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Legend

Taxpayer =

State A =

Corp X =

Corp Y =

Corp Z =

Limited Partnership =

Enterprise =

Dear :

This is in response to a request for a ruling dated May 12, 2009, submitted on behalf of Taxpayer by your authorized representative. The ruling concerns the application of cooperative tax law to a transaction described below.

Taxpayer is a nonexempt rural cooperative telephone company that operates on a cooperative basis. Taxpayer was previously granted exemption as a rural telephone company under section 501(c)(12) of the Internal Revenue Code but in recent years it is no longer exempt.

The members of Taxpayer consist of those who obtain telecommunications services from Taxpayer within Taxpayer's "Certified Area" as designated by the State A Public Utilities Commission.

Each member of Taxpayer is entitled to only one vote on governance matters and a majority of the votes cast will control on most matters on which the members are entitled to vote. Taxpayer Bylaws, Article III, Section 3.6.

Pursuant to Section 8.2(a) of Article VIII of Taxpayer's Bylaws, margins (or profits) earned by Taxpayer from patronage sourced business must be credited as capital credits to the capital accounts of members. Margins from non-patronage activities are not subject to the obligations to distribute to members as is patronage sourced income under Section 8.2(a).

Section 2.4 of Article II of Taxpayer's Bylaws provides that, upon dissolution, all debts and liabilities of Taxpayer shall be paid and then the members shall be entitled to receive repayment of their patronage capital, repayment of their membership fees, and any remaining property and assets that shall be distributed based on the patronage of the members.

Taxpayer provides all regulated telephone services to its members in an area certified by the State A Public Utilities Commission for the provision of Taxpayer's services in portions of northeastern State A. The regulated telephone services basically include everything that is telephone related including local telephone services, access to long distance and special access; it does not include inside wiring and long distance service itself, or equipment and telephone sales and lease, all of which are deregulated. Taxpayer has endeavored throughout its existence to provide its members with access to communications technology advances as they become available and feasible for deployment.

Taxpayer serves approximately Access Lines (telephone lines) over a relatively sparsely populated area of approximately square miles where there is a household density of approximately households per square mile compared to a consumer density of approximately households per square mile in the metropolitan area. Taxpayer's service area is significantly rural and is substantially agricultural.

According to Taxpayer, the commercial wireless technology industry began in the early 1980's. The beginning years, as in most infant industries, were marked by explosive growth, little to no regulation, and burgeoning technologies. The Federal Communications Commission ("FCC"), the main regulator of the wireless industry, notes that there were approximately 340,000 wireless subscribers in 1985. A decade later, wireless subscribers had grown to over 33 million. At the end of 2005, the total number of wireless subscribers stood at an estimated 213 million clearly indicating that wireless telephony and other wireless services are significant in the competitive communications arena.

The FCC regulates the wireless industry primarily through wireless spectrum management, a system developed in part to encourage development of wireless technology. Providers access the country's airwaves by acquiring a license to provide services within a specific area. These geographic areas, defined at the smallest level by counties, range from one to two counties to the whole nation. The smallest license areas are called Cellular Market Areas ("CMAs") and are further defined by Metropolitan Statistical Area ("MSAs") and Rural Service Areas ("RSAs").

RSAs, unlike MSAs, do not cross state boundaries. RSAs account for approximately 75 percent of the nation's land mass, but only 25 percent of the national population. RSAs are characterized by rural areas with small cities and towns. Most of State A has technical access to wireless services, and market concentration is above 90 percent. As of June 2006, the FCC reported that State A had a total of million wireless subscribers. Taxpayer operates in a RSA in several counties of State A.

As previously noted, Taxpayer has historically endeavored to make telecommunications advances available to its member-customers. In , after study by management and the Board of Directors of Taxpayer, the Board authorized Taxpayer to join Corp X and pay $ for purchasing the stock that was required to be a member of Corp X in order to access cellular telephone technology for the members of Taxpayer. Subsequently rural telephone cooperatives, including Taxpayer, participated in the creation of Corp Y for the same purpose. By , Limited Partnership was organized with Corp X and Corp Y as general partners. Through this structure the rural telephone cooperatives (including Taxpayer) were able to obtain and make cellular telephone technology available to their members.

In the discussion that follows, Corp Y and Limited Partnership will be referenced together as the Enterprise. As Corp Z acquired greater interests in the Enterprise, concerns about conflicts of interest developed on the part of some of the rural cooperative telephone companies. Corp Z was endeavoring to sell its cellular services to customers while cellular services were also being offered by the Enterprise. At the same time, alternative cellular phone services were becoming available from other sources for Taxpayer to provide to its members.

The Board of Directors of Taxpayer determined it would be in the best interest of Taxpayer to sell its interest in Enterprise, use proceeds from the sale of its interest for capital investments in plant and equipment to provide services to Taxpayer's members, and potentially obtain cellular service for its members from a different source after a required two year continuing contractual commitment to obtain cellular service from Corp Z. Following negotiations, Taxpayer's interests were acquired by the Corp Z companies in .

During the time following its initial investment of $ in Corp X, Taxpayer invested an additional $ in the aggregate into the Enterprise for a total investment of $. Its last investment was made in . Taxpayer sold its interests in the Enterprise to the Corp Z for a total purchase price (after expenses) of $. The total gain was $.

Taxpayer proposes to allocate the gain to its members as patronage dividends as provided in its Bylaws which state:

> Section 8.2 Patronage Capital In Connection With Furnishing Telecommunications and Information Services:
>
> a) In the furnishing of telecommunications and information services, the company's operations shall be so conducted that its revenues shall be applied to meeting losses and expenses and all members will through their patronage furnish capital for the company. In order to induce patronage and to insure that the company will be operated at cost, the company is obligated to account on a patronage basis to all its members for all amounts received and receivable from its patrons for the furnishing of telecommunications and information services in excess of operating costs and expense properly chargeable against the furnishing of such services. All such amounts in excess of operating costs and expenses at the moment of receipt by the company are received with the understanding that they are furnished by the members as capital. The company is obligated to pay by credits to a capital account for each member all amounts in excess of operating costs and expenses. The books and records of the company shall be set up and kept in a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each member is clearly reflected and credited in an appropriate record to the capital account of each member. All such amount credited to the capital account of ant member shall have the same status as though it had been paid to the member in cash in pursuance of a legal obligation to do so and the member had then furnished the company corresponding amounts for capital. To the extent required by law, such amounts shall be reported to the members by the company giving to the appropriate recipient a written notice of allocation (as defined in 26 U.S.C. 1388).

Taxpayer further purposes to allocate the amount of gain from the sale of its interest in the Enterprise by issuing capital credits to its members, and not take into account (exclude or deduct) the amounts allocated in determining its taxable income for 2009. Based on the foregoing, Taxpayer requests a ruling that the amount realized from Taxpayer's sale of its interest in the Enterprise constitutes "patronage-sourced" income and, if properly allocated to its members, will not be included in the taxable income of Taxpayer in 2009, the year in which the sale of its interest in the Enterprise occurred.

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 now qualify for this exemption; Taxpayer falls into this category, and thus 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 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 Taxpayer, 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 Taxpayer, 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 Enterprise to be deductible to Taxpayer upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Taxpayer'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 v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (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)).

In Rev. Rul. 69-576, 1962-2 C.B. 166, 167, 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 patronaged 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 Taxpayer is comprised of two parts: the original decision to participate in the organization of Corp X and LIMITED PARTNERSHIP and the current sale of Enterprise. Both elements of the transaction are "directly related" to Taxpayer's cooperatives business and will facilitate Taxpayer's ability to provide communications services to its members.

Taxpayer actively participated in the formation and funding of Corp X and LIMITED PARTNERSHIP to insure that cellular service would be available on reasonable terms to Taxpayer's customers and to ensure that Taxpayer's wireline customers would not be adversely affected by other customers' migration to cellular. Taxpayer represents and has submitted affidavits from its current and former board members that state unequivocally and without hesitation that the purpose of Taxpayer'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, 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 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.

Taxpayer's investment in Corp X and Enterprise 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 foundation is to provide telephone service to its patrons. Taxpayer's sale of the Enterprise is also directly related to its cooperative business purpose. The sale of Enterprise to Corp Z is the natural conclusion of an enterprise calculated to build the cellular network and guarantee service to rural customers.

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 Taxpayer 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. See section 1.1382-3(c)(2) of the Income Tax Regulations. But Taxpayer did nothing of this sort. It was an active participant in a venture, Enterprise, that was directly related to its cooperative telecommunication business. Enterprise was not a passive investment of the type Judge Posner implies would be impermissible.

Accordingly based solely on the above, we rule that the amount realized from Taxpayer's sale of its interests in the Enterprise constitutes patronage sourced income and, if properly allocated to its members, will be excluded from Taxpayer's gross income in 2009, the year in which the sale of its interests in the Enterprise occurred. Because Taxpayer 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 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
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

CC: