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Internal Revenue Service

Department of the Treasury
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Date: June 15, 2004

Legend:

Trust (Taxpayer) =

State A =

State B =

Company A =

Company B =

x =

Court =

Facility =

Date 1 =

Date 2 =

Date 3 =

Dear _____ :

This letter responds to Trust's authorized representative's letter, dated February 13, 2004, in which he requested on behalf of Trust several rulings concerning the organization, by Trust and one or more other qualified settlement funds (QSFs) under section 468(g) of the Internal Revenue Code and sections 1.468B-1 through 1.468B-5 of the Income Tax Regulations, of a new corporation to operate a claims processing unit on a cooperative basis. Specifically, the letter requested the following rulings:

(1) the new corporation will qualify as a corporation operating on a cooperative basis within the meaning of § 1381(a)(2);

(2) assuming that Trust and the other members in the new cooperative otherwise qualify as QSFs under § 468(g) and §§ 1.468B-1 through 1.468B-5, Trust's membership in and receipt of patronage dividends from the new cooperative will not affect its status as a QSF; and

(3) assuming that Trust and other members in the new cooperative otherwise qualify as QSFs under § 468(g) and §§ 1.468B-1 through 1.468B-5, Trust's transfer of certain assets to the new cooperative will not affect Trust's status as a QSF.

FACTS

Trust is a State A trust created in connection with the bankruptcy reorganization of Company A and its wholly-owned subsidiary, Company B. The Plan of Reorganization was confirmed on Date 1, and became effective on Date 2.

Prior to its reorganization, Company A manufactured and distributed products containing x. Trust was established pursuant to an order of the court to pay and satisfy personal injury and property damage claims of Company A and its affiliates resulting from x. In a private letter ruling dated Date 3, the Internal Revenue Service ruled that Trust is a QSF under § 468B.

Trust is subject to the continuing jurisdiction of the Court, and uses the accrual method of accounting. Trust's taxable year is a calendar year.

Trust owns and operates its claims processing facility (Facility), which processes x claims. In order to reduce expenses and conserve assets for the benefit of future claimants, Trust proposes to make Facility available to unrelated QSFs and x settlement trusts on a long-term basis by operating Facility on a cooperative basis within the meaning of subchapter T.

Pursuant to the proposal, Trust and several unrelated QSFs (collectively, "Members") will establish a corporation to be operated on a cooperative basis (the "Cooperative") to process x related claims on behalf of the Members. The Cooperative will be organized as a corporation under the laws of State B and will operate Facility as a corporation operating on a cooperative basis.

To implement the proposal, Trust will contribute all of its interests in its claims processing assets, which will include the physical facility, the employees, the computer system, the database (subject to the right of individual claimants to withhold consent to sharing of data), and other accompanying information and know-how to the Cooperative in exchange for an amount of nonvoting preferred and common stock in the Cooperative determined by the Members to be equal to the relative value of the Trust's Facility assets contributed. The Members, other than Trust, will contribute cash for working capital purposes of the corporation in proportion to the amount of claims expected to be processed by the Cooperative, receiving in exchange an amount of stock of the corporation that is determined by the Members to be proportionate in value to their capital contributions. Additionally, the Cooperative will enter into long-term contracts with the Members to provide at-cost claims processing services.

It is anticipated that Trust will own a majority of the shares of stock of the Cooperative and other Members will own similar amounts of stock in relation to the amount of claims expected to be processed on their behalf. The Cooperative will process claims for Members and will charge on a basis that reflects relative costs incurred to process claims of various Members. Although it is possible that the Cooperative may in the future provide claims processing services for non-Members, initially it will provide service to Members only.

The Cooperative's articles of incorporation and bylaws will provide that each Member will be entitled to one vote regardless of the number of shares owned. The bylaws will also provide that the Cooperative's net income derived from business with or for the Members will be allocated and distributed as patronage dividends to them in proportion to the relative amount of business done with or for each Member. Patronage dividends will be distributed either in cash or in the form of qualified checks (as defined in § 1388(b)) no later than the fifteenth day of the ninth month of the year following the year in which earnings are derived. Dividends attributable to any nonpatronage income from business done with non-Members, when distributed, will be distributed to the Members in proportion to historical patronage.

Members generally will not be permitted to sell their interest in the Cooperative except to new Members in connection with the admission of such new Members or to the Cooperative in connection with the withdrawal or expulsion of a Member, or for purposes of balancing ownership interests of the Cooperative. If additional Members are admitted to join the Cooperative, pursuant to approval by a majority of existing Members, the new Member will be required to contribute cash as working capital to the Cooperative in an amount determined by the Members to be proportionate with the

relative value of stock received, and generally in relation to anticipated patronage by the new Member.

Trust intends to liquidate after all claimants have been paid or its assets have been exhausted. At such time, Trust could sell all of its assets, including its interest in the Cooperative.

LAW AND ANALYSIS

1. SECTION 1381(A)(2) – THE COOPERATIVE

Section 1381 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) 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 remains 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, 44 T.C. at 308, is typically achieved by voting on a one-member, one-vote basis. The principle of democratic control was further discussed in Etter Grain Co. v. United States, 462 F.2d 259, 263 (5th Cir. 1972), in which the court noted that § 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, “envision(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 associations are required to make periodic allocations of the same among the members in proportion to their active participation as workers. Puget Sound, 44 T.C. 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 § 1381(a)(2).

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) 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) and § 1.1381-2(b) (1) 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) defines the term "nonqualified written notices of allocation" as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year.

Section 1382(d) provides, in part, that the payment period 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) 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) 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) 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.

Cooperatives are distinguished from ordinary business corporations by how they allocate and distribute their earnings. In an ordinary business corporation, net earnings are shared by investors based upon the capital they invest in the business. In a cooperative, net earnings are shared by the patrons on a patronage basis.

Rev. Rul. 93-21, 1993-1 C.B. 188, and Rev. Rul. 72-602, 1972-2 C.B. 511, state that “in order to be considered ‘operating on a cooperative basis’ under section 1381(a)(2) of the Code, the taxpayer must have sufficient membership to form a mutual joinder of interest in the risks and benefits of the organization...”

In this instant case, the Cooperative will fulfill the three principles fundamental to cooperative operations: (1) subordination of capital; (2) democratic control by members; and (3) operation at cost. The Cooperative will meet the principle of subordination of capital in that its only stockholders will be its Members, net earnings from business done with or for Members will be returned based on each Member business done, and any dividends from non-Member nonpatronage business will be distributed to Members based on historical patronage. Upon liquidation of the Cooperative, property and assets will be distributed to each Member in proportion to and up to the amount of capital contributed to each Member and any balance will be distributed to the Members based on historical patronage.

Operation at cost, or return of the fruits of the activity in proportion to participation in the cooperative endeavor, is mandated under the bylaws of the Cooperative, which requires that net revenue attributable to processing claims for Members be returned to the Members at least annually in the form of cash, qualified check, or written notices of allocation on the basis of the amount of business done with the Cooperative.

Democratic control of the Cooperative is established under the Cooperative’s articles of incorporation and bylaws, because each Member is entitled to only one vote. Thus, the Cooperative will be controlled by the Members who are patronizing it and not by outside investors.

Therefore, the Cooperative's proposed articles, bylaws, and operations fulfill the requirements of cooperative operation as stated above. Accordingly, based solely on the above, we conclude that the Cooperative will be operating on a cooperative basis within the meaning of subchapter T of the Code.

2. SECTION 468B – QSF STATUS

Section 468B(g) provides that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. This section authorizes the Secretary to prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

Pursuant to this legislative grant of regulatory authority, the Secretary has issued regulations that provide that a QSF is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e), the tax imposed on estates and trusts. See § 1.468B-2(a).

Sections 1.468B-1(a) and (c) provide that a QSF is a fund, account, or trust that satisfies the following requirements:

- (1) It is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;
- (2) it is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability –
 - (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA); or
 - (ii) arising out of a tort, breach of contract, or violation of law; or
 - (iii) designated by the Commissioner in a revenue ruling procedure; and
- (3) it is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-2(f) provides that a QSF must treat a distribution of property as a sale or exchange of that property for purposes of § 1001(a). That section further provides that in computing gain or loss, the amount realized by the QSF is the fair market value of the property on the date of distribution.

Section 1.468B-2(k)(2) provides, in pertinent part, that for purposes of subtitle F, a QSF ceases to exist on the earlier of the date the fund either no longer satisfies the requirements of § 1.468B-1 or no longer has any assets and will not receive any more transfers.

The regulations contain no restrictions or prohibitions with respect to the type of transactions to which Trust proposes or the type of assets which a QSF may hold. Therefore, as long as the regulatory requirements of § 1.468B-1(c) are satisfied, Trust will retain its QSF status.

CONCLUSIONS

Based on the information provided and the representations made, we conclude:

(1) The Cooperative will qualify as a corporation operating on a cooperative basis within the meaning of § 1381(a)(2).

(2) Assuming that Trust has been determined to be a QSF under § 468B(g) and §§ 1.468B-1 through 1.468B-5, Trust membership in and receipt of patronage dividends from the Cooperative will not affect its status as a QSF.

(3) Assuming that Trust has been determined to be a QSF under § 468B(g) and §§ 1.468B-1 through 1.468B-5, Trust's contribution of its interest in Facility to the Cooperative will not affect Trust's status as a QSF.

Except as specifically set forth above, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed regarding the tax consequences of the transaction to any party other than Trust. In addition, no opinion is expressed on the following matters: (1) Trust's basis in Facility prior to the transfer of its interest to the Cooperative and (2) the application of subchapter C of the Code, including but not limited to §§ 351, 358, and 362.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

THOMAS A. LUXNER
Chief, Branch 6
Office of Associate Chief Counsel
Income Tax & Accounting)

Enclosures:

Copy of this Letter
Copy for section 6110 purposes