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Date:

February 24, 1999

LEGEND

Coop =

City A =

b =

LLC =

Dear :

This is in response to a letter dated October 13, 1998, submitted on your behalf by your authorized representative. The letter request a ruling regarding the application of subchapter T of the Internal Revenue Code to a proposed transaction described below.

Coop is a cooperative operating under the provisions of subchapter T of the Code. Coop processes b into and . Coop markets these processed products and returns the net earnings to its members on a patronage basis.

Coop is located in City A. It was incorporated in to, among other things:

“ engage in any activity in connection with the marketing, selling, harvesting, preserving, drying, processing, manufacturing, canning, packing, grading, storing, handling or utilization of any agricultural product produced or delivered to it by its members, or the manufacturing or marketing of the by-products; Articles of Incorporation, Article II, (b).

and

to act as agent or representative of any member or members in any such activities, and to that end to enter into contracts with its members for the exclusive and irrevocable right to purchase and market their b. Id., (d)

and

To do each and every thing necessary, suitable or proper for the accomplishment of any of the purchases or the attainment of any one or more of the objects enumerated . . . [c]onducive to or expedient for the interest or benefit of the association, and to contract accordingly; and in addition. . . [p]ossess all powers, rights and privileges . . . [a]s may be necessary or incidental to the purpose for which the association is organized.” Id., (k).

The cooperative owns and operates its own b processing facility. For its year ending, 1997, Coop had total sales of \$, of which \$ was from the sale of b and the balance resulting from the sale of . Coop’s 1997 earnings totalled \$. All of the 1997 allocation was paid to the Coop’s members in cash, in proportion to the amount of b the Coop purchased from each of its members.

The Board of Directors of Coop wants to improve its profitability and reposition the cooperative in anticipation of changing economic conditions resulting from NAFTA and the possibility that b support prices might be cut in future farm bills. For the past ten years, the market price of b has ranged between \$ and \$ cents per pound. Under NAFTA, it is expected that Mexico will continue to improve its production of b and become an ever larger competitor in the domestic b market. There is also concern that b price supports will be in jeopardy when the present farm bill expires. All in all, there will be significant market pressure on b prices in the coming years. Unless the cooperative repositions itself, it cannot survive that expected economic storm. Accordingly, Coop proposes to align itself with LLC who will thereafter process the b produced by Coop’s members.

LLC is a very successful processor and marketer of b. Its annual business volume is three times larger than Coop’s. LLC is owned by two corporations (not co-ops), and it has an excellent management team and record of financial success. For its recent fiscal year end, the LLC processed slightly under 1.2 million tons of b, which compares to the Coop’s volume of approximately 422,000 tons. None of Coop’s members now sell any of their b production to the LLC. LLC is, however, a natural partner for Coop because the LLC and the cooperative operate in close proximity to each other.

Repositioning Coop with the LLC will dramatically reduce the cost per ton of processing b and permit the cooperative to compete more dynamically in the b market. Coop’s cost of production for the 1997 crop (direct costs plus overhead) was \$ per

ton. Adding Coop's volume to the LLC's business will permit the cooperative to take advantage of economies of scale and size. Total operating costs (direct costs plus overhead) are projected to decrease to \$ per ton as a result of realigning Coop with LLC. Consequently, economies of size and scale will have caused the cooperative to realize a \$ per ton reduction in the cost of production, a 28% reduction in the cooperative's cost structure.

Naturally, a 28% reduction in Coop's cost structure will dramatically improve its patronage earnings. Over the past five year, the cooperative's average annual patronage earnings are \$. Realigning with LLC has the potential of increasing the co-op's annual earnings by \$ million on the upside so that total patronage earnings are expected to be \$ million. If either or both of the board's concerns about the farm bill or NAFTA develop, the cooperative would at least have a reasonable fighting chance of weathering those events if it starts with annual earnings of \$ million dollars rather than only \$ of earnings. If Cooperative cannot realign itself with LLC, the cooperative may not survive.

Coop shall have a supply agreement with each of its members that commits the member to deliver its b to the Coop for processing and the Coop to arrange for b processing and marketing services on behalf of its members. Coop, in turn, will contract with the LLC to process the b that the cooperative will receive under its member supply agreements. Coop will purchase b from its producers and will pay the producers the market price for the b delivered. Coop will sell the b to LLC who will process the b. The Coop's share of the LLC's earnings attributable to the marketing of Coop's members b will be distributed to Coop's members on the basis of the number of tons of b each member sells to the Coop.

Coop will convey its b processing facility and equipment, plus an anticipated cash infusion of \$ million to the LLC in exchange for an ownership/voting member interest in the LLC. Coop, along with the two existing corporations will own the LLC. Coop's ownership interest is expected to be somewhere between 26% and 30%. Coop's voting rights will equal its ownership interest (between 26% and 30%).

Coop anticipates that it will operate with few or no employees. It will hire LLC under arms-length terms to undertake administrative activities such as bookkeeping. Coop will reimburse LLC for the salaries and other expenses of the LLC's employees who perform those activities and for the other expenses such as performing bookkeeping functions on computer.

This proposed structure will not alter the cooperative's status. It will continue to be democratically controlled, and, so long as new b producers otherwise qualify for membership in the cooperative, those producers will receive a membership and be permitted to vote in the cooperative's affairs. It will continue to have a pre-existing legal obligation to return net earnings from patronage to its members based on the quantity

or value of product delivered to it, and its capital is subordinated.

Section 1381(a) of the Internal Revenue Code of 1986, as amended provides, in part, that part 1 of subchapter T shall apply to any corporation operating on a cooperative basis other than certain organizations not relevant to this ruling application.

Section 1382(a) of the Code provides that except as provided in subsection (b), the gross income of any organization to which subchapter T applies shall be determined without any adjustment by reason of any allocation or distribution to a patron out of the net earnings of such organization or by reason of any amount paid to a patron as a per-unit retain allocation.

Section 1382(b) of the Code provides, in part, that in determining the taxable income of an organization to which part 1 of subchapter T applies, there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during such taxable year. For purposes of title 26, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and a deduction therefrom.

Section 1388(a) of the Code defines a "patronage dividend" as an amount paid to a patron by an organization to which part 1 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.

Section 1.1382-3(c)(2) of the Income Tax Regulations provides the following definition of the term "income derived from sources other than patronage" (i.e., nonpatronage income):

As used in this paragraph the term "income derived from sources other than patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

Although the regulations under section 1382 of the Code are concerned with exempt farmer's cooperatives, the Service and the courts have uniformly applied the

regulations to both exempt and nonexempt cooperatives. See, e.g., Illinois Grain Corporation v. Commissioner, 87 T.C. 435 (1986).

Section 1.1388-1(e) of the Income Tax Regulations defines the term "patron" to include any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

Rev. Rul. 69-576, 1969-2 C.B. 166, refined the definition of patronage and nonpatronage income, providing that 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 that 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.

A number of cases 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. Linnton Plywood Association V. United States, 410 F. Supp. 1100 (D. Oregon 1976) (dividends from a corporate glue manufacturing joint venture); Astoria Plywood Corporation v. United States, 79-1 U.S.T.C. ¶9197 (D. Oregon 1979) (lease termination payment); St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Cl. Ct. 1980) (interest on working capital, gain on the sale of an automobile, interest on bonds held to meet capital requirements); Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982) (dividend on stock owned in a bank for cooperatives); Cotter & Company v. United States, 765 F.2d 1102 (CAFC 1985) (interest on working capital, rent sprinkler income); Illinois Grain Corporation, 81 T.C. 435 (1986) (interest on working capital, barge rents), Dundee Citrus Growers Association, 62 T.C.M. 879 (1991) (interest on pool proceeds earned prior to distribution); CF Industries, Inc. v. United States, 995 F.2d 101 (7th Cir. 1993) (interest on working capital).

In this case, Coop will receive a distributive share of LLC income because of its status as an owner of LLC. The portion of the distributive share of LLC income that is attributable to the processing and marketing of Coop's members is "patronaged sourced" income eligible for the patronage dividend deduction under § 1382 of the Code.

Accordingly, based solely on the above, we rule that:

Coop's share of LLC operating income attributable to the processing and marketing of Coop's members' b is income from patronage sources eligible for the patronage dividend deduction.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than the sections described above. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. In accordance with a power of attorney on file with this office a copy of this letter is being sent to your authorized representative.

Sincerely yours,

Walter Woo

WALTER WOO
Senior Technician Reviewer
Branch 5
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