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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-128432-19

Date:
May 26, 2020

In Re:

LEGEND:

Cooperative =

Land =

X =

Y =

Z =

Dear :

This letter responds to a request for a private letter ruling, dated November 25, 2019, submitted on behalf of Cooperative by its authorized representatives, regarding the application of cooperative tax law to the transaction described below.

FACTS

Cooperative files a consolidated federal income tax return using a December 31 year end and the accrual method of accounting. Cooperative is a nonexempt agricultural cooperative corporation operating on a cooperative basis. Cooperative's bylaws require it to allocate patronage earnings among its member-patrons on a patronage basis. Cooperative provides processing and marketing services for the agricultural products of its member-patrons and of nonmembers. Approximately X

percent of Cooperative's business is with member-patrons, and approximately Y percent is with nonmembers.

Cooperative purchased Land many years ago to facilitate its processing and marketing cooperative purpose. Land is no longer necessary to Cooperative's cooperative purpose. Cooperative has agreed to sell Land to an unrelated, third-party buyer. The sale will result in a gain. Cooperative will use the sale proceeds to facilitate its cooperative purpose. The sale proceeds will be used to fund the cash portion of the patronage dividend allocated to member-patrons relating to the gain, pay down Cooperative's debt, increase Cooperative's capital for additional investment in the patronage business, and redeem qualified written notices of allocation previously issued to member-patrons. Cooperative will be able to continue its processing and marketing cooperative purpose without Land.

Cooperative will allocate the X percent member portion of the gain from the sale of Land to each member-patron based on the proportion of products marketed for the member-patron to the total products marketed for all member-patrons using a Z-year lookback period. The Z-year lookback period will limit the participation in the gain to those member-patrons who were active in Cooperative during the years to which the gain is attributable. Cooperative's member-patrons have been relatively stable over the Z-year lookback period. Cooperative will report the Y percent nonmember portion of the gain as nonpatronage income on its consolidated federal income tax return for the year of the sale.

LAW AND ANALYSIS

Subchapter T of the Code (sections 1381 through 1388) provides the statutory scheme for taxing most cooperatives.

Section 1381(a) provides the organizations to which part I of subchapter T applies. Cooperative is a nonexempt agricultural cooperative corporation operating on a cooperative basis to which part I of subchapter T applies.

Section 1382(b)(1) permits an organization to which part I of subchapter T applies, in determining taxable income, not to take into account amounts paid during the payment period for the taxable year as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except non-qualified written notices of allocation (as defined in section 1388(d))).

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.

If a capital gain is realized by a cooperative from the sale or exchange of a capital asset used by the cooperative in its business done with or for patrons, then income realized from the capital gain must be paid, insofar as is practicable, to the persons who were patrons during the taxable years in which the capital asset was owned by the cooperative in proportion to the amount of business done by such patrons with the cooperative during those taxable years. See 1.1382-3(c)(3) of the Income Tax Regulations.

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, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 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 to its chief supplier was patronage source, because the loans "actually facilitated the accomplishment of taxpayer's cooperative activities, in that [the loans] enabled the taxpayer to obtain necessary supplies for its operations.")

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 Tax 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 a transaction that 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 864-65. The Tax Court 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 Tax 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 was 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 district 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 district court held that the dividends received by a plywood workers cooperative from West Coast Adhesives, a glue supplier that the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income because glue is essential for the manufacture of plywood and because the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

In CF Industries, Inc. v. Commissioner, 995 F.2d 101 (7th Cir. 1993), 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.

In this case, the Cooperative's ownership and sale of the Land are directly related to its cooperative business purpose of processing and marketing agricultural products. Taxpayer's use of a Z-year lookback period, rather than for the entire period it owned the Land, will not affect Taxpayer's ability to deduct the member portion of gain that is paid to the members.

RULINGS

Accordingly, based on the facts submitted and the representations made, we rule as follows:

1. The X percent member portion of the gain from the Cooperative's sale of Land is patronage-sourced income.
2. If Cooperative properly distributes the X percent member portion of the gain to each member-patron based on the proportion of products marketed for the member-patron to the total products marketed for all member-patrons during the Z-year lookback period, then the distribution is eligible to be deducted as a patronage dividend under section 1382(b)(1).

Except as expressly provided herein, no opinion is expressed or implied regarding the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding the effect of the transaction on the member-patrons or nonmembers of Cooperative.

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

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

JAMES A. HOLMES
Senior Counsel, Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy of this letter for § 6110 purposes

cc: