



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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501.12-02

Legend:

State =
Corp X =
Corp Y =
Corp Z =
Year 1 =
Year2 =
Year3 =
M =
\$A =
\$B =
\$C =
\$D =
Limited Partnership =
Enterprise =

Dear

We have considered your ruling request dated May 12, 2009, regarding the tax consequences of the proposed transaction described below.

You are a nonexempt rural cooperative telephone company that operates on a cooperative basis. You were previously granted exemption as a rural telephone company under section 501(c)(12) of the Internal Revenue Code, but in recent years you are no longer exempt.

Your members consist of those who obtain telecommunications services from you within your "Certified Area" as designated by State's Public Utilities Commission.

Each of your members is entitled to only one vote on governance matters and a majority of the votes cast will control on most matters on which the members are entitled to vote. According to your bylaws, margins (or profits) earned by you from patronage sourced business must be credited as capital credits to the capital accounts of members. Margins from non-patronage

activities are not subject to the obligations to distribute to members as is patronage sourced income.

Your bylaws provide that, upon dissolution, all your debts and liabilities shall be paid and then the members shall be entitled to receive repayment of their patronage capital, repayment of their membership fees, and any remaining property and assets that shall be distributed based on the patronage of the members.

You provide regulated telephone services to your members in your service area. The regulated telephone services basically include everything that is telephone-related, including local telephone services, access to long distance and special access; it does not include inside wiring and long distance service itself, or equipment and telephone sales and lease, all of which are deregulated. You have endeavored throughout your existence to provide members with access to communications technology advances as they become available and feasible for deployment.

You serve less than M customers. Your service area is significantly rural and is substantially agricultural.

You have said that the commercial wireless technology industry began in the early 1980's. The beginning years, as in most infant industries, were marked by explosive growth, little to no regulation, and burgeoning technologies. The Federal Communications Commission ("FCC"), the main regulator of the wireless industry, notes that there were approximately 340,000 wireless subscribers in 1985. A decade later, wireless subscribers had grown to over 33 million. At the end of 2005, the total number of wireless subscribers stood at an estimated 213 million, clearly indicating that wireless telephony and other wireless services are significant in the competitive communications arena.

The FCC regulates the wireless industry primarily through wireless spectrum management, a system developed in part to encourage development of wireless technology. Providers access the country's airwaves by acquiring a license to provide services within a specific area. These geographic areas, defined at the smallest level by counties, range from one to two counties to the whole nation. The smallest license areas are called Cellular Market Areas ("CMAs") and are further defined by Metropolitan Statistical Area ("MSAs") and Rural Service Areas ("RSAs").

RSAs, unlike MSAs, do not cross state boundaries. RSAs account for approximately 75 percent of the nation's land mass, but only 25 percent of the national population. RSAs are characterized by rural areas with small cities and towns. Most of State has technical access to wireless services, and market concentration is above 90 percent. As of June 2006, the FCC reported that State had a total of 3.4 million wireless subscribers. You operate in an RSA located in State.

As previously noted, you have historically endeavored to make telecommunications advances available to your member-customers. In Year1, after study by management and your board of directors, the board authorized you to join Corp X and purchase the stock required to be a member of Corp X in order to access cellular telephone technology for your members.

Subsequently, a number of other rural telephone cooperatives participated with you in the creation of Corp Y for the same purpose. By Year2, Limited Partnership was organized with Corp X and Corp Y as general partners. Through this structure the rural telephone cooperatives (including you) obtained and made cellular telephone technology available to members. In the discussion that follows, Corp Y and Limited Partnership will be referenced together as the Enterprise. As Corp Z acquired greater interests in the Enterprise, concerns about conflicts of interest developed on the part of some rural cooperative telephone companies. Corp Z was endeavoring to sell its cellular services to customers while cellular services were also being offered by Enterprise. At the same time, alternative cellular phone services were becoming available from other sources to provide to your members.

Your board of directors determined it would be in your best interest to sell your interest in Enterprise, use proceeds from the sale for capital investments in plant and equipment to provide services to members, and potentially obtain cellular service from a different source after a required two-year continuing contractual commitment to obtain cellular service from Corp Z. Following negotiations, your interests were acquired by the Corp Z companies in Year3.

During the time following its initial investment of \$200.00 in Corp X, you invested an additional \$A in the aggregate into Enterprise for a total investment of \$B. Your last investment was made in 1995. You sold your interests in Enterprise to Corp Z for a total purchase price (after expenses) of \$C. The total gain was \$D.

You propose to allocate the gain to your members as patronage dividends as provided in your bylaws which state:

Article VI, Section 2 Patronage Capital In Connection With Furnishing Telephone Service:

- (a) In furnishing of telephone service, the Corporation's operations shall be so conducted that all patrons will through their patronage furnish capital for the Corporation. In order to induce patronage and to assure that the Corporation will operate on a non-profit basis the Corporation is obligated to account on a patronage basis to all its patrons for all Patronage Sourced (as determined by IRS Code section 501(c)(12)) amounts received and receivable from the furnishing of telephone service in excess of operating costs and expenses properly chargeable against the furnishing of telephone service. Non-patronage sourced revenues may be retained by the Corporation or be allocated to patrons by the Board of Directors. Patronage sourced amounts in excess of operating costs and expenses at the moment of receipt by the Corporation are received with the understanding that they are furnished by patrons as capital. The Corporation is obligated to pay by credits to a capital account for each member all such amounts in excess of operating costs and expenses. The books and records of the Corporation shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron and the Corporation shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account.

You further purpose to allocate the amount of gain from the sale of your interest in Enterprise by issuing capital credits to your members, and not take into account (exclude or deduct) the amounts allocated in determining its taxable income for Year3. Based on the foregoing, you request a ruling that:

- (1) The amount realized from your sale of your interest in Enterprise constitutes "patronage-sourced" income and, if properly allocated to your members, will not be included in your taxable income in Year3, the year in which the sale of your interest in Enterprise occurred.

Law

Section 501(c)(12) of the Code contemplates that rural cooperative telephone companies may qualify as tax-exempt organizations. As the telephone business has developed, however, some rural telephone cooperatives do not qualify for this exemption; you fall into this category, and thus are a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, sections 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 section 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 you, 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. 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 each 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 Enterprise to be deductible to you upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for your 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 v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (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)).

In Rev. Rul. 69-576, 1962-2 C.B. 166, 167, 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 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.

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 you is comprised of two parts: the original decision to participate in the organization of Corp X and Limited Partnership and the sale of Enterprise in Year3. Both elements of the transaction are directly related to your cooperative business and will facilitate your ability to provide communications services to your members.

You actively participated in the formation and funding of Corp X and Limited Partnership to insure that cellular service would be available on reasonable terms to your customers and to ensure that they would not be adversely affected by other customers' migration to cellular. You have submitted affidavits from three current board members who state that the purpose of your participation was to provide cellular service to your members and to protect against losing your core business to cellular services offered by others. You represent that your investment was not made primarily for the purpose of receiving earnings, although the ultimate return on the investment is substantial.

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, 43 A.F.T.R. 2d 79-816, 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.

Your investment in Corp X and Enterprise was directly related to its cooperative business. Investing in a company in order to provide wireless telephone service is directly related to the business of a cooperative whose foundation is to provide telephone service to its patrons. Your sale of Enterprise is also directly related to your cooperative business purpose. The sale of Enterprise to Corp Z is the natural conclusion of an enterprise calculated to build the cellular network and guarantee service to rural customers.

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. Id. Certainly, if you had taken your 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. See section 1.1382-3(c)(2) of the Income Tax Regulations. But you did nothing of this sort. You were an active participant in a venture, Enterprise, that was directly related to your cooperative telephone business. Enterprise was not a passive investment of the type Judge Posner implies would be impermissible.

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

- (1) The amount realized from your sale of your interests in Enterprise constitutes patronage sourced income and, if properly allocated to your members, will be excluded from your gross income in Year3, the year in which the sale of your interests in Enterprise occurred.

Because you do 100 percent of your telephone business with patrons on a cooperative basis, no allocation between patronage and nonpatronage is required.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437