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Person To Contact:

Telephone Number:

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Legend

COOP1 =

COOP2 =

COOP3 =

Corp =

State A =

LLC =

Dear :

This is in response to a request for a ruling dated August 5, 2014, submitted on behalf of COOP2 by your authorized representative. The ruling concerns the application of cooperative tax law to the transaction described below.

COOP1, COOP2, and COOP3 (the Cooperatives) are nonexempt rural cooperative telephone companies that operate on a cooperative basis. Each cooperative has less than \_\_\_\_\_ customers in its respective statutory exchange area (as defined by the State A Utilities Board). Each cooperative's service area is significantly rural and substantially agricultural. COOP1 has \_\_\_\_\_ telephone access lines; COOP2 has \_\_\_\_\_ telephone access lines; and COOP3 has \_\_\_\_\_ telephone access lines. As discussed below, each cooperative (consistent with its respective business goal) seeks to provide its member-patrons with access to communications technology advances as these advances become available and feasible for deployment.

COOP1 was organized to (among other things): (i) furnish communication services to its members at the lowest cost, (ii) contract for exchange service and toll service and reciprocal telecommunications service with connecting lines with local exchanges and long distance companies, and (iii) do and perform any and all acts and things as necessary or convenient to accomplish any or all of the cooperative's objectives. Members are issued a certificate of membership, which is required in order to receive communication services. No member of the association may own more than one membership and each member shall be entitled to one vote at meetings of the members of the association. COOP1's articles of incorporation enumerate the manner in which the directors are to "annually dispose of the earnings of the Association in excess of its operating expenses." The articles provide, among other things, that "remaining net earnings shall be allocated to a revolving fund and shall be credited to the account of each member ratable in proportion to the business he has done with the Association during each year. Such credits are herein referred to as 'Deferred Patronage Dividends'. Upon dissolution or liquidation, the assets of the Association shall be applied first to pay liquidation expenses, then to pay Association obligations and other Capital Credit Statements issued therefore, and the remainder of such assets shall be distributed in the manner and order provided by law.

COOP2 was organized to (among other things): (i) furnish, improve, and expand telephone service to its members at the lowest possible cost consistent with the proper maintenance of its telephone lines and other facilities, (ii) contract for exchange service and toll service and reciprocal telecommunications service with connecting lines with local exchanges and long distance companies, and (iii) do and perform any and all acts and things as necessary or convenient to accomplish any or all of the cooperative's objectives. A member purchases a membership in the cooperative (at the issuing price) and is eligible to receive telecommunication services. Each member may only own one membership, which entitles him or her to one vote at all meetings of the association. The cooperative's articles of incorporation explain the manner in which "the directors shall annually dispose of the earnings of the Association in excess of its operating expenses." "[R]emaining net earnings shall be allocated to a revolving fund and shall be credited to the account of each member ratably in proportion to the business he has done with the Association during the year. Such credits are herein referred to as 'deferred patronage dividends'." Upon dissolution or liquidation, the assets of the

association shall be applied first to pay liquidation expenses, next, to pay obligations to general creditors, next to redeem preferred stock and pay accumulated dividends thereon, if any, and finally the remainder of the assets shall be distributed in the manner and or of priority provided by law and the by-laws.

COOP3 was organized to (among other things): (i) furnish, improve and expand telecommunication services to its members and others at the lowest possible cost consistent with the proper maintenance of its telephone lines and other facilities, (ii) contract for exchange service and toll service and reciprocal telecommunications service with connecting lines with local exchanges and long distance companies in such manner as shall be deemed to be in COOP3's best interest, and (iii) to do and perform all acts and things, and to have and exercise any and all powers, as may be necessary or convenient to accomplish any of all of the foregoing purposes, or as may be permitted by the provisions of the laws under which COOP3 was formed, and to exercise any of its powers anywhere. COOP3 members are composed of "any person, firm, cooperative, corporation, limited liability company, partnership, limited liability partnership, or body politic" who receive retail telecommunication services from the cooperative at a premise within its established service area and the execution of a membership application, agree to comply with and be bound by articles of incorporation and bylaws and relevant rules – and accepted by majority vote of board of directors (and are issued a certificate of membership at an issuing price). No member may own more than one membership and each member entitled to one vote on each issue presented for vote of the members of the cooperative. COOP3 is operated on a cooperative nonprofit basis for the mutual benefit of its patrons (members). The cooperatives articles of incorporation provide the manner in which the directors "shall annually dispose of the earnings of the Cooperative in excess of its operating expenses." The cooperative's articles of incorporation provide in relevant part that:

The Cooperative shall allocate all remaining net earnings as provided in Section 2 below. [Section 2] In the furnishing of telecommunications service, the Cooperative's operations shall be conducted so that all persons will through their patronage furnish capital for the Cooperative. In order to induce patronage and to assure that the Cooperative will operate on a nonprofit basis, the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of telecommunications service in excess of operating costs and expenses at the moment of receipt by the Cooperative and received with the understanding that they are furnished by the patrons as capital. The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses.

In the event of dissolution or liquidation, after all outstanding indebtedness of the cooperative shall have been paid, outstanding capital credits shall be

retired without priority on a pro rata basis before any payments are made on account of property rights of its members.”

: “It is expressly understood that amounts paid for telecommunications services in excess of the cost of service are furnished by members as capital and each member shall be credited with the capital so furnished as provided in the Bylaws or Articles of Incorporation.

The provision of telecommunication services by small, independent telecommunication providers, such as the Cooperatives, to the relatively few customers in a respective statutory exchange areas is costly, particularly the provision of switching, calling features, broadband, IPTV, and call announcements. In an effort to provide their respective customers with a broader range of telecommunication services of higher quality delivered in a more efficient manner, the Cooperatives and similarly-situated providers formed LLC. LLC enabled the providers to pool their respective resources and provide furnish, improve and expand telecommunication services to their respective customers at the lowest possible cost, which was consistent with each of the Cooperatives respective goals. The partnership’s operating agreement provides in relevant part that the “business of the Company shall...provide for switching telecommunications traffic.” To that end, LLC enabled the participating providers to pool their resources in securing a switch in which the partners could direct their respective telecommunications traffic. The partnership agreement provides that each member participate in the switch sharing agreement.

In , in furtherance of LLC’s overall purpose, LLC executed an agreement with and , State A to purchase the State A License and State A License for \$ and \$ , respectively. LLC purchased this spectrum in order to assist its members in enhancing the telecommunications services that each member provides to member-patrons; that is, it was intended that the spectrum acquisition would enable LLC’s members to provide its member-patrons with enhanced voice, data, wireless internet, and wireless backhaul. LLC did not purchase the spectrum for investment purposes; the intention was to use the spectrum in order to enhance the telecommunication services that each member provided to its respective member-patrons.

LLC did not put the spectrum to use immediately because the construction costs associated with its usage (e.g., tower construction and electronic equipment installation) was approximately \$ . In addition to the construction-related costs, it was estimated that on-going operational and management costs, such as paying customer services representatives and fiber transport costs, would be approximately \$ annually. Neither LLC nor its members had the financial wherewithal at the time the spectrum was purchased to use the spectrum. LLC and its members, however, did anticipate using the spectrum in the future to enhance their respective customers’ telecommunication services.

Between \_\_\_\_\_ and \_\_\_\_\_ the spectrum market exploded due, in large part, to advances in telecommunications technology which boosted the spectrum's value. In order to support the advances in technology, the key players in the telecommunications marketplace sought available spectrum. In some instances, these players would consult spectrum brokers in their respective searches for available spectrum.

Corp learned of the licenses that LLC purchased in \_\_\_\_\_ – and Corp (ultimately) made an offer, which LLC accepted. As mentioned above, LLC purchased the spectrum in \_\_\_\_\_ with the intent to use it; however, at the time, LLC could not use the spectrum because construction costs were prohibitive. Importantly, the spectrum license required LLC to complete its “build out” by \_\_\_\_\_.

Following the purchase, the costs associated with using the spectrum continued to climb, as the spectrum market began to heat up. The key players in the telecommunications industry were better positioned to use the spectrum and possessed the financial wherewithal to bear the costs associated with using the spectrum. As the costs associated with spectrum usage were ever-increasing, LLC determined in \_\_\_\_\_ that it would not be in a position to use the licenses and accepted Corp's offer. On \_\_\_\_\_, LLC sold the spectrum. As a result of the spectrum sale, COOP2 received a distributive share of partnership income relative to the sale. COOP2 submits that because the spectrum sale relates directly to its respective enterprise such distributive share constitutes patronage sourced income.

Based on the foregoing, COOP2 requests a ruling that its distributive share of partnership income from LLC's Spectrum Sale constitutes patronage sourced income and, if properly allocated to COOP2's member-patrons, is excludable from COOP2's gross income in the tax year ending \_\_\_\_\_.

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, very few rural telephone cooperatives now qualify for this exemption; COOP2 falls into this category, and thus is 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, 87<sup>th</sup> Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87<sup>th</sup> 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 COOP2 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. In cooperatives, 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 the 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 the spectrum to be deductible by COOP2 upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Cooperatives 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 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, 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.")

Rev. Rul. 83-135, 1983-2 C.B. 149 provides that 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.

Cooperatives became partners in LLC to insure that telecommunication services would be available to the Cooperatives' customers.

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.

COOP2's investment in LLC and its purchase of the spectrum 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 rural cooperative telephone company whose "reason for existence" is to provide telephone service to its patrons. COOP2's sale of the spectrum through LLC is also directly related to its cooperative business purpose.

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 COOP2 had taken its 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. But COOP2 did nothing of this sort. Rather it became a partner in LLC for the purpose of providing its patrons with advanced telecommunication services.

Accordingly based solely on the above, we rule that:

COOP2's distributive share of partnership income from LLC's Spectrum Sale constitutes patronage sourced income and, if properly allocated to COOP2's



member-patrons, is excludable from COOP2's gross income in the tax year ending .

This ruling is directed only to the taxpayers 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)

cc: