

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

March 28, 2002

### Legend

Coop =

State A =

Federated =

Exempt =

Area =

b =

c =

d =

Dear

This is in response to a request for rulings dated November 2, 2001, submitted on behalf of Coop by your authorized representative.

Coop is a cooperative corporation organized under State A's Nonprofit Corporation Law.

Coop is a nonexempt Subchapter T cooperative (subject to the provisions of Sections 1381-1388 of the Code) organized to provide group purchasing and other services to hospitals, clinics, surgery centers, nursing homes and other healthcare providers located in b Area states. Coop serves more than c hospitals and d other health-cater provides. As a cooperative, Coop is obligated to pay patronage dividends to its members and participating patrons.

Coop offers to its patrons a portfolio of contracts with suppliers covering a broad

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array of products and services required by healthcare providers, including such things as medical/surgical products, pharmaceuticals, clinical laboratory items, and capital equipment and services. Coop is a shareholder-member of a federated cooperative known as Federated, which negotiates and administers contracts on behalf of its shareholder-members and makes available to shareholder-members (such as Coop) a contract portfolio for them to offer to their patrons.

In addition, Coop provides other services to its patrons, including education and bench marking.

As a cooperative, Coop is obligated to distribute its earnings from business done with or for members and other participating patrons to its members and other participating patrons in the form of patronage dividends. Coop does business with some healthcare providers on a nonpatronage basis. In accordance with the rules of Subchapter T, Coop is subject to tax on business conducted on a nonpatronage basis.

Coop charges annual dues to members and participating patrons. Currently, Section 4.5 of Coop's Bylaws permits Coop to "apply the cash portion of the patronage dividend of a Member or Participating Patron against the dues of the Member or Participating Patron to the extent that the cash portion of the patronage dividend exceeds the 20% minimum set by Section 1388(c)(1) of the Code and provided that the application is made within the payment period specified in Section 1382(d) of the Code."

Under the existing Bylaw provision, if a member owes Coop \$6,000 in dues and Coop owes the member a patronage dividend of \$20,000, and if Coop plans to pay that patronage dividend 45% in cash (\$9,000) and 55% in written notices of allocation (\$11,000), Coop will apply no more than \$5,000 of the cash portion of the patronage dividend to the member's dues. Coop will cut a check to the member in the amount of at least \$4,000 in payment of cash portion of the patronage dividend, which will accompany a qualified written notice of allocation in the amount of \$11,000 for the noncash portion of the patronage dividend and a notice informing the member of the application of the remaining cash portion of its patronage dividend to the member's dues. The member will in turn cut a check back to AmeriNet Central in the amount of \$1,000 in payment of the remainder of its dues.

For administrative convenience, Coop would like to change its Bylaws to allow it to apply the entire cash portion of the patronage dividend of a member or participating patron against the Coop dues of that member or participating patron, unless the member or participating patron requests that 20% be paid in cash.

In the example above, this change would eliminate (unless the member requested otherwise) the necessity of Coop having to cut a check for \$5,000 to the member, and the member in turn of having to cut a check in the amount of \$1,000 back to Coop. Given the number of member and participating patrons it serves, this change will simplify administration and result in cost savings for Coop.

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In addition, many of Coop's members are also members of the Exempt, a Section 501(c)(3) organization which exists to provide the health care community with the information and analysis, education, shared resources and management assistance that enhances the quality of care delivery. These members are charged dues by exempt. Exempt and Coop would like to establish a mechanism that would allow Coop to remit any remaining cash portion of the patronage dividend due to a member (after first offsetting cash against the member's dues to Coop to Exempt in payment of the member's dues Exempt, unless the member requests that 20% of its patronage dividend be paid in cash.

Thus, with these two changes, if a member is entitled to a patronage dividend from Coop of \$20,000 (\$9,000 in cash and \$11,000 in written notices of allocation), if the member owes Coop \$6,000 of dues and Exempt \$12,000 of dues, unless the member requested otherwise, Coop would offset \$6,000 of the cash portion of the patronage dividend against Coop dues and would remit \$3,000 of the remaining cash portion of the patronage dividend to Exempt. Coop would notify the member that \$9,000 of its patronage dividend has been retained for dues and send the member an \$11,000 written notice of allocation. If the member requested that 20% of the patronage dividend be paid in cash, Coop would apply \$5,000 of the patronage dividend to dues owed by the member to Coop, and it would send the member a \$4,000 check along with an \$11,000 written notice of allocation. The member would owe Coop \$1,000 for the unpaid portion of its dues, and it would owe Exempt \$12,000 for its dues.

These changes would be embodied in the following amendment to the Bylaws of Coop (new language is underscored) (referred to herein as the "Amended Bylaw"):

"B. Patronage dividends so allocated shall be distributed and paid to Members and Participating Patrons within eight and one-half months of the close of the fiscal year. Payment shall be in cash, property, written notices of allocation (qualified or nonqualified) or any combination thereof, as the Board of Directors may determine. Subject to the limitation contained in the next sentence, the Corporation may apply all or any portion of the patronage dividend allocated to a Member or Participating Patron first against dues payable by the Member or Participating Patron to the Corporation and then against dues payable by the Member or Participating Patron to the Exempt provided that application is made within the payment period specified in Section 1382(d) of the Code. Notwithstanding the preceding sentence, if a Member or Participating Patron makes a written request to the Corporation prior to the time patronage dividends are paid for a year, then an amount equal to twenty (20%) percent of the total patronage dividend allocated to the Member or Participating Patron for the year shall be paid to the Member or Participating Patron in money and offset against dues."

If this ruling request is granted, the Amended Bylaw will be submitted to the Board of Directors of Coop for approval. If the Amended Bylaw is approved, members and participating patrons will be informed of the adoption of the Bylaw, of its significance, and of their option to request payment of 20% in cash.

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For those member and participating patrons not opting to receive 20% in cash, in the case of patronage dividends retained for Coop and Exempt dues, Coop will, within the payment period, make appropriate book entries and notify members and participating patrons of the amounts that have been retained for Coop Exempt dues.

Coop is on a September 30 fiscal year. Since Coop pays its patronage dividend in mid-year (no later than June 15) and sends out its dues statement after the beginning of its fiscal year (i.e., ordinarily in November or December), the amounts retained from a patron in mid-year will be reflected as credits on the patron's next dues statement. In the case of patronage dividends retained for Exempt dues, once the over-all amount is determined, Coop will remit the amount to Exempt. Amounts so applied with respect to a patron will be reflected as credits on the patron's next Exempt dues statement (which also customarily is sent in October).

When Congress was considering the passage of Subchapter T in 1962, the version of Subchapter T that was passed by the House of Representatives required cooperatives to withhold from and pay to the government 20% of each patronage dividend. In its version of Subchapter T, the Senate eliminated withholding, and substituted in its place a system of reporting and what is commonly referred to as the "20% cash requirement." The Senate Finance Committee Report (S. Rep. No. 1881, 87<sup>th</sup> Cong., 2<sup>nd</sup> Sess.), 1962-3 CB 707, at 818, explains the change as follows:

"The House bill provided for withholding on interest, dividends, and patronage dividends at the rate of 20 percent. Your committee's bill has substituted for the withholding provision a reporting system for dividends, interest, and patronage dividends. However, in the case of patronage dividends, withholding also served the purpose of providing the patron with at least enough funds to pay the full first bracket tax on any qualified allocations taxable to him. Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons enough cash to pay at least the first bracket income tax. To give assurance that the cooperative provides the patron with at least enough money to pay this first bracket tax, your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deduction for allocations (and the patrons are to be required to include any such amounts in their income)."

With some minor variations, the Senate version of Subchapter T was the version ultimately enacted.

The 20% cash requirement was incorporated into the definition of "qualified" written notice of allocation. Under Section 1382(b)(1) of Subchapter T, cooperatives are permitted to exclude "amounts paid during the payment period for the taxable year – (1) as patronage dividends ... to the extent paid in money, qualified written notices of allocation ... or other property ... with respect to patronage occurring during such

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taxable year ...” In order for a written notice of allocation to be “qualified,” Section 1388(c)(1) requires that “20 percent or more of the amount of such patronage dividend, or such payment [be] paid in money or by qualified check.” For this purpose, Treas. Reg. § 1.1388-1(c) states:

“A ‘payment in money,’ as that term is used in subdivision (ii) of this subparagraph, includes a payment by a check drawn on a bank but does not include a credit against amounts owned by the patron to the cooperative organization, a credit against the purchase price of a share of stock or a membership in such organization, nor does it include payment by means of a document redeemable by such organization for money.”

For federal income tax purposes, it has long been accepted that if X owes Y money and Y owes X money, and X and Y agree to offset the amounts due each other, the offset will be treated as if each paid the other cash in full payment of its obligation. In the cooperative area, this principle is illustrated by Rev. Rul. 81-103, 1981-1 CB 447. Section 1382(b)(2) allows a cooperative to deduct amounts paid “in money ... in redemption of a nonqualified written notice of allocation...” Rev. Rul. 81-103 considered whether a cooperative had in fact redeemed a \$15,000 nonqualified written notice of allocation held by a patron for \$15,000 of “money” when it paid the patron \$11,000 of cash and offset the remainder against a \$4,000 receivable that it had from the patron. The ruling concluded that the offset would be treated as a payment of cash:

“For federal income tax purposes, X [the cooperative] is treated as having paid A [the patron] \$15,000 in cash in redemption of the nonqualified written notice of allocation and as having received from A \$4,000 to pay the account receivable due X.”

In addition, for federal income tax purposes, it has long been accepted that if X owes Y money and Y owes X money, and if Y assigns his right to the payment from X to Z, then when X then pays Z, X is treated as having paid Y and Y is treated as having paid Z. In the cooperative area, this principle has been applied to the assignment of patronage dividends. If a patron is entitled to receive a patronage dividend from a cooperative, and if the patron assigns that patronage dividend to a third party, then, when the cooperative pays the third party, the cooperative is treated as having paid the patronage dividend to the patron. See, for example, Land O’Lakes, Inc. v. United States, 675 F.2d 988 (8<sup>th</sup> Cir. 1982), and Mississippi Chemical Corporation, 86 TC 627 (1986).

In a series of rulings, the Internal Revenue Service has applied these offset and assignment principles to patronage dividends and the 20% cash requirement.

The first of these rulings, Rev. Rul. 65-128, 1965-1 CB 432, deals with an offset of patronage dividends against amounts due a cooperative. A cooperative regularly sold power equipment to patrons under a conditional sales contract. According to the ruling:

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“The conditioned sales contract required that a minimum stated payment must be made by the patron on his equipment purchases each year. The contract also provides that one hundred percent of the patron’s annual allocable patronage dividends from M are specifically assigned to M and will be credited against the minimum annual payment due under the contract.”

The ruling goes on to state that for the year in question the cooperative paid its patronage dividend 25% by qualified check and 75% in written notices of allocation. The issue was whether the cooperative could exclude patronage dividends credited to a patron’s obligation to the cooperative under the conditional sales contract. The ruling concludes that it could:

“It is apparent from the facts in the instant case that, notwithstanding the terms of the condition sales contract, M paid by qualified check at least twenty percent of the patron’s allocable patronage dividend as required under section 1388(c) of the Code.”

The ruling recited the language of Treas. Reg. § 1.138801(c) that states that a “payment in money” does not include “a credit against amounts owed by a patron to the cooperative organization,” but did not find that language applicable. As later rulings make clear, a critical fact was that the application of the patronage dividends to the conditioned sales obligation was not a unilateral act upon the part of the cooperative. Rather, it was done by mutual agreement pursuant to the terms of the conditional sale agreement.

Later in the same year, the IRS issued Rev. Rul. 65-221, 1965-2 CB 320, which focused on the 20% cash requirement in a situation where patronage dividends were assigned and paid to a third party. Many of the member-patrons of a cooperative were also members of a farmers’ education organization and paid dues to that organization. The cooperative, the farmer’s education organization and the member-patrons of the cooperative sought to establish a mechanism whereby a portion of the patronage dividend paid by the cooperative to a farmer-member could be applied directly to the dues owed by that farmer-member to the farmers’ education organization. The cooperative wanted to make certain that such a direct payment to the farmers education organization could be counted in determining whether the 20% cash requirement was met.

The ruling considered three alternatives:

“The bylaws of X provide that it may deduct from patronage dividends otherwise payable to a member an annual amount for dues to M, provided that the member has first authorized the deduction or “check-off” of such dues in writing. The bylaws of Y similarly provide for the check-off of dues to M, provided that no such dues shall be deducted if the member notifies the cooperative in writing that he does not wish his dues checked off. The bylaws of Z provide for the check-off of dues to M, but there is no provision for authorization by the Z member either for Z to deduct such dues or to discontinue deducting such dues. If the patron

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does not choose to have his dues deducted by Z, his only alternative is withdrawal from membership in Z.”

The Service rules that the 20% cash requirement was met in the case of X and Y “since such payments are made at the option of the member-patron for whom such dues are paid.” In the case of Z, the 20% cash requirement was not met because “payments are not made at the option of the individual member for whom such dues are paid.”

According to the ruling, the key to satisfying the 20% cash requirement is making certain the patron has “the opportunity to use the money he is entitled to have made available to him from the cooperative to pay his taxes.” The patron can choose not to avail himself of the opportunity:

“However, where the disposition of the money, the patron is entitled to receive from the cooperative is beyond the control of the cooperative, a payment by the cooperative to a third party at the option of the patron can be treated as a payment in money to the patron. The cooperative, in effect, has made the money available to the patron and is simply following his authorization as to payment.”

“The twenty percent ‘paid in money’ requirement was intended by Congress to insure that cooperatives would make available to each patron enough cash to pay at least the first bracket income tax. (See Sen. Rept. No. 1881, 87<sup>th</sup> Cong., 2<sup>nd</sup> Sess., 1962-3 C.B. 707, 818). A credit to the account of the patron does not satisfy the statutory requirement because the patron does not have the opportunity to use the money he is entitled to have made available to him from the cooperative, to pay his taxes.

However, where the patron has the option of receiving the money he is entitled to receive from the cooperative, in cash, rather than as a credit to his account with the cooperative, the cooperative, in effect, has made the money available to the patron and is simply following his authorization in regard to payment, whether such authorization is given either actively or passively. (see Rev. Rul. 65-221, 1965-2 C.B. 320).”

“In Rev. Rul. 65-221, 1965-2 C.B. 320, the by-laws of a cooperative, provide for the payment of dues to a third party from the patronage dividend otherwise payable to the member provided that no such dues shall be deducted if the member notifies the cooperative that he does not want his dues to be deducted. The ruling holds that where the disposition of the money the patron is entitled to receive from the cooperative is beyond the control of the cooperative, a payment to a third party at the option of the patron can be treated as a payment in money to the patron. The cooperative has in effect made the money available to the patron and is simply following this passive authorization as to payment.

In the instant case, as in Rev. Rul. 65-221, the patron may elect by filing a timely written request to receive the entire cash portion of his patronage dividend. Therefore,

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the payment of the cash portion to X to be applied against the patron's indebtedness to X can be treated as a payment in money to the patron."

The rulings applying the "20% cash requirement" in set-off and assignment situations involving patronage dividends consistently focus upon whether money has been "made available" to the patron. If the patron has the option to receive cash, but does not exercise that option and rather allows its patronage dividend to be applied to amounts that the patron owes the cooperative or to a third party, the patron will be treated as having received a "payment in money" as that term is used in Section 1388(c)(1) of the Code. See, Rev. Rul. 65-128, Rev. Rul. 65-221, Ltr. 7850073 (September 18, 1978), Ltr. 8006112 (November 20, 1979), and Ltr. 8150125 (September 21, 1981). If the patron does not have the option to receive 20% cash, and the patronage dividend is automatically applied to amounts the patron owes the cooperative or to a third party, then the 20% cash requirement is not met. See, Treas. Reg. § 1.1388-1(c) and Rev. Rul. 65-128.

The amended Bylaw gives members and participating patrons the option to request payment of 20% in cash. The operative language is as follows:

"Notwithstanding the preceding sentence, if a Member or Participating Patron makes a written request to the Corporation prior to the time patronage dividends are paid for a year, then an amount equal to twenty (20%) percent of the total patronage dividend allocated to the Member or Participating Patron for the year shall be paid to the Member or Participating Patron in money and not offset against dues."

This provision assures that 20% in cash is "made available" to members and participating patrons of Coop. Thus, the "payment in money" requirement should be met when members and participating patrons allow the entire amount of the cash portion of their patronage dividends to be applied to dues owed to Coop or to Exempt.

Accordingly, based solely on the facts submitted and the above analysis we rule that:

1. Amounts applied pursuant to the Amended Bylaw out of annual patronage dividends by Coop in accordance with the procedure described above to dues owed by members and participating patrons to Coop will be treated as patronage dividends "paid in money" as that term is used in section 1388(c)(1) of the Code within the payment period for the year.
2. Amounts applied pursuant to the Amended Bylaws out of annual patronage dividends by Coop in accordance with the procedure described above to dues owed by members and participating patrons to exempt will be treated as patronage dividends "paid in money" as that term is used in section 1388(c)(1) of the Code within the payment period for the year.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3)



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of the Code provides that it may not be used or cited as precedent.

Sincerely yours,  
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Senior Technical Reviewer  
Assistant Chief Counsel  
Passthroughs and Special Industries