

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:5:PLR-161789-01

Date:

March 15, 2002

LEGEND

Cooperative =

State A =

City B =

City C =

D =

Country E =

a =

b =

c =

Dear :

This is in response to your request dated October 30, 2001, and subsequent correspondence requesting a ruling that the Cooperative will be “operating on a cooperative basis” within the meaning of section 1381(a)(2) ) of the Internal Revenue Code. You have provided the following representations.

The Cooperative is a State A corporation. The books and records of the Cooperative will be kept on the accrual method of accounting. The Cooperative’s principal office is located in City B, and its returns will be filed with the Internal Revenue Service Center in City C. The Cooperative has adopted a fiscal year ending in the month of D.

The Cooperative has a members who are non-resident Country E corporations, not doing business within the United States. All a members are resident corporations for purposes of Country E taxation. The purpose of the Cooperative is to market b

products in the United States. Pursuant to the by-laws of the Cooperative, each member of the Cooperative shall be entitled to one vote without regard to the amount of shares the member owns. In addition, each member will designate an individual to serve on the Cooperative's board of directors.

The Cooperative is obligated to account on a patronage basis to all member patrons on an annual basis for all amounts received from business conducted with members. The patronage dividend will be such that all amounts of net profit before tax earned by the Cooperative in the form of patronage income in any fiscal year shall be distributed to the members of the Cooperative in proportion to the patronage of each such member in that fiscal year calculated according to a weighting of  $\underline{c}$  by volume and  $\underline{c}$  by value of produce shipped to or through the Cooperative by the member. All patronage dividends distributed shall be distributed to the members in cash or qualified written notices of allocation as permitted by section 1382(b) of the Code.

Pursuant to the bylaws of the Cooperative, the amount of capital, if any, furnished by each member, shall at the end of each fiscal year be clearly reflected and properly credited in the appropriate record to the capital account of each member. The Cooperative shall, within 8 ½ months after the close of each fiscal year, notify each member of the capital so credited to the member's account. The notice shall be in the form of a written notice of allocation or per-unit retain certificate.

When a member patron discontinues participation in the Cooperative, any unredeemed patronage allocations will be retained by the Cooperative until the allocation instrument is due for redemption by its terms. Based on the discretion of the board of directors and based on the financial condition of the Cooperative, a withdrawing member may have its retained patronage allocation redeemed for amounts agreeable to the Cooperative and the withdrawing member in full satisfaction of the claim. Any discount would be includable in the Cooperative's non-patronage income pursuant to the tax benefit rule.

Pursuant to the by-laws, the Cooperative upon dissolution, after all debts and liabilities of the Cooperative shall have been paid, all shares of any stock redeemed, and all capital furnished through patronage shall have been retired without priority on a pro rata basis, distribution of any remaining assets shall be distributed on a patronage basis to all member patrons on the basis of their amount of patronage conducted by them to the extent practicable.

Pursuant to the by-laws, any entity which applies for and is accepted to membership of the Cooperative, by such act alone, will consent that the amount of any distributions with respect to the member's patronage, occurring after acceptance for membership status, which are made in written notices of allocation (as defined in section 1388 of the Code), will be taken into account by the member at the stated dollar amount in the manner provided in section 1385(a) of the Code in the taxable year in which such written notices are received by the member.

Section 1381 of the Code provides that subchapter T shall apply to “any corporation operating on a cooperative basis...” (with certain exceptions not here relevant). Section 1.1381-1(a) of the Income Tax Regulations states that subchapter T of the Code “applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of business done with or for patrons.”

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), acq., 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: 1) subordination of capital; 2) democratic control by the members; and 3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor.

Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative’s business remain in the hands of the member/patrons of the cooperative rather than with nonpatron equity investors in the cooperative. The purpose of this limitation is to insure that the gains that accrue to the cooperative from the business that it transacts with its patrons will largely or completely inure to the benefit of those patrons rather than to its stockholders. To be operating on a cooperative basis, a cooperative must limit the financial return with respect to its equity capital. Puget Sound, 44 T.C. at 308. Stated differently, a cooperative may not be operated for the purpose of paying a return on equity investments.

Democratic control of the cooperative, as envisioned in Puget Sound at 308, is typically achieved by voting on a one-member, one-vote basis. The principal of democratic control was further discussed in Etter Grain Co. v. United States, 462 F.2d 259, 263 (5<sup>th</sup> Cir. 1972), in which the court noted that section 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, “envisio[n]s the exempt association organized according to a model of a widely-based participatory democracy in which all the members are able to exercise a franchise of equal strength.” Each member must have a single vote regardless of the size of its investment or the amount of business it does with the corporation.

The requirement of operation at cost is met if the cooperative’s net earnings or savings are distributed to the cooperative’s patrons in proportion to the amount of business conducted with them. This requirement relates to:

the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, Bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the association are required to make periodic allocations of the same among the members in proportion to their active participation as workers. Puget Sound, at 308.

Rev. Rul. 70-481, 1970-2 C.B. 170, holds that a corporation supplying services

to its members at cost and making distributions to each member based on the value of business done with each member was “operating on a cooperative basis” within the meaning of section 1381(a)(2) of the Code.

Rev. Rul. 72-36, 1972-1 C.B. 151, states that in accordance with fundamental cooperative principles, the rights and interests of the members in the savings of a cooperative should be determined in proportion to their business with the cooperative. With respect to liquidating distributions, the Service has stated that the cooperative principle of operation at cost requires that a cooperative’s Articles of Incorporation or Bylaws obligate the cooperative to distribute its remaining assets upon liquidation to both its current and former members in proportion to the value or quantity of business that each did with the cooperative over some reasonable number of years.

Section 1382(b)(1) of the Code provides, in part, that in determining the taxable income of a cooperative 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.

Section 1382(b)(1) of the Code and section 1.1381-2(b)(1) of the regulations provide, in pertinent part, that there is allowed as a deduction from the gross income of any cooperative to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation that is not cashed on or before the 90 day after the close of the payment period for the taxable year.

Section 1382(d) of the Code provides, in part, that the payment for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or done for such patron. Section 1388(a)(2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) of the Code provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the corporation from business done with or for its patrons. That section further provides that “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. Section 1.1382-3(c)(2) of the regulations states that 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.

Concerning the requirement of subordination of capital, we note that the Cooperative does not have any nonpatron investors, nor do they plan to accept any nonpatron investors. The bylaws mandate that the Cooperative operate on a cooperative basis for the benefit of its members. Further, the bylaws mandate that each of the members shall have one and only one vote with majority rule controlling. In addition, we note that after dissolution distribution of remaining assets shall be distributed to all member patrons on the basis of their amount of patronage with the Cooperative. Concerning the requirement of democratic control, we note the Cooperative's bylaws provide that each member shall be entitled to a single vote. Majority rule is also in effect. Concerning the requirement of operation at cost, we note that net earnings are distributed to the patrons in proportion to the quantity and value of business conducted with them thereby ensuring that it is operated at cost.

Based solely on the representations provided, we conclude that the Cooperative will be "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the Code.

No opinion is expressed or implied on any other provision of law. This letter is addressed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,  
Walter Woo  
Senior Technician Reviewer  
Branch 5  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Attachments:  
Copy for section 6110 purposes