Internal Revenue Service

Number: **200152035**
Release Date: 12/28/2001
Index Number: U.I.L. No.: 1381.00-00

Department of the Treasury

Washington, DC 20224

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Date:
October 2, 2001

Legend

Coop	=
Sub	=
State A	=
State B	=
Inc	=
Cellular	=
Corp A	=
Corp B	=
b	=
c	=
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e	=

Dear

This is in response to a request for rulings dated May 16, 2001, submitted on behalf of Coop concerning the proper treatment of the amount received from the sale fo stock in a proposed transaction.

Incorporated in b as State A corporation, Coop is a rural telephone company operated on a cooperative, non-profit basis for the mutual benefit of its members. According to Coop's articles of incorporation, the stated purpose of Coop is to furnish, improve and expand telephone service on a cooperative basis. Coop provides directly and through its wholly owned subsidiary, Sub, telecommunications services, including telephone, long distance, internet and computer services, to its customers in south-central State A and north-central State B. Coop's bylaws state that any person or entity may become a member of Coop by making an application, agreeing to purchase services from Coop and agreeing to pay value for one share of stock. It is possible for a patron to purchase services without becoming a member, but it is not possible to be a member without purchasing services. No interest or dividends are paid by Coop on any capital furnished by its members. No member is permitted to hold more than ten shares of stock, and each member is entitled to only one vote, regardless of the number of shares owned. As June 30, 2000, c shares of Coop stock were owned by Coop's members.

As members of a cooperative corporation, Coop patrons furnish capital to Coop through their patronage. Coop is obligated to account on a patronage basis to all its patrons to the extent such amounts are in excess of operating costs and expenses chargeable against furnishing such services. Such amounts are paid by credit to the capital amounts of Coop patrons. Any amount credited to the capital of a patron is treated as if it had been paid to the patron pursuant to a legal obligation to do so, and the patron had then furnished Coop with a corresponding amount as a capital. All other amounts received by Coop, whether or not non-operating income, may in the sole discretion of the board of directors be allocated on a patronage basis to the capital accounts Coop patrons or may remain unallocated and be reserved as retained earnings.

In general, Coop's board retains discretion as to how and when to redeem a patron's capital. At present, Coop's policy is to retire any patron's capital at the time of such patron's death. At the discretion of the board, Coop regularly redeems members' capital at a rate of approximately $d per year. Pursuant to this practice, credits accrued through e have been paid. In the event of liquidation or dissolution, the patrons' capital contributions would be returned on a pro rata basis after payment of all of Coop's indebtedness and a return of the amount paid by each member for his shares.

Coop provides telephone service to residential customers and businesses in south-central State A and north-central State B. This area is exceedingly rural and agrarian, and most of Coop's owner-members depend on agribusiness for their livelihood. For the farmer's convenience, Coop's annual meeting is schedule for November. The population in Coop's service area is extremely sparse, and Coop's customers are thinly spread over an area of 1,416 square miles. In comparison to the average Bell telephone territory, which has 130 access lines per line mile, the Coop territory has only 2.14 access lines per line mile. This low population density makes it extremely difficult to provide the infrastructure for telephone services on a cost-effective basis.

In early 1980s, a new technology, cellular telephone, began to emerge. In order to foster development of the cellular market, the Federal Communication Commission (the "FCC") divided the available radio spectrum in each market into two channel blocks. One block was set aside for development by wireline telephone companies and the other for nonwireline companies. In markets where there was more than one applicant for a network construction permit, lotteries were used to select the winning applicant.

Because each initial network construction permit holder was given 5 years from the date of authorization to build and expand its cellular system within its market, the FCC system insured a temporary duopoly in every service area. During this 5-year fill-in period, no application from anyone other than the permit holder were accepted within the market of the holder's channel block without its consent. Any remaining area within the market not covered by the permit holder was considered an "unserved area."

At an early stage, Coop recognized the enormous potential of cellular technology and its potential importance to its members. Most of Coop's members spend their days working outdoors and away from wireline telephones. Wireless telephone service was therefore a potential godsend, permitting farmers and ranchers to use the telephone while in the field or otherwise away from home. Coop was committed to providing the best telephone technology to its customers and knew therefore that it had to participate in the development of a rural cellular network.

On the other hand, a cellular network had the potential to undermine the continued economic viability of wireline companies and leave some customers without services. If cellular technology has significantly supplanted wireline technology it would have decreased the customer bases of wireline companies, and it would have become economically unfeasible for rural wireline companies to continue to maintain a large telecommunications infrastructure. The wireline companies were concerned that they would be "bypassed" and left with "stranded investments" in wireline infrastructure. Some remaining wireline customers (most likely those customers in cellular network "unserved areas") could have been stuck with rapidly escalating costs for wireline services or (if the costs went too high) left without service. The only way for Coop to ensure that it would not be bypassed and that each one of its customers would continue to be provided with the most advanced and cost-effective service was to enter the cellular market as a construction permit holder and thereby help to determine the direction of cellular development for its members.

Because the lottery system instituted by the FCC, Coop had no assurances that it would win a license and be able to participate in cellular development. Many of the other rural telephone companies of State A had a similar concern, and all of them were concerned about whether they had the capital to make the necessary investment in cellular infrastructure. The companies therefore decided to combine their efforts in order to improve their chances of getting the necessary licenses and raising the required capital. Through its subsidiary, Sub, Coop invested in Inc, a management company set up to organize the independent rural wireline companies in State A. It also invested in Cellular, a company in which the participating rural wireline companies had informally agreed to combine any construction permits they acquired through the FCC lotteries. In July of , each of the rural wireline companies in State A that was a party to the non-binding, informal agreement formed one or more corporations that participated in the FCC's lotteries for cellular network construction permits in the cellular rural service areas where there was more than one wireline applicant. At the conclusion of the lottery and application process, corporations (one for each rural service area) were created to hold the construction permits acquired in the FCC process. These "construction permit companies" were owned in part by Cellular, and in part by other entities controlled by thee rural wireline companies. Several months later, Cellular and all of the interests in the construction permit companies held by wireline companies were merged into Cellular's successor, Corp A, pursuant to the non-biding, informal agreement among the rural wireline companies to build, develop, and operate a cellular network that spanned State A's rural service areas.

In substance, Corp A was a partnership formed to enable each of its constituent small telephone companies to participate in the cellular market. By participating in Corp A, each of these companies could thereby ensure that the best interests of its shareholders would be protected, including those shareholders living in remote, rural areas. Each company that participated in the Corp A venture originally held approximately four percent of the stock, which was received in exchange for a contribution of construction permits and/or cash (those founders that failed to acquire permits in the FCC lottery contributed only cash). In subsequent capital calls, every founder was given an equal opportunity to acquire the same number of additional shares, and shares offered for sale by the shareholders were required to be offered pro rata to each of the founding companies.

Sub continued to acquire additional stock in Corp A until 1995 by subscribing to later offerings and purchasing its pro rata share of the stock and options of some of the other Corp A founders. By the end of 1995, Sub owned 93,454 shares of Corp A common stock. As an owner of Corp A, Sub was able to play a role in determining the direction of Corp A's development. Form 1986 to 1991, , then General Manager of Coop, sat on the boards of Cellular and its successor Corp A, and four Coop board members were closely involved in the project from the beginning. In addition, Sub acted as a sales agent for Corp A's services.

By 1999, Corp A had reached its goal: the cellular network in State A had been built and was providing a valuable service to the customers of the rural wireline companies. Meanwhile, national competition in the wireless market was growing fierce. The duopoly enjoyed by the initial winners of the FCC lotteries had expired and new technologies and alternatives were emerging, particularly digital PCS offered by Sprint, Southwestern Bell, and other companies national in scope. In an effort to offer seamless national service other companies were working to consolidate cellular networks. This wave of consolidation was changing the economics of the cellular telephone business. Networks with a multi-state footprint were able to offer uninterrupted service in a much larger area; a benefit that did not escape the notice of customers. Smaller cellular networks were being forced to sell larger networks or risk obsolescence. By selling to one of the companies that was consolidating cellular networks, the rural wireline companies saw that they would be able to provide greater value and service (in the form of a larger, multi-state or nationwide service area) to their customers. As a result, in September 1999, Corp A was acquired by Corp B, a publicly traded company that was consolidating cellular networks in states, in exchange for million shares of Corp B common stock. Those shares had a value of approximately $ million. The transaction was structured to qualify as a reorganization pursuant to § 368(a)(1)(B) of the Internal Revenue Code of 1986, as amended (the "Code"). In exchange for its interest in Corp A, Sub received shares of Corp B common stock worth approximately $ million as of June 30, 2000.

Coop now proposes to cause Sub to contribute all of its operating business to a single-member limited liability company. Sub then will be liquidated, distributing all of its remaining assets, including the Corp B stock, to Coop. Coop will then sell the Corp B stock. Consistent with § 1.1382-3(c)(3) of the regulations, the proceeds from the sale will be allocated to the capital accounts of the patrons based on the balance of such patronage accounts accrued during the holding period of the Corp B stock (or the stock of its predecessors) owned by Coop. The capital generated from the transaction will be retained to meet Coop's expansion needs.

Based on the information and representation set forth herein, Coop requests that the following ruling: the amount realized from Coop's sale of Corp B stock constitutes "patronage-sourced" income, which may be excluded from Coop's gross income when allocated to Coop's patrons.

Code § 501(c)(12) 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; Coop falls into this category, and thus is a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, §§ 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 Code § 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 Coop, 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 such as Coop, 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 Corp B stock to be deductible to Coop upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Coop'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, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106; Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993; Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243; Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459).

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 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 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 cooperative's operation, the income is from non-patronage 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 transaction that will generate income for Coop is comprised of two parts: the original decision to participate in the organization of Cellular and Corp A and the currently proposed sale of Corp B stock. Both elements of the transaction are "directly related" to Coop's cooperatives business and will facilitate Coop's ability to provide communications services to its members.

Coop actively participated in the formation and funding of Cellular and Corp A to insure that cellular service would be available on reasonable terms to Coop's customers and to ensure that Coop's wireline customers would not be adversely affected by other customers' migration to cellular. Coop represents and has submitted affidavits from its board members that state unequivocally and without hesitation that the purpose of Coop's participation was not to make a profit from investing in cellular telephone technology but to facilitate the accomplishment of its service goals.

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, 1979WL 1287 (D.Or.), 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.

Coop's investment in Cellular and Corp A 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 cooperative whose *raison d'etre* is to provide telephone service to its patrons.

Coop's proposed sale of the Corp B stock is also directly related to its cooperative business purpose. The sale of Corp A to Corp B and Coop's proposed sale of the Corp B stock is the natural conclusion of an enterprise calculated to build the cellular network and guarantee service to rural customers. Coop now has achieved what it set out to do; the FCC-created, cellular duopoly has expired and new, national players have entered the wireless market. Coop should therefore be free to redeploy its capital to other aspects of its communications business, such as internet, voice-over internet, satellite telephony, DSL, LMDS, etc.

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. See id. Certainly, if Coop 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 Coop did nothing of this sort. It was an active participant in a venture, Corp A, that was directly related to its cooperative telecommunication business. In fact, investment in Corp A was only open to companies that were in the telephone business. The Corp A investors were all rural telephone companies that held "tickets" in the FCC lottery by virtue of the fact that they were wireline telephone companies. They were not temporarily investing their members' capital in a security but pooling a rare commodity (the "tickets"), the value of which increased dramatically when combined. Corp A was not a passive investment of the type Judge Posner implies would be impermissible. The founders remained active as shareholders in Corp A once it was formed, and at one point, Coop's General Manager sat on the boards of directors of Cellular and its successor, Corp A.

Accordingly based solely on the above, we rule that the sale of Corp B stock will result in patronage sourced income, which may be excluded from Coop's gross income when allocated to Coop's patrons. Because Coop does 100 percent of its telephone business with patrons on a cooperative basis no allocation between patronage and nonpatronage is required.

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 Coop.

Sincerely yours,
Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)