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April 05, 2023

Re:

Legend

Taxpayer =

Consolidated Subsidiary A =

Consolidated Subsidiary B =

Consolidated Subsidiary C =

Partnership =

Entity A =

Entity B =

State A =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

Dear :

This is in response to a letter dated September 28, 2022, on behalf of Taxpayer by your authorized representative requesting a ruling on the transaction described below.

Taxpayer is a rural telephone cooperative that was incorporated in a, under State A statutes. Taxpayer operates on a cooperative basis and was formed to bring telephone service to rural regions of State A. Taxpayer's Bylaws require it to allocate

patronage earnings among its patrons on a patronage basis. Taxpayer considers a customer as any other entity with which the Taxpayer does business on a nonpatronage basis.

Taxpayer was previously granted exemption as a rural telephone cooperative under section 501(c)(12) of the Internal Revenue Code (Code). At some point in its history, Taxpayer was no longer able to satisfy the requirement that it derive 85 percent or more of its income from members as required by the Code. As a result, Taxpayer now operates as a taxable cooperative corporation.

Taxpayer is the parent and agent of an affiliated group that files a consolidated federal income tax return using a December 31 year end and the accrual method of accounting. Taxpayer wholly owns Consolidated Subsidiary A. Prior to b, Consolidated Subsidiary A wholly owned Consolidated Subsidiary B. Effective b, Consolidated Subsidiary B merged into Consolidated Subsidiary A, with Consolidated Subsidiary A as the surviving corporation. At the time of this merger, Consolidated Subsidiary B owned c percent of the partnership interests in Partnership, and an unrelated party owned the remaining d percent of the partnership interests in Partnership.

Consolidated Subsidiary A was Taxpayer's sole subsidiary from e through f. On the day after f, Consolidated Subsidiary C was formed as a wholly owned subsidiary of Consolidated Subsidiary A. On g, Consolidated Subsidiary C acquired the d percent minority partnership interest in Partnership from the unrelated party that owned it. As a result, effective g, Taxpayer owned h percent of the partnership interests in Partnership through its ownership of Consolidated Subsidiary A, which directly owned c percent of Partnership, and its ownership of Consolidated Subsidiary C, which directly owned the remaining d percent of Partnership.

As the result of transactions occurring on i and j, substantially all assets of Partnership, including related wireless licenses and equipment held by Consolidated Subsidiary A that were used in Partnership's business, were sold to unrelated parties.

Taxpayer owns, operates, and maintains a fiber optic communications system in rural regions of State A, that it uses to provide state-of-the-art telecommunications services to homes and businesses in the rural communities it serves. Taxpayer's services include telecommunications exchange and local access services, long distance services, internet services, video services, wireless communications, and telecommunication equipment sales. Taxpayer provides these services to its patrons and to customers with which the Taxpayer does business on a nonpatronage basis. As a provider of telecommunication services, Taxpayer is subject to federal, state, and local regulations. To assist Taxpayer in complying with applicable regulations, Consolidated Subsidiary A holds nonregulated telecommunication assets for the benefit of Taxpayer and in furtherance of Taxpayer's telecommunication services.

In k, four telecommunication companies, including Taxpayer, formed Partnership to serve rural State A communities. Partnership was formed to build a cellular network and provide cellular telecommunication services and equipment to patrons and customers with which the Taxpayer does business on a nonpatronage basis in rural areas in State A. The pooling of resources in Partnership enabled the four partners to: 1) raise necessary capital to be awarded a cellular license, 2) share costs of developing, operating, and maintaining a cellular network in rural regions of State A, 3) leverage the partners' combined purchasing power to get more favorable pricing terms on roaming and telecommunications equipment for their patrons and non-patron customers, 4) improve the quality, reliability, and affordability of the cellular services offered in their respective service areas, and 5) develop new revenue generating services and products using state-of-the-art technology, among other things.

When Partnership was formed in k, Consolidated Subsidiary B and the other three partners in Partnership, each acquired a d percent partnership interest in Partnership. In l, Consolidated Subsidiary B purchased the partnership interests of two other partners, increasing its ownership to c percent of Partnership. The remaining d percent partnership interest in Partnership was owned by Entity A, a wholly owned subsidiary of Entity B.

In m, Consolidated Subsidiary A and Entity A decided to end their partnership due to differences of opinion on operational matters. On n, Consolidated Subsidiary A and Entity A entered into a purchase and sale agreement, whereby Entity A agreed to sell its d percent partnership interest in Partnership to Consolidated Subsidiary C for an all-cash purchase price. The sale closed on g. Following the sale, Taxpayer owned h percent of Partnership through its ownership of Consolidated Subsidiary A, which directly owned c percent of Partnership, and its ownership of Consolidated Subsidiary C, which directly owned the remaining d percent of Partnership.

During its existence, Partnership constructed and operated a wireless network in rural regions of State A that grew to include telecommunications towers and related wireless equipment and facilities at various other cellular service sites. Partnership also operated retail stores. Taxpayer used the wireless network and retail stores to provide cutting-edge wireless communication services and equipment to its patrons and to customers with which the Taxpayer does business on a nonpatronage basis in its service areas at competitive prices.

In o, Taxpayer decided to exit the wireless business conducted through Partnership and focus on its services delivered through fiber optic cable. This decision was based on the belief that Taxpayer could not effectively compete with other major wireless carriers. As a result, Taxpayer decided to divest Partnership's wireless business by selling substantially all of Partnership's assets, including the wireless licenses and equipment held by Consolidated Subsidiary A that Partnership used in its business.

To effectuate the divestiture, four sale agreements were entered into with three unrelated buyers. Following regulatory approval, the sale agreements were executed on i and j. Taxpayer is using the proceeds from these divestiture transactions to build out its fiber optic local exchange networks, to improve fiber-delivered services to its patrons and other customers, and to focus on its core mission of bringing state-of-the-art telecommunications services to businesses and residents in the rural communities it serves.

Based on the foregoing, Taxpayer requests a ruling that:

1. Consolidated Subsidiary A's distributive share of partnership income from Partnership's sale of substantially all its assets resulting from three separate divestiture transactions, constitutes patronage-sourced income and, if properly allocated to Taxpayer's patrons, is excludable from Taxpayer's consolidated gross income in the tax year of the sale.

2. Consolidated Subsidiary C's distributive share of partnership income from Partnership's sale of substantially all its assets resulting from a singular divestiture transaction, constitutes patronage-sourced income and, if properly allocated to Taxpayer's patrons, is excludable from Cooperative's consolidated gross income in the tax year of the sale.

In the event a rural telephone cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) no longer applies until such time as the cooperative again satisfies the requirements for exemption. During any taxable period, the rules applicable to the telephone cooperative depend on the reasons why it failed its exemption test. If exemption was lost because the company failed to operate on a cooperative basis, then it will be taxed under the same rules applicable to for-profit corporations. Alternatively, if the cooperative becomes taxable because it failed the so-called 85-percent-income test imposed by section 501(c)(12), then the organization will be taxed as a cooperative.

While the requirements of subchapter C of the Code regarding corporate distributions and adjustments and other provisions are generally applicable to nonexempt cooperatives, these entities are distinguished from other types of corporations by a specific body of tax law. The scheme of taxation for nonexempt cooperatives was developed from the administrative pronouncements of the Service and decision of the judiciary over a fifty-year period. These rules for tax treatment of most nonexempt cooperatives and their patrons were finally codified with the enactment Subchapter T of the Code as part of the Revenue Act of 1962. Pub. L. No. 87-834 (H.R. 10650).

With passage of Subchapter T, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative's patrons were defined. However, section 1381(a)(2)(C) of the Code states that Subchapter T is not applicable to an organization engaged in furnishing electric energy, or providing

telephone service to persons in rural areas. According to the Senate Finance Committee Report accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under “present law.”

In its report accompanying the legislation, the Senate Finance Committee described “present law” as follows:

> “Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only if they are paid during the taxable year in which the patronage occurred or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted).” S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

Under this earlier body of tax law applicable to nonexempt telephone cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to their members/patrons. Further, under pre-1962 cooperative rules, the term “paid” means paid in cash or paid by notice of allocation. See also Rev. Rul. 83-135, 1983-2 C.B. 149 (A taxable cooperative not subject to the provisions of subchapter T may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws).

While Subchapter T does not control the taxation of nonexempt telephone cooperatives, its foundations rest upon pre-1962 cooperative tax law. As a result, there are certain basic parallels between the tax treatment of nonexempt utility cooperatives and treatment of other cooperative organizations under Subchapter T. Therefore, to extent that Subchapter T reflects cooperative taxation as it existed prior to 1962, it is in instructive resolving certain issues facing rural telephone cooperatives. This is because Congress stated that in enacting Subchapter T it was merely codifying the long common law history of cooperative taxation (with the exception of ensuring at least one annual level of tax at the cooperative or patron level. See S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962)) and, arguably, the case law post-enactment is merely a continuation and refinement of the pre-enactment common law. This is particularly true with respect to defining certain terms such as “operating on a cooperative basis” and “patronage income.”

Perhaps the most succinct definition of the term “cooperative” for Federal income tax purposes was provided by the U.S. Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3. The Tax Court said:

> “Under the cooperative association form or organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and

> then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as coworkers, in proportion to the amounts of their active participation in the cooperative undertaking."

The Tax Court went on to describe three guiding principles at the core of economic cooperative theory as:

> "(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 allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members active participation in the cooperative endeavor." 44 T.C. at 308.

The mechanism by which telephone cooperatives achieve operation at cost is the patronage dividend (or capital credit). Since the payment of patronage dividends (and operation at cost) is so critical to achieving cooperative status as defined by *Puget Sound*, it is important to analyze this issue.

Rural telephone cooperatives perform a final accounting at year-end to determine the net margin derived from their members' patronage during the course of the year. Then, the excess over cost collected from members is returned to them by a capital credit allocation based on each member's patronage. Those capital credits are typically "paid" by allocations of capital credit certificates or notices of allocation, rather than in cash. The capital credits retained form the foundation for the organization's equity capital.

A true patronage dividend that may be excluded from the income of a rural telephone cooperative must meet the three tests set forth in *Farmers Cooperative Co. v. Birmingham*, 86 F.Supp. 201 (N.D. Ia. 1949), and *Pomeroy Cooperative Grain Co. v. Commissioner*, 31 T.C. 674 (1958), *acq.*, AOD 1959-2 C.B. 6. Those tests are:

1. It must be made subject to a preexisting legal obligation;

2. the allocation must be made on the basis of patronage; and

3. the margins allocated must be derived from the profits generated from patrons' dealings with the cooperative.

Although the Code does not provide specific guidance as to what constitutes patronage-sourced income for a nonexempt telephone cooperative, regulations and rulings address the issues for cooperatives governed by Subchapter T. While not

directly applicable to taxable utility cooperatives per se, arguably they reflect the correct analysis with respect patronage income of cooperatives subject to pre-1962 law.

The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax “ordinary” (i.e., non-farmer) cooperatives for:

> “non-operating income…not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis.” S. Rep. No. 781, 82d Cong. 1st Sess. (1951).

In response to that guidance of Congress, the Service promulgated regulations distinguishing nonpatronage income from that which is patronage derived.

Section 1388(a) of the Code defines the term “patronage dividend” as an amount paid to a patron (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. Such 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. The (B) exception is further explained under Section 1.1388-1(a)(2)(ii) of the Income Tax Regulations:

> “An amount paid to a patron by a cooperative organization to the extent that such amount is paid 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. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.”

In Rev. Rul. 69-576, 1962-2 C.B. 166, the taxpayer (a nonexempt farmers' cooperative) borrowed money from a bank for cooperatives to finance the acquisition of agricultural supplies for resale to its members. At the close of the taxable year for the bank, the bank determined its net earnings, which it then allocated to its patrons, including the nonexempt farmers' cooperative, on a patronage basis. The patronage allocations were based on the proportion of the total interest paid to it by each cooperative during the taxable year. The nonexempt farmers' cooperative included the patronage allocations received by it from the bank for cooperatives in its gross income

for the taxable year received under section 1385 of the Code. Under a preexisting obligation the nonexempt farmers' cooperative then allocated and paid the same amount it received from the bank for cooperatives to its own patrons. The Rev. Rul. held that the allocation and payment of the amount by the nonexempt farmer's cooperative to its own patrons qualified as a patronage dividend. The Rev. Rul. stated that: "The classification of an item as from either patronage or non-patronage 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 servicing activities, the income is from patronage sources."

In Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03, 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, along with the income from the sale of its gas and soybean facilities, and miscellaneous depreciable business assets classified as patronage source. In articulating the "directly related" test for making the determination, the Court provides 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. On the other hand, if the income is derived from a transaction that has no integral and necessary linkage to the cooperative enterprise, such that it may fairly be said that the income is merely incidental to the cooperative enterprise and does nothing more than add to the overall profitability of the cooperative, then the income is deemed to be nonpatronage income. The determination of whether income derived from a transaction that is directly related to the cooperative enterprise, and, thus, is patronage income is a determination that is necessarily fact intensive. In considering the relatedness of the income-producing transaction to the cooperative enterprise, it is important to focus on the "totality of the circumstances" and to view the business environment to which the income-producing transaction is related and not to view the transaction so narrowly as to limit it only to its income-generating characteristic when such a characterization is not consistent with the actual activity. The Court ruled that the sale of cooperative's assets met the directly related test and therefore the resultant gains and losses were patronage sourced.

Section 1.1388-1(e) defines patron to include any person with whom or for whom the cooperative association does business on a cooperative basis.

Based on consideration of Taxpayer's representations, since Consolidated Subsidiary A and Consolidated Subsidiary C were used for the purpose of securing cellular service for Taxpayer's patrons, income from these investments satisfies the directly related test.

Accordingly, the portion of Taxpayer's income that is allocable to Taxpayer's patrons' use of Consolidated Subsidiary A's and Consolidated Subsidiary C's networks

is directly related to securing cellular service for Taxpayer's patrons and is patronage sourced income, which may be excluded from Taxpayer's income if properly allocated to Taxpayer's patrons.

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.

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.

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

In accordance with the power of attorney submitted with the ruling request, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

Associate Chief Counsel
(Passthroughs & Special Industries)

By: *James Holmes*
James A. Holmes
Senior Counsel, Branch 5
Office of Associate Chief Counsel
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Enclosure
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cc: