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LEGEND

Cooperative =

Sub 1 =

Year 1 =

Year 2 =

Dear :

This letter responds to a request for a private letter ruling, dated October 16, 2017, submitted on behalf of Cooperative by its authorized representative, regarding the application of cooperative tax law to the transaction described below.

Cooperative is a nonprofit, nonexempt, 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. Cooperative was previously granted exemption as a rural telephone company under section 501(c)(12) of the Internal Revenue Code (Code), but in recent years it is no longer exempt. Cooperative is the parent of an affiliated group that includes Sub 1, a corporation wholly owned by Cooperative.

Cooperative provides telecommunication services to rural customers. The purpose of Sub 1 is to hold nonregulatory telecommunication assets for the benefit of Cooperative and in furtherance of Cooperative’s telecommunication services. Entities that provide regulated services, like telephone services, create subsidiaries to hold nonregulated assets in an effort to comply with federal, state, and local regulations. The

separation of regulated and nonregulated assets by the creation of subsidiaries assists telecommunications cooperatives in complying with such regulations.

Before Year 1, Cooperative identified internal and external pressures that required a change in the business model of providing telephone service to its member patrons. These pressures included shrinking plain-old telephone service (“POTS”) access lines and declining access minutes of use as member patrons switched to mobile cellular services.

In Year 1, Cooperative was granted licenses for advanced wireless service spectrum to provide cellular phone and other wireless services to its member patrons. Cooperative transferred one license to Sub 1, which then began using the spectrum for the purposes of providing wireless broadband.

Cooperative ultimately concluded that it could not effectively utilize the spectrum and should sell it before the licenses expired, rendering them worthless.

In Year 2, Cooperative and Sub 1 sold all the spectrum licenses to unrelated third parties at a gain. This private letter ruling request concerns the treatment of the gain arising from the sale of all the spectrum licenses.

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.

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. The legislative history states that cooperative corporations engaged in providing telephone service to persons in rural areas would continue to be treated the same as under prior law. 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. While the cases and rulings interpreting subchapter T may not control the taxation of rural telephone cooperatives, 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, each member has one vote regardless of how much capital the member contributed. Cooperatives are required to allocate their net margins from business done with or for their patrons back to their 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 business 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 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, the cooperative's patrons realize the income. Patronage-sourced income flows through the cooperative and is taxed only once.

If a capital gain is realized by a cooperative from the sale or exchange of a capital asset used by the cooperative in its business done with or for patrons, then income realized from the capital gain must be allocated, insofar as is practicable, to the persons who were patrons during the taxable years in which the capital asset was owned by the cooperative in proportion to the amount of business done by such patrons with the cooperative during those taxable years. See 1.1382-3(c)(3).

For the amount realized from the sale of the spectrum licenses to be deductible by Cooperative upon allocation, the amount must be patronage-sourced income, *i.e.*, income derived from business done with or for Cooperative'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, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 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, 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 patronage source, because the loans "actually facilitated the accomplishment of taxpayer's cooperative activities, in that [the loans] enabled the taxpayer to obtain necessary supplies for its operations.")

Rev. Rul. 83-135, 1983-2 C.B. 149, provides that 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.

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 a transaction that 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 864-65. The Tax Court 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 Tax 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 that the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income because glue is essential for the manufacture of plywood and because the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

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. But Cooperative did nothing of this sort.

Cooperative's acquisition of the spectrum licenses and the transfer of one license to Sub 1 were directly related to its cooperative business. Providing wireless telephone service is directly related to the business of a rural telephone cooperative whose "reason for existence" is to provide telephone service to its patrons. The sale of the spectrum licenses by Cooperative and Sub 1 is also directly related to its cooperative business purpose.

Accordingly, based on the facts submitted and the representations made, we rule that:

1. Cooperative's gain on the sale of the spectrum licenses constitutes patronage-sourced income and, when allocated to Cooperative's member-patrons based on the member-patrons' respective patronage during the time that Cooperative owned the spectrum licenses, is excludable from Cooperative's gross income for Year 2.

2. Sub 1's gain on the sale of the spectrum license constitutes patronage-sourced income and, when allocated to Cooperative's member-patrons based on the member-patrons' respective patronage during the time that Sub 1 owned the spectrum license, is excludable from Cooperative's gross income for Year 2.

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.

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.

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.

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

Sincerely,

THERESA M. MELCHIORRE
Assistant to the Branch Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure:
Copy of this letter for § 6110 purposes

cc: