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Person To Contact:
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Telephone Number:

Refer Reply To:
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Legend

Taxpayer =

State A =

Sub =

Dear :

This is in response to a request for a ruling dated December 8, 2006, submitted on behalf of Taxpayer by your authorized representative. The ruling concerns the application of cooperative tax law to a transaction described below.

Taxpayer was incorporated in as a for-profit corporation. On Taxpayer changed its structure to that of a cooperative pursuant to State A's Cooperative Statute. Since then, Taxpayer has operated on a cooperative, nonprofit basis for the mutual benefit of its members serving patrons in rural western State A.

Effective , Taxpayer was granted exemption under section 501(c)(12) of the Internal Revenue Code. Taxpayer failed tax exemption in because it received less than 85 percent of its income from members as required by the Code.

While Taxpayer's primary business purpose is to provide each of its approximately active members local exchange telephone carrier services, it also provides long distance and Internet services. Taxpayer holds investment under its wholly-owned corporate subsidiary, Sub, and three corporate subsidiaries of Sub.

Under Taxpayer's Articles of Incorporation, Taxpayer is organized as a cooperative to provide communications to its members in and around its service area. Further, Taxpayer's Articles provide that it shall operate on a cooperative basis for the mutual benefit of its members with the net savings derived from transactions with members belonging to such members in proportion to their respective patronage and returned either in the form of cash or credits.

Taxpayer's bylaws provide that it shall at all times be operated on a cooperative not-for-profit basis for the mutual benefit of its member patrons.

On May 7, 1971, the Rural Telephone Bank (RTB or Bank) was established by amendment to the Rural Electrification Act (RE Act) as a source of supplemental financing for telecommunications companies and rural telephone cooperatives eligible to borrow under the RE Act's telephone loan program. A Board of Directors was appointed to manage the operations of the Bank and the employees of Rural Electrification Administration (now USDA Rural Development Utilities Programs) performed the Bank's day to day operations.

By establishing a capital structure which provided for a mixed Federal and private ownership, the Bank was designed to assure rural telephone systems access to private sources of capital by establishing a supplemental credit mechanism to which borrower systems could turn for all or part of their future capital requirements. The capital structure of the Bank consists of three classes of stock: Class A, Class B, and Class C.

Class A stock was issued by the Bank in exchange for approximately $600 million of capital provided by various taxpayers. This provided the Bank with its initial "seed" money to begin its lending operations. The Bank paid an annual dividend of two percent on Class A stock.

Class B stock was required to be purchased by recipients of RTB loans in an amount equal to five percent of the face value of the loan. Class B stock did not earn a cash dividend, but Bank borrowers acquired additional shares of Class B stock through annual patronage refunds.

Class C stock was acquired through the conversion of Class B stock after repayment of the loans associated with the Class B stock, and earned a cash dividend at a rate determined by the Board of Directors. Since the Class B stock paid no cash

dividends and could not be otherwise redeemed, conversion was the only route available to borrowers that extinguished their loans.

Class C stock was also available for purchase by Bank borrowers and by organizations controlled by Bank borrowers. However, such voluntary transactions were extremely rare because no borrower would want to invest in instruments that have no schedule of principal repayment.

In addition to providing for a mixed-ownership through the A, B, and C Classes of stock, the RE Act amendment also provided that the ownership, control, and operation of the Bank be transferred to the Class B and Class C stockholders after a 51 percent of the Class A stock was retired (known as privatization of the Bank). The retirement of Class A stock began in fiscal year 1996.

In February 2005 the fiscal year 2006 Federal Budget proposed the dissolution of the RTB. The RTB's Board of Directors unanimously approved resolutions to liquidate and dissolve the Bank on August 4, 2005. After more than nine months of congressional negotiations, the bill was signed into law on November 10, 2005, authorizing the initiation of the liquidation and dissolution process.

Stock redemption agreements were sent to shareholders beginning on January 5, 2006, for final consideration and ratification by borrowers' boards of directors. The dissolution process is expected to be largely completed by the end of fiscal year 2006.

Taxpayer first borrowed money from the RTB in and continued to have outstanding loans through . Taxpayer purchased shares of RTB Class B stock during the period it held loans with the RTB. The RTB Class B stock dividends received by Taxpayer over the years totaled shares, making a total amount of Class B stock owned of shares.

Taxpayer extinguished its loan balance with the RTB in and converted shares of Class B stock and $ cash into shares of RTB Class C stock.

Taxpayer received the proposed liquidation and stock redemption agreements from the RTB on , and Taxpayer's Board of Directors ratified the agreement on . The total amount of Class B stock redeemed was shares and the total amount of Class C stock redeemed was shares. Taxpayer received the RTB liquidation funds of $ on . Taxpayer does not expect any additional payments relating to the liquidation.

Based on the foregoing, Taxpayer requests a ruling that:

> The income realized by Taxpayer by the liquidation payment for Class B and Class C stock of the RTB constitutes "patronage-sourced" income which may be excluded from its gross income when allocated to Taxpayer's patrons by a true patronage dividend.

In the event a rural telephone cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) of the Code 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 tests. 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 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 of the Code 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 co-workers, 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 cooperative 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 of the Code. 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)(3) of the Code specifies that a patronage dividend must be "determined by reference to the net earnings of the organization from business done with or for its patrons." That section further provides that the term "patronage dividend" does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers "to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

> 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. Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The Court held that the relation of income activity to the cooperative's business was too tenuous.

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 v. Commissioner*, 78 T.C.M. 846, 864 (1999), *acq*., AOD 2001-03 (citing *Cotter & Co. v. United States*, 765 F.2d 1102, 1106 (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)), 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.

In *Land O'Lakes, Inc., supra*., the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

In the instant case, Taxpayer borrowed from the congressionally established RTB pursuant to the RE Act's purposes. As a result, it was required to purchase the Class B stock and pursuant to the Bank's regulations, have that Class B stock converted to Class C stock when its loans were repaid. These loans and stock acquisitions were directly related to Taxpayer's cooperative purpose in providing telephone service to rural customers, its member/patrons. Further, in light of the fact

that the Federal government has caused the dissolution of the RTB, the redemption of Taxpayer's Class B and Class C stock in liquidation of the RTB also can be seen as "directly related" to Taxpayer's cooperative purposes.

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

The income realized by Taxpayer by the liquidation payment for the Class B and Class C stock of the RTB constitutes "patronage-sourced" income which may be excluded from its gross income when allocated to Taxpayer's patrons by a true patronage dividend. However, to the extent, if any, that Taxpayer conducted telecommunications or related business with nonmembers or on a noncooperative basis, it is required to make an allocation of the income between patronage and nonpatronage sources based on the proportion of business conducted with members and nonmembers and between its cooperative and noncooperative activities.

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,

Paul F. Handleman
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)