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In Re:

Legend

Cooperative =

State A =

Dear :

This is in response to a request for a ruling dated February 11, 2014, submitted on behalf of Cooperative by your authorized representative. The ruling concerns the application of cooperative tax law to the transaction described below.

Cooperative is a rural telephone cooperative organized in the State A in . Since that time, it has provided telecommunication services to rural residents in its State A exchanges.

Cooperative has operated on a cooperative basis by returning net earnings to its patrons on a patronage basis. In , Cooperative applied for and received tax

exemption under I.R.C. § 501(c)(12). However, Cooperative lost its exempt status under 501(c)(12) and has been filing as a taxable cooperative.

Cooperative provides telecommunications services to rural customers in State A. Its services include telecommunications exchange and local access services, long distance services, internet services, video services, wireless communications, and telecommunications equipment sales.

Cooperative's management and board of directors identified internal and external pressures that required a change in the business model of providing telephone service to its customers. These pressures included shrinking plain-old telephone service (POTS) access lines and declining access minutes of use, as customers migrated to mobile cellular services. Competition from cellular providers within the exchange area, and the loss of POTS lines, required investment in new technologies for its customers, including additional spectrum to provide advanced mobile telecommunication services.

In _____, Cooperative purchased the spectrum at issue. At such time, Cooperative fully intended to use the spectrum in support of future telecommunication services to its members. Cooperative saw the next generation demand for communications services would be primarily wireless services.

In _____, Cooperative determined that the spectrum did not meet its strategic objectives. The spectrum had certain build-out requirements beginning in _____ for use of the spectrum. The cashflow and other management requirements to complete the build-out were not considered an effective use of Cooperative's resources. The build-out along with other considerations, listed below, led to the decision that the spectrum should be sold.

Cooperative was forced to sell the spectrum because of (i) unanticipated inadequacy of the spectrum, (ii) the onerous time constraints on the use of such spectrum, and (iii) the assessment that services provided over wireless spectrum require a much larger scale than what Cooperative was capable of providing. Specifically, Cooperative reviewed its business needs and determined that it had insufficient _____ Mhz spectrum (_____ Mhz) to provide over _____ Mbps fixed service to customers, and that speed would be less if a large number of customers were ultimately served.

In _____, Cooperative intends to sell its interest in the spectrum at issue to an unrelated third party. The third party is capable of providing the necessary wireless services to its cooperative members. The sale is pending FCC approval.

Based on the forgoing, Cooperative request a ruling that:

1. Cooperative's gain on sale of cellular-phone non-utilized spectrum, which was purchased for the purpose of meeting existing patrons' service demands and potentially expanding its cellular-phone service to new patrons of Cooperative, qualifies as patronage-sourced income.

Section 501(c)(12) of the Code contemplates that rural cooperative telephone companies may qualify as tax-exempt organizations. As the telephone business has developed, however, very few rural telephone cooperatives now qualify for this exemption; Cooperative falls into this category, and thus is a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, sections 1381-1388, provides the statutory scheme for taxing most cooperatives. Rural telephone cooperatives, however, are not governed by subchapter T, because of the exclusion provided by section 1381(a)(2)(C) for rural telephone cooperatives. When Congress enacted subchapter T in 1962, Congress excluded rural telephone cooperatives in order to avoid over-regulating them and, presumably, to provide them with more flexible tax treatment because of the necessary services they provided to under-served parts of the country. The underlying committee reports stated that cooperative corporations engaged in providing telephone service to persons in rural areas would continue to be treated the same as under prior law. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 113, 310 (1962); see also, Rev. Rul. 83-135, 1983-2 C.B. 149.

Sections 1382 and 1388 of subchapter T placed new restrictions on the ability of cooperatives to deduct patronage dividends that were allocated but not paid; in many other ways, however, subchapter T codified the law that existed prior to 1962. Since its enactment in 1962, most of the development in the law regarding the taxation of cooperatives has occurred in cases under subchapter T. Thus while the cases and rulings interpreting subchapter T may not control the taxation of rural telephone cooperatives such as Cooperative, these authorities indicate the position of the Service and the courts on many of the issues that do control the taxation of rural telephone cooperatives.

Cooperatives are a unique form of business entity, which are democratically controlled by their patrons. In cooperatives, each member has one vote regardless of how much capital he or she contributed. Cooperatives are required to allocate their net margins from business done with or for their patrons back to such patrons in proportion to their patronage. This return of patronage-sourced income is bound up with the basic concept of a cooperative. Rather than using their net income to pay dividends to their shareholders, as a regular corporation would, cooperatives pay patronage dividends to their members based on the amount of business that the member does with the cooperative. Patronage dividends are thus effectively price rebates for member-patrons. See CF Industries, Inc. v. Commissioner, 995 F.2d 101, 103 (7th Cir. 1993).

The taxable income of a cooperative is calculated in much the same manner as the taxable income of a taxable corporation, with one distinct difference: the income of a cooperative that is attributable to business done with or for patrons is excluded from or deducted from the income of the cooperative when such income is allocated to the cooperative's patrons. At the time this patronage-sourced income is allocated or (in the case of cooperatives not subject to subchapter T) at the time it is distributed, the cooperative's patrons realize the income. Patronage-sourced income flows through the cooperative and is taxed only once.

In order for the amount realized from the proposed sale of the spectrum to be deductible to Cooperative upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Cooperative's patrons. While neither the Code nor the regulations provide a clear definition of patronage-sourced income, the courts have, in general, held that if the income at issue is produced by a transaction which is directly related to the cooperative enterprise, such that the transaction facilitates the cooperative's marketing, purchasing or service activities, then the income is deemed to be patronage income. Farmland Industries v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (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)).

In Rev. Rul. 69-576, 1962-2 C.B. 166, the Service provided the following analysis of what it means for income to be patronage sourced:

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.

See also Rev. Rul. 74-160, 1974-1 C.B. 245 (ruling that interest income realized from loans made by the taxpayer was patronage source, because the loans "actually facilitated the accomplishment of taxpayer's cooperative activities, in that [the loans] enabled the taxpayer to obtain the necessary supplies for its operations.")

The sale of the spectrum by Cooperative will generate income for Cooperative.

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, 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.

Emphasizing the need to focus on the totality of the circumstances and to view the business environment to which the income producing transaction is related, the Tax Court analyzed the reasons behind both the organization of the subsidiaries and their eventual disposition, Id. at 864, 865. First, it looked at whether the taxpayer's subsidiaries were organized to perform functions related to its cooperative enterprises. The subsidiaries had been organized to explore for, produce, and transport crude oil. The court determined that all of the subsidiaries were organized to perform functions related to the taxpayer's business and were not mere passive investments. Id. at 871.

In other cases, the direct relationship between the purpose of a cooperative business and its reasons for investing in a subsidiary were found to be dispositive on the question of whether income received from the subsidiary was patronage sourced. For example, in Astoria Plywood Corp. v. United States, 43 A.F.T.R. 2d 79-816, 79-1 USTC ¶ 9197 (D. Or. 1979), the court found that the income derived by a plywood and veneer workers cooperative from the cancellation of a lease on a veneer plant was patronage sourced, because the production of veneer was an integral part of the cooperative's business. In other words, the reason the cooperative leased the property to begin with had nothing to do with investing in real estate and everything to do with making veneer. Similarly, in Linnton Plywood Assoc. v. United States, 410 F.Supp. 1100 (D. Or. 1976), the court held that the dividends received by a plywood workers cooperative from West Coast Adhesives, a glue supplier which the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income, since glue is essential for the manufacture of plywood, and the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

Cooperative's acquisition of the spectrum was directly related to its cooperative purpose of providing telecommunications services. Cooperative's sale of the spectrum is also directly related to its cooperative business purpose.

In CF Industries, Judge Posner noted in his opinion that the court was not aware of any dramatic opportunities for tax avoidance by use of the cooperative form. 995 F.2d at 104. However, the court implied that a cooperative would be gaining an unfair tax advantage for its members if it were investing in businesses unrelated to its cooperative purpose and in effect running a mutual fund for its members on the side.

Id. Judge Posner indicated that one type of transaction would not pass the mutual fund test: a temporary investment by a cooperative in securities. Id. Certainly, if Cooperative had taken its members capital and purchased a diversified portfolio of public company securities, there can be no doubt that the proceeds from such a portfolio should not and would not be patronage sourced. But Cooperative did nothing of this sort. It was an active participant in the purchase of the spectrum, which was directly related to its cooperative telecommunication services.

Accordingly based solely on the above, we rule that:

Cooperative's gain on sale of cellular-phone non-utilized spectrum, which was purchased for the purpose of meeting existing patrons' service demands and potentially expanding its cellular-phone service to new patrons of Cooperative, qualifies as patronage-sourced income.

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,

Nicole Cimino
Senior Technician Reviewer
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)