taxpayer is a registered insurance agent. Taxpayer helps members find and evaluate the insurance products that best fit their needs. For instance, Taxpayer helps the human resources departments of members' affiliates evaluate and purchase life insurance, long term disability insurance and other insurance products. When members and their affiliates purchase insurance through Taxpayer, Taxpayer earns agency commissions.

- Other services. Taxpayer also provides a variety of other services ("other services") to its members and their affiliates. These services are focused on enhancing clinical performance to improve the quality of care delivered to patients; improving business processes to reduce hospital costs, increase revenue and strengthen the competitive position of members; and education, knowledge and information sharing, and leadership training. Taxpayer facilitates these activities for members through arranging forums for key employees, (an active online learning management system) and database sharing among members.

Taxpayer allocates patronage dividends by treating its activities as a single allocation unit. Historically, Taxpayer's group purchasing and insurance services have been profitable, and its other services have broken even or operated at a modest loss. Net earnings are shared by group purchasing and insurance services members and their affiliates based upon patronage. Patronage is measured by each patron's contribution to the group purchasing and insurance services gross revenues for the year.

The b hospitals have a number of unique needs and interests. Historically, these needs and interests have been served by Taxpayer and two other national organizations.

- Association 1 nonprofit corporation which operates as a trade association for b hospitals. It is exempt from taxation under section 501(c)(6) of the Code. Association 1's mission is to advocate for public policies that support the ability of b hospitals to fulfill their missions of clinical care, education, research and advocacy.

- Association 2 also is a nonprofit corporation. It operates as a charitable organization exempt from taxation under section 501(c)(3) of the Code. Association 2 provides a number of information and educational services to its members and also develops data for Association 1 to use in its advocacy efforts.

There is considerable overlap in the membership of the three organizations. Association 1 has b hospitals as voting members, including all members of Taxpayer. Association 2's voting members are the same hospitals that are the voting members of Association 1 (including Taxpayer's members). Association 2 also has non-voting members.

The members and leadership of Taxpayer, Association 1 and Association 2 have long felt that the three organizations could more effectively serve the needs of b hospitals if their activities were more closely aligned. In early 2010, the Board of Directors of Taxpayer and the Executive Committees of the Boards of Trustees of Association 2 and Association 1 charged a joint Task Force to explore an alignment between and among the organizations.

On , the three organizations entered into a nonbinding Memorandum of Understanding setting forth "the mutual intention of the Parties to work together to restructure and consolidate the three organizations under a single parent trade association for [b] health care providers…"

On , Taxpayer, Association 1 and Association 2 entered into a Consolidation Agreement (the "Consolidation Agreement"). The Consolidation Agreement begins by reciting why the three organizations are taking steps to become more closely aligned:

> "WHEREAS, on [ ], the Parties signed a Memorandum of Understanding … signifying their intent to pursue an alignment of the three organizations that would restructure and consolidate the three organizations under a single parent trade association with aligned governance, consolidated operational leadership and a single nationwide advocacy voice for [b] health care providers (the 'Alignment');
>
> WHEREAS, the Parties are at pivotal moments in their respective histories, in which the national health care, economic and political environments are in a state of substantial change and the needs and responsibilities of [b] health care providers are being reshaped;
>
> WHEREAS, the members and owners of the Parties will require effective and coordinated representation in order to respond to these challenges and to continue to improve the quality and efficiency of the care they provide, while also continuously enhancing the health of all [b];
>
> WHEREAS, the executive leadership of the Parties is in transition, offering an opportunity for potential restructuring and alignment of the three organizations to better meet the challenges and needs of the future; and
>
> WHEREAS, the Parties have determined that the Alignment will better serve the needs of their members and owners and wish to create a new organization to advance their aims through the alignment of the Parties under a single fiduciary and executive leadership with streamlined operations."

The Consolidation Agreement then describes the purposes of the alignment. Section 1.1 of the Consolidation Agreement provides:

> "1.1 Purposes: This Agreement is entered into in order to improve and enhance the ability of the members and owners of the Parties to achieve a number of important goals, including:
>
> 1.1.1. Strengthening the prospects of advancing into the future ' ' as a single national b organization and advocate for all [b] health care providers.
>
> 1.1.2. Rationalizing future information technology and related organizational investments that must be made to support continued advances in the quality, safety and costs of caring for b by sharing with greater economy the elements of

> the fundamental infrastructure, data capture, processing, and support currently in use by the Parties.
>
> 1.1.3. Sharing and cost rationalization of other selected services, including overall executive leadership structures, educational and meeting support, administrative support, performance improvement and quality transformation, and spending on outside assistance in order to improve the ability of the new organization to increase funding in critical areas such as public policy and advocacy.
>
> 1.1.4. Aligning governance in order to maximize the most efficient use of member time and resources and more effectively define and implement consolidated programs on behalf of the sponsoring membership and avoid unnecessary duplication and redundancy.
>
> 1.1.5. Promoting a more effective and coordinated development of services and activities that may be sponsored or purchased by subgroups within the combined membership."

Section 1.2 of the Consolidation Agreement provides a general overview of the alignment transaction (the "Alignment Transaction"). The Consolidation Agreement provides that Association 1 will become the "Parent Trade Association" and that Association 2 and Taxpayer will become subsidiaries of Association 1. Association 1 will continue to operate as a section 501(c)(6) trade association, conducting its current advocacy activities. Association 2 will continue to operate as a section 501(c)(3) organization and will be responsible for the charitable activities of the three organizations. Association 2's activities will include its current information technology and educational services. It is envisioned that Association 2 will eventually also assume responsibility for the other services currently being provided to members by Taxpayer. Taxpayer will continue to provide group purchasing and insurance services on a cooperative basis.

The Consolidation Agreement provides that the alignment will occur in two steps. The first step in the alignment is alignment of governance of the three organizations. This step, which took place on , focuses on aligning the Boards of the three organizations and starting a search for a person to serve as the Chief Executive Officer of all three organizations.

As part of the alignment of governance, on , the Taxpayer members approved an amendment to the Bylaws of Taxpayer to reflect the alignment of its Board of Directors with that of Association 1 and Association 2. In pertinent part, Section 4.2 of the Bylaws was amended by adding:

> "As of [ ], the directors shall consist of those persons elected at a meeting of the stockholders held on or about [ ], each to serve for either a one or two year term, as assigned to him or her at the time of election, provided that the effective date of such terms may occur

at a date other than [ ] as determined in accordance with the resolution adopted by the stockholders at such meeting."

In accordance with this Bylaw, the Taxpayer members then elected new directors. The members of Association 1 and Association 2 went through a similar process. The same persons were elected to the Boards of each of the three organizations. Each of the Boards now has thirteen members: the person serving as President of Taxpayer, Association 1 and Association 2, seven representatives of b hospitals, four representatives of institutions that are a b hospital within a hospital or hospital system, and one representative of a specialty b hospital. Of these directors, eight are representatives of institutions that are members of Taxpayer (the representatives of the b hospitals and the representative of one of the b hospitals within a hospital or hospital system).

At the same meeting, the Taxpayer members also approved an Amended Certificate of Incorporation and Amended and Restated Bylaws for Taxpayer which become effective at a Final Closing to be held within thirty (30) days following this ruling. As a result, the Amended Certificate of Incorporation and the Amended and Restated Bylaws have not yet gone into effect.

In addition, during and , all members of Taxpayer entered into a Stock Transfer Agreement with Taxpayer and Association 1 (the "Stock Transfer Agreement"). As described in detail below, it is contemplated that the members of Taxpayer will transfer their shares of Common Stock of Taxpayer to Association 1, making Taxpayer a subsidiary of Association 1. Concurrent with such transfer of shares, Association 1 will grant each member of Taxpayer a proxy entitling such member to vote the transferred shares at stockholders' meetings. The consummation of the stock transfers contemplated in the Stock Transfer Agreements will occur at a Final Closing to be held within thirty (30) days following this ruling, so the transfers have not yet occurred.

The second step in the alignment process will be the Final Closing, which will occur after this ruling. See Section 1.3.2 of the Consolidation Agreement. At that time, (i) the Amended Certificate of Incorporation will be filed with the Secretary of State A; (ii) the Amended and Restated Bylaws will become effective; (iii) the transfers of the shares of Common Stock pursuant to the Stock Transfer Agreements will occur; (iv) the initial grant of voting proxies by Association 1 to the transferring Taxpayer members will take place; and (v) Taxpayer will become a subsidiary of Association 1.

The focus of this ruling is upon whether the Alignment Transaction will have any effect on Taxpayer's status as a nonexempt subchapter T cooperative. Taxpayer believes it will not.

Taxpayer currently operates at cost, its capital is subordinated, and it is controlled by its members on a one-member, one-vote basis. In the event of dissolution, its residual assets will be distributed on a patronage basis. None of these things will change as a result of the transfer by Taxpayer's members of their shares of Taxpayer Common Stock to Association 1 pursuant to the Alignment Transaction.

The Alignment Transaction is driven by a desire to achieve aligned governance among Taxpayer, Association 1 and Association 2 and to achieve improved efficiency for their collective members, while at the same time preserving Taxpayer's status as a nonexempt subchapter T cooperative. Three key documents establish Taxpayer's continuing cooperative character after the Alignment Transaction – namely, Taxpayer's Amended Certificate of Incorporation (the "Certificate of Incorporation"), Taxpayer's Amended and Restated Bylaws (the "Bylaws") and the Stock Transfer Agreement. The pertinent portions of these documents are described below.

Taxpayer's Articles of Incorporation and Bylaws continue to provide that Taxpayer "will be organized and operated on a cooperative basis for the benefit of the members, associate members and their affiliates as patrons and not as stockholders." Articles of Incorporation, Article Fourth (J); Bylaws, Article II, Section 2.1.

Historically, Taxpayer's members have been b hospitals. All current members will continue as Taxpayer members after the Alignment Transaction (whether or not they remain members of Association 1). Certificate of Incorporation, Article Fourth (J); Bylaws, Article II, Section 2.2(a). Other health care organizations may become members of Taxpayer in the future. In order to be eligible to become a new member of Taxpayer, an organization must be (i) a voting member of Association 1, (ii) committed to care, education and research, (iii) financially able to meet its commitments to Taxpayer, and (iv) in good standing under, and in substantial compliance with, applicable licensing and health laws. In addition, a prospective member's membership application must be approved by the Board of Directors of Taxpayer. Bylaws, Article II, Section 2.2(b) and (c).

Organizations interested in participating in Taxpayer's group purchasing and insurance services programs on a patronage basis that do not meet all of the requirements for membership will continue to be eligible to become associate (nonvoting) members. Bylaws, Article II, Section 2.3. Historically, Taxpayer has not had any associate members, but this category has been preserved to maintain the flexibility to be able to do business with institutions other than members on a patronage basis should the occasion arise.

Affiliates of members and associate members will continue to be eligible to do business with Taxpayer on a patronage basis. For this purpose, "affiliate" means "an entity which directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with a member or an associate member." Bylaws, Article II, Section 2.2(c).

Taxpayer may provide services to nonmembers on a nonpatronage basis, but historically its business with nonmembers has been quite limited (i.e., less than percent of its over-all business in recent years). For purposes of this ruling, Taxpayer represents that business on a patronage basis with or for members, associate members and affiliates will constitute more than 50 percent of its overall business.

Taxpayer continues to be required by its Certificate of Incorporation and Bylaws to determine its net earnings from business done with or for members, associate member and affiliates (its “patronage earnings”) and its net earnings from other sources (its “nonpatronage earnings”) after the end of each year. Certificate of Incorporation, Article Fourth (B)(i); Bylaws, Article VIII, Section 8.2(a). Taxpayer is then required to allocate its patronage earnings among members, associate members and affiliates on a patronage basis and to distribute and pay the amounts so allocated within eight and one-half months of year end as patronage dividends in cash, property, written notices of allocation (qualified or nonqualified) or some combination thereof. Certificate of Incorporation, Article Fourth (B)(iii) and (iv); Bylaws, Article VIII, Section 8.2(c) and (d).

Taxpayer continues to be authorized to retain nonpatronage earnings (after payment of taxes) as unallocated reserves or surplus. Certificate of Incorporation, Article Fourth (B)(ii); Bylaws Article VIII, Section 8.2(b). Amounts not retained (and not used to pay taxes) are allocated among members, associate members and affiliates in the same manner that patronage earnings are allocated. Certificate of Incorporation, Article Fourth (B)(iii) and (iv); Bylaws, Article VIII, Section 8.2(c)and (d). While any amounts of nonpatronage earnings added to reserves or surplus may be “unallocated,” Taxpayer is required to apportion any unallocated reserves or surplus on the books on a patronage basis each year (or to maintain the records to do so) “so that in the event of distribution of amounts from such unallocated reserves or surplus, other than upon dissolution, each past or present member, each associate member and each affiliate may receive its pro rata share of such distribution.” Certificate of Incorporation, Article Fourth (C); Bylaws, Article VIII, Section 8.3.

Taxpayer’s Certificate of Incorporation authorizes it to issue two classes of capital stock – Common Stock and Preferred Stock. Certificate of Incorporation, Article Fourth. Currently, there are no shares of Preferred Stock issued and outstanding.

The economic rights of holders of Common Stock and Preferred Stock are limited. Neither class of shares is entitled to receive dividends. Certificate of Incorporation, Article Fourth (A). Upon dissolution, the right of each class of stock to share in assets is limited. Holders of shares of Common Stock are entitled to receive an amount equal to what was paid for the shares and no more. Certificate of Incorporation, Article Fourth (G). Holders of shares of Preferred Stock are entitled to receive par value per share and no more. Certificate of Incorporation, Article Fourth (G). In the event of dissolution, any residual assets are shared by members, associate member and affiliates on a patronage basis. Certificate of Incorporation, Article Fourth (G).

The only class of stock with voting rights is the Common Stock, and each share has one vote. Certificate of Incorporation, Article Fourth (E). Historically, only members of Taxpayer have been permitted to own shares of Common Stock, and each member of Taxpayer was required to purchase five shares of Common Stock. Certificate of Incorporation, Article Fourth (F). Thus, each member of Taxpayer had an equal number of votes (i.e., five), and Taxpayer effectively operated on a one-member, one-vote basis. This ruling refers to Taxpayer as operating on a “one-member, one-vote” basis as a short-hand for the actual system where each member has an equal five votes.

As part of the Alignment Transaction, all members of Taxpayer have entered into Stock Transfer Agreements with Association 1 and Taxpayer. Upon issuance of this ruling, the members will transfer their shares of Taxpayer Common Stock to Association 1, making Taxpayer a wholly-owned subsidiary of Association 1.

Because of the way Taxpayer is structured and because of various provisions in the Stock Transfer Agreement, the proposed share transfers should have no impact on Taxpayer’s status as a nonexempt subchapter T cooperative.

First, the Alignment Transaction will not change beneficial ownership of the shares. The limited economic rights that accompany ownership of shares of Common Stock in Taxpayer will remain with the members of Taxpayer, and thus members will continue to be the beneficial owners of the Common Stock. Section 1 of the Stock Transfer Agreement provides that a member agrees “to transfer legal title (and only legal title)” to its five shares of Common Stock to Association 1. It goes on to provide that:

> “<u>All economic incidents of ownership of such Shares</u>, as provided now and from time to time in Article Fourth of the Company’s Certificate of Incorporation and in Article VIII of the Company’s Bylaws and elsewhere in said Certificate of Incorporation or Bylaws <u>shall remain in Member-Transferor</u> for so long as Member-Transferor remains a member of Company. [Association 1] agrees to promptly pay over to Member-Transferor any amounts it may hereafter receive in any capacity with respect to the Shares.” (emphasis added).

The economic rights of the shares of Common Stock will remain limited as described above. The shares of Common Stock are not entitled to receive dividends. Holders of shares of Common Stock are not under any circumstances entitled to receive more than they originally paid for the shares ($5,000.00 per share). Moreover, Association 1 has agreed “to promptly pay over to Member-Transferor any amounts it may hereafter receive in any capacity with respect to the Shares,” thus preserving in the Taxpayer members their right to their original investment in Taxpayer.

Second, Association 1 will not have any patronage rights by reason of the transfer of the shares. Association 1 will not become (and it will not be eligible to become) a member, associate member or affiliate of Taxpayer by reason of the transfers of shares of Common Stock from members to Association 1. Association 1 will not be a patron of Taxpayer.

The current members, associate members and affiliates will continue to be the patrons of Taxpayer. As such, they (and not Association 1) will continue to be entitled to share on a patronage basis in earnings, retained earnings and residual assets of Taxpayer on dissolution. Section 4 of the Stock Transfer Agreement emphasizes that:

> "… no rights Member-Transferor enjoys by reason of its status as a member patron (or its historic status as a holder of shares of Common Stock/member) of the Company are being transferred or otherwise affected by virtue of the transfer of the Shares, including without limitation, Member-Transfer's patronage rights." (emphasis added).

Third, the members of Taxpayer will continue to control Taxpayer on a one-member, one-vote basis. As the record owner of the transferred shares of Common Stock, Association 1 will have the legal right to vote the shares. However, Association 1 has committed in the Stock Transfer Agreement and elsewhere to give each member (referred to in the Stock Transfer Agreement as "Member-Transferor") a proxy to vote the shares it transferred to Association 1:

> "As a condition of Member-Transferor's transfer of the Shares, [Association 1] will grant to Member-Transferor immediately following the Closing Date, and periodically thereafter so long as Member-Transferor continues as a member of the Company in accordance with the Company's Bylaws and such policies as the Company's Board of Directors may from time to time approve, a proxy to vote the Shares on any matter submitted for a vote of the stockholders, including any matters on which a vote of the stockholders is required under the [State A], the Company's Bylaws or the Company's Certificate of Incorporation." (emphasis added)

This grant of proxies ensures that Taxpayer will continue to be controlled by its member patrons on a one-member, one-vote basis, just as it is today.

This obligation to grant proxies contained in the Stock Transfer Agreement is backstopped by a provision being added to the Bylaws of Association 1, which provides:

> "Section 11. Voting of Shares in [Taxpayer]. During 2011, the Association entered into a transaction with the [Taxpayer] and the [Association 2] designed to bring about greater alignment among the three organizations (the 'Alignment Transaction'), pursuant to the terms of a consolidation agreement among the parties to the Alignment Transaction (the 'Consolidation Agreement'). As part of the Alignment Transaction, certain holders of shares of the Common Stock of [Taxpayer] agreed, subject to the terms of a stock transfer agreement executed by each such holder, [Taxpayer] and the Association, to transfer legal title to their shares of Common Stock to the Association, intending such transfer to take effect in accordance with the Consolidation Agreement and in furtherance of the

> objectives of the Alignment Transaction, but without relinquishing any of the economic incidents of ownership of such shares, as defined in Article Fourth of [Taxpayer]'s Amended and Restated Certificate of Incorporation, in Article VIII of [Taxpayer]'s Bylaws and in the stock transfer agreements (the 'Stock Transfer Agreements'). For so long as the Association is a shareholder of [Taxpayer], the Association shall, in advance of each annual or special meeting of [Taxpayer] stockholders, grant to each member of [Taxpayer] that transferred shares to the Association in connection with the Alignment Transaction or thereafter, a proxy to vote the five shares of Common Stock transferred to the Association by such member, entitling the member to a corresponding number of votes at such meeting on any matter on which a vote of the stockholders is required under the [State A], the Corporation's Bylaws or the Corporation's Certificate of Incorporation or on any other matter that may be submitted to the stockholders for a vote in accordance with the bylaws of [Taxpayer], and further entitling each such member to the right to approve, by the affirmative vote of a majority of such member, any amendment or repeal of this Section 11 prior to such amendment or repeal being presented for action in accordance with Article IX of these bylaws during the period in which the proxy held by such member is effective." (emphasis added).

Section 9 of the Stock Transfer Agreement provides for an automatic retransfer of the shares to members upon the occurrence of a variety of events, including, among other things, (i) the failure of Association 1 to grant a proxy to any member of Taxpayer to vote the shares the member transferred to Association 1 pursuant to a Stock Transfer Agreement, (ii) any actual or attempted vote of any of the shares by Association 1 itself at any Taxpayer stockholder meeting other than in accordance with a proxy granted by Association 1 pursuant to Section 3 of the Stock Transfer Agreement, (iii) any actual or attempted transfer of the shares, or (iv) "[a]ny change to the Company's Certificate of Incorporation, Bylaws or other governing documents that effects a change to the cooperative status of the Company pursuant to Section 1381(a)(2) of the code, or that affects the patronage rights of members, associate members and their affiliates, unless such change is duly adopted and approved" by the members.

The provisions outlining the composition of Taxpayer's Board of Directors after the Alignment Transaction are contained in Section 4.2 of the Bylaws. While persons that are not members (or representatives of members) will be eligible to serve on Taxpayer's Board of Directors, Taxpayer represents this arrangement is not unusual for cooperative organizations. What is important is that Taxpayer's members, and only Taxpayer's members, will remain the persons who will elect the members of Taxpayer's Board of Directors. In addition, members will continue to have the power to remove Directors. Bylaws, Article IV, Section 4.4.

One new provision in the Bylaws is the requirement that at least eight directors approve certain specified actions, namely:

"(a) the approval of candidates to serve as Directors, including those proposed to fill vacancies; (b) the selection or removal of the President; (c) the election of the Chairman and the Vice Chairman; and (d) the approval of each annual budget and any capital budget; and (e) the issuance or incurrence of any significant debt."

This provision was added to ensure that there be a consensus on important matters among the various constituencies served by the aligned entities. It was added not only to the Taxpayer Bylaws, but also to the organizational documents of Association 1 and Association 2.

Based on the foregoing, Taxpayer requests a ruling that after the Alignment Transaction described above, Taxpayer will continue to be a corporation "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the Code.

Section 1381(a)(2) of the Code provides that subchapter T shall apply to any corporation operating on a cooperative basis with certain exceptions. 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 such patrons. However, section 1381(a)(2) excepts from subchapter T an organization (A) which is exempt from tax under Chapter 1, (B) which is subject to the provisions of part II of subchapter H (relating to mutual savings banks, etc.), or subchapter L (relating to insurance companies), or (C), which is engaged in furnishing electric energy, or providing telephone service, or persons in rural areas.

What it means to be operating on a cooperative basis within the mean of subchapter T of the Code is not defined in the Code or the regulations. Rev. Rul. 93-21, 1993-1 C.B. 188, provides that the cooperative principles in Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), acq. 1966-1 C.B. 3, provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of subchapter T.

In Puget Sound Plywood, the Tax Court described three principles as fundamental to cooperative operation:

"(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 the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

> Implementation of the first of these three principles, relating to the subordination of capital contributions in determining the right to the pecuniary benefits, is effected through the statutes under which the cooperatives are organized, and also by the charters and bylaws of the cooperatives themselves—all of which contain limitations upon the amounts that may be distributed to members in respect of the stock which represents the necessary capital that the members themselves supply. Indeed in the case of many cooperatives, distributions in respect of the worker-members' stock are forbidden entirely. Also, implementation of the subordination of capital as regards control over the management and direction of the cooperative, is achieved through bylaw provisions which vest in the members themselves the right and power to elect the trustees and the officers of the cooperative.
>
> Implementation of the second of the above principles, relating to democratic control, is effected by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted; and these workers there deal personally with all problems affecting the conduct of the cooperative.
>
> And finally, the third of the above-mentioned principles of cooperatives, relating 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."

Taxpayer will continue to be a "corporation operating on a cooperative basis" after the Alignment Transaction. Thus, it will continue to be a subchapter T cooperative unless one of the exceptions listed in section 1381(a)(2) of the Code applies. Taxpayer represents that it does not currently, and after the Alignment Transaction it will not, fall in one of the exceptions listed in section 1381(a)(2) of the Code:

- Taxpayer is not and will not be exempt from tax under Chapter 1 of the Code.

- Taxpayer is not and will not be subject to the provisions of part II of subchapter H of the Code (relating to mutual savings banks, etc.). It is not involved in the banking business.

- Taxpayer is not and will not be engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

- Taxpayer is not and will not be a corporation subject to the provisions of subchapter L of the Code (relating to insurance companies). While Taxpayer provides, among other things, insurance services to members and affiliates, it does not act as an insurance company assuming risks as an insurer or reinsurer. Taxpayer provides insurance advisory services and acts as an insurance agent, but neither of those activities makes it an insurance company subject to the provision of subchapter L. Taxpayer does not itself write insurance or annuity contracts or reinsure the risks underwritten by insurance companies.

After the Alignment Transaction, Taxpayer will continue to be a corporation "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the Code. Each of the Puget Sound Plywood principles and its application to Taxpayer is considered in turn below. Taxpayer's Certificate of Incorporation and Bylaws provide that it "will be organized and operated on a cooperative basis for the benefit of the members, associate members and their affiliates as patrons and not as stockholders."

The first characteristic of a cooperative identified in Puget Sound Plywood is "subordination of capital." Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remains in the hands of the member 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 Plywood, 44 T.C. at 308. Stated differently, a cooperative may not be operated for the purpose of paying a return on equity investments.

Taxpayer has and will continue to have a single class of Common Stock. Shares of Common Stock are not entitled to dividends and are limited on dissolution. After the Alignment Transaction takes place, record ownership of all of the shares of Common Stock will be in the hands of Association 1. However, Association 1 will be required to give proxies to vote the shares to the members of Taxpayer, ensuring that the members of Taxpayer, and not Association 1, will continue to control Taxpayer. Should Association 1 fail for any reason to grant proxies, the shares will automatically be transferred back to the members of Taxpayer who transferred shares to Association 1, providing a firm backstop to the requirement that Association 1 grant proxies.

Taxpayer is authorized to issue shares of Preferred Stock, but there are no shares issued and outstanding. The Certificate of Incorporation and Bylaws provide that any Preferred Stock that Taxpayer might issue in the future will not bear dividends and will be nonvoting, and that upon dissolution, a holder of any shares of Preferred Stock will be limited to receipt of par value, and no more. Thus, any Preferred Stock that may be issued in the future will provide fixed and limited rights to share in earnings. For this reason, and given the fact that the shares of Preferred Stock will not be entitled to vote, the tests for determining that "capital is subordinated" will be met. Thus, both the Common Stock and Preferred Stock are subordinated to the interests of the members, associate member and affiliates.

The second characteristic of a cooperative identified in Puget Sound Plywood is "democratic control by the worker-members." Democratic control of the cooperative, as envisioned in Puget Sound Plywood, is typically achieved by voting on a one-member, one-vote basis. The only class of voting stock will be common stock, and each Member will own one (and only one) share of common stock. Thus, voting will be on a one-member one-vote basis. After the Alignment Transaction, Taxpayer will continue to be democratically controlled by its members.

While Association 1 will own all of the shares of Common Stock of Taxpayer, the members of Taxpayer will retain beneficial ownership of the limited economic rights of that stock. In addition, the Stock Transfer Agreements require Association 1 to grant to each member of Taxpayer transferring shares of Common Stock a proxy to vote the shares the member transfers. After granting such proxies, Association 1 will have no remaining votes. As a consequence, at any meeting of the stockholders, the members will have all of the votes, and, because each member will have transferred five shares of Common Stock to Association 1, each member's proxy will result in each member voting on a one-member, one-vote basis.

Article III, Section 3.8 and 3.10 of the Bylaws of Taxpayer expressly contemplate and authorize this arrangement:

> "Section 3.8. Transfer of Legal Title to Shares of Common Stock to [Association 1] During 2011, certain holders of shares of the Common Stock of the Corporation agreed, subject to the terms of a stock transfer agreement executed by each such holder, the Corporation and [Association 1], to transfer legal title to their shares of Common Stock to [Association 1], intending such transfer to take effect in accordance with the Consolidation Agreement and in furtherance of the objectives of the Alignment Transaction … Legal title to any share of Common Stock of the Corporation issued to new members pursuant to Section 2.2(b) shall transfer automatically to [Association 1] subject to terms and conditions substantially similar to those of the Stock Transfer Agreements."

> "Section 3.10. Proxies. It is expressly contemplated that [Association 1] shall at any time be entitled to a number of votes equal to the shares of Common Stock transferred to it in the manner described in Article III, Section 3.8, and that [Association 1] shall, in advance of each annual or special meeting of the stockholders, grant to each member of the Corporation that has transferred shares to [Association 1] a proxy to vote the five shares of Common Stock transferred to [Association 1] by such member entitling the member to a corresponding number of votes at that meeting on any matter on which a vote of the stockholders is required

> under [State A], the Corporation's Bylaws or the Corporation's Certificate of Incorporation or on any other matter that may be submitted to the stockholders for a vote, including without limitation the selection of the Corporation's Board of Directors, any amendment or restatement of the Corporation's Certificate of Incorporation or Bylaws, any sale of the Common Stock of the Corporation …, any merger or consolidation of the Corporation or any sale of all or substantially all of the Corporation's assets."

In connection with the Alignment Transaction, Association 1 has amended its Bylaws to require that proxies to vote the shares it will own in Taxpayer be granted to the members of Taxpayer. Any change to that Bylaw requires approval of the Taxpayer members entitled to receive proxies from Association 1.

Further, if, for any reason, Association 1 fails to grant proxies to any or all of the members who transferred shares to Association 1 or if Association 1 itself votes or attempts to vote any of the shares of Common Stock at a Taxpayer meeting, all of the shares of Common Stock will automatically be transferred back to the Taxpayer's members.

These procedures will leave control of Taxpayer in the hands of its members, thus ensuring that after the Alignment Transaction Taxpayer will continue to be democratically controlled by its members.

The Service has recognized that cooperatives may have proxy voting without jeopardizing cooperative status. Rev. Rul. 75-97, 1975-1 C.B. 167, holds that an exempt section 521 cooperative "will not be denied exemption solely by reason of … proxy voting." In Thwaites Terrace House Owners Corp. v. Commissioner, 72 T.C.M. 578 (1996), a housing cooperative was found to be "operating on a cooperative basis" notwithstanding that it permitted proxy voting. In so holding, the Tax Court cited Rev. Rul. 75-97.

The proxy arrangements provided for in the Association 1 and Taxpayer operative documents and in the Stock Transfer Agreements are designed to ensure that the members of Taxpayer continue to remain in control of Taxpayer and that they continue to vote on a one-member, one-vote basis. Thus, the democratic control requirement will continue to be met.

Rev. Rul. 93-21, 1993-1 CB 188, provides that a cooperative that operates on a for-profit, nonpatronage basis with nonmembers will not be precluded from being considered operating on a cooperative basis simply because it does less than 50 percent in value of its business with members on a patronage basis. Whether a corporation is operating on a cooperative basis under section 1381(a)(2) of the Code will be determined from all the facts and circumstances and the cooperative principles enunciated in Puget Sound Plywood.

Taxpayer is authorized to provide services to nonmembers on a nonpatronage basis. However, Taxpayer’s focus has historically been on business done with or for members and their affiliates. Business with nonmembers on a nonpatronage basis has been limited (less than percent of Taxpayer’s total business in recent years). Taxpayer represents that after the Alignment Transaction over 50 percent of its business will continue to be with members, associate members and affiliates and will be conducted on a patronage basis.

The third characteristic of a cooperative identified in Puget Sound Plywood is “the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor.” Consistent with that objective, the Certificate of Incorporation and Bylaws provide that members, associate members, and affiliates of Taxpayer will share the “fruits and increases from their cooperative endeavor” in the following manner:

- Each year Taxpayer will determine its net earnings or loss from business done with or for members, associate members and affiliates (its “patronage earnings”) and its net earnings or loss from other business (its “nonpatronage earnings”).

- Taxpayer will then allocate its patronage earnings among members, associate members and affiliates on a patronage basis, and it will distribute and pay the amounts so allocated within eight and one-half months after the end of the fiscal year as patronage dividends in cash, property and written notices of allocations (qualified or nonqualified), or any combination thereof, as the Board of Directors determines.

- Taxpayer will use any nonpatronage earnings to pay or provide for taxes. All or any portion of remaining nonpatronage earnings may, if the Board of Directors so determines, be allocated and distributed to members, associate members and affiliates in the same manner that patronage earnings are allocated. Amounts not so allocated and distributed will be added to unallocated reserves or surplus. While the amounts of nonpatronage earnings added to reserves or surplus may be “unallocated,” Taxpayer is required to apportion any unallocated reserves or surplus on the books on a patronage basis each year (or to maintain the records to do so) so that, if the amounts are later distributed, they will be shared on a patronage basis.

These provisions are contained in Article Fourth of Taxpayer’s Certificate of Incorporation and in Article VIII of Taxpayer’s Bylaws. In addition, Article Fourth (G) of Taxpayer’s Certificate of Incorporation provides that upon dissolution any residual assets will be shared by members, associate members and affiliates upon the basis of the quantity or value of business done with Taxpayer as shown by the records of Taxpayer. These provisions provide for a strict sharing of all earnings (not just patronage earnings) of Taxpayer on a cooperative basis, both currently and on dissolution. Thus, Taxpayer will be operating at cost.

In conclusion, after the Alignment Transaction, Taxpayer will continue to have all of the characteristics necessary for an organization to be "operating on a cooperative basis" as that term is used in section 1381(a)(2) of the Code. Taxpayer will operate at cost, its capital stock will be subordinated to the patronage interests of its members, associate members and affiliates, and it will be democratically controlled on a one-member, one-vote basis by its members. In addition, it will continue to do over half of its business with members, associate members, and affiliates on a patronage basis.

Accordingly, we rule as requested that after the Alignment Transaction, Taxpayer will continue to be a corporation "operating on a cooperative basis" within the meaning of section 1381(a)(2) 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 representative.

Sincerely yours,

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

cc: