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Date:
June 09, 2008

LEGEND

Taxpayer =

State A =

Cities =

B =

C =

D =

Cooperative E =

Pool Project =

Pool =

Project =

Agency =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

Dear :

This is in response to a request for a ruling dated February 8, 2008, submitted on behalf of Taxpayer by your authorized representatives. The ruling concerns the Federal income tax consequences of a proposed transaction as described below.

Taxpayer is a nonprofit, nonstock cooperative business corporation formed under State A law in b. Taxpayer has been recognized as a tax-exempt organization described under section 501(c)(12) of the Internal Revenue Code since c. Taxpayer's Articles of Incorporation state its purposes to be, among other things, to generate and purchase electric energy for its members, to transmit and sell such electric energy to its members, and to construct, acquire, lease, and operate any and all plants, dams, reservoirs, pipelines, turbines, generators, transformers, machinery, supplies, equipment, electric transmission and distribution lines, etc., necessary or appropriate for carrying out the purposes of the corporation.

Taxpayer has approximately d members. Taxpayer allocates the excess revenues collected over cost to its members based on their purchases from the organization. Taxpayer accounts on a patronage basis to its members for all amounts received from each member for the furnishing of electric energy and heat, and pays by credits to capital account for each member all such amounts in excess of operating costs.

Taxpayer is the sole electrical utility for the communities of B and C in State A and the surrounding vicinities. Taxpayer produces and distributes electricity to approximately e customers. Currently, Taxpayer operates power plants: a liquid-fuel turbine cogeneration (electricity and heat) plant, diesel generator plants, and the D project. The D project consists of a hydroelectric generating plant with a dam, reservoir, dike, spillway and penstocks, and associated real property, structures and equipment located approximately miles south of C.

Taxpayer also maintains f miles of transmission lines, g miles of distribution lines, transmission stations, distribution substation operations, and office facilities in B and C.

Taxpayer constructed the D project in h. In i, Taxpayer sold the D project to the State A Power Authority (Authority), a political subdivision of State A. The sale was a part of the Pool Project, pursuant to which other hydroelectric generating plants were contributed to the Authority. The hydroelectric projects in the Pool Project are known collectively as the Pool.

As part of the Pool Project, Taxpayer operates D, and each of the other hydroelectric projects is operated by the electrical utility provider that transferred it to the Pool (one of the projects is operated by utilities). Along with the other utility providers, Taxpayer has entered into a Long Term Power Sales Agreement (PSA) with the Authority for a term that will end in j. The other parties to the PSA are Cooperative E and the municipal power agencies of Cities. The utilities and Taxpayer are referred to as the Purchasing Utilities.

Under the PSA, each of the Purchasing Utilities agrees to operate and maintain its respective facility and to purchase electrical power from the Authority to the extent of available capacity. None of the facilities or associated power lines maintained by the Purchasing Utilities is interconnected with the others. Taxpayer is responsible for operating and maintaining the D project and for purchasing all power produced by the D project from the Authority.

Pursuant to State A legislation establishing the Pool Project, the projects are considered as one project for purposes of providing uniform rates and sharing risks. Under the terms of the PSA, each of the Purchasing Utilities purchases power at the same wholesale power rate, even though the costs of producing power at the

facilities is not uniform, and each of the Purchasing Utilities obtains power only from the particular facility it is responsible for operating and maintaining. The pooling arrangement reduces Taxpayer's costs because the cost to operate the D project is more than Taxpayer pays for power under the PSA.

In k, the Agency, determined previously by the Internal Revenue Service to be a political subdivision of State A, purchased the Pool facilities from the Authority. In l, an engineering firm that was commissioned to provide an estimate of value of the Agency facilities estimated the value of the D project assets at a $. The firm estimated the D project's repair and replacement costs at and the costs to relocate its transmission lines to be $.

The Purchasing Utilities have proposed that Taxpayer and Cooperative E withdraw from the Agency and the PSA. Taxpayer and Cooperative E would withdraw from the Agency, and the Agency would release Taxpayer and Cooperative E from all obligations and rights under all agreements relating to the Agency, including the PSA. Cooperative E would transfer $ to the Agency, and the Agency would transfer $ to Taxpayer. Ownership of the D assets, including the D facility and the associated transmission lines, equipment, contracts, material, real property interests, records and documents, would be transferred to Taxpayer. Ownership of the Project, including associated infrastructure, obligations, etc., would be transferred to Cooperative E. In the future, Taxpayer would not transfer ownership of D, and Cooperative E would not transfer ownership of the Project, without legislative approval.

In the event a rural electric cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) of the Code no longer applies until such time as the cooperative again satisfies the requirements for exemption. During any taxable period, the rules applicable to the electric 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 nonexempt 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 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 electric cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to its 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 of the Code 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 electric 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 instructive in resolving certain issues facing rural electric 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 co-workers, 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 electric 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 electric 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 electric 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 electric cooperative, regulations and rulings address the issues for cooperatives governed by Subchapter T of the Code. 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)(3) of the Code specifies that a patronage dividend must be "determined by reference to the net earnings of the organization from business done with or for its patrons." That section further provides that the term "patronage dividend" does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers "to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

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. 69-576 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 v. Commissioner*, 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.

In *Land O'Lakes, Inc., supra*., the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

In the instant case, Taxpayer is swapping an asset used in the cooperative's business, the PSA, for the real assets that produce electricity that Taxpayer sells to its patrons and cash. Thus, the gains at issue are realized in a transaction that is directly related to the cooperative enterprise and patronage sourced.

Accordingly, based solely on the above, we rule that:

Any gross income to Taxpayer as result of Taxpayer's receipt of the D project assets and cash from the Agency, if the receipt of such income causes Taxpayer to fail to qualify for exemption under section 501(c)(12) of the Code for the year of such receipt, will be patronage sourced income and Taxpayer may allocate such income to its members as patronage dividends and deduct or exclude such income from its taxable income under Rev. Rul. 83-135 and the rules applicable to taxable electric cooperatives.

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. In accordance with a power of attorney filed with the request, a copy of this ruling is being sent to your authorized representatives.

Sincerely yours,

Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)