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LEGEND:

Coop	=
State A	=
State B	=
Town	=
Corp A	=
Corp B	=
Corp C	=
b	=
c	=
Holdings #1	=

Holdings #2 =

Holdings #3 =

Sub =

Dear :

This is in response to a request for rulings dated July 31, 2002, submitted on behalf of Coop by its authorized representative concerning the proper tax treatment of a transaction fully described below.

Incorporated in 1939 pursuant to the State A Cooperative Statute, Coop is a rural telephone company operated on a cooperative, non-profit basis for the mutual benefit of its members. Its headquarters is located in Town, and it serves access lines in a rural, agricultural area.

From 1938 through 1973, Coop was a tax exempt telephone cooperative claiming exemption under the provisions of section 501(c)(12)(A) of the Internal Revenue Code of 1986, as amended ("the Code"). Coop failed the annual income test required for exemption in 1974, but reclaimed exemption for the period 1975 through 1990. Again, the Cooperative periodically failed the income test in tax years 1991, 1992, 1995 and 1996.

In tax year 2000 it failed the 85 percent member income test required for exemption and filed Form 1120, U.S. Corporation Income Tax Return. It intends to file a Form 1120 for tax year 2001 and has requested an extended due date for filing the return of September 15, 2002.

While Coop's primary business purpose is to provide to each of its approximate members local exchange telephone carrier service, it also provides to members cable television service, and dial-up internet service.

Under its Articles of Incorporation, Article II, the Cooperative is to operate a cooperative telecommunications system for the mutual benefit of its members. Further, paragraph (c) of the Article states:

> "All activities of this association shall be non-profit and cooperative in character and for the mutual benefit of its members."

Moreover, Article V states the "association is organized without capital stock..." and, "The property rights of members in the property of the association shall be equal."

Article I of the “Amended Bylaws of Coop Cooperative Telephone Company” generally provide that any person, firm, association, corporation or body politic may become a member of Coop by subscribing to local exchange telephone service upon such terms as the Board may, or the Bylaws shall, from time to time prescribe. Memberships may not be transferred except as provided by the Bylaws.

Article II, Section 2-4, “Property interest of Members”, states that in the case of dissolution:

> “after (a) all debts and liabilities of the Cooperative shall have been paid; (b) all capital furnished by members through patronage shall have been retired as provided in the By-laws, and (c) the remaining property and assets of the Cooperative shall be distributed among the members and former members in proportion which the aggregate patronage of each member and former member bears to the total patronage of all such members and such former members on the date of dissolution unless otherwise provided by law.”

Article III, Section 3.7(a), “Voting”, states that each member shall be entitled to one vote. Further, Section 3.7(b) states the voting by proxy shall not be permitted.

Article VIII of Coop’s Bylaws, “Non-Profit Operations”, proscribes the payment of interest on any patronage credits of the Cooperative’s members. Instead, Section 8.1, “Patron’s Equity Account”, of that Article states:

> “In the furnishing of telecommunications and information service, the Cooperative’s operations shall be so conducted that all members will through their patronage furnish capital for the Cooperative.”

Section 8.1 also states:

> “The patron’s equity account in the Cooperative is a part of the capital of the Cooperative and shall consist of that portion of the net saving of the Cooperative not returned in cash to patrons...”

Further, Section 8.1 provides:

> “The Cooperative shall establish a separate account for each of its members and allocate to such patron’s account the portion of such members equity account to which such member is entitled.

Section 8.3, “Retirement of Patron’s Equity”, defines the terms under which member patronage equity may be redeemed. It states,

> “If, at any time prior to dissolution or liquidation, the Board shall determine that the financial condition of the Cooperative will not be impaired thereby, capital then credited to patrons’ accounts may be retired in full or in part. Any such retirements of capital shall be at the discretion and direction of the Board as to kind, timing, method and type of assignment and distribution.”

In early 1980, American Telephone & Telegraph (AT&T) advised the independent telephone industry of the prospective availability of a new telephone service to subscribers. AT&T’s new system was known as a “Data Basis Administration System” (DBAS) and it enabled its customers to use the then recently developed Calling Card Service (CCS), also known as the Auto Bill Calling service (ABC). With that service, customers wold be able to make credit card, collect or third-party long distance calls without the assistance of an operator.

While AT&T offered this service to the over 1,100 independent telephone companies, it was not a viable option for the smallest independent companies (including many rural telephone cooperative such as Coop) because of the data processing capital requirements that would be necessary to participate. But at the same time, it was clear to the small companies that they needed to offer the same type of services to their subscribers enjoyed by customers of larger telephone companies. Therefore, the smallest companies needed to identify a means by which they could participate in the new program.

Based on these circumstances, the b smallest companies joined together to form Corp A for the purpose of aggregating their capital and achieving the economy of scale necessary to participate in the CCS service. For that purpose Corp A was organized on March 6, 1981 as a State B corporation and authorized 400 Class A voting shares to be issued. To participate, each small company had to ensure that it had valid line numbers, public station and credit card numbers, and appropriate hardware and software available.

The number of Corp A shares that each small telephone company had to purchase was determined by the number of main stations it serviced. Each participating telephone company in the Corp A venture received one (1) Class A Common Stock voting share, and then Class B Common Stock nonvoting shares equal to the number of stations (subscribers) that the participant served. Corp A had the first right of refusal to repurchase all Common Stock held by all of the participants should a sale be proposed. Profits, if any, would be distributed based on the total number of shares held which corresponded directly with the number of customers each participant had. In many respects, Corp A began with rules of participation and governance very similar to a cooperative organization.

On June 30, 1981, Coop's Board of Directors authorized the management of the organization to participant in the Corp A venture. On August 14, 1981, Coop acquired one (1) Class A voting share and 484 Class B nonvoting shares of Corp A. At that point the Cooperative's total investment in Corp A was $

By the summer of 1982 the data processing equipment was installed and by December 1983 full installation of all systems was complete and ready for operation. From 1984 through 1996 Corp A provided the b members the DBAS and technology support necessary to have seamless participation with AT&T in its CCS services offered nationwide.

Concurrent to the development of Corp A, several other organization evolved in Corp A in which Coop participated. In 1985 Corp A dropped certain services that it had originally provided to its members. In response to that development, Coop along with other State A telephone companies formed a new service bureau to perform the services dropped by Corp A. The new organization offered billing and collection, accounts receivable, general ledger and specialized telephone revenue accounting services.

Nevertheless, Coop used Corp A and its successor organization continuously into 2001 for specific services, including:

! Contract negotiations for billing and collections services

! Monthly settlement under billing and collection contracts

! Long distance clearing house services

On January 1, 1989, Coop joined fifteen other small State A telephone companies to form yet another partnership, Corp B. The purpose of Corp B was to invest the pooled capital of its participants in the charter series preferred stock of Corp C. Coop's contribution to the partnership was $

Corp C's purpose was to develop an SS7 network, a highly sophisticated digital information transport and database development mechanism then being introduced into the telephone industry. By investing together these companies hoped to develop this leading technology that would have required capital investment beyond any one company's capability. The SS7 network would provide a broad range of enhanced telephone services to the Cooperative's members.

The new switch represented a quantum leap in technology at the time. In the following years Corp A and Corp C had a number of opportunities to work jointly on projects relating to the SS7 technology as well as database, fraud management and wireless applications. Throughout the period from Coop's initial investment to the end of 2001 the Cooperative utilized the services of Corp C and its successor organization. On August 6, 1993, the members of Corp A voted to have a two (2) for one (1) Class A stock split. As a result, Coop held two (2) shares of Class A stock and 968 Class B shares of Corp A. To achieve its business objectives in the marketplace, Corp A reorganized itself into a holding company structure on December 2, 1994, exchanging the original shares held by its participants for the same amount in Holdings#1 shares. Following that, Coop held two (2) Class A Holdings#1 shares and 968 Class B Holdings#1 shares. Those shares were dated November 1, 1994.

By the mid-1990s, the prospects for local competition became evident to nearly all in the telecommunications industry. Congress had a variety of hearings concerning the coming competitive environment for these companies over the course of several years. This effort culminated with the passage of the Telecommunications Act of 1996 in early February of that year. The Act authorized telecommunications competition at local levels for much of the United States.

Prior to and during the hearings and debate of the 1996 Act, Holdings#1 and Corp C conducted discussions as to how the two organizations could work more closely. Ultimately, it was concluded that a merger of the two entities was appropriate. The merger was completed on February 23, 1996, nearly coinciding with the passage of the Telecommunications Act. Resulting from the merger was Holdings#2 and its wholly-owned subsidiary, Sub. Based on this, Corp B shares in Corp C were converted to shares in Holdings#2, the Corp B partnership dissolved, and the shares of Holdings#2 were transferred to the partners.

Coop received 1,409 shares of Holdings#2, upon dissolution of Corp B and 6,388 shares from the merger of Holdings#1 and Corp C.

While Coop did not object to the merger in 1996, it became concerned that the focus of the combined entity might be shifting from that of a service company for small companies to something else. It was evident that management and seemingly a majority of the shareholders wanted Holdings#2 to pursue for-profit ventures beyond the original scope of Corp A. Though uncomfortable with that trend, Coop really did not have any reasonable means to extricate itself from its investment since there was no outside market for the stock.

In 1997 Holdings#2 changed its name to Holdings#3 and on November 25, 1997, the Cooperative received a stock certificate for 7,797 shares of Class A common stock.

Prior to 1999 Holdings#3 was not publicly traded and in October 1999 they had their first public offering. For 180 days, during the time of the initial public offering, a sales restriction was placed on the Class A common stock.

On April 5, 2000 each share of Holdings#3 Class A common stock converted to four shares of publicly-traded common stock and the selling restriction was lifted. Coop owned 31,188 shares after the conversion.

During the time of the initial public offering, the Board of Directors of the Cooperative determined that it would be prudent to divest themselves of their Holdings#3 holdings. The publicly traded stock had significantly increased in value from their original investment in Corp A. While still using the services of Holdings#3, they felt that the cooperative should not have such a large investment in a potentially volatile stock. In addition, the Board still had abiding concerns about the direction of Holdings#3 and the fact that they had very little control over this large publicly traded company.

During 2001, Coop sold the following shares of Holding#3 common stock:

Number of Shares	Date	Price/Share	Total Realized

Since its substantial divestiture of its minority interest in Holdings#3, Coop has been buying only those services that it requires from it. The proceeds of the Holdings#3 stock sales have been used to make continuing upgrades of the telephone network, effect repairs to its existing systems and support Coop's patronage redemption system.

Based upon the information set forth herein, Coop requests the following ruling:

The amount realized from Coop's sale of Holdings#3 stock during 2001 constitutes "patronage-sourced" income, which may be excluded from Coop's gross income when allocated to Coop's patrons by a true patronage dividend.

Code § 501(c)(12) 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; Coop falls into this category, and thus is a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, §§ 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 Code § 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 Coop, 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 such as Coop, 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 (in the case of cooperatives not subject to subchapter T) or 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 Holdings#3 stock to be deductible to Coop upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Coop's 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, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106; Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993; Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243; Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459).

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 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 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 cooperative's operation, the income is from non-patronage 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 Coop is comprised of two parts: the original decision to participate in the organization Corp A and the currently proposed sale of Holdings #3 stock. Both elements of the transaction are "directly related" to Coop's cooperatives business and will facilitate Coop's ability to provide communications services to its members.

Coop actively participated in the formation and funding of Corp A to insure that its members would have the same type of "modern" services that would be available to larger, nationally recognized telephone companies. Indeed, it had no choice but to participate in that venture because it was too small to meet AT&T's requirements for participation. All of its transactions with Corp A, from the beginning of its participation in the company until the day it sold the final tranche of Holdings #3 stock, were conducted exclusively for Coop's member patrons.

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, 1979WL 1287 (D.Or.), 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.

Coop's investment in Corp A was directly related to its cooperative business. Investing in a company in order to provide modern telephone services is directly related to the business of a cooperative whose *raison d'etre* is to provide telephone service to its patrons.

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. See id. Certainly, if Coop 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 Coop did nothing of this sort. It was an active participant in a venture, Corp A, that was directly related to its cooperative telecommunication business. In fact, investment in Corp A was only open to companies that were in the telephone business. The Corp A investors were all rural telephone companies. Corp A was not a passive investment of the type Judge Posner implies would be impermissible. Corp A was organized much like a cooperative. Its members were the smallest companies in the country. Each shareholder had only one vote on the affairs of the company. Corp A’s distribution of profits, if any, to its shareholders were based approximately on a participation basis. For over a decade the arrangement between Corp A and its shareholders was very successful and grew as more technology became available that could only be accessed through a larger organization. However, following the merger of Holdings and Corp C in 1996, it became apparent that the new company intended to depart from its original purpose of serving the b small telephone companies. Following the statutorily prescribed lock-out period for such an issuance, Coop obtained its new stock and immediately proceeded with systematic liquidation of its minority interest which resulted in capital gains.

Accordingly based solely on the above, we rule that the sale of the Holdings#3 stock will result in patronage sourced income, which may be excluded from Coop’s gross income when allocated to Coop’s patrons. Because Coop does 100 percent of its telephone business with patrons on a cooperative basis no allocation between patronage and nonpatronage is required.

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,

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

cc: