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Legend:

Coop	=
Corp A	=
State A	=
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Dear :

This is in response to a request for a ruling dated October 19, 2005, submitted on behalf of Coop by your authorized representative. The ruling concerns whether certain income received by Coop is patronage sourced income. The facts of Coop's transaction are fully described below.

Coop is a State A corporation organized under the State A Not-For-Profit corporation statute. Coop is a b products and services group purchasing organization (GPO) operating on a cooperative basis within the meaning of subchapter T of the Internal Revenue Code. The original and continuing primary purpose of Coop is to allow small b facilities to join together in order to purchase at wholesale or discounted cost. By purchasing cooperatively, small b facilities can receive substantial discounts otherwise unavailable to them.

The By-Laws of Coop allow any entity (typically a facility such as providers) to become a member. Members are entitled to one vote irrespective of their size and volume of business conducted through Coop.

Coop does business with member and nonmember patrons on a cooperative basis. Patrons directly and primarily benefit from Coop by obtaining supplies and services at lower group cost. A secondary and far smaller benefit results when the patrons receive a patronage dividend distribution from Coop.

Coop charges an administrative fee, typically less than e% of the items' cost, to negotiate contracts with vendors, to provide salesmen, management, office support and vendor lists. Coop meets its salary and overhead cost out of the administrative fee. Any excess fees (profit) are returned annually to the patrons as patronage dividends either in cash or in cash and allocated surplus. No return of capital, interest, or ordinary dividend is paid.

Coop as a fully-independent organization was free to operate in any state or geographical area it chooses. Its sales force could present its portfolio of contracts to any b facility that was interested. Its key selling features were its reputation, employees, and portfolio of contracts offered to potential patrons.

Although one of the largest independent regional GPOs in the country, Coop's volume of purchases under its contracts was small in comparison to the national GPOs. Accordingly, Coop was at a disadvantage when negotiating with vendors for price discounts. Prior to its affiliation Coop's overhead, administrative and sales costs created a situation where the administrative fee was just adequate to meet these costs. To develop a new program, add a new contract or to expand its in-house electronic purchasing services required significant cost outputs. These costs were not spread over large amounts of purchases as with the national GPOs.

Coops management, Board of Directors, and members felt it was in their best interest to pursue an affiliation, rather than a sale, in order to retain as much independence as possible and protect access to vendor contracts. The affiliation would bring access to a larger portfolio of group purchasing contracts with larger discounts. Various national GPOs were considered for affiliation with Corp A being the company chosen. Accordingly, on f Coop entered into an affiliation agreement with Corp A in order to obtain larger price discounts and more competitive programs for the benefit of its patrons.

Since the inception of the affiliation agreement, the ability to market a wider range of products and service and the addition of new patron facilities has resulted in significant increases in net income to Coop. The affiliation agreement has been beneficial to Coop's patrons as they have received lower product and service prices and additional patronage dividend income.

In c, Corp A made an unsolicited offer to purchase Coop. On d, the Board of Directors of Coop approved a recommendation to sell the business assets of Coop (goodwill, workforce in place, geographical marketing rights under the affiliation agreement, furniture and equipment) to Corp A. Pursuant to the bylaws, the members must consent to the sale. In g, the members by vote agreed to the sale.

Following the sale of its business assets, Coop will no longer conduct any active business but will restrict its activities to collection of its receivables, payment of its payables, and distribution of its patronage dividends prior to final liquidation.

Coop request a ruling that the amount realized from the sale of its assets to Corp A is patronage sourced income eligible for the patronage dividend deduction under subchapter T.

Section 1381(a)(2) of the Code provides that subchapter T applies to any corporation operating on a cooperative basis. In the instant case, Taxpayer represents that it has been operating on a cooperative basis from its incorporation and has filed federal income tax returns in accordance with its status as a cooperative.

Cooperatives are permitted to exclude patronage dividends from their taxable income under section 1382(b) of the Code. Section 1388(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 such amount is out of earnings other than from business done with or for patrons.

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

> 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. Rev. Rul. 690-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The court held that the relation of income activity to the cooperative's business was too tenuous.

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, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03 (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)), 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, 78 T.C.M 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, 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.

In the proposed sale h% of the sales proceeds will be allocated to goodwill, sales force in place, and the exclusive territory. Maintaining a sales force and providing patron support in a successful organization over many years has naturally resulted in an intangible asset: workforce in place. Further, the closely associated asset of goodwill is also a natural result of the successful business because the natural bias of a Coop patron/member would be to do business with Coop. These two assets were not purchased or created as an incidental act of Coop, but are solely and directly related to actions of the sales for and management of Coop over many years of service to Coop's patrons.

Prior to the affiliation, Coop's management's forecast was for a continued erosion of margin, increased competition resulting in a gradual, yet definite wasting away of Coop's goodwill and sales force in place. Although, the affiliation provided many positive features, management is still uncertain of the future of the organization. At the expiration or termination of the affiliation agreement, Coop will be left with access to its patrons but will not have a catalog of contracts, nor an electronic format in which to offer these contracts to patrons. Coop's creation and subsequent sale of its assets are both directly related to its cooperative business purpose of providing value to it patrons.

Accordingly, based solely on the foregoing we rule that the amount realized from the sale of its business assets to Corp A is patronage sourced income eligible for the patronage dividend deduction under subchapter T.

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. No opinion is expressed or implied as to the proper allocation of the purchase price to the assets. 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
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)