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Person To Contact:
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December 19, 2019

Legend

Coop =

Corporation A =

State A =

X =

Y =

Dear :

This is in response to a letter dated June 25, 2019, submitted on behalf of Coop by your authorized representative requesting a ruling on the transaction described below.

Coop represents the facts as follows. Coop is currently a corporation operating on a cooperative basis under the laws of State A. Coop is operating on a cooperative basis within the meaning of subchapter T of the Internal Revenue Code (Code). Coop uses the calendar year for financial accounting and tax return reporting purposes.

In , began a business to provide shared access to . In , that business was transferred to a wholly-owned, for-profit subsidiary of a not-for-profit trade association, whose membership consisted of federally and state-chartered credit unions. The subsidiary expanded the

business and also developed a _____ to allow

In _____, Coop incorporated under the laws of State A, organized as a corporation operating on a cooperative basis, and subject to income taxation under subchapter T of the Code. Following its incorporation, Coop purchased the business from the for-profit subsidiary and offered _____ that were customers of the business to become shareholder-members of the Coop.

Coop's purpose was to develop, maintain, and operate on a cooperative basis an _____ network for _____ transactions to make it possible for its members, _____ located across the country, to issue _____ to their members and thus to compete with _____ and other _____. Coop's business activities included network administration, network operations, and sales and product development. Coop did not engage in any business activity not related its purpose.

Coop's objective was to serve _____, and its bylaws limited membership to _____, _____-owned subsidiaries, and associations of _____. Coop was also authorized to do business with other persons (nonmembers) on a nonpatronage basis. The other persons that chose to participate in the network on a nonpatronage basis were _____ that chose not to become members of Coop.

Coop operated successfully as a cooperative for many years. However, Coop was a small, limited-service, niche-market company in an increasingly competitive _____ industry. At the beginning of _____, Coop undertook a comprehensive strategic analysis to review its options going forward, and the analysis identified several factors that presented significant threats to Coop's business. While this review was underway, Corporation A expressed an interest in buying Coop's business. Ultimately, after careful review by Coop's Board of Directors and after obtaining approval from members, Coop made the decision to sell the business to Corporation A.

Coop's members unanimously approved the sale of Coop's assets as an on-going business to Corporation A, and the sale closed on _____, _____. The agreed purchase price was \$X. The transaction was structured as an asset sale. With a few specified exceptions, Corporation A bought all of Coop's assets "real, personal or mixed, tangible and intangible, of every kind and description, wherever located." These assets included all tangible personal property, all accounts receivable, all inventories, all of the network service and license agreements with Coop's members and other _____ customers, other agreements related to the business, settlement accounts, business records, all intangible rights and property (including the names " _____" and " _____"), and all goodwill and going concern value. Excluded assets included cash, and cash equivalents and corporate (as opposed to business) records such as minute books, tax returns, tax work papers, etc.

When approving the sale, Coop's members also approved winding up and liquidating Coop. Coop's Bylaws create an obligation to distribute patronage earnings to members on a patronage basis. In the case of asset gains, Coop's Bylaws are silent as to what period to use for measuring patronage. Coop's Bylaws provide that upon dissolution, after debts and obligations have been paid and allocated equities have been retired, residual assets shall be shared by shareholders (including both active and inactive members) based on historic participation.

Coop plans to make distributions to persons who were members (shareholders), both active and inactive, at the time of dissolution based on their historic participation in Coop's business. Coop has historically paid patronage dividends only to members. Coop has determined Y percent of the gain from the sale to Corporation A is eligible for distribution as a patronage dividend (the "Member Portion"). That percentage is the average of the patronage/nonpatronage business ratios over the past years. Coop is using years because the patronage/nonpatronage data for the first years of its operations is no longer available. Coop believes that the period used is representative of its business activities over its entire existence, and that the Member Portion would be slightly higher if information from the earlier years was available. Coop plans to treat the remainder as a non-deductible liquidating distribution.

Based on the foregoing, Coop is requesting rulings that:

1. The Member Portion of the net gain realized by Coop on the sale of substantially all of the assets of its cooperative business to Corporation A is net income from business done "with or for" patrons within the meaning of section 1388(a)(3).
2. Pursuant to section 1382(b)(1), Coop will be entitled to exclude or deduct as a "patronage dividend" a portion of the patronage-based distributions equal to the Member Portion of the net gain realized on the sale.

Section 1381(a) provides the organizations to which part I of subchapter T applies. Coop 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.

Section 1382(b)(1) permits an organization to which part I of subchapter T applies, in determining taxable income, to not take into account patronage dividends (as defined in section 1388(a)) paid during the payment period for the taxable year.

Section 1388(a) provides that the term "patronage dividend" means an amount paid to a patron by an organization to which Part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the

organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

In Rev. Rul. 69-576, 1962-2 C.B. 166, the taxpayer (a nonexempt farmers' cooperative) borrowed money from a bank for cooperatives to finance the acquisition of agricultural supplies for resale to its members. At the close of the taxable year for the bank, the bank determined its net earnings, which it then allocated to its patrons, including the nonexempt farmers' cooperative, on a patronage basis. The patronage allocations were based on the proportion of the total interest paid to it by each cooperative during the taxable year. The nonexempt farmers' cooperative in the instant case included the patronage allocations received by it from the bank for cooperatives in its gross income for the taxable year received under section 1385 of the Code. Under a preexisting obligation the nonexempt farmers' cooperative then allocated and paid the same amount it received from the bank for cooperatives to its own patron. The Rev. Rul. held that the allocation and payment of the amount by the nonexempt farmer's cooperative to its own patrons qualified as a patronage dividend. The Rev. Rul. stated that: "The classification of an item as from either patronage or non-patronage 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 servicing activities, the income is from patronage sources."

In Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03, 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, along with the income from the sale of its gas and soybean facilities, and miscellaneous depreciable business assets classified as patronage source. In articulating the "directly related" test for making the determination, the Court provides 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. On the other hand, if the income is derived from a transaction that has no integral and necessary linkage to the cooperative enterprise, such that it may fairly be said that the income is merely incidental to the cooperative enterprise and does nothing more than add to the overall profitability of the cooperative, then the income is deemed to be nonpatronage income. The determination of whether income derived from a transaction that is directly related to the cooperative enterprise, and, thus, is patronage income is a determination that is necessarily fact intensive. In considering the relatedness of the income-producing transaction to the cooperative enterprise, it is important to focus on the "totality of the circumstances" and to view the business environment to which the

income-producing transaction is related and not to view the transaction so narrowly as to limit it only to its income-generating characteristic when such a characterization is not consistent with the actual activity. The Court ruled that the sale of cooperative's assets met the directly related test and therefore the resultant gains and losses were patronage sourced.

Section 1.1382-3(c)(3) of the Income Tax Regulations, provides that it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, 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 gains 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.

Based on consideration of Coop's representations, the Member Portion of the net gain from the sale of its business assets is directly related to the amount of business done with or for patrons. Taxpayer's use of data from only X years, rather than for its entire existence, will not affect Taxpayer's ability to deduct the Member Portion paid to the members. Accordingly, the Member Portion of the net gain from the sale of its business assets to Corporation A is patronage income eligible for patronage dividend deduction under subchapter T.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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

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

Sincerely yours,

James A. Holmes
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)