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Person To Contact:
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Telephone Number:

In Re:

Refer Reply To:
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PLR-103329-21
Date:
December 22, 2025

LEGEND

Cooperative =

Sub =

Z =

P =

Buyer =

Area =

Date 1 =

Date 2 =

Dear :

This letter responds to a request for a private letter ruling, dated Date 1, and subsequent correspondence, submitted on behalf of Cooperative by its authorized representatives, regarding the application of cooperative tax law to the transaction described below.

FACTS

Cooperative is a rural telephone cooperative corporation operating on a cooperative basis. Cooperative's bylaws require it to allocate patronage earnings among its patrons on a patronage basis.

Section 501(c)(12) of the Code contemplates that rural telephone cooperatives 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 taxable cooperative corporation.

Cooperative is the parent of an affiliated group that files a consolidated federal income tax return using a December 31 year end and the accrual method of accounting. Cooperative owns all the stock of Sub.

Cooperative provides telecommunications services to its members (patrons) and to nonmember customers in the rural area it serves, including telecommunications exchange and local access services, long distance services, internet services, video services, wireless communications, and telecommunications equipment sales. As a provider of telecommunications services, Cooperative is subject to federal, state, and local regulations. To assist Cooperative in complying with applicable regulations, Sub holds nonregulated telecommunications assets for the benefit of Cooperative and in furtherance of Cooperative's telecommunications services.

Prior to Date 2, Sub owned a Z percent partnership interest in P, a partnership for federal income tax purposes. Prior to Date 2, P owned, operated, and maintained a cellular network and provided cellular telecommunications services in Area. Prior to Date 2, Cooperative used P's cellular network to provide cellular telecommunication services to its patrons and other customers in the rural area it serves.

On Date 2, Sub sold its Z percent partnership interest in P to Buyer, and P dissolved. Cooperative will use the sale proceeds to build out its local exchange networks, improve services to its patrons and other customers, and focus on its core mission of bringing state of the art telecommunications services to businesses and residents in the rural area it serves.

RULING REQUESTED

Cooperative requests a ruling that the portion of Sub's gain from the sale of its interest in P that is allocable to Cooperative's patrons use of P's network constitutes patronage-sourced income and, if that proportion of gain is properly allocated to Cooperative's patrons, is excludable from Cooperative's consolidated gross income in the taxable year of the sale.

LAW AND ANALYSIS

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 decisions 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 the treatment of other cooperative organizations under Subchapter T. Therefore, to the extent that Subchapter T reflects cooperative taxation as it existed prior to 1962, it is instructive in 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 stated:

Under the cooperative association form of 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 cooperatives achieve operation at cost is the patronage dividend (or capital credit). Because 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 nonexempt 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 rural telephone cooperative, regulations and rulings address the issues for cooperatives governed by Subchapter T. While not directly applicable to nonexempt utility cooperatives per se, arguably they reflect the correct analysis with respect to 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 Congress intended to tax “ordinary” (i.e., non-farmer) cooperatives for their “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. Rev. Rul. 69-576 held that the allocation and payment of the amount by the nonexempt farmers' cooperative to its own patrons qualified as a patronage dividend. Rev. Rul. 69-576 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 Tax Court stated 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

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 Tax Court held 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.

CONCLUSION

Sub's ownership of its partnership interest in P was directly related to the cooperative business purpose of Cooperative. The telecommunications services provided by P were directly related to the cooperative business purpose of Cooperative whose "reason for existence" is to provide telecommunications services to its members. Sub's sale of its partnership interest in P was directly related to the cooperative business purpose of Cooperative. Cooperative will use the sales proceeds to build out its local exchange networks, improve services to its members and other customers, and focus on its core mission of bringing state of the art telecommunications services to businesses and residents in the rural area it serves.

Based on consideration of Taxpayer's representations, because P was used to provide telecommunication services to Cooperative's patrons, the sale of Sub's partnership interest in P satisfies the directly related test, and the portion of gain that is allocable to Cooperative's patrons use of P's network is patronage sourced income.

Accordingly, based on the facts submitted and the representations made, we rule that the patron portion of Sub's gain from the sale of its partnership interest in P constitutes patronage-sourced income and, if properly allocated to Cooperative's patrons, is excludable from Cooperative's consolidated gross income in the taxable year of the sale.

Except as expressly provided herein, no opinion is expressed or implied regarding the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding the effect on the patrons of the transaction.

The ruling contained in this letter is 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 ruling, it is subject to verification on examination.

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.

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

Sincerely,

NICOLE R. CIMINO
Chief, Branch 1
Office of the Associate Chief Counsel
(Energy, Credits, & Excise Tax)

Enclosure:
Copy of this letter for § 6110 purposes

CC: