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Legend:

Coop	=
Bylaws	=
State A	=
State B	=
Corp X	=
Corp A	=
Corp B	=
Corp C	=
State B	=
Affiliate	=
Service Area	=
Document 1	=

Document 2 =

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Dear :

This is in response to a ruling request dated August 17, 2005, submitted on behalf of Coop by your authorized representative. The ruling concerns whether certain income earned by Coop is patronage sourced income. The facts as represented by Coop are described below.

Coop is a rural cooperative telephone company which was incorporated in State A on b. Pursuant to its by-laws, Coop is operated on a cooperative basis for the mutual benefit of its subscriber/patrons ("the "Members"). Coop provides telephone services to its Members. These services include local telephone service and directory assistance. An individual or entity becomes a Member of Coop by subscribing for telephone service, and the ownership of Coop is vested in the Members. Moreover, each Member has one vote regardless of how much capital is contributed.

Coop operates on a cooperative basis. Under its Bylaws, Coop must at all times be operated on a cooperative nonprofit basis for the mutual benefit of its Members. As Members of a cooperative corporation, Coop's Members furnish capital to Coop through their patronage. Coop is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of telephone service in excess of operating costs and expenses properly chargeable against the furnishing of telephone service (Margin). Such amounts are allocated by credit to the capital accounts of Coop's members. Any amount credited to the capital of a Member is treated as if it had been paid to the Member pursuant to a legal obligation to do so, and then the Member had furnished the Coop a corresponding amount as a capital.

Coop generates income from a number of sources. Local service revenue is revenue generated from the provision of local telephone service by Coop to its Members. The revenue is generated on a monthly basis, and the provision of local telephone service to each Member is a fundamental cooperative activity of Coop. End User revenue consists of a monthly flat rate fee charged to Coop's members (i.e., end users) for the completion of long distance calls (including both intrastate and interstate calls) to or from Coop's members.

In general, Coop's Board of Directors retains discretion as to how and when to redeem a Member's capital. In the event of liquidation or dissolution, the Members' capital contributions is returned on a pro rata basis after payment of all of Coop's indebtedness.

Coop provides telephone service to residential customers and businesses in x State A. This area is exceedingly rural and agrarian, and a substantial number of Coop's Members depend on agribusiness for their livelihood. The population in Coop's service area is extremely sparse, and Coop's customers are thinly spread over an area of j square miles. In comparison to the average urban telephone territory, which has k access lines per line mile, Coop's territory has only l access lines per line mile. This low population density makes it extremely difficult to provide the infrastructure of telephone services on a cost-effective basis.

On c, Coop was granted tax-exempt status under Section 501 (c)(12) of the Internal Revenue Code. Coop remains exempt from Federal income tax under section 501(c)(12) only if 85% or more of [its] income consists of amounts collected from members for the sole purposes of meeting losses and expenses. (the "85% Test"). Coop has satisfied the 85% Test for each tax year since its inception and, therefore, it has been exempt from Federal income tax for each of those tax years.

In d, however, Coop sold its e% stock ownership interest in Corp X to Corp A. As a result, Coop will not satisfy the 85% Test for d because the sale proceeds it received from Corp A (a nonmember) will exceed 15% of its total income.

In the m's, cellular telephone technology began to emerge as a viable option for consumers. This technology was especially attractive to customers for rural telephone companies because it freed those persons from being limited to "wireline" telephone service. For example, farmers would no longer have to leave the fields to make or receive telephone calls.

Coop was interested in this new technology for at least two principal reasons. First, this technology was very desirable from a customer service perspective. As previously indicated, people working on farms or out in the country could now utilize

telephone services without having to find a “land-line” telephone. In that regard, Coop’s management was committed to providing the best telephone technology to its Members, and Coop’s management knew that it had to participate in the development of a rural cellular telephone network. Second, it was clear to Coop’s management that cellular telephone technology was the “wave of the future.” Coop’s management was deeply concerned that it would lose a significant portion of its “wireline” customer base if it did not offer cellular telephone technology to its Members. Such a loss of customer base would be devastating to Coop because it would leave Coop with “stranded investments” in wireline infrastructure, and Coop’s remaining customers would be faced with escalating costs caused by the loss of other customers (and their revenue) to wireless providers. Thus, Coop’s management was keenly interested in pursuing this new technology in order to benefit Coop’s Members.

On a national level, the Federal Communications Commission (the “FCC”) also wanted to make sure that the traditional “wireline” telephone companies (such as Coop) had the opportunity to develop cellular telephone networks. In that regard, the FCC divided the radio spectrum in each market into two channel blocks. One channel block was set aside for development by traditional “wireline” telephone companies, and the second channel block was set aside for development by “non-wireline” companies. The FCC license for each of these two channel blocks was very desirable because it gave the holder a five year “exclusivity “ period with respect to building and operating a cellular telephone system.

In markets where more than one applicant existed for either type of license, the FCC held a lottery to determine the winner. In addition, the winning applicant then had to prove to the FCC that it had the technical expertise and financial strength to build and operate a cellular telephone system.

As represented, Coop was a small rural telephone cooperative. In order to compete for the FCC license, Coop had to “partner” with much stronger communications provider. On n, Coop entered into Document 1 with Corp B to provide for the creation of a joint venture (eventually, Corp X) to (i) file an initial application with the FCC to compete in the “wireline” lottery for Coop’s FCC territory (known as the Service Area) and (ii) if Coop won the lottery and the final application was successful, to construct and operate the cellular telephone system.

Document 1 also provides that if the joint venture was successful in obtaining the FCC license, Corp B would loan (or arrange for a loan) to the joint venture of funds to be used by the joint venture for the construction and operation of the cellular telephone system. In return, Corp B would receive interest at prime rate on the loan, and Corp B would also receive a management fee for providing management services to the joint venture.

On f, Corp X was incorporated in State B as the joint venture company to construct and operate a cellular mobile telephone system in Federal Communications Commission designated Service Area.

As set forth in its Articles of Incorporation dated f, Corp X was initially capitalized with z shares of common stock, par value $aa per share, of which z shares were issued and outstanding. Coop contributed $bb in exchange for bb common shares (e%), and Corp B contributed $ cc in exchange for cc common shares (g%). As previously indicated, Corp B agreed to loan (through Affiliate) funds to Corp X to construct and operate the cellular telephone system, and Corp B through Affiliate also provided management services to Corp X in exchange for a management fee.

In p, Corp X submitted its initial application to the FCC for the “wireline” FCC license for the Service Area, and on q, a lottery was held by the FCC to determine which applicants would win the opportunity to pursue the final FCC license. Corp X won the FCC lottery, and its application for the FCC license was then accepted for a detailed review. On r, Corp X’s application was accepted by the FCC, and it was then granted a license to construct and operate a cellular telephone system in the Service Area.

Once the analog cellular telephone system (the “System”) was constructed and operational, the System was managed and operated by Affiliate as part of it regional rural cellular telephone system. Under Document 2, Affiliate was responsible for managing and operating the System and Corp X paid Affiliate a management fee for its services.

During the s, Corp X was constructing the analog cellular telephone system and it was adding new subscribers. Coop was approached on more than one occasion to sell some or all of its e% interest in Corp X. These expressions of interested included: A solicitation by Corp B to purchase Coop’s e% interest in Corp X in early t; a solicitation by Affiliate to purchase a dd% interest in Corp X in early t; a solicitation by Corp C to purchase Coop’s e% interest in Corp X in spring t; an offer by Affiliate to sell its g% interest in Corp X to Coop, or, alternatively, that Coop join with Affiliate to collectively sell ee% of Corp X in early u. However, Coop refused to sell its e% stock interest in Corp X because Coop wanted to be involved in the provision of cellular services to its Members.

By the late v’s, Coop had reached its goal: the cellular network system in State A had been built and was providing a valuable service to Coop’s Members. However, Corp X was proving to be a costly enterprise. Over the years, Corp X had incurred significant losses, and Corp B continued to loan money to Corp X to pay for operating expenses and capital improvements. As time progressed, the outstanding loan balance owed by Corp X to Corp B continued to grow, and Coop’s management

became concerned that any equity that Coop had in the shares of Corp X would eventually be wiped out due to the ever increasing debt level of Corp X.

In addition, the cellular technology landscape was changing drastically. By the late v's it was becoming clear that digital technology was replacing analog technology at a faster pace than originally anticipated. Moreover, large national companies were aggressively consolidating cellular networks. This wave of consolidation was changing the economics of the cellular telephone business. Networks with multi-state or national foot prints were able to offer uninterrupted service in a much larger area; a benefit that did not escape the notice of customers. The rapid shift in technology from analog to digital, combined with industry consolidation, made it very difficult for small wireline providers (such as Coop) to provide cutting-edge digital telephone technology to their subscribers.

Finally, the FCC modified its radio spectrum allocation methods for issuance of PCS licenses. In that regard the FCC had determined that digital licenses had to be obtained through a PCS Block auction, rather than through a limited lottery procedure as had previously occurred in the early m's. If Corp X was to provide digital PCS service, it would have to raise the necessary capital to participate in the FCC PCS License block auction, and then it would have to be build and operate the PCS network.

All these factors led Coop to seriously consider selling its e% interest in Corp X. On w, the Board of directors authorized that Coop negotiate an offer to sell Corp X.

Eventually, these efforts resulted in a sale of Corp X to Corp A in d. The purchase price for all of the Corp X stock was $h million, plus or minus a working capital adjustment. The amount payable to Coop for its e% stock interest had to be reduced by Coop's allocable portion of the debt of Corp X to Corp B. As a result, Coop was paid $i for its shares of Corp X.

Coop represents that the Margin ($i proceeds less expenses of sale) attributable to the sale of Corp X stock will be allocated, insofar as is practicable, to the capital accounts of the Members of Coop who are Members of Coop during the time that Coop owned the stock Corp X, and in proportion to the amount of business done by such Members during such taxable years consistent with allocations described in section 1.1382-3(c)(3) of the Income Tax Regulations for subchapter T cooperatives. The capital generated from the sale of Corp X stock will be retained by Coop to meet its operating and/or capital improvement needs. The Margins attributable to Local Service revenue and End User Revenue for d will be allocated to the capital accounts of Members (patrons) of Coop on a patronage basis pursuant to the Bylaws.

Section 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. After d, Coop falls into this category, and thus is a non-profit, but taxable cooperative corporation.

Subchapter T, §§ 1381-1388, provides the statutory scheme for taxing cooperatives. Rural telephone cooperatives, however, are not governed by subchapter T, because of the exclusion provided by § 1381(a)(2)(C) for rural telephone cooperatives. When Congress enacted subchapter T in 1962, Congress excluded rural telephone cooperatives. The underlying committee reports states 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.

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.

In order for the amount realized from the sale of the Corp X 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 (1985); Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993 (8th Cir. 1982); Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243 (1987); Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459 (1986), acq. in part and nonacq. in part, 1990-2 C.B. 1)

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 sourced, 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, 1979 WL 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.

Accordingly, based solely on the facts and representations submitted by Coop and the discussion above we rule that:

1. The sales proceeds received by Coop in d from the sale of the Corp X stock constitute patronage sourced income and such income may be excluded from Coop's d taxable income when margins attributable to such income are paid or allocated to the members of Coop in proportion to patronage pursuant to a preexisting legal obligation created by Coop's bylaws.

2. Local service revenue and end user revenue accrued or received by Coop in d is patronage sourced income and may be excluded from Coop's d taxable income when margins attributable to such income are paid or allocated to the members of Coop in proportion to patronage pursuant to a preexisting legal obligation created by Coop's bylaws.

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,

Susan J. Reaman
Chief, Branch 5
Office of Associate
Chief Counsel
(Passthroughs and Special Industries)