

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No. _____

Telephone Number: _____

Refer Reply To:
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Date: August 3, 2015

LEGEND:

Taxpayer =

b =

Dear _____:

This is in response to a request for rulings dated January 13, 2015, submitted by your authorized representatives.

Taxpayer is a taxable wholesale distributor of grocery products to individual retail grocery operators that operates on a cooperative basis, subject to Subchapter T of the Internal Revenue Code. Taxpayer's business is almost exclusively done with its cooperative members. In accordance with its bylaws, Taxpayer is annually obligated to distribute its patronage earnings to its member/patrons. Historically, Taxpayer has paid approximately _____ percent of its patronage dividend in the form of cash, with the remainder being paid in the form of a qualified written notices of allocation, within the meaning of section 1388(c)(1).

Historically, Taxpayer purchased b for sale to its members as part of Taxpayer's patronage business activities. In _____, Taxpayer filed a lawsuit against b producers and related parties for _____ regarding Taxpayer b purchases that occurred from _____ through _____ (the "litigation period"). During the litigation period, Taxpayer purchased approximately \$ _____ million of b.

In _____, Taxpayer entered into separate settlement agreements with individual defendants and groups of defendants. In each settlement agreement, the defendant paid or agreed to pay an agreed amount in settlement of any and all claims made in the litigation and any potential claims related to, arising out of, based upon, or in any way concerning the facts, matters, occurrences, allegations, transactions, conduct alleged, or subject matter of the litigation. In aggregate, Taxpayer received approximately \$ _____ million settlement proceeds in settlement of the lawsuit.

Settlement proceeds do not exceed the amount of Taxpayer's claimed damages. In fact, in the case of some of the defendants, the amount paid in the settlement was reflective of the defendant's distressed financial condition.

Section 3(a) of Article IX of Taxpayer's bylaws provides that Taxpayer is required to annually distribute as patronage dividends an amount equal to Taxpayer's net patronage sourced earnings. Although Taxpayer's bylaws allow Taxpayer to maintain and allocate among pools, Taxpayer historically has maintained all of its patronage business in a single patronage pool. The bylaws provide that Taxpayer is to distribute its patronage dividend "in proportion to the quantity of business done with such patron during such fiscal year."

The gross receipt of the \$ _____ million settlement proceeds is a significant amount to Taxpayer and its patrons. Although the litigation was funded by the overall membership, the settlement proceeds are directly attributable to overpriced b, the cost of which was borne directly by Taxpayer's patrons who purchased b over the year time period.

Taxpayer's board determined that in order to fairly allocate the portion of its patronage dividend attributable to the settlement proceeds, a portion (approximately _____ percent) should be allocated in Taxpayer's general patronage pool and the remainder (approximately _____ percent) should be allocated to Taxpayer's patrons who purchased b during the litigation period. In addition, with respect to the portion to be allocated to the b patrons, Taxpayer's board believes that the allocation should take into account patronage of the b patrons over the applicable time period.

Although Taxpayer's historic bylaws allowed the utilization of various pools, Taxpayer's historic bylaws provided that any allocation of the patronage dividend was to be based upon current year quantity of business done. The historic bylaws failed to authorize an allocation based upon either (i) the value of the business done with of for the patron, or (ii) the quantity of business done for more than the current year. In order to grant Taxpayer the flexibility to allocate the portion of Taxpayer's patronage dividend attributable to the settlement proceeds, Taxpayer amended its bylaws prior to the end of _____ to allow the board flexibility in the allocation of the patronage dividend with respect to the b settlement proceeds and similar circumstances. Section 3(a) of Article IX of the bylaws was amended to add paragraph (ii), which provides as follows:

(ii) In the event the Corporation realizes net earnings from an extraordinary event or transaction with respect to which the patronage sourced earnings are attributable to the current year and/or prior years ("Extraordinary Event") and a determination is made by the Board of Directors to be appropriate under the particular circumstances, the Board of Directors may distribute the Patronage with respect to the Extraordinary Event among the patrons based upon (A) the value of the business done by the respective patrons with the Corporation ("Value Based") (as opposed to Quantity Based), (B) distribute based on Quantity Based or (C) distribute based on a combination of Quantity Based and Value Based, as the Board determines appropriate. The Board of Directors may take into account applicable business conducted prior to the then current fiscal year, if appropriate.

As defined, the patronage attributable to the settlement proceeds would constitute an Extraordinary Event. Under Section 3(a)(ii) of Article IX of the bylaws, Taxpayer's board would determine the appropriate portion to be allocated pursuant to such Section 3(a)(ii). As determined by Taxpayer's board, the portion allocated under Section 3(a)(ii) would be based upon either the quantity or value of business done (which would take into account the past patronage during the litigation period) or a combination of the two.

Under Taxpayer's bylaws, Taxpayer only distributes patronage to its members. Although Taxpayer's membership has generally remained fairly stable, changes in membership have occurred from the beginning of the litigation period through the present. To the extent that a portion of the settlement proceeds are attributable to former patrons, for whom Taxpayer has no obligation to distribute such amounts as patronage dividends, Taxpayer intends to retain such amount and treat such amount as non-patronage income.

On the basis of the foregoing information, Taxpayer requests the following rulings:

1. The settlement proceeds constitute patronage sourced income pursuant to section 1388(a).
2. Pursuant to Section 3(a)(ii) of Article IX of its bylaws, Taxpayer may allocate among its members a portion of the patronage dividends attributable to the settlement proceeds to the general pool (based upon current year patronage) and the remainder to the members (the "b Members") that purchased b during the litigation period (based either upon the value of the business done by the b Members (taking into account the business done during the litigation period) or the quantity of the business

done by the b Members (taking into account the quantity of business done during the litigation period).

Taxpayer, as a cooperative, is obligated to annually pay patronage dividends to its patrons on the business done with or for its members. Taxpayer pays the patronage dividend through a combination of cash and qualified written notices of allocation, which are currently deductible in determining Taxpayer's taxable income in accordance with section 1382(b). The settlement proceeds constitute patronage dividends because they are directly related to Taxpayer's patronage business activity with its patrons.

Section 1388(a), in relevant part, provides that for purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of subchapter T applies: (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. The term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions

As to the initial requested ruling, the focus of the analysis is whether the settlement proceeds are attributable to "net earnings of the organization from business done with or for its patrons."

Neither the Code nor the regulations promulgated thereunder defines business "done with or for" patrons. However, Reg. § 1.1382-3(c)(2) provides that:

the term "income derived from sources other than patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

In Rev. Rul.69-576, 1969-2 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 on 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 necessary supplies for its operations").

The settlement proceeds are with respect to damages incurred by Taxpayer for excessive prices paid on b purchased by Taxpayer and resold by Taxpayer to its b Members. Thus, the settlement proceeds are attributable to the b purchases that Taxpayer made in order to supply its patrons. Pursuant to section 1388(a) and the rulings cited above, the settlement proceeds directly relate to Taxpayer's purchase of products sold as part of its cooperative business and are not incidental income to Taxpayer's operation. Taxpayer's purchases of b to service its members led to Taxpayer's filing of the lawsuit and receipt of the settlement proceeds. Therefore, the settlement proceeds constitute patronage sourced income that is directly related to and facilitative of Taxpayer's cooperative operation and not incidental to Taxpayer's cooperative operations.

Taxpayer will only be allocating and paying a patronage dividend to its current members. Thus, if and to the extent that a portion of the settlement proceeds are attributable to the business done with or for former b Members to whom no patronage dividend will be paid, such portion of the settlement proceeds will not be distributed to the b Members. Instead, Taxpayer will report such amounts in its computation of its taxable income.

Under Section 3(a) of Article IX of Taxpayer's historic bylaws, Taxpayer is required to allocate and distribute as a patronage dividend its income attributable to the settlement proceeds. Although Taxpayer's historic bylaws allowed Taxpayer to create multiple patronage pools, Taxpayer has historically only utilized one pool. Under Taxpayer's historic bylaws, all patronage dividends are to be allocated among Taxpayer's members based upon the quantity of business done by Taxpayer's members in the most recent year.

Section 1388(a)(1) provides that a patronage dividend may be allocated and paid "on the basis of quantity or value of business done with or for such patron." Taxpayer's historic bylaws limited Taxpayer's board to allocating Taxpayer's patronage dividend among its members based upon the relative quantity of business done by Taxpayer with or for such members. Under the newly adopted provisions of Section 3(a)(ii) of Article IX of the Taxpayer bylaws, the Board is allowed to allocate the portion of Taxpayer's patronage dividend attributable to an Extraordinary Event either based upon value or

based upon quantity, or a combination of both. In any of the three methods, the board may take into account patronage activity that occurs prior to the most recent year.

In the context of the patronage dividend attributable to the settlement proceeds, the value of business done by a particular b Member relates to the business that such member did with Taxpayer during the litigation period, as opposed to the business the b Member did with Taxpayer in the most recent year. Thus, under an allocation based upon the value of business done, the board will take into account the business transacted during the litigation period.

If the board determines to allocate the patronage based upon quantity, the Taxpayer board will take into account the b Members' patronage during the litigation period. Such allocation is most consistent with the economic realization of the income attributable to the settlement proceeds. The Service has approved of taking into account past patronage in allocating a cooperative's patronage dividend among its patrons. In Revenue Ruling 74-84, 1974-1 C.B. 244, a cooperative recognized income from depreciation recapture. After confirming that such income as patronage sourced income, the Service approved the allocation of the patronage dividend attributable to the depreciation recapture over the period in which the depreciation was claimed, thereby tracing the depreciation recapture income to the years in which tax depreciation was claimed in excess of the economic depreciation. Accordingly, Taxpayer board's allocation of the patronage dividend based upon the b Members' patronage during the litigation period would be appropriate.

In accordance with section 1388(a)(2), in order for an amount putatively paid as a patronage dividend to be deductible as a patronage dividend, the amount must be paid under a preexisting legal obligation. Section 1.1388-1(a)(1) provides that:

For the purpose of subdivision (ii) of this subparagraph, amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment.

The legal obligation must exist at the time when the participating member patrons transact their business with the cooperative, and not pursuant to an obligation created after the allocated amount was earned. See Pomeroy Cooperative Grain Company v. Commissioner, 31 T.C. No. 674 (Dec. 31, 1958).

Taxpayer's bylaws (both before and after the recent amendment through the addition of Section 3(a)(ii)) create a preexisting legal obligation. Taxpayer is obligated to distribute to its patrons all of its net earnings from the business done with or for its members. This obligation has existed throughout Taxpayer's operation as a cooperative. Thus, Taxpayer's legal obligation has existed throughout the period that

Taxpayer realized and recognized the income attributable to the settlement proceeds. Taxpayer's preexisting legal obligation is not altered by Taxpayer board's discretion to utilize different pools in its allocation of its patronage dividends among its members.

Likewise, the additional discretion granted to Taxpayer's board as to the method to allocate its patronage dividend among its members pursuant to the newly adopted provisions of section 3(a)(ii) of Article IX of Taxpayer's bylaws does not alter or affect Taxpayer's preexisting legal obligation – it simply allows Taxpayer the discretion to allocate the patronage dividend among the members under a different approved method under section 1388(a). Given the unusual circumstances involved with the nature of the income related to the settlement proceeds, in that the settlement proceeds represent income attributable to improper overcharges imposed on Taxpayer over a year time period that ended _____ years prior to the year of the receipt, the exercise of the board's discretion in accordance with Taxpayer's bylaws is the appropriate allocation of the patronage dividend. In addition, the exercise of discretion does not undermine Taxpayer's preexisting legal obligation to pay its members the patronage dividend, it only allows Taxpayer to allocate that patronage dividend to the members that should receive such patronage dividend.

The courts have recognized the key aspect of a cooperative, its board and its membership in determining the appropriate allocation of patronage dividends among the membership. In Kingfisher Coop. Elevator Assoc. v. Commissioner, 84 T.C. 600, 613-14 (1995), Taxpayer, a subchapter T agricultural cooperative, was allocated patronage dividends from several cooperatives in which it was a member. The dividends received related to fiscal years other than the fiscal year in which Taxpayer reported such income. Instead of determining that the dividend be allocated precisely in proportion to the patronage that generated them, the Taxpayer's Board of Directors employed an accounting method that allocated all of the dividends based upon the patronage in the year in which the dividends were taxable to it. The Service contended that the Taxpayer should allocate its patronage to its members based upon the years to which the patronage dividends received by Kingfisher related. The Tax Court agreed with Taxpayer, stating that "the allocation method chosen by its democratically elected Board of Directors, ratified annually and employed consistently for many years, was equitable and reasonable." Kingfisher, 84 T.C. at 614. Noting that a board of director's "weighing of the equity should be overturned by this Court only when the exercise of that discretion appears to have been unreasonable," the Tax Court held that the government's proposed reallocation was not superior to Taxpayer's, particularly when it appeared that Taxpayer's "directors made a concerted effort to ensure that all members were treated fairly." *Id.* at 617-18.

The proposed allocation by Taxpayer's board under its recently adopted Section 3(a)(ii) of Article IX of its bylaws represents the concerted effort of Taxpayer's board to ensure that all members are treated fairly. The split of the settlement proceeds is necessary to be fair, based upon the historic treatment of prior and significantly smaller

settlement receipts and the fact that the overall membership provided support to the litigation and the fact that the b Members disproportionately suffered from the price fixing that gave rise to the settlement proceeds.

Based on the foregoing, Taxpayer may allocate the settlement proceeds pursuant to the recently adopted bylaw amendment and such allocation and distribution of funds constitute a deductible patronage dividend under section 1382(b).

Accordingly, based solely on the foregoing, we rule that:

1. The Settlement Proceeds constitute patronage sourced income pursuant to section 1388(a).
2. Pursuant to Section 3(a)(ii) of Article IX of its bylaws, Taxpayer may allocate among its members a portion of the patronage dividends attributable to the settlement proceeds to the general pool (based upon current year patronage) and the remainder to the b Members that purchased b during the litigation period (based either upon the value of the business done by the b Members (taking into account the business done during the litigation period) or the quantity of the business done by the b Members (taking into account the quantity of business done during the litigation period)).

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. 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 R. CIMINO
Senior Technician Reviewer Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)