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Date:
March 21, 2022

Re:

Legend

Taxpayer =

RSA A =

RSA B =

RSA C =

MSA A =

RSA Entity A =

RSA Entity B =

RSA Entity C =

MSA Entity A =

Entity A =

Entity B =

Entity C =

Entity D =

State A =

State B =

a =

b =

c =

d =

e =

f =

g =

h =

i =

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k =

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Dear :

This is in response to a letter dated September 10, 2021, on behalf of Taxpayer by your authorized representative requesting a ruling on the transaction described below.

Taxpayer is a rural telephone cooperative that was incorporated in a, under State A statutes. Taxpayer was previously granted exemption as a rural telephone cooperative under section 501(c)(12) of the Internal Revenue Code (Code). At some point in its history, Taxpayer was no longer able to receive 85 percent or more of its income from members as required by the Code. As a result, Taxpayer now operates as a taxable cooperative corporation.

Taxpayer provides telecommunications and information services on a cooperative basis to its members located in various counties of State A and State B. As a taxable rural telephone cooperative, Taxpayer's members elect a board of directors on a one-member, one-vote basis. The business and affairs of Taxpayer are managed by the board. Each year, Taxpayer allocates its net income among its members and provides notice thereof to each member. Each year, the board determines the amount of capital credits to be retired to members without financial detriment to Taxpayer.

Taxpayer holds interests in certain cellular entities associated with Rural Service Areas (RSAs) and Metropolitan Statistical Areas (MSAs). Taxpayer acquired interests in RSA/MSA entities over the years through initial investment and several transactions. The initial acquisition and subsequent transactions were effected to provide and maintain cellular service to its customers.

During the b, telephone companies began to provide cellular service. Taxpayer recognized that if a competitor offered cellular services in its service areas, it would take away Taxpayer's existing customers and potentially leave Taxpayer with stranded investment in the wireline infrastructure. To safeguard its core wireline business and

offer the new cellular technology to its members, the Taxpayer decided to invest in new cellular technologies as the opportunities arose.

To develop its cellular service, Taxpayer needed to acquire spectrum through c auctions. The c 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 levels 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 RSAs and MSAs.

To improve their chances of winning the auction, Incumbent Local Exchange Carriers would form partnerships or other entities to submit a collective bid. Particularly for Rural Local Exchange Carriers (RLECs), these RSA investments were necessary to acquire spectrum to provide cellular service for members and customers.

Taxpayer served customers located in three RSAs and one MSA, and has participated in the RSA/MSA entities to serve those areas: Entity A, Entity B, Entity C, and Entity D.

In each RSA and MSA, a cellular corporation proposed a partnership with RLECs, including Taxpayer, to bid and acquire cellular licenses. The RLECs and the corporate partner believed that by bidding together, they would increase the odds of winning a license. In addition, the corporate partner would handle all administrative matters, financing, and management.

As part of the plan for RSAs, the RLECs first formed an RSA entity, then the RSA Entity and the corporate partner formed a separate entity (License Entity). Each RLEC bid for a license, and the winner put the license into the License Entity. Initially, the RSA Entity owned d percent of the License Entity, and Entity A owned e percent. If at any time thereafter an owner in the License Entity sold some or all of its interest, the other owners held a right of first refusal to purchase pro rata the interest sold.

Each time an opportunity arose to purchase additional shares, Taxpayer considered whether to find new management, attempt to manage the License Entity and cellular system without the corporate partner, or sell its interest. Taxpayer believed that the RLECs could not manage the License Entity and cellular system alone, but it did not believe new management was an ideal result. Taxpayer wanted to keep the corporate partner, but it wanted to avoid the corporate partner gaining too much of a controlling interest over Taxpayer's service area and its members.

In RSA A, a corporate partner, Entity B, owned f percent and the remaining g percent was split between RSA Entity A (h percent) and another corporate partner, Entity A (d percent). In i, Entity B sold its entire share, and Taxpayer purchased it pro

rata share. Thereafter, three RLECs sold their interests in RSA Entity A, and on each occasion, Taxpayer purchased shares. Currently, Taxpayer holds j percent ownership in RSA Entity A.

RSA B was originally divided among four entities: Entity B, Entity A, Entity C, and RSA Entity B. In the k and l, Entity B, Entity C, and two RLECs sold their shares, and the Taxpayer purchased its pro rata share thereof. Currently, Taxpayer holds m percent ownership in RSA Entity B.

In RSA C, Entity B held n percent ownership and the remaining o percent ownership was split between RSA Entity C (h percent) and Entity A (d percent). In the early k, Entity B sold its shares to Entity A. In p, another RLEC sold its shares, and Taxpayer purchased its pro rata share. Currently, Taxpayer holds q percent ownership in RSA Entity C.

Finally, the structure of ownership associated with MSA Entity A was different from the RSA entities. Taxpayer held direct ownership of MSA Entity A. Entity B held r percent, Taxpayer held f percent, and Entity D held f percent. In the early k, Taxpayer increased its initial ownership stake from f percent to s percent when Entity D sold its entire share and Entity B sold f percent. In t, Entity B planned to sell its u percent ownership interest to Entity A, and Entity A offered to purchase Taxpayer's s percent ownership interest. Taxpayer declined Entity A's offer and sought to exercise its right of first refusal for the shares being sold by Entity B. Entity A would not accept being a minority partner, and if it was not a majority owner, it would not manage the License Entity. Taxpayer lacked the financial ability and expertise to manage MSA Entity A alone. Therefore, Entity A purchased enough shares for h percent ownership, and Taxpayer purchased enough shares to increase its ownership to d percent.

In the past, Taxpayer characterized the income from RSA/MSA Entities as non-patronage-sourced income. But in consultation with its legal and accounting with its legal and accounting advisors, Taxpayer has determined that the transactions should, more appropriately, be characterized as patronage-sourced income.

Based on the foregoing, Taxpayer requests a ruling that:

> To the extent Cooperative's income from RSA/MSA Entities, which were organized for the purpose of providing cellular service to its patrons, is attributable to securing cellular service for its patrons, such income is classified as patronage-sourced income.

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 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 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 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 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 telephone cooperatives 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. 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) 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. The Rev. Rul. held that the allocation and payment of the amount by the nonexempt farmer's cooperative to its own patrons qualified as a patronage dividend. The Rev. Rul. 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 Court provides 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 that 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 Court ruled 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.

Based on consideration of Taxpayer's representations, Taxpayer's members are patrons of Taxpayer. Since the RSA/MSA Entities were used for the purpose of securing cellular service for Taxpayer's patrons, income from these investments satisfies the directly related test. The portion of income that is allocable to Taxpayer's patrons' use of the RSA/MSA Entities' networks is directly related to securing cellular service for Taxpayer's patrons and is patronage sourced income, which may be excluded from Taxpayer's income if properly allocated to Taxpayer's patrons.

Accordingly, to the extent Taxpayer's income from RSA/MSA Entities is attributable to securing cellular service for its patrons, such income is classified as patronage-sourced income.

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.

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.

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 your authorized representatives.

Sincerely yours,

Associate Chief Counsel
(Passthroughs & Special Industries)

By: *James Holmes*
James A. Holmes
Senior Counsel, Branch 5
Office of Associate Chief Counsel
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Enclosure
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cc: