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March 27, 2015

LEGEND:

Taxpayer =

Corp 1 =

Corp 2 =

LLC 1 =

LLC 2 =

Dear

This is in response to a letter dated September 30, 2014, submitted by your authorized representative regarding a planned method for handling a loss realized by Taxpayer.

Taxpayer is a nonexempt Subchapter T cooperative. As a consequence, Taxpayer files its federal income tax return on Form 1120-C (U.S. Income Tax Return for Cooperative Associations). It does so on the basis of a calendar year. Taxpayer's overall method of accounting for federal income tax purposes is the accrual basis.

Taxpayer is a cooperative serving the nation's leading centers and their affiliate . Taxpayer offers members a variety of products and services to help members measure and improve , operational, and financial performance. Currently, Taxpayer has as members approximately centers and affiliate .

Taxpayer's members use a broad range of products and services in the day to day operation of their centers. One of Taxpayer's core functions is what it describes as "supply chain optimization." Focusing on the unique needs of centers, Taxpayer provides a comprehensive array of services to help members reduce total supply cost and improve their overall supply chain performance while remaining focused on quality.

As part of supply chain optimization, Taxpayer provides its members with access to contracts with a wide variety of vendors (both suppliers and distributors). The contracts cover most of the products and services that a or other

uses in the course of serving its . Taxpayer members place orders under the contracts directly with the vendors. The vendors ship the products directly to the members. The vendors bill Taxpayer members directly, and Taxpayer members pay vendors directly.

Before , Taxpayer negotiated and managed the portfolio of contracts itself. In , Taxpayer agreed with Corp 1, another group purchasing organization serving and organizations, to combine their contract negotiation and management functions. They did so to enhance their bargaining power with vendors, eliminate duplication, achieve other cost savings and generally expand and improve the portfolio of contracts they could offer to patrons. They formed a joint venture known as LLC 1 which now handles the contract negotiation and management functions for Taxpayer and Corp 1.

Today LLC 1 considers that it has

LLC 1's contracts

During Taxpayer members purchased approximately of products and services through LLC 1.

In choosing vendors for particular products, LLC 1 looks for suppliers that provide the best-quality products and demonstrate broad-based acceptability at the optimal total value for members. The contracts negotiated by LLC 1 typically provide lower prices and better terms than patrons could find elsewhere. They also typically provide for a payment from vendors (referred to as a "marketing fee" or an "administrative fee") related to the volume of purchases under the contract. The administrative fees related to purchases by Taxpayer patrons under the LLC 1 contracts are collected by LLC 1 and remitted to Taxpayer. They are, in turn, used to cover Taxpayer's group purchasing operating expenses (including its share of LLC 1 costs), and any excess is distributed by Taxpayer to members and other participating patrons in the form of a patronage dividend. Taxpayer's patronage dividends for related to supply chain management activities totaled approximately $.

During , Taxpayer sold its interest in a limited liability company, known as LLC 2, to a private equity investment firm. Taxpayer's sale of its interest was part of a negotiated sale of LLC 2 by all its owners. Taxpayer received a cash payment of $ for its interest. For tax purposes, Taxpayer realized a loss of approximately $, all of which Taxpayer anticipates will be capital in nature. For patronage purposes, Taxpayer has consistently regarded the activities that culminated in the sale of its interest in LLC 2 to be patronage in nature, and it regards the loss it realized as a patronage loss.

This ruling request relates to Taxpayer's plan for handling the proceeds and loss resulting from the sale of its interest in LLC 2 for patronage accounting purposes.

Taxpayer's supply chain optimization activities, and in particular its contracting activities, are described above. Once contracts are negotiated, members deal directly with vendors in placing orders, shipping, billing and payment for the products covered by the contracts. Historically, members placed orders with vendors using a variety of different channels of communication – mail, private courier service, telephone, fax, or electronic data interchange.

In the late 1990s, use of the internet for business purposes was still in its infancy. Many thought that the internet would allow for the development of business-to-business exchanges which would permit customers to deal directly with vendors and thus would change how many products, including products used by and , were purchased and sold. No exchanges of this sort existed at the time in the industry. The major companies involved in the industry, group purchasing companies representing and large suppliers and distributors, realized that they would likely need to play a leading role if such sites were to be developed.

Several companies were formed with the objective of constructing exchanges and then attracting companies to use their exchanges. . (later known simply as Corp 2) was one such company. It went public in , raising approximately $ to be used to develop an exchange. At the same time, some of the large suppliers and distributors of supplies decided to pool their resources and build an exchange. In of the world's largest product manufacturers formed LLC 2 for just this purpose.

Corp 1, Taxpayer, and LLC 1 considered their options. They believed that potential benefits for members would be substantial if an exchange could be developed. Such an exchange promised to significantly improve supply chain optimization, one of their core missions on behalf of their members. As a result, they wanted to be in the forefront of any developments. They considered building their own exchange, but ultimately decided to join forces with Corp 2 to develop a web site to serve as a portal for Corp 1 and Taxpayer patrons to place orders with vendors for products purchased under the LLC 1 contracts.

The business relationship made sense for both sides. Corp 2 was in the process of developing an exchange, and brought development expertise to the table. However, Corp 2 was developing an exchange in the hope that it would be able to attract suppliers, distributors and to the site and that they would be willing to pay to use it. Corp 1, Taxpayer and LLC 1 had the capacity to bring users (i.e., their members) to the website.

Corp 2 agreed to develop a website in accordance with Corp 1, Taxpayer and LLC 1 's specifications and for the exclusive use of Taxpayer, Corp 1 and LLC 1 . Corp 1 and Taxpayer agreed to make substantial annual payments to fund the development and to compensate Corp 2 on an ongoing basis for servicing and maintaining the exchange. Corp 1, Taxpayer and LLC 1 also agreed to encourage their members to participate in the exchange.

For their support and commitment, Corp 2 agreed to award shares of Corp 2 stock and penny warrants to purchase Corp 2 stock to Corp 1 and Taxpayer. The shares and warrants were awarded on . After the issuance of the shares, Corp 1 and Taxpayer together owned approximately of Corp 2. The shares were vested. The warrants (which were soon thereafter exchanged for restricted shares) vested over a five-year period so long as Corp 1 and Taxpayer met certain targets for signing up members to use the exchange.

Both the shares and warrants were compensatory in nature. When Taxpayer received the original vested shares and as the restricted shares of stock vested, Taxpayer included an amount in taxable income equal to the fair market value of the shares. Fair market value was determined by reference to the trading value of the shares on the day the original vested shares were awarded and on the days the restricted shares vested.

Taxpayer viewed its relationship with Corp 2 as a patronage relationship. In , when Taxpayer entered into the arrangement, it adopted an Addendum to its Patronage Policy which included the following preamble:

> "With the rapid development of the Internet, it appears possible, and perhaps likely, that in the near future the best and most efficient means for the Participating Patrons of Taxpayer to place orders under the contracts

developed by LLC 1 will be over the Internet. It is considered critical to the fulfillment of the mission of Taxpayer that such a channel of communication be developed and that it be available to the Participating Patrons of Taxpayer on fair terms and at a reasonable cost. Taxpayer, Corp 1 and LLC 1 have considered various alternatives for developing an Internet platform on their own, and ultimately have determined that it is in the best interests of their Participating Patrons that the activity be outsourced to **.** (“Corp 2”), a business-to-business e-commerce company.

Acting on behalf of the Participating Patrons, Taxpayer, Corp 1 and LLC 1 have negotiated an arrangement with Corp 2 whereby Corp 2 will develop and make available to Participating Patrons of Taxpayer and Corp 1 an e-commerce platform that will allow Patrons to place orders under LLC 1 contracts over the Internet.

As part of these negotiations, Taxpayer and Corp 1 sought to assure that the e-commerce platform would meet certain performance standards. Taxpayer and Corp 1 bargained to obtain for their Participating Patrons favorable terms and conditions for placing orders through that platform.

As a result of these negotiations, upon closing of the Corp 2 transaction, which is expected to occur during , Taxpayer will receive shares (the “Shares”) of Corp 2 common stock and a warrant (the ‘Warrant’) to purchase up to shares (the ‘Warrant Shares’) of Corp 2 common stock over a period of 5 years provided certain targets are met for signing up Participating Patrons.”

The patronage policy provided that any income and expense arising from the arrangement would be treated as patronage income or expense. This included income that Taxpayer realized upon receipt of the stock and upon vesting of the restricted stock.

In , Corp 2 and LLC 2 agreed to join forces. LLC 2 operated an exchange that was in many respects similar to the Corp 2 exchange, except that it was open to all. LLC 2 described its business as follows:

By a number of other companies had joined LLC 2. Combining with LLC 2's exchange appeared to be a preferable alternative to continuing to go it alone with Corp 2.

There were obvious efficiencies to be gained by the combination:

In the combination, most of Taxpayer's Corp 2 shares were exchanged for a partnership interest in LLC 2. After the combination, Taxpayer had a interest in LLC 2. LLC 2 entered an outsourcing agreement with Corp 1, Taxpayer and LLC 1 to provide supply chain management products and services for Corp 1 and Taxpayer members. With the addition of Corp 1 and Taxpayer as members, the membership of LLC 2 grew to . All of the members were users of the site.

Taxpayer viewed its relationship with LLC 2 as a continuation of its relationship with Corp 2. Taxpayer updated its patronage policy to provide that income and expense related to its interest in LLC 2 and any gains or losses from the disposition of that interest would be treated in the same manner as originally provided for its interest in Corp 2.

The sale was a logical next step for LLC 2 and its members. LLC 2 was originally formed at a time no exchange existed to allow its members to develop such an exchange. Having developed the exchange to a level where it was self-sustaining, the members of LLC 2 felt they could step back from ownership and active control of the exchange. They reached the conclusion that new ownership was best suited to take the exchange to the next level.

, the President and Chief Executive Officer of LLC 2, described the thinking of the LLC 2 Board in deciding to go forward with the sale as follows:

Taxpayer, Corp 1, and LLC 1 plan to continue to use LLC 2.

Since the sale, Taxpayer considered the alternatives for distributing the proceeds from the sale and handling the tax loss resulting from the sale.

Taxpayer treated the income arising from the receipt of vested shares of Corp 2 stock and from the vesting of shares of restricted stock as patronage-sourced income and included that income in patronage dividends paid to members . Because there was a public market for shares of Corp 2 stock, the amount of income earned was determined by valuing the shares at the fair market value at the time of receipt (for the original vested shares) or vesting (for the restricted shares). Taxpayer planned to hold the Corp 2 stock indefinitely because ownership of those shares helped cement the relationship between Taxpayer, Corp 1, LLC 1 and Corp 2.

However, from the start, Taxpayer recognized that this presented a risk. The Corp 2 business was speculative. That had already been reflected in the performance of the shares, which had dropped dramatically earlier in the year. There was a real possibility that the Corp 2 shares could decline further in value, leaving Taxpayer with a loss. In that event, Taxpayer wanted to be able to trace that loss to the members that had benefited in the years the Corp 2 shares were originally received or vested.

To lay the groundwork for accomplishing that result, Taxpayer separately determined the portion of its patronage dividend that was paid out of net earnings resulting from receipt and vesting of the Corp 2 stock. It then paid the noncash part of that portion in a separate class of written notices of allocation which it designated in its records as “special” written notices of allocation. Taxpayer’s patronage policy was amended in to include the following:

> "Prior to the time a patronage dividend is paid out of this income [arising from the receipt of shares of Corp 2 stock], it is anticipated that the Bylaws of Taxpayer will be amended to create a new class of written notices of allocation know as Special Written Notices of Allocation for use in such patronage dividend. It is contemplated that the new class of Special Written Notices of allocation will be redeemable at the discretion of Taxpayer not only for cash, but also for Corp 2 shares. In addition, it is contemplated that the new class of Special Written Notices of Allocation will not be automatically redeemed over five years upon the departure of a Participating Patron. In addition, it is contemplated that Taxpayer will be entitled at the discretion of the Governing Board to offset any capital losses it may incur for federal income tax purposes pro rata against such notices…."

The contemplated amendments were, in fact, adopted later in . In particular, Section Article VIII, Section 2(g)(ii) of Taxpayer's Bylaws was amended to provide:

> "(ii) in the event that the Corporation shall incur a loss or losses that are treated as capital for federal income tax purposes, such notices [the Special Written Notices of Allocation] may, at the discretion of the Governing Board, be reduced pro rata by the amount of such loss or losses either in the year of the loss or thereafter…"

Taxpayer is considering adopting the following plan (the "Plan") related to the sale of its interest in LLC 2. First, Taxpayer is considering using the $ of sale proceeds (less related expenses) to redeem a portion of the special written notices of allocation at their stated dollar amount. Second, Taxpayer is considering exercising the power granted to it by its Bylaws to offset the approximately $ tax loss triggered by the sale against an equal dollar amount of special written notices of allocation on a pro rata basis. Third, after these things are done, Taxpayer is contemplating leaving the remaining special written notices of allocation outstanding indefinitely.

Based on the foregoing, Taxpayer requests the following rulings:

1. The loss resulting from the sale of Taxpayer's interest in LLC 2 is properly chargeable to members holding special qualified written notices of allocation as provided in the Plan.

2. Charging the LLC 2 loss to members as provided in the Plan by cancelling special written notices of allocation will have no tax effect to Taxpayer other than the reduction of the tax loss incurred by reason of the sale of the interest in LLC 2.

When a cooperative incurs a loss related to patronage activities, it has long been recognized that a cooperative may charge that loss to members. See, for example, Rev. Rul. 70-407, 1970-2 C.B. 52 (loss charged to members by cancelling written notices of allocation) and Rev. Rul. 81-103, 1981-1 C.B. 447 (loss charged to members by offsetting nonqualified written notices of allocation).

The rationale behind allowing cooperatives to pass losses through to members rests upon the fundamental element of “operating on a cooperative basis,” namely the principle of “operation at cost.”

Revenue Ruling 69-67, C.B. 1969-1, 142, provides that one of the fundamental principles associated with a cooperative is that it be operated at cost for its patrons. This principle is usually evident when the net earnings (net savings) resulting from the operation of the cooperative from business done with or for its patrons are returned by the cooperative to its patrons in proportion to the amount of business done with or for each patron.

A corollary to this cost principle of operation is that any losses of the cooperative operation attributable to excess advances or undercharges to the patrons are recoverable from the patrons. This recovery can be made through the cancellation of outstanding credits that the patron has on account with the cooperative. It can be made through direct assessment of each patron’s share of the loss, or the cooperative may set up an account receivable from each patron if it is on the accrual basis. Under any of these methods the cooperative would in fact have no loss due to excess advances or undercharges.

Section 1.1382-3(c)(3) of the Income Tax Regulations provides generally that, ‘if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year income realized from such gain must be paid, insofar as is practicable, to the persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years. The same general rule should also apply to capital losses or to any other type of loss which, although recognized for tax purposes in one year, is really a result of a decrease in value of an asset which was held for more than one taxable year. Such allocation of gain or loss need not be done with exactitude. All that is required is an allocation insofar as is practicable.

Taxpayer believes that the Plan is the fairest treatment of the proceeds and the loss resulting from the sale of its interest in LLC 2**.**

As described above, one of Taxpayer’s core activities is to provide products and services that assist its member with supply chain optimization. Taxpayer entered into the relationship with Corp 2 (and later with LLC 2) to help develop an internet-based tool that members could use for just this purpose. Taxpayer has consistently treated its relationship with Corp 2 (and later with LLC 2) as a patronage relationship. The resulting losses are patronage-sourced and thus losses of a sort that can be properly charged to supply chain members.

The approach for handling the loss by charging it pro rata to special written notices of allocation is the fairest means to apportion responsibility of the loss among the members of Taxpayer. As described above, the special written notices of allocation were initially authorized for use in patronage dividends out of income realized when Taxpayer earned the Corp 2 stock. When those patronage dividends were paid, Taxpayer was concerned that the value of the Corp 2 stock might later decline leaving Taxpayer with losses. Taxpayer felt then, and it feels now, that it is fairest to charge those losses to the members that benefited from the patronage dividends paid out of income recognized when the Corp 2 stock was received (in the case of the original vested shares) or became vested (in the case of the restricted shares). Taxpayer believes that its proposed plan meets the test of reasonableness and practicality in the approach that it is using to allocate this loss.

The loss which Taxpayer proposes to charge members will be characterized as a capital loss for tax purposes. From a patronage accounting perspective, there is no distinction between capital and ordinary losses. The approaches recognized over the years for fairly charging ordinary patronage losses to members apply equally to charging capital patronage losses to members.

The approach followed in the Plan follows the approach that was built into Taxpayer's patronage policy at the time Taxpayer entered into the arrangement with Corp 2. While Taxpayer and its members did not know at the time that Taxpayer's ownership interest in Corp 2 (or its successor LLC 2) would ultimately generate a loss, there was concern that could be the case. The special written notices of allocation were created to provide a means to charge any loss to appropriate members.

Taxpayer's members were aware of the patronage policy, and the Bylaws were amended with member approval to authorize the creation of the special written notices of allocation to implement the plan. Handling the loss in any other manner would upset the expectations of Taxpayer and its members.

Accordingly, based solely on the law and analysis discussed above, we rule that:

1. The loss resulting from the sale of Taxpayer's interest in LLC 2 is properly chargeable to members holding special qualified written notices of allocation as provided in the Plan.

2. Charging the LLC 2 loss to members as provided in the Plan by cancelling special written notices of allocation will have no tax effect to Taxpayer other than the reduction of the tax loss incurred by reason of the sale of the interest in LLC 2.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. 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 the ruling is being sent to your authorized representative.

Sincerely yours,

Nicole R. Cimino
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)