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LEGEND:

Coop	=
State A	=
Corp A	=
Company	=
Corp B	=
LLC	=

Dear :

This is in response to a request for rulings dated June 2, 2003, submitted on behalf of Coop by its authorized representative concerning the proper tax treatment of a transaction fully described below.

Organized in 1955 pursuant to the State A Statutes, Coop is a rural telephone company operated on a cooperative basis. Coop was previously granted tax exempt status under section 501(c)(12) of the Internal Revenue Code and operated as a tax exempt rural telephone cooperative until 1987. Since that time, Coop has been a taxable telephone cooperative subject to the common law principles of cooperative operation.

Coop provides telephone service to residential and business members in northeastern State A. The area is very rural and agrarian, and many of the Cooperative's owner-members depend on agribusiness either directly or indirectly for their livelihood.

The population in Coop's service area is sparse, with its members thinly spread over a large area. In comparison to the average "Baby Bell" telephone company's territory that has approximately 130 access lines per square mile, Coop's territory has only about 4 access lines per square mile. The very low density of its service territory increases the difficulty of providing telecommunications infrastructure to support the latest technology.

In the early 1980s, a new technology, cellular telephone, began to emerge. In order to foster development of the cellular telephone market, the Federal Communications Commission ("FCC") divided the available radio spectrum in each market into two channel blocks. One block was set aside for development by wire-line telephone companies and the other for non-wire-line companies. In markets where there was more than one applicant for a network construction permit, lotteries were used to select applications.

After observing the early successes of providers of analog wireless telephone service in major metropolitan markets, Coop's Board of Directors and management reached several conclusions. First, wireless technologies was bringing about a revolution in the communications business; its potential was almost unlimited in rural areas where a greater number of people work outdoors instead of office buildings. More importantly, cellular technology had the potential to undermine the continued economic viability of Coop if it was brought to the members by some competing organization.

The fear was that growing "foreign" cellular telephone penetration in Coop's service area would cause an ever-shrinking base of members to support the fixed costs of a wire-based system. In other words, it would be a "death spiral" for the Cooperative. To protect the organization and its members from this unacceptable risk, Coop's Board of Directors concluded that the Taxpayer had to invest in the cellular technology when the FCC opened the licenses for rural areas.

In , Coop joined with other small local exchange carriers in the region to purchase stock in three Rural Service Area Corporations (RSA). By doing this the Coop could keep its members involved in the analog cellular network in their region of State A. In October , Coop and 33 other local exchange carriers contributed total of $ million for acquisition of approximately million shares of Corp A stock in its first private offering. Coop made a cash contribution of $ in exchange for shares of Corp A common stock.

During the period from the cash contribution in the first private offering to the end of , Coop contributed an additional $ and received shares of Corp A stock in subsequent private offerings. Also, during , the three RSA's were merged into Corp A. Based on that transaction, Coop received an additional shares of Corp A stock.

In 1995, Corp A merged with Company in a partially taxable transaction in which Coop received shares of Company's stock and approximately $ in cash. In 1999, Company (doing business as) participated in a statutory merger with Corp B. In that tax free exchange, Coop's interest in Company was converted into shares of Corp B which the Cooperative still holds as of the date of this request for rulings.

By the early 1990's, the “Personal Communication Service” (PCS) digital technology was emerging with the promise of bringing high quality wireless communications for not only telephones, but also for a host of other products such as laptop computers, combination devices and video devices. Based on the experience the FCC had gained with lotteries for distribution of the original analog cellular telephone licenses, it determined that an auction of the various PCS licenses would serve the government’s interests better.

The United States and its territories were divided by both metropolitan and rural areas into many individual “Blocks.” Not surprisingly, the price paid in the auction for a PCS Block in the Los Angeles market would be many times more expensive than a PCS Block in rural State A. For the major metropolitan markets, PCS license Blocks were established as Blocks A through C. The rural license Blocks were Blocks D through F. For all PCS Block licenses sold in the auction, the successful bidder had to commit to full development of the PCS infrastructure (switching equipment and”office equipment” and radio towers) within a five year period.

In the FCC’s auction for the rural PCS territories the largest companies were either excluded or put at a disadvantage. This gave the smaller telephone companies, including Coop, the opportunity to bring the advanced services to their customers on their own. Also, it protected the continued existence of the smaller telecommunications companies.

Based on its very positive experience with investing in the original analog cellular RSA’s, Coop’s Board of Directors instructed management to determine a prudent method to participate in the impending FCC PCS License Block auction. Coop’s objectives were to acquire sufficient, appropriate licenses to enable Coop to provide digital wireless telecommunications services for its members through all of the local exchanges Coop served, and to have a large enough service area to realize economies of scale.

The results of the bidding were that the Taxpayer won F Block licenses for the “basic trading areas” (BTA) of The FCC issued these licenses to Coop on

Coop first turned its attention to trading area. They had paid $ in the original auction, and expended significant additional cash and time in investigating possible strategies for development of the license. Coop decided to join with other license holders for the BTA and license holders from other areas of State A in order to ensure that it members would have full service in the area and that the system could be developed in a reasonable timeframe. This strategy served the Coop’s objectives of making the PCS technology available to all of its members and to achieve economies of scale in the implementation of its business plan.

On , Coop made a cash contribution in the amount of $ million for a membership interest in LLC and promise to transfer the Cooperative's licenses for the BTA. Following FCC approval, the license was transferred on Since that time the Taxpayer has made an additional cash contribution of .

Concurrent to Coop's investigation and analysis of the BTA license, the Cooperative also evaluated the economic viability of the and BTA licenses. Coop expended considerable time and money on a series of business plans and engineering studies for construction and operation of a PCS segment with the footprint providing services to Coop's rural wire-line members in areas contiguous to each BTA footprint.

Ultimately, Coop's Board of Directors and management concluded that, while technically feasible from an engineering perspective, neither the nor the BTA's were economically feasible to develop. The reason was that the construction costs were greater than anticipated and the number of other competitors in those PCS markets precluded financial viability. Finally, the fact that Coop was obligated by FCC conditions to complete construction of the system by a date certain made transfer of those licenses to organizations with greater resources even more compelling.

Accordingly, the Board of Directors instructed management to solicit offers for the sale of the two F Block licenses, that is, the licenses for and

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On May 8, 2003, Coop's Board of Directors authorized management to begin the initial sale of Corp B Stock. This action was authorized in anticipation of a rebound in the telecommunications market during this year and next. On , 2003 Coop initiated the first in a series of Corp B stock sales, realizing $ per share gain. It is anticipated that future sales will render an increasing price per share.

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 sale of the Corp B 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.")

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.

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.

Accordingly, based solely on the facts submitted and discussion above we rule that the gain from the sale of the and licences and the Corp B stock constitutes "patronage sourced" income to the Coop which may be excluded from gross income when allocated to Coop's patrons as true patronage dividends.

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: