

INTERNAL REVENUE SERVICE

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March 7, 2001

LEGEND

Coop 1 =

Coop 2 =

Coop 3 =

Coop4 =

Corp A =

State A =

LLC =

LLC2 =

b =

PLR-123587-00

c =

Venture =

Company =

d =

e =

Dear :

This is in response to your letter dated October 30, 2000, submitted on your behalf by your authorized representative requesting rulings that certain income will be "patronage-sourced" income within the meaning of subchapter T of the Internal Revenue Code.

The supply chain between manufacturers and users of products is undergoing fundamental changes as a result of a wide variety of developments, not the least of which are technological developments that make it possible to coordinate activities in ways which were previously impossible. Historically, wholesale distributors played a key role in the supply chain. Now that role is being challenged. There are increasing pressures forcing wholesalers to rethink how they conduct their businesses, and, among other things, to operate on a larger scale and to be more efficient as a matter of business survival.

The agricultural economy and the cooperatives that serve farmers are not immune from these pressures. The historic mission of many of the federated farm supply cooperatives in the United States was wholesale distribution of farm supply products, serving as a cooperative middleman between their members (who were local cooperatives which sold farm supplies at retail) and the manufacturers of farm supplies. Many federated farm supply cooperatives ultimately themselves also became cooperative manufacturers of farm supplies either directly or through inter-regional cooperatives. However, all have remained cooperative wholesalers of the farm products they manufacture as well as others they purchase for resale.

Coop 1, Coop 2, and Coop 3 have historically each been engaged in wholesale distribution on a cooperative basis of b and c products. Each historically also has been engaged in the manufacture on a cooperative basis of b either directly or indirectly. Coop 1, Coop 2, and Coop 3 have concluded that their wholesale distribution functions can be conducted more efficiently if they join together thereby eliminating redundant facilities and overhead and better coordinating their activities.

The Joint Venture Agreement calls for the formation of a State A limited liability

PLR-123587-00

company. That limited liability company is known as LLC.

The Joint Venture Agreement describes the business objectives of the LLC as follows:

“(a) Business Objectives: The [LLC’s] objectives and scope of business include: (i) selling b and c products to cooperative members and patrons of Members (and others as may be otherwise agreed to by the Members) for resale or use in North American markets, and (ii) providing other goods and services to Members and members and patrons of Members (and others as may be otherwise agreed to by Members).” (Section 1.1(a)).

LLC has two members: Coop2 and LLC2.

LLC2 is a newly-formed LLC whose members are Coop1 and Coop3.

LLC2 is a holding company. LLC2 is not and will not be an operating entity. The parties desired that the governance of LLC be split on a _____ basis between Coop2 and Coop1/Coop3 as would have been the case if the Coop1/Coop3 merger had occurred. LLC2 allows this result to be accomplished. Should Coop1 and Coop3 merge at some time in the future, because of LLC2 such a merger would not require a reorganization of LLC.

LLC2 has an additional function. Prior to the formation of LLC, Coop1 conducted its c activities through Venture, a joint venture with Company (which is not a cooperative). Venture had combined the c businesses of Coop1 and Company. The Venture business will, in the future, be conducted as part of LLC. The parties did not want to expend the capital required to buy out the Company interest, but did not want Company to have a direct interest in LLC. The solution was to give Company a limited nonvoting interest in LLC2 which represents a continuation of its economic interest in Venture. LLC’s Operating Agreement requires separate accounting for its “c Business” and for its “Non-c Business.” That separate accounting carries through to LLC2. Company has a right to share in _____ % of LLC2’s c business earnings or loss (or, since LLC2 is entitled to _____ % of LLC’s earnings, _____ % of the overall LLC c Business earnings). Company has no right to share in LLC2’s or LLC’s non-c business earnings. Company has no right to participate in the governance of LLC2 or LLC.

The economic interests in LLC today are: Coop2 - _____ %, LLC2 - _____ %. The economic interests in LLC2 are: Non-c Business – Coop1, _____ % and Coop3 _____ ; c Business – Coop3, _____ %, Coop1, _____ %, and Company, _____ %.

LLC directly owns almost all of the assets and liabilities associated with the e

PLR-123587-00

business formerly conducted by Coop1 (directly, in the case of the b business and through Venture in the case of c products), Coop3 (directly and through Corp A), Coop2 (directly, including the Coop2 Eastern Region, and through Corp A). LLC has five single-member limited liability company subsidiaries (whose separate existence will be disregarded for federal income tax purposes and which will be treated as divisions of LLC):

- (i) _____ LLC
- (ii) _____ LLC, which will conduct the historic businesses of _____ LLC and _____, Inc.
- (iii) _____, LLC, which will conduct the historic business of _____, Inc.
- (iv) _____, LLC, an LLC formed to facilitate financing LLC's business, and _____
- (v) _____, LLC, another LLC formed to facilitate financing LLC's business.

The following segments of LLC's business will be conducted on a nonpatronage basis - _____ LLC, the portion of the activities of _____ LLC related to the historic tolling business of _____ LLC (but not the activities related to the historic business of _____, Inc.), and _____ LLC. Collectively, these nonpatronage activities are referred to as the "Nonpatronage Activities."

Coop1, Coop3, and Coop2 remain committed to providing e products to their members and other participating patrons on a patronage basis. To achieve economies and efficiencies, wholesale activities will be combined and conducted jointly through LLC in a manner that assures that they will continue to be conducted on a patronage basis.

LLC will conduct the wholesale b business now being conducted by Coop1, Coop3, and Coop2. In its simplest terms, that business consists primarily of buying and selling b. It is anticipated that most of the b LLC sells will be manufactured by Coop1 and Coop4.

Coop1's b manufacturing activities will continue unchanged. Its entire output will be sold to LLC, but will remain destined principally for sale to persons who are members or other participating patrons of Coop1. Coop1 will continue to earn a profit or loss arising from the manufacture of d. (Coop1's "d manufacturing profit or loss").

Coop3 and Coop2 will continue as members of Coop4. All b they buy from

PLR-123587-00

Coop4 will be resold to LLC, but will remain destined principally for sale to persons who are members or other participating patrons of both Coop3 and Coop2. Coop3 and Coop2 will continue to realize a profit or loss arising from the manufacture of d (Coop3's and Coop2's' d manufacturing profit or loss"). This profit will consist of patronage refunds from Coop4.

LLC also may purchase b from third parties. LLC will resell most of the d it purchases to the cooperative members and participating patrons of Coop1, Coop3 and Coop2. In addition, LLC will provide related products and services to its customers, such as storage, blending, application, consulting, training, etc. The results of this business ("d wholesale profit or loss") will be accounted for separately by LLC.

LLC will not sell b on a retail basis (except through _____ as described in the next paragraph). Coop3 currently sells some b on a patronage basis at retail to farmers and ranchers through _____ and through other arrangements. Coop2 also sells some b on a patronage basis at retail to farmers and ranchers through _____. Both will continue to make such sales. LLC will be the preferred provider of b to Coop3 and Coop2 for such purposes. Coop3 and Coop2 have agreed to purchase b, "for retail resale as long as its commercially reasonable to do so and the price and terms offered by LLC are competitive." Coop3 and Coop2 will continue to realize a profit or loss from the retail sales they make ("d retail profit or loss").

LLC will conduct the wholesale c business now being conducted by Coop1, Coop3, and Coop2. In its simplest terms, that business consists primarily of buying and selling c products.

After formation of LLC, neither Coop1, Coop3, nor Coop2 will be involved directly or indirectly in the manufacture or purchase of c products. LLC will conduct the c product manufacturing activities now being conducted by _____, which has been merged into _____ (a one-member LLC) and thus will be treated for federal income tax purposes as part of the _____ division of LLC. This portion of the _____ division will be treated as patronage to the extent _____ products are sold to members and other participating patrons of Coop1, Coop3, and Coop2.

LLC is expected initially to purchase approximately _____ % of the c products it sells from manufacturers and middlemen. It will manufacture (through what as historically _____ and what will be part of its _____ division approximately _____ % of the c products it sells. Finally, it will make c products available under "agency arrangements."

LLC will sell c products (and provide related products and services) primarily to the cooperative members and participating patrons of Coop1, Coop3, and Coop2. The results of the c business ("c manufacturing and wholesale profit or loss") will be accounted for separately by LLC.

PLR-123587-00

As in the case of b, LLC will sell some c products to Coop3 and Coop2 for resale at retail on a cooperative basis to farmers and ranchers through the Coop3 and Coop3's other arrangements and through the Coop2 .

Formation of LLC will not affect the existing membership and participating patron relationships between Coop 1 and its members and participating patrons, Coop2 and its members and participating patrons, between Coop3 and its members and participating patrons. Coop1, Coop3, and Coop2 will remain committed to serving as a reliable source of quality e products for members and participating patrons. Maintaining membership relations will continue to be a function conducted by Coop1, Coop3, and Coop2. The other cooperative activities of each (which are substantial) will continue unaffected.

However, there will be one significant change in membership relationships. In the Joint Venture Agreement, Coop1, Coop3, and Coop2 have agreed that they

“ . . . will each as soon as practical following the Operational Closing extend the offer of membership and the ability to procure b and c products through the [LLC] on a cooperative basis as facilitated by each of them, the intention being that all qualified patrons of Coop2, Coop3 and Coop1 will be entitled to participate on a patronage basis in the earnings of the Members derived from the [LLC] . . . ” (Section 8.2).

It is anticipated that this offer will be extended to each person purchasing b and c products on a wholesale basis who is now entitled to receive patronage dividends with respect to its purchases from Coop1, Coop3, or Coop2. It is anticipated that most, if not all, such persons will accept the offer. Persons purchasing b and c products from LLC on a patronage basis thus will be entitled to receive patronage dividends from all three cooperatives.

Coop1, Coop3, and Coop2 intend to continue to conduct the e business on a patronage basis. Each will continue, at a minimum, to maintain a separate patronage allocation unit for b products and a separate allocation unit for c products. They may also establish (in the case of Coop1) or continue (in the case of Coop3 and Coop2) additional sub units in one or both categories.

For d patronage purposes, Coop1, Coop3, and Coop2 will each treat the following categories of income as patronage-sourced income: (i) “d manufacturing profit or loss” attributable to the manufacture of d ultimately sold to its members and participating patrons, (ii) its share of the “d wholesale profit or loss” of LLC attributable to sales of d and related products and services to its members and participating patrons, and (iii) “d retail profit or loss” arising from sales (in the case of Coop3 and Coop2) of d and related products and services to farmer and rancher members and participating patrons. Such income will be included in patronage dividends paid by each to members and participating patrons with respect to their purchases of d at wholesale through LLC or at retail from Coop3 and Coop2.

PLR-123587-00

For c product patronage purposes, Coop1, Coop3, and Coop2 will each treat the following categories of income as patronage-sourced income: (i) its share of the "c manufacturing and wholesales profit or loss" of LLC attributable to sales of c and related products and services to its members and participating patrons, and (ii) "c product retail profit or loss" arising from sales (in the case of Coop3 and Coop2) of c and related products and services to farmer and rancher members and participating patrons. Such income will be included in patronage dividends paid by each to members and participating patrons with respect to their purchases of c products at wholesale through LLC or at retail from Coop3 and Coop2.

LLC and LLC2 will provide to Coop1, Coop3 and Coop2 records in such detail to permit each to allocate patronage-sourced d and c product earnings to members and participating patrons based upon the quantity or value of their purchases of d and c products.

The following categories of earnings will not be included in patronage-sourced earnings by Coop1, Coop3 or Coop2 (i) "d manufacturing profit or loss" attributable to the manufacture of d ultimately sold by LLC to persons that are not members or participating patrons, and (ii) their respective shares of the "d wholesale profit or loss" and of the "c manufacturing and wholesale profit or loss" attributable to sales of products and services to persons that are not members or participating patrons and attributable to any business activities which would be nonpatronage if conducted directly by Coop 3, Coop1, LLC2 or Coop2. The profit or losses of the activities identified above as Nonpatronage Activities will be treated as nonpatronage income.

In the joint Venture Agreement, Coop1, Coop3, and Coop2 articulated the following common objective in structuring the Joint Venture:

“. . . Except as may be otherwise agreed by the Members, all marketing of d and c by LLC is anticipated to be for the benefit of members and patrons of the members with the intention being that Coop2, Coop3 and Coop1 will be able to treat their respective earnings therefrom as patronage business done for their respective members and patronage as permitted under the Internal revenue Code. . . .”

The structure described above is intended to accomplish this objective. Once this structure is in place, a local cooperative member or participating patron purchasing d and c products from LLC will be a member and participating patron of Coop1, Coop3 and Coop2 and will be entitled to receive patronage dividends from each with respect to its purchase.

Coop2, Coop1, and Coop3 request that we rule that the following categories of income will be (in case of item (ii)) or will remain (in case of items (i) and (iii) patronage-sourced for each:

PLR-123587-00

(i) “d manufacturing profit or loss” attributable to the manufacture of d ultimately sold to its members and participating patrons. (As noted above, for Coop3 and Coop2, this profit or loss will include patronage refunds from Coop4. For Coop1, this profit or loss will consist of its d manufacturing profit and any margin earned on b purchased from others and resold to LLC, less allocable expenses. The profit or loss will be included in patronage dividends paid by each to members and participating patrons with respect to their purchases of d through LLC.)

(ii) its distributive share of the “d wholesale profit or loss” and “c manufacturing and wholesale profit and loss” of LLC attributable to sales of d, c products and related products and services to its members and participating patrons

(iii) in the case of Coop3 and Coop2, “c product and d retail profit and loss” arising from sales of c products, d and related products and services to farmer and rancher members and participating patrons entitled to receive patronage dividends.

Cooperatives are permitted to exclude patronage dividends from their taxable income by Section 1382(b) of the Code. Section 1388(a) defines a "patronage dividend," as, among other things, an amount paid to a patron of a cooperative "which is determined by reference to the net earnings of the organization from business done with or for its patrons." Section 1388(a) also states that a patronage dividend "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..."

The phrase "business done with or for patrons" is not defined in the Code or in the regulations. The standards for determining whether earnings are from business done "with or for patrons" are set forth in several cases and revenue rulings. The first case to discuss this issue in detail was St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (Ct. Cl. 1980). That case reviewed the statute and its history and held that a test based on the standard contained in Treas. Reg. § 1.1382-3(c)(2) (which defines "income derived from sources other than patronage," a term used in section 1382(c)(2)(A) of the Code) was proper. The Court held:

"A particular item of income is patronage sourced when the transactions involved are `directly related to the marketing, purchasing, or service activities of the cooperative association..." (624 F.2d at 1045).

Recognizing that this is a factual test, the Court looked to Internal Revenue Service rulings for guidance in applying the test. The Court noted four published rulings, one of which, Rev. Rul. 73-497, 1973-2 C.B. 314, it held to be "inherently defective." (624 F.2d at 1050). As to the remaining three, the Court stated:

PLR-123587-00

"Revenue Rulings 69-576, 74-160, and 75-228 are persuasive to indicate the scope of the activities that are encompassed in the 'directly related' test. A reasonable application of Treasury Regulations § 1.1382-3(c)(2) encompassed activities 'facilitating' the accomplishment of the business activities of the cooperative, activities not 'merely enhancing the overall profitability,' and activities not 'merely incidental to the cooperative association's overall operation.'" (624 F.2d at 1051).

The Court quoted portions of two of the three rulings. Rev. Rul. 69-576, 1969-2 C.B. 166, states:

"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." (at 167).

Identical language is contained in Rev. Rul. 74-160, 1974-1 C.B. 245. Rev. Rul. 75-228, 1975-1 C.B. 278, states:

"The classification of an item of income as from either patronage or nonpatronage sources is dependent upon the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. Thus, if the income is produced by a transaction directly connected with marketing patrons' products, the income is from patronage sources." (at 279).

A number of cases have applied this approach and have held that where a cooperative earns income as a result of an activity that "actually facilitates" or is "directly related" to its cooperative purpose, the income is properly characterized as patronage-sourced. See for example, *Linnton Plywood Association v. United States*, 410 F.Supp.1100 (D. Oregon 1976 (dividends from a corporate glue manufacturing venture); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988 (8th Cir. 1982)(dividend on stock owned in a bank for cooperatives).

LLC was formed and is and will be operated to allow Coop1, Coop2, and Coop 3 to better serve their members and participating patrons by obtaining economies of scale, elimination of duplication, the ability to achieve operational efficiencies by working together, and reducing costs without sacrificing service. Coop1, Coop2, and Coop 3 anticipate significant cost savings and efficiencies. These savings will flow through to members and participating patrons in the form of lower prices for e products or increased

PLR-123587-00

patronage dividends. LLC is directly related to and actually facilitates the accomplishment of the cooperative mission of Coop1, Coop2, and Coop3. Accordingly, we rule that the following income will be treated as “patronage sourced”:

- (i) “d manufacturing profit or loss” attributable to the manufacture of d ultimately sold to its members and participating patrons. (As noted above, for Coop3 and Coop2, this profit or loss will include patronage refunds from Coop4. For Coop1, this profit or loss will consist of its d manufacturing profit and any margin earned on b purchased from others and resold to LLC, less allocable expenses. The profit or loss will be included in patronage dividends paid by each to members and participating patrons with respect to their purchases of d through LLC.),
- (ii) its distributive share of the “d wholesale profit or loss” and “c manufacturing and wholesale profit and loss” of LLC attributable to sales of d, c products and related products and services to its members and participating patrons, and
- (iii) in the case of Coop3 and Coop2, “c product and d retail profit and loss” arising from sales of c products, d and related products and services to farmer and rancher members and participating patrons entitled to receive patronage dividends.

As noted above, the following categories of earnings will not be included in patronage-sourced earnings by Coop1, Coop3 or Coop2 (i) “d manufacturing profit or loss” attributable to the manufacture of d ultimately sold by LLC to persons that are not members or participating patrons, and (ii) their respective shares of the d wholesale profit or loss” and of the c manufacturing and wholesale profit or loss” attributable to sales of products and services to persons that are not members or participating patrons and attributable to any business activities which would be nonpatronage if conducted directly by Coop 3, Coop1, LLC2 or Coop2. The profit or losses of the activities identified above as Nonpatronage Activities will be treated as nonpatronage income.

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 Coop and a second representative.

Sincerely yours,
Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)