

Internal Revenue Service

Department of the Treasury

Number: **200252027**
Release Date: 12/27/2002
Index Number: 1388.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC: P&SI:5 - PLR-123142-02

Date:

Legend

Coop =

State A =

State B =

State C =

Sub =

City A =

City B =

b =

Dear :

This is in response to a letter dated April 17, 2002, submitted on behalf of Coop by your authorized representative requesting a ruling on a proposed transaction described below.

Coop incorporated under the laws of State A in , as a State A not for profit corporation. The entity was taxed under subchapter C of the Internal Revenue Code

until _____, when it was reincorporated under the laws of State B as a cooperative. Effective with this reorganization, the Coop commenced operating on a cooperative basis and was subject to income taxation under subchapter T of the Code.

Effective _____, the Coop was reincorporated in State C and continued to operate on a cooperative basis pursuant to section 1381 of the Code.

Its members include b retailers, supermarkets, individual buying clubs and cooperative retailers. Sub, a wholly owned subsidiary of the Coop, was established for the purpose of loaning funds to member retail customers for expansion or relocation.

The Coop is a wholesaler and distributor of high quality b and related products. It owns a warehouse and office facility located in City A and leases another warehouse facility in City B. Both facilities are used exclusively for the warehousing and distribution of b and related products that are sold to members and nonmembers. The office space is used exclusively for administrative functions relative to the operation of the Coop. The Coop also maintains a fleet of trucks used exclusively to ship products to the Coop's warehouses and from the warehouses to members.

According to the Coop's articles of incorporation dated _____, and the bylaws, the Coop is organized for the purposes of providing access to b and healthful products, to encourage the production and use of b that promote long-term health, to stimulate and support local and national production of b and other agricultural products, to offer the best value and service to its customers and to develop in its members an awareness of the benefits of cooperative organization.

The Coop's bylaws state that all entities and individuals purchasing goods from the Coop shall be classified in one of the following four categories:

Class A: Any consumer-owned or worker-owned cooperative or other entity operating on a cooperative basis;

Class B: Any nonprofit organization or any privately or publicly owned entity;

Class C: Any nonprofit organization or any privately owned business purchasing goods as a nonmember of the Cooperative; and

Class D: Any consumer purchasing goods from the Cooperative on a retail basis

Entities in Classes A and B are considered members of the Coop for patronage purposes and only members share in patronage allocations. Currently, the Coop has approximately _____ members. Approximately 95 percent of annual sales are to

members. The majority of the sales to nonmembers consist of purchases by retail b customers, employees and individual consumers directly from one of the two warehouse facilities on a retail basis.

The Coop's bylaws provide for the allocation and distribution of the Coop's adjusted net income from business done with members. Adjusted net income is defined as the Coop's federal taxable income for the fiscal year, determined without regard to the deduction for patronage, less reductions for (a) amounts not attributed to business done with members, and (b) reasonable reserves established by the Coop's Board of Directors for necessary business purposes.

The Coop's bylaws give the Board of Directors the discretion to determine the allocation units used for purposes of allocating adjusted net income for patronage purposes. To date, the Board has elected to use a single allocation unit based on the total patronage by members during the fiscal year. Members are required to consent to the receipt of qualified patronage as a condition of membership, but are given the option to elect to decline the receipt of patronage distribution. Qualified notices of allocation are given to members when patronage distributions are declared.

The Coop's bylaws also provide that if adjusted net income includes a substantial gain or loss or extraordinary income or expense such amount shall be excluded from the allocation based on patronage by members during the fiscal year. Instead, such substantial gain or loss or extraordinary income or expense shall be allocated, insofar as is practicable, within the maximum limits of subchapter T of the Code, to the members or class of members for which such substantial gain or loss or extraordinary income or expense is attributed. The amount of such substantial gain or loss and the members or class of members to which such gain, loss, income or expense is attributed shall be determined by the Board of Directors in its sole discretion in a manner that will provide equitable treatment to all members of the Coop.

As a result of an increased public awareness of the benefits of b, and an increasing demand for b products, the availability of b products has improved significantly since the formation of the Coop. This increased availability has reduced the cooperative members dependence on the Coop as the source of b products. The increased distribution, sales and growth rates of b products have created additional competition within the food industry and brought large competitors into the b products market. In addition, wider distribution and greater availability has driven down the cost of b products. This increased availability, greater competition, and lower pricing have reduced the cooperative members' need for the Coop as their source of b products.

As a result of this change in the industry, the Coop is contemplating the sale of substantially all of its assets to a single buyer, followed by a distribution of the proceeds to its members. The Coop is currently negotiating with a publicly held, unrelated third party, food wholesaler for the sale of the Coop's assets and assumption of its business

operations. The consideration received would include cash, marketable securities, and the assumption of certain liabilities. The gain on the sale of the assets, based on the proposed sales priced, is estimated to be \$. Of this gain, \$ is estimated to be Code sections 1245 and 1250 gain, with the balance being gain pursuant to Code section 1231.

The assets sold would consist of the following categories: Trade receivables; Inventories; Land, Property and Equipment; Customer lists, trade name and other intangible assets; and Sub stock.

All of the assets included in the sale, other than the stock of Sub, are used exclusively in the wholesale and distribution activities of the Coop.

The trade receivables consist of accounts receivables between the Coop and the b retailers, supermarkets, buying clubs and cooperative retailers that comprise its customer base.

The inventories consist of b and b related products for sale to patrons and supplies used in the wholesale and distribution activities of the Coop.

The land, property and equipment consists of the following:

Land, building, and improvements used for b inventory storage and distribution and offices housing the Coop's management, administration and accounting personnel located in City A.

Improvements made to a leased warehouse used for b storage and distribution located in City B.

Warehouse equipment used for b storage and distribution, such as freezers, coolers, conveyors, forklifts and scales.

Transportation equipment used for inbound and outbound shipping and distribution of inventory.

Office equipment, furniture, computers and software used in the administrative, accounting and marketing activities of the Coop.

Intangible assets consist of customer lists, agreements with vendors, leases, trade names and other intangibles, such as goodwill, associated with the wholesale and distribution activities of the Coop.

The only asset of the Coop contemplated to be sold that would not be used in the cooperative activities of the Coop is the stock of Sub.

Pursuant to the provision of the Coop's bylaws, the Board of Directors believes the gain on sale is a substantial gain. The Board of Directors proposes to allocate the sections 1245, 1250, and 1231 gain recognized from the sale of assets, other than the stock of Sub, between members and nonmembers based on business done with the Coop from inception of Coop operations through the date of sale.

Coop requests that the amount realized from the sale of the Coop's assets consisting of gain pursuant to Code section 1231 constitutes "patronage sourced" income, which may be excluded from the Coop's gross income, to the extent of patronage with members, when allocated to the Coop's members by a qualified patronage distribution.

Section 1381(a) provides the organizations to which part I of subchapter T of the Internal Revenue Code applies. Subchapter T provides the statutory scheme for taxing most cooperatives.

Section 1388(a) provides that the term "patronage dividend" means an amount paid to a patron by an organization to which Part I of subchapter T applies on the basis of quantity or value of business done with or for such patron, under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and 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 that 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 from other than patronage."

In Rev. Rul. 69-576, 1962-2 C.B. 166, the taxpayer (a nonexempt farmers' cooperative) borrowed money from a bank for cooperatives to finance the acquisition of agricultural supplies for resale to its members. At the close of the taxable year for the bank, the bank determined its net earnings, which it then allocated to its patrons, including the nonexempt farmers' cooperative, on a patronage basis. The patronage allocations were based on the proportion of the total interest paid to it by each cooperative during the taxable year. The nonexempt farmers' cooperative in the instant

case included the patronage allocations received by it from the bank for cooperatives in its gross income for the taxable year received under section 1385 of the Code. Under a preexisting obligation the nonexempt farmers' cooperative then allocated and paid the same amount it received from the bank for cooperatives to its own patron. The Rev. Rul. held that the allocation and payment of the amount by the nonexempt farmer's cooperative to its own patrons qualified as a patronage dividend. The Rev. Rul. stated that: "The classification of an item 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 servicing activities, the income is from patronage sources."

In Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999) 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, along with the income from the sale of its gas and soybean facilities, and miscellaneous depreciable business assets classified as "patronage sourced" income. The income from the sale included section 1231 and section 1245 recapture gain realized on the sale of taxpayer's gas and soybean facilities and from the sale of miscellaneous assets used in the course of the taxpayer's business activities. The gain also included "capital gain" from the sale of the stock in the taxpayer's subsidiaries. The Service did not contest the classification of the section 1245 recapture as patronage source, but argued that all of other gains and losses at issue were capital in nature and should be automatically classified as nonpatronage under the per se rule prescribed by section 1.1382-3(c)(2) of the regulations. The court ruled that the sale of these assets was closely related to and stemmed from the taxpayer's cooperative enterprise of providing products and services to its patrons and therefore the section 1231 gain and the capital gain were patronage sourced income to the extent of business done with members. 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's marketing, purchasing, or servicing activities on behalf of its patrons."

Section 1.1382-3(c)(3) of the regulations, provides that it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year income realized from such gains must be paid, insofar as is practicable, to the persons who were patrons during the

taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

The assets held by the Coop, other than the stock of Sub, are directly related to its business of operating as a wholesaler and distributor of b and related products, which are predominantly sold to members. The assets being sold facilitate the accomplishment of the cooperative activities of the Coop. Accordingly, the gain from the sale of such assets will result in patronage sourced income, which when allocated to the Coop's members should be deducted from gross income of the Coop.

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,

Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)