Internal Revenue Service

Number: **200525010**
Release Date: 6/24/2005
Index Number: 1381.00-00

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

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Refer Reply To:
CC:PSI:B05
PLR-153261-04

Date:
March 18, 2005

LEGEND

Taxpayer =

State A =

Corp A =

Corp B =

X =

Y =

Date 1 =

a =

b =

c =

d =

Dear :

This is in response to your request for rulings dated September 10, 2004, submitted on behalf of Taxpayer by your authorized representatives. The facts as represented by the Taxpayer are as follows.

The Taxpayer was incorporated in date 1 as a corporation not for profit under the State A Not for Profit Corporation Act. The Taxpayer was formed to serve its d members by providing them with the economies of scale to effectively compete in the b business by: (1) providing cost effective membership into X/Y b through the Taxpayer's sponsorship and (2) providing card processing services through a master contract with a third party provider at favorable pricing by aggregating the purchasing power of a large number of d members.

Taxpayer represents that it is operating on a cooperative basis within the meaning of subchapter T of the Internal Revenue Code, with state and federal chartered d as its only member organizations. As a member of X and Y, the Taxpayer has obtained the necessary c identification numbers issued by X and inter c b association numbers issued by Y to sponsor its d members to issue b to their respective members. The Taxpayer has negotiated with Corp A, a major b processing and related support services provider, to provide b processing and related support services to the Taxpayer's Principal d members.

Members of the Taxpayer are either Principal Members or Affiliate Members. Principal Members are members that utilize the b processing and related services provided by the Taxpayer through the Taxpayer's contract with Corp A. Affiliate Members are members that utilize the b processing and related services provided by Corp A through a relationship other than the Taxpayer's contract with Corp A.

The Taxpayer also receives revenue from Corp A in the form of annual administration fees to cover the cost of office expenses and, from time to time, from sales of software directly relating to the b processing business. All of this revenue is allocated to pay the Taxpayer's expenses and is not returned to any of the Members as patronage dividends.

The Taxpayer is concerned about the growing trend among d in the United States that are selling their b portfolios. When a member of the Taxpayer sells its portfolio, there is an erosion of the total account base and transaction volume, which produces a negative impact on the Taxpayer's revenue and could severely hamper the Taxpayer's ability to take advantage of economies of scale, which, in turn, would affect the cost efficiencies available to the members. Without the benefit of the economies of scale offered by the Taxpayer, Taxpayer represents that many smaller d would be unable to offer b to their members.

The Taxpayer is considering plans to proactively alter this trend by participating as an equity investor in the creation of a holding company that would own 100% of an Industrial Loan Corporation (ILC). Investors in the ILC include the Taxpayer, Corp A, and Corp B. Corp B is a provider of financial services to d and their members including insurance, investment, and mortgage products. Additional like-minded institutions are being considered to invest in the ILC. The Taxpayer represents that an ILC functions essentially as a c would function, with the exception of accepting demand deposits if its

assets exceed $100 million. ILC's are regulated by the Federal Deposit Insurance Corporation and the appropriate state regulator of financial institutions. An ILC can also function as a member of X and Y for the purposes of issuing b. Generally, ILC's operate with a specific purpose, such as the issuance of b, and generally do not offer the full array of retail products a c would offer. A large number of brokerage houses own ILC charters for the sole purpose of issuing b as part of their cash management accounts. By investing in an ILC whose primary purpose is b issuance, the Taxpayer feels it can successfully achieve both a defensive strategy by acquiring and retaining existing member portfolios as well as an offensive strategy by (1) providing an opportunity for d in the United States that do not currently issue b an opportunity to do so through an agent program and, (2) acquiring the portfolios of credit unions that are not currently members of the Taxpayer that elect to sell their portfolios.

In order to raise working capital to purchase portfolios, the ILC will issue certificates of deposit. In addition, the ILC plans to bundle the b receivables, securitize them as investments, and make them available for sale to d. The Taxpayer plans to purchase certificates of deposits and the securitized receivables to further promote the success of the ILC and, ultimately, the Taxpayer, while providing income to the Taxpayer. Lastly, the Taxpayer expects to receive an undetermined fee amount from the ILC annually for marketing and endorsing the ILC to its d membership through its various media assets.

The funds used by the Taxpayer to invest in the ILC would be funds retained by the Taxpayer in the form of written notices of allocation. The equity investment would total approximately $a. Future capital needs are unknown at this time.

Based on the foregoing, the Taxpayer requests rulings that:

1. The investment by the Taxpayer in certificates of deposit or securitized b receivables issued by an industrial loan corporation will not disqualify the Taxpayer as a cooperative under section 1381(a) (2) of the Code.

2. The investment by the Taxpayer as an equity investor in an industrial loan corporation or holding company will not disqualify the Taxpayer as a cooperative under section 1381(a) (2) of the Code.

3. The interest earned by the Taxpayer on the certificates of deposits or securitized b receivables will be patronage sourced income.

Section 1381(a)(2) of the Code provides that subchapter T applies to any corporation operating on a cooperative basis. In the instant case, Taxpayer 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.

Cooperatives are permitted to exclude patronage dividends from their taxable income under 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 such amount is out of earnings other than from business done with or for patrons.

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling 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).

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines nonpatronage income to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

Taxpayer relies on St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980) which held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that 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).

In Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The court held that the relation of income activity to the cooperative's business was too tenuous.

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, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03 (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) 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 Ato 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, 78 T.C.M 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, 79-1 USTC 9197 (D. Or 1979), 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.

The Taxpayer argues its strategic investment in the ILC is directly related to the marketing, purchasing, or service activities of its b processing business and thus should be patronage sourced income. We disagree. The income generated from its equity investment in the ILC and from the investments in CD's and securitized b receivables does not facilitate the Taxpayer's b servicing business and is incidental to the services performed by the Taxpayer to its members. The Taxpayer's investments merely enhance its overall profitability by serving as a hedge against a downturn in its member base and promote financial stability. However, nothing in subchapter T prevents the Taxpayer from making these nonpatronage investments.

Therefore, based solely on the foregoing facts including Taxpayer's representation that it is operating on a cooperative basis for purposes of subchapter T, we rule that:

1. The investment by the Taxpayer in certificates of deposit or securitized b receivables issued by an industrial loan corporation will not disqualify the Taxpayer as a cooperative under section 1381(a) (2) of the Code.

2. The investment by the Taxpayer as an equity investor in an industrial loan corporation or holding company will not otherwise disqualify the Taxpayer as a cooperative under section 1381(a) (2) of the Code.

3. The interest earned by the Taxpayer on the certificates of deposits or securitized b receivables is not patronage sourced income for purposes of section 1382(b) of the Code.

This ruling is directed only to the taxpayer that requested it. Under section 6110 (k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative

Sincerely yours,

SUSAN REAMAN
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: