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Legend

Coop =

LP =

LLC#1 =

LLC#2 =

INC =

Limited =

State A =

State B =

Cities =

b =

c =

Dear :

This is in response to a request for rulings dated April 5, 2002, submitted on behalf of Coop.

Coop is a federated cooperative organized in State B. Coop's cooperative business operations include the processing and marketing of c**,**

. Coop owns a percent limited partnership interest in LP.

LP is a State A limited partnership. LP's principle business activity involves the purchase of b**,** of the finished products. LP conducts its operations primarily through its processing facilities situated in Cities, State B. LP's partnership interests are currently owned by two general partners and two limited partners. The general partners are LLC#1, and LLC#2. The limited partners are Limited and Coop.

LLC #1 is a State B limited liability company. LLC#1 sole business activity is its ownership of a percent general partnership interest in LP. LLC#1 is owned percent by Coop, and percent by INC.

INC is a State B cooperative marketing association. Coop owns substantially all of INC's equity. INC's predominant business activity is the purchase of , the processing of the and the sale of the processed products and by-products. INC owns a one percent interest in LLC #1.

Limited is a State B cooperative marketing association engaged principally in the marketing of its members' b production on a cooperative basis through LP. Limited owns a percent limited partnership interest in LP.

LLC #2 is a State B limited liability company. Since LLC #2 is wholly-owned by Limited, LLC #2 is a disregarded entity for Federal income tax purposes. LLC #2 owns a 0.4966 percent general partnership interest in LP.

LP's primary business activity is the purchase of b**,** b**,** c c. LP currently purchases all of its b from Coop and Limited, with Coop providing the vast majority of b to LP.

Limited is contractually obligated and entitled to supply a specified quantity of b to LP, which quantity relates to Limited's ownership interest in LP. Limited is a closed cooperative and, thus, acquires all of the b which it sells to LP solely from its membership. Since Limited is not involved with the requested ruling, no further information has been provided with respect to Limited and its b sales.

Coop supplies the remaining b purchasing requirements of LP, which constitutes approximately percent of LP's purchases. Coop employs a staff of buyers who inspect and purchase live b from Coop members and nonmembers. Coop's buyers consult with LP as to the type of b which LP desires to purchase and process. In additional, Coop's buyers consult with LP as to the terms of purchase, including whether the b are purchased on the basis of specified price per hundred weight or under the application of various pricing grids. Coop then sells such b to LP. Coop and LP retain records of Coop member b supplied to LP.

For patronage dividend allocation purposes, Coop historically has accounted for its b marketing activities as a single allocation unit. Coop has allocated and distributed as patronage dividends its b marketing unit earnings from business done with or for such members based upon the dollar value of b marketed to Coop. Net earnings of that unit attributable to purchases from nonmembers and to any nonpatronage activities of that unit are retained by Coop (and are subject to Federal income tax). The predominant income of Coop's b marketing activities is attributable to Coop's share of LP's income.

LP is operating in an extremely competitive marketplace. The largest three c packers process approximately percent of c processed in the United States. Thus, even though LP is the largest c packer in the United States, LP is a small player in the marketplace and must react to the changes in the competitive marketplace so that it can survive and thrive and thus, allow Coop to serve its members and distribute its net margins through patronage dividend payments.

In addition to the concentrated c processing marketplace, significant changes are taking place throughout the United States and world economy which impact Coop and LP. As trade barriers are lifted, producers and marketers in the United States find themselves forced to compete on a bigger stage, exposed to the often erratic world market. The world marketplace has a significant impact, since a substantial portion of LP's quality c products are exported to Japan, Canada, Mexico and Korea. Technological advances are creating greater cost efficiencies, which place greater competitive pressures on LP and Coop.

The agricultural economy in general and the cooperatives that serve farmers are subject to these economic and market pressures. While farmers in the United States have historically been afforded some protection from market extremes, they still face great uncertainty as to the continued availability of federal subsidies, as well as the negative impact that trade agreements can have on produce price. B farmers in particular have been negatively impacted by the growth of the "one world" market in recent years as fears of contaminated b in Europe have threatened the b market in the United States.

Coop's sole purpose in transferring its b buying function to LP is to enable Coop and LP to better serve its members, increase its efficiency and eliminate unnecessary costs. In order to increase the market value of its members' b and LP's b marketing margins, LP, Coop, and Coop's members have been attempting to increase its sales of premium c products, such as through the Coop or c programs. In order to increase its supply of premium c, LP and Coop have altered their b pricing approaches in the purchase of b. Historically, b were purchased on a weight basis, i.e., a certain price per hundred weight of the . More recently, as c purchasers have attempted to encourage higher qualify c products, b now are often purchased based upon a pricing grid, under which the purchase price is determined based upon the finished weight and the grade of the finished c product. If a finishes out favorable, the generally will generate more revenue for the farmer if sold under a pricing grid, as opposed to a price per hundred weight. Even though the packer will pay a higher price for the quality under the pricing grid, the packer generally will realize greater margins on the sale of the finished c products. However, if grid pricing is utilized, a c packer must coordinate the quantity of its grid pricing purchases to insure that it has demand for such quantity of premium finished c products. If not, the c packer's margin will be adversely affected under the grid pricing. Thus, the competitive marketplace is forcing greater coordination between the b acquisition function and the packer's marketing function. The transfer of the b purchasing function to LP will improve the ability to coordinate the b acquisition and finished c products demand.

In addition, greater cost efficiencies may be realized by LP conducting the purchasing functions, presently conducted by Coop's buyers. Presently, Coop purchases the b from the producers. In accordance with the Packers and Stockyard Act, Coop generally must pay the b farmers within one day of its purchase of the b. Coop then sells the b to LP. LP must then pay Coop for the purchase of the b. The timing of Coop's payment and LP's payment is complicated by the different pricing arrangements for the purchase of live b in the current marketplace.

Eliminating multiple payment levels will provide significant administrative and cost savings benefits. In addition. both Coop and LP will not be required to maintain adequate working capital to fund their current respective operations. LP may fund the inventory cost more effectively, given the financial marketplace's approach in providing financing to Coop and LP.

Furthermore, LP's employees will benefit from shared knowledge, which will reduce the potential for errors in not only the inspection and buying of b, but in all areas of its processing and marketing operations. LP's employees may eventually be able to "multi-task," which could mean fewer employees are needed. Coop and LP will also reduce costs by streamlining their operations. Transferring the purchasing division to LP will eliminate previously duplicated costs and redundant facilities and overhead. For example, the administration costs will be reduced by LP's ability to centralize Human Resources and Payroll for all personnel involved in the b marketing business operations.

The resulting revenue growth and cost savings, which are projected to be significant, will benefit Coop's members by increasing net margins, while increasing demand and revenues with respect to quality c. By staying competitive, Coop and LP will be better prepared for changes in the c products market, strengthening their place in the centralized domestic workplace and global market, while providing greater security for the farmers that depend on them.

The shift in the buying function will not alter Coop's ability to accurately allocate and pay its patronage dividends to its members and participating patrons. Coop and LP will continue to maintain all of the member and non-member purchase information, that is presently maintained. Thus, the same degree of accuracy in the computation of Coop patronage dividend will remain.

On the basis of the foregoing information, Coop request the following ruling:

Coop's profits realized from its b marketing activities will remain patronage sourced income after Coop has transferred its b acquisition activities to LP. Coop's profits from its b marketing activities are to be allocated and distributed on a patronage basis to Coop's members based upon the b purchased from Coop's members by LP on behalf of Coop. Coop's c marketing profits attributable to LP's purchase of b from nonmembers attributable to Coop will continue to be taxable as nonmember income.

Cooperatives are permitted to exclude patronage dividends from their taxable income by section 1382(b). Section 13881(a) defines a "patronage dividend," as, among other things, an amount paid to a patron of a cooperative "which is determined by reference to the net earnings of the organization from business done with or for its patrons." Section 1388(a) also states that a patronage dividend" 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."

The phrase "business done with or for patrons" is not defined in the Code or in the regulations. The standards for determining whether earnings are from business done "with or for patrons" are set forth in several cases and revenue rulings. In St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (1980), the court held that income was business done with or for patrons, i.e. patronage sources, if the income is attributable to transactions "directly related to the marketing, purchasing, or service activities of the cooperative association," opposed to simply incidental. In Revenue Ruling 69-576, 1969-2 C.B. 166, the Service stated that:

> 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.

Coop is attempting to best serve its members in the changing economic climate. The increased efficiency realized through the transfer of the buying function will increase LP's profitability and, concomitantly, Coop's patronage sourced earnings and patronage dividends. In addition, the closer relationship will better allow LP to institute aggressive grid pricing programs in such a manner to maximize net margins and to match the supply of high quality c to LP's demand for such finished c products. This will provide better pricing for Coop's members and greater patronage dividends. Finally, the transfer of the buying function will eliminate duplication of certain administrative activities, increase operational efficiencies and profits, and help protect LP's market position in the highly concentrated c packing marketplace. Coop's ability to determine and distribute its b marketing margins to its members will not be adversely affected, since LP will continue to maintain the required records to insure that such margins are properly allocated and distributed to Coop's members.

In the proposed transaction, the cooperative is fulfilling its cooperative service activities through its interest in a limited liability company. The cooperative's participation in the partnership was due to the cooperative's need to react to changing and more competitive market conditions and the need to better and more cost effectively serve its members.

Under these circumstances, Coop's activities through LP are directly related to and actually facilitate, the accomplishment of Coop's cooperative mission. Based upon the foregoing, Coop's share of the LP income should be treated as patronage sourced, since such income directly facilitates Coop in furnishing its b marketing services to its members. The income should be allocated by Coop between and among (i) its members and participating patrons and (ii) its non-members, based upon the b purchases made by LP on behalf of Coop.

Accordingly, based solely on the foregoing we rule that:

Coop's profits realized from its b marketing activities will remain patronage sourced income after Coop has transferred its b acquisition activities to LP. Coop's profits from its b marketing activities are to be allocated and distributed on a patronage basis to Coop's members based upon the b purchased from Coop's members by LP on behalf of Coop. Coop's c marketing profits attributable to LP's purchase of b from nonmembers attributable to Coop will continue to be taxable as nonmembers income.

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)