



Entities that provide regulated services, like telephone services, create subsidiaries to hold nonregulated assets in an effort to comply with federal, state, and local regulations. The separation of regulated and nonregulated assets by the creation of subsidiaries assists telecommunications cooperatives in complying with such regulations.

On or before Year 1, 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 telecommunications services.

In Year 1, Cooperative, through Sub 1, purchased the additional spectrum. Sub 2 used the spectrum to provide wireless service to Cooperative members. Sub 1 received compensation from Sub 2 for use of the spectrum.

Cooperative eventually determined that the spectrum did not meet its long-term objectives because of unanticipated inadequacy of the spectrum together with fiber options that had substantial bandwidth capacity that would be more consistent with its strategic goals.

In Year 2, Sub 1 sold the spectrum to an unrelated third party. This private letter ruling request concerns the treatment of the gain arising from the sale of the spectrum.

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, including Cooperative, qualify for this exemption. Therefore, Cooperative 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 to avoid overregulating them and, presumably, to provide them with more flexible tax treatment because of the necessary services they provided to underserved 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, 87<sup>th</sup> Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87<sup>th</sup> 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. While the cases and rulings interpreting subchapter T may not control the taxation of rural telephone cooperatives, 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 their 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 business 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 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 by Cooperative upon allocation, the amount must be patronage-sourced income, *i.e.*, income derived from business done 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. See Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), *acq.*, AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 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.”)

Rev. Rul. 83-135, 1983-2 C.B. 149 provides that a taxable cooperative not subject to the provisions of subchapter T of the Code may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws.

The sale of the spectrum by Sub 1 will generate income for Cooperative.

Cooperative purchased the spectrum through Sub 1 to insure that telecommunication services would be available to Cooperative’s customers.

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 a transaction that 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 864-65. 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 Tax 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 that the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income because glue is essential for the manufacture of plywood and because the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

Cooperative's purchase of the spectrum through Sub 1 was directly related to its cooperative business. Investing in a company in order to provide wireless telephone service is directly related to the business of a rural cooperative telephone company whose "reason for existence" is to provide telephone service to its patrons. Cooperative's sale of the spectrum through Sub 1 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. Rather Cooperative through Sub 1 purchased the spectrum for the purpose of providing its patrons with advanced telecommunication services.

Accordingly based on the facts submitted and the representations made, we rule that:

1. Taxpayer Group's gain on the sale by Sub 1 of the spectrum, which was purchased for the purpose of meeting existing patron's service demands and potentially expanding service to new patrons of Cooperative, qualifies as patronage-sourced income.

2. Taxpayer Group's gain on the sale of the spectrum, which was purchased and sold by Sub 1 in furtherance of Cooperative's cooperative function, is patronage sourced income, and, therefore, excludable under cooperative tax laws applicable to taxable rural telephone cooperatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

THERESA M. MELCHIORRE  
Assistant to the Branch Chief, Branch 5  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosure:  
Copy of this letter for § 6110 purposes