Internal Revenue Service

Number: **200206044**
Release Date: 2/8/2002
Index Number: U.I.L. No. 1388.00-00

Department of the Treasury

Washington, DC 20224

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Refer Reply To:
CC:PSI:5 PLR-137986-01
Date:
November 9, 2001

<u>Legend</u>

Coop	=
State A	=
Town	=
Corp A	=
State B	=
Holdings	=
Corp B	=
Holdings#2	=
Holdings#3	=
<u>b</u>	=

Dear

This is in response to a request for rulings dated June 20, 2001, submitted on behalf of Coop concerning the proper treatment of the amount received from the sale of stock by Coop.

Incorporated in 1951 pursuant State A Code, Coop is a rural telephone company operated on a cooperative, non-profit basis for the mutual benefit of its members. Its headquarters is located in Town, a town of persons. It serves members in rural telephone exchanges in northwestern State A.

According to Coop's amended and restated articles of incorporation dated April 8, 1986, Coop is organized for the purpose of furnishing, improving and expanding communication services and to engage in any other activity within the purpose for which cooperatives may be organized. The Coop is organized without capital stock and the property rights of all members shall be equal.

In the case of dissolution, the Articles of Incorporation require that:

> "after (a) all debts and liabilities of the cooperative shall have been paid; (b) all capital furnished by members through patronage shall have been retired as provided in the By-Laws; and (c) the property and assets of the cooperative shall

be distributed among the members and former members in proportion to the ratio that the unretired capital credits of each bear to the total unretired capital credits of all such members and former members."

Coop's primary purpose is to provide each of its members local exchange telephone carrier service. However, it also provides cable television, wireless television, dial up Internet service, wireless Internet and Digital Subscriber Line services to a portion of its members on a cooperative basis and nonmembers on a for-profit basis.

Coop's Bylaws state that any person may become a member of Coop by subscribing to local exchange telephone service upon such terms as the Board may, or or the Bylaws shall, from time to time prescribe . Memberships may not be transferred except as provided by the Bylaws. Further, the Bylaws provide that each member shall have only (1) vote in meetings called to conduct the cooperative's business, including election of the cooperative's Board of Directors.

Coop's Bylaws proscribe the payment of interest or dividends on any capital furnished by its members. Instead, Coop is obligated to account on a patronage basis to all ita members for all amounts received that are attributable to furnishing communications services to them to the extent such amounts are in excess of operating costs and expenses chargeable against furnishing telephone service. Such amounts may be paid in cash, credits, letters of advice, or other certificates or securities of the Coop, or on any combination thereof.

If prior to dissolution or liquidation, the Board of directors determines that the financial condition of the Coop will not be impaired thereby, capital then credited to patrons' accounts may be retired in full or in part. The method, basis priority and order of retirement, if any, are in the discretion of the Board. Also within the Board's discretion is retirement of capital credits to estates of members who were natural persons.

In early 1980, American Telephone & Telegraph (AT&T) advised the independent telephone industry of the prospective availability of a new telephone service to subscribers. AT&T new system was known as a "Data Basis Administration System" (DBAS) and it enabled its customers to use the then recently developed Calling Card Service (CCS), also known as the Auto Bill Calling service (ABC). With that service, customers would be able to make credit available, collect or third-party long distance calls without the assistance of an operator.

While AT&T offered this service to the over 1,100 independent telephone companies (Including many rural telephone cooperative such as Coop) because of the data processing capital retirements that would be necessary to participate. But at the same time, it was clear to the small companies that they needed to offer the same type of services to their subscribers enjoyed by customers of larger telephone companies. Therefore the smallest companies. Therefore, the smallest companies needed to identify a means by which they could participate in the new program.

Based of these circumstances, the b smallest companies joined together to form Corp A for the purpose of aggregating their capital and achieving the economy of scale necessary to participate in the CCS service. For that purpose Corp A was organized on as a State B corporation and authorized b Class A voting shares to be issued. To participate, each smallest company had to ensure that it had valid line numbers, public station and credit card numbers, and appropriate hardware and software available.

The number of Corp A shares that each small telephone company had to purchase was determined by the number of main stations it serviced. Each participating telephone company in the Corp A venture received one (1) Class A Common Stock voting share, and then Class B Common Stock nonvoting shares equal to the number of stations (subscribers) that the participant served. Corp A had the first right of refusal to purchase all Common Stock held by all participants should a sale be proposed. Profits, if any, would be distributed based on the total number of shares held by which corresponded directly with the number of customers each participant had. In many respects, Corp A began with rules of participation and governance very similar to a cooperative organization.

On August 25, 1981 Coop's Board of Directors authorized the management of the organization to participate in the Corp A venture. On August 27, 1981, Coop acquired one (1) Class A voting share and Class B nonvoting shares of Corp A.

By the summer of 1982 the data processing equipment was installed by and December 1983 full installation of all systems was complete and ready for operation. From 1984 through 1996 Corp A provided the b members the DBAS and technology support necessary to have seamless participation with the AT&T in its CCS services offered nationwide.

On August 6, 1993, the members of Corp A voted to have a two (2) for one (1) Class A stock split. As a result, Coop held two (2) shares of Class A and Class B shares of Corp A. To achieve its business objectives in the marketplace, Corp A reorganized itself into a holding company structure on December 2, 1994, exchanging the original shares held by its participants for the same amount in Holdings shares. Following that, Coop held two (2) Class A Holdings shares and Class B Holdings shares.

Throughout the entire period, the governance of Corp A and then Holdings remained in the hands of b small companies that came together for mutual participation in AT&T CCS program. However, over time the technology of telecommunications changed. Accordingly, Corp A became increasingly involved in supporting its participating companies in the technology evolution. It developed leading intelligent network applications (including database and billing services) to facilitate the growth and competitiveness of its small company participants. The Coop purchased the original and expanded services throughout the period for the exclusive benefit of its members.

In 1998 another company, Corp B, was created by a private group for the purpose of developing applications and solutions for the advent of the new SS7 telecommunications switch. The new switch represented a quantum leap in technology at the time. In the following years, Corp A and Corp B had a number of opportunities to work jointly on projects relating to the SS7 technology as well as database, fraud management and wireless applications.

By the mid 1990s, the prospects for local competition became evident to nearly all in the telecommunications industry. Congress had a variety of hearings concerning the coming competitive environment for these companies over the course of several years. This effort culminated with the passage of the Telecommunications Act of 1996 in early February of that year. The Act authorized telecommunications competition at local levels for much of the United States.

Concurrent with the hearings and debate of the 1996 Act, Holdings and Corp B conducted discussions as to how the two organizations could work closely. Ultimately, it was concluded that a merger of two entities was appropriate. The merger was completed on nearly coinciding with the passage of the Telecommunications Act.

As a result of the merger of these two private companies, the Coop's interest in Holdings was converted into shares of Holdings#2 Common stock on With that combination, the new entity's focus began to move beyond Corp A 's original objective of serving its b small participants. Holdings#2 viewed itself as an aggressive supplier of services to the marketplace as a whole, not just as a group of small telecommunications providers.

While Coop did not object to the merger in 1996, it became concerned that the focus of the combined entity might be shifting from that of a service company for small companies to something else. It was evident that management and seemingly a majority of the shareholders wanted Holdings#2 to pursue for-profit ventures beyond the original scope of Corp A. Through uncomfortable with that trend, Coop really did not have ant reasonable means to extricate itself from its investment since there was no outside market for the stock.

By 1998 the Coop had a sense that a majority of the owners of the combined entity believed that the company would have greater access to equity and debt capital markets if Holdings#2 eventually became a publicly traded company. Bearing out the Coop's concerns, Holdings#2 changed its name once again to Holdings#3, in the expectation of the converting the company into a publicly traded company. As a result, on Coop received Class A Common Shares in Holdings#3 for its shares in Holdings#2.

At this point it was clear to Coop that Holdings#3 was being taken in a direction in which the Coop did not agree. However, at this point Coop did not know of any viable means of liquidating its stock.

Holdings#3 filed with the Securities and Exchanged Commission (SEC) expressing the intent to issue an initial public offering on Holdings#3's common stock offering occurred on and its common stock began trading on the NASDAQ shortly thereafter. On Coop Class A Common Shares in Holdings#3 was converted to shares of Holdings#3 Common Stock.

Upon expiration of the lock-out period following the initial public offering, the Coop's Board of Directors authorized the sale of Coop's interest in Holdings#3 on a staggered basis. The reason for the sale was that Holdings#3 no longer was operated in a manner that satisfied the Board, and the Directors did not want to gamble with the appreciation in value that could be realized for the Coop 's members and former members. In June and July of 2000, the Coop sold shares for prices between $ and $ per share realizing a gain of approximately $ million. In June 2001 November sold the balance of its interest for approximately $ per share thereby realizing a gain approximately $ Coop will allocate these gains as patronage dividends.

Since the divestiture of its minority interest in Holdings#3, Coop has been buying only those services that it requires from Holdings#3. The proceeds of those sales will be used to make continuing upgrades of the telephone network, effect repairs to its existing systems, and support Coop's patronage redemption system.

Based on the information set forth herein, Coop requests the following ruling:

> The amount realized from Coop's sale of Holdings#3 stock constitutes "patronage-sourced" income, which may be excluded from Coop's gross income when allocated to Coop's patrons by a true patronage dividend.

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 Holdings#3 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 Corp A and the currently proposed sale of Holdings#3 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 Corp A to insure that its members would have the same type of "modern" services that would be available to larger, nationally recognized telephone companies. Indeed, it had no choice but to participate in that venture because it was too small to meet AT&T's requirements for participation. All of its transactions with Corp A, from the beginning of its participation in the company until the day it sold the final tranche of Holdings#3 stock, were conducted exclusively for Coop's member patrons.

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 Corp A was directly related to its cooperative business. Investing in a company in order to provide modern telephone services is directly related to the business of a cooperative whose *raison d'etre* is to provide telephone service to its 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. 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. Corp A was not a passive investment of the type Judge Posner implies would be impermissible. Corp A was organized much like a cooperative. Its members were the smallest companies in the country. Each shareholder had only one vote on the affairs of the company. Corp A's distribution of profits, if any, to its shareholders were based approximately on a participation basis. For over a decade the arrangement between Corp A and its shareholders was very successful and grew as more technology became available that could only be accessed through a larger organization. However, following the merger of Holdings and Corp B in it became apparent that the new company intended to depart from its original purpose of serving the b small telephone companies. Following the statutorily prescribed lock-out period for such an issuance, Coop obtained its new stock and immediately proceeded with systematic liquidation of it minority interest which resulted in capital gains.

Accordingly based solely on the above, we rule that the sale of the Holdings #3 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)