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Legend

Taxpayer =

State A =

b =

c =

d =

e =

f =

g =

Brand Name =

Geographic Area =

Trade Mark =

Dear :

This is in response to a request for a ruling dated July 17, 2004, submitted on behalf of Taxpayer by its authorized representative. The ruling concerns the conversion of Taxpayer to a corporation "operating on a cooperative basis " within the meaning of Subchapter T, of the Internal Revenue Code as explained below.

Taxpayer is a State A corporation formed in g, that markets and distributes premium quality b under the brand name and other c through a franchise network of established b producers covering most of Geographic Area. Additionally, Taxpayer sells b purchased from its franchise network directly to certain customers. From d, Taxpayer has intended to operate on a cooperative basis for the benefit of its franchise-patron. The Taxpayer engages in its business by franchising certain rights with respect to the production and marketing of b and c to franchisees pursuant to a Franchise Agreement individually entered into by and between each franchisee and the Taxpayer. The b and c covered by the franchise agreements are those produced by f fed the feed supplement and marketed under the . The terms of this agreement recognize the franchisee's ability to produce and distribute the product in a specified territory, and the Taxpayer's ability to advertise and promote the product.

Under the terms of the franchise agreements, the Taxpayer has granted each franchisee the right to produce, sell and distribute the b known as Brand Name (or any other trademark or trade name approved by the Taxpayer) in the territory specified in the particular franchise agreement. The initial term of a franchisee's rights under the agreement is years with options specified in the agreement for renewal. The franchise agreement also covers the terms by which franchisees are required to purchase the feed additive or other feed supplements under the Trade Mark or other name. The Taxpayer currently has a contract with a feed manufacturer to produce and sell the Taxpayer's feed additive and other feed supplements to the franchisees at pricing negotiated by the Taxpayer. Franchisees are also required to purchase packing supplies and promotional materials bearing the Brand Name trade names, at sizes and according to package designs specified by the Taxpayer from approved manufacturers at pricing negotiated by the Taxpayer.

In consideration of the advertising, promotion, publicity, research, quality control, and other services provided by the Taxpayer, franchisees pay the Taxpayer a fee based on the franchisee's net sales of Brand Name b and c. Net sales for this purpose, is the franchisee's sales volume, less returns, at the then current wholesale price suggested by the Taxpayer for the franchisee's region. The

fees are incurred by the franchisee as of the date the franchisee sells the b or c to an unrelated party. The Taxpayer recognizes fees as revenue upon delivery of the c by the franchisee to the customer. Under the terms of the franchise agreements, the Taxpayer is obligated to spend the fees on advertising, promotion, and publicity of the Brand Name b and c within each of the franchise territories.

The Taxpayer operates a franchise territory repurchased in , geographically within one state. The Taxpayer purchases b and c from franchisees producing b in neighboring territories and re-sells the products to wholesalers at prevailing market prices. The Taxpayer does not charge the supplying franchisees a

fee on these purchases. The Taxpayer funds its advertising, promotion, and publicity costs in this repurchased territory through the gross margin earned on these direct product sales and proportionate funding as needed from fees received from all franchisees. The Taxpayer believes continued operation of this repurchased territory benefits all franchisees by maintaining a national market and source of supply to Taxpayer's customers operating both within and without the repurchased territory.

The Taxpayer also consolidates the sale of b and c on behalf of its franchisees for sales to retail outlets on U.S. military installations. The U.S. government requested a single source of supply of Brand Name products, rather than having each military installation purchase directly from the franchisee distributing c in the territory in which the military installation is located. The Taxpayer purchases b and c from the franchisee producing b in the franchise territory in which the military installation is located and re-sells the products to the applicable U.S. military procurement office at prevailing market prices. The franchisee responsible for the territory in which the military installation is located delivers the c directly to the military installation. The Taxpayer collects fees from the franchisees on the same basis as described above, on these sales to the U.S. military to cover the Taxpayer's advertising, promotion, and publicity activities in the respective franchise territories.

The Taxpayer has a contract with a feed manufacturer to supply the Taxpayer's proprietary feed supplements to its franchisees. The manufacturer's services include procurement, blending, packaging, warehousing, and distribution of the Taxpayer's proprietary feed supplement to franchisees. The manufacturer also provides franchisees with technical services relating to the implementation of the Taxpayer's feed program. The franchisees purchase the feed products directly from the manufacturer at pricing negotiated by the Taxpayer.

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The Taxpayer has contracts with approved manufacturers of Brand Name packaging materials to supply packaging materials to its franchisees. The franchisees purchase the packaging materials directly from the manufacturers at pricing negotiated by the Taxpayer.

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The Taxpayer also purchases promotional materials (e.g. small kitchen ware, pens, golf balls, apparel items, etc.) and re-sells them to the franchisees. These promotional materials are used by the franchisees in retail promotion programs targeted to the consumer.

Plan of Reclassification to Cooperative Operation and Business Purpose

Taxpayer has operated since g as a Subchapter C corporation without any major changes to its corporate structure. On , the Taxpayer's shareholders voted to approve a Plan of Reclassification to make certain adjustments to its capital structure and approve amendments to the Taxpayer's Articles of Incorporation and Bylaws in order to qualify the Taxpayer as "operating on a cooperative basis" within the meaning of section 1381(a) (2) of the Code. The majority of the voting shares were owned by franchisees. Of the franchisees who were shareholders, all were eligible to vote and of the franchisees that voted, all voted for the Plan of Reclassification.

For about two years prior to the approval of the Plan of Reclassification on , , the Board of Directors evaluated alternative entity structures. The goal of this evaluation was selection of an entity that would vest the financial benefits of the Taxpayer's operations in the hands of the franchisees. In the months leading up to the adoption of the Plan of Reclassification, the Board of Directors determined that the "cooperative" form of operation would be most consistent with this stated goal. At a meeting in early 2004, attended by the Taxpayer's Board of Directors and substantially all of the franchisees (representing a majority of the shareholders entitled to vote), the franchisees finalized their deliberations on whether to recommend proceeding with conversion to the "cooperative" form of operation. The franchisees concluded that the Taxpayer and its franchisees would gain substantial economic and operational benefit by operating the Taxpayer's business as a "Cooperative" as classified under and for the purposes of section 1381(a) (2) of the Code, as amended. The franchisees recommended the Plan of Reclassification be presented to the shareholders, and was approved by the shareholders on . The business purpose of the Taxpayer's reclassification as a cooperative, included the following identified economic and operational business benefits:

- Better opportunity for the Taxpayer, acting on behalf of its franchisees, to introduce new products throughout the network;

- Better enables the franchisee/patrons to coordinate production and distribution schedules;
- Better enables the franchisee/patrons to manage and coordinate national customer accounts by sharing the benefits derived on a cooperative basis;
- Enables the franchisee/patrons to democratically control who their fellow franchisees are in an era of industry consolidation to associate only producers achieving high standards with their trademarked product;
- Increases the franchisee/patrons' commitment to the cooperative and its products through the operation at cost principle; and,
- Formalizes a one-man, one-vote concept of a cooperative consistent with the operations of the franchisees' democratically managed Franchisee Association. The Franchisee Association is an independent organization controlled by the franchisees. Its purpose has been to represent the franchisee group in dealing on a collective basis with the Taxpayer. For example, the Franchisee Association might negotiate any proposed revisions to the terms of the franchise agreement on behalf of the franchisees. The Taxpayer expects the Franchisee Association to have less of a direct role in the future, given the franchisees' democratic control of the Taxpayer resulting from its conversion to cooperative status.

The b production industry has been experiencing consolidation and the franchisees have a strong interest in controlling who their fellow franchisees are. There are instances where certain producers have not maintained high standards evidenced by continual occupational health and safety issues, environmental concerns and problems complying with local ordinances. It would cause very detrimental consequences for the business of the franchisees and the Taxpayer if a "rogue" producer became a franchisee. In the case where a "rogue" producer attempted to acquire a franchise, the franchisees through their Board of Directors, must approve all those applying for membership and would prevent a potential acquirer not meeting high standards from becoming a member of the Taxpayer. Without the assurance that their membership would be approved, the benefits of such membership being substantial, a potential acquirer would be less likely to seek to acquire a franchise. Thus, the cooperative principle of democratic control will help the franchisees ensure that only producers achieving high standards become franchisees and members of the Taxpayer.

The Plan of Reclassification became effective on . It made certain adjustments to the Taxpayer's capital structure and approved amendments to the Taxpayer's Articles of Incorporation and Bylaws in order to qualify the Taxpayer as "operating on a cooperative basis" within the meaning of section 1381(a) (2) of the Code. The changes to the capital structure authorized a single class of voting common stock. Under the Plan of Reclassification, all outstanding shares of capital stock on

were converted into Non-Voting Common Stock. This conversion eliminated any voting shares in the hand of non-franchisee shareholders and also eliminated all voting shares with the exception of one share of membership Voting Common Stock held by each franchisee-member. The amendments to the Taxpayer's Articles of Incorporation and Bylaws govern the Taxpayer's operations on a cooperative basis.

Under the Plan of Reclassification, Non-member Shareholders (a shareholder who does not have a current franchise agreement in effect by and between the franchisee and the Taxpayer) will have each share of common stock held on the effective date of the reclassification converted into one share of non-voting common stock. Member Shareholders (a shareholder who has a current franchise agreement in effect by and between the franchisee and the Taxpayer) will have each share of common stock held on the effective date of the reclassification converted into one share of non-voting common stock and will receive solely one share of voting common such evidencing the franchisee's membership in the Taxpayer.

Non-Voting Common Stock

The Taxpayer's Plan of Reclassification designated a total of e shares of the Corporation's authorized stock as Non-Voting Common Stock, $ par value per share. The holders of the Non-Voting Stock shall not be permitted or entitled to vote on any matters presented to the stockholders of the Taxpayer. During the Taxpayer's first fiscal year operating as a cooperative under the Code, dividends shall accrue at the rate of four percent per annum of the par value of the Non-Voting Stock and be paid by the last day of such fiscal year out of funds legally available therefore. Thereafter, the holders of Non-Voting Stock have no right to any dividends. Dividends shall be paid on each share of Non-Voting Stock only when and if declared by the Taxpayer's Board of Directors, provided, however, that such dividend shall not exceed eight percent per annum of the par value of the Non-Voting Stock. As of May 1, 2004, the Taxpayer had shares of Non-Voting Common Stock issued and outstanding.

Voting Common Stock

The Taxpayer's Plan of Reclassification designated a total of shares of the Taxpayer's authorized stock as Voting Common Stock, $ par value per share. Holders of Voting Stock shall be entitled to vote on all matters submitted to a vote of shareholders of the Taxpayer. Each holder of Voting Stock shall be entitled to one vote for each share of Voting Stock held by such holders of Voting Stock. No person or entity shall hold more than one share of Voting Stock. The holders of Voting Stock are not entitled to receive dividends, but will receive patronage refunds As of May 1, 2004, the Taxpayer had shares of Voting Common Stock issued and outstanding.

Reclassification in Cooperative Organization and Operation

- Under the Plan of Reclassification, the Articles of Incorporation and Bylaws were amended to ensure for each Member Shareholder of the cooperative may exercise its vote in the nomination and election of all board of directors and in any other matter of business that requires Member Shareholder approval as provided in the Articles, Bylaws, and under state law. Voting Stock will be issued only to persons or entitles who or which meet the requirements to be classified as a "Member Shareholder" as set forth in the Bylaw and approved as a Member Shareholder by the Board. Member Shareholders must execute a Membership Agreement by and between the Member Shareholder and the Taxpayer. The requirements to be classified as a Member Shareholder contained in the Bylaws of Membership Agreement specify that the person or entity must be a franchisee under the terms of an executed franchise agreement with the Taxpayer.

- Under the Plan of Reclassification, the Bylaws were amended to ensure that the cooperative is governed by democratic control, in which each Member Shareholder of the cooperative has one vote, including for the election of the members of the Board of Directors, regardless of the size of its investment or the amount of business it does with the cooperative. Actual voting power is complete and unrestricted. The Board of Directors possesses the right to decide matters pertaining to the management of the cooperative's business enterprise.

- Under the Plan of Reclassification, the Bylaws were amended to ensure that all Member Shareholders of the cooperative are patrons of the cooperative and the cooperative conducts substantially all of its business with or for its Member Shareholder and Non-Member Patrons (Non-Member Patrons are franchisees of the Taxpayer who are a party to a franchise agreement and a Non-Member Patron Agreement with the Taxpayer. Non-Member Patrons must be affiliates of Member Shareholders. Section 6.03 of the Taxpayer's Bylaws restricts ownership of voting stock to only one share of voting stock held within an Affiliated Group, as defined in the Bylaws. The requirements to be classified as a Non-Member Patron contained in the Bylaws and Non-Member Patron Agreement specify that the person or entity must be a franchisee under the terms of an executed franchise agreement with the Taxpayer.

- Under the Plan of Reclassification, the Articles of Incorporation and Bylaws were amended to ensure that the Taxpayer operates on a service at cost basis with respect to its Member Shareholders and Non-Member Patrons, the Taxpayer distributes its net earnings to its Member Shareholders and Non-Member Patrons of the cooperative in proportion to the amount of business conducted with or for its patrons.

- Under the Plan of Reclassification, the Articles of Incorporation and Bylaws were amended to ensure that amounts received from or on behalf of Member Shareholder and Non-Member Patrons in excess of cost of service belong to those patrons, and the cooperative is obligated to return such amounts to the

patrons as patronage refunds. The Bylaws provide discretion to the board of directors in setting aside funds for reasonable reserves for necessary purposes for the Taxpayer. Such reasonable reserves will first be set aside from net earnings from other than business done with or for Member Shareholders and Non-Member Patrons. If there are no net earnings upon such business, or if such net earnings are insufficient to provide funds for reasonable reserves for necessary purposes for the Taxpayer, reasonable reserves may be set aside and paid from the net earnings on business done with or for Member Shareholder and Non-Member Patrons. In the reasonable reserves are set aside from the net earnings on business done with or for Member Shareholder and Non-Member Patrons, the Taxpayer will maintain adequate records to apportion such reasonably reserves to Member Shareholders and Non-Member Patrons based upon the value of business done with the Taxpayer by the Member Shareholder and Non-Member Patron during such fiscal year.

- Under the Plan of Reclassification, the Bylaws were amended to provide that any patronage net earnings are allocated based upon factors determined by the board of directors as related to the value of business done with the Taxpayer and distributed to the Member Shareholders and Non-member Patrons within the payment period set forth in section 1382(d) of the Code. The factors to be used in determining such allocation shall be announced by the board of directors to the Member Shareholders and Non-Member Patrons at least thirty (30) days prior to the start of the fiscal year, except in the first fiscal year that the board of directors shall make such determination of the basis of such allocations (beginning May 1, 2004), no later than forty-five (45) days after the commencement of such fiscal year. The net earnings to be distributed annually shall be distributed in accordance with such separate allocation units or pools as may established by the board of directors and on the basis of the value of business done with or for the Member Shareholders and Non-Member Patrons. On or before June 14, 2004, the Board of Directors announced to the Member Shareholders and Non-Member Patrons that a single allocation unit or patronage pool would be utilized to account to patrons for its first fiscal year (ended April 30, 2005), and any patronage net earnings to be allocated will be allocated on the basis of fees earned from each Member Shareholder and Non-Member Patron in proportion to all fees earned by the Taxpayer for said fiscal year.

- Under the Plan of Reclassification, the Bylaws were amended to provide that the cooperative is prohibited from making payments of interest and dividends on any equity capital held by its Member Shareholders and Non-Member Patrons in the form of written notices of allocation.

- Under the Plan of Reclassification, the Bylaws were amended to provide that if any loss if sustained by the Taxpayer for any fiscal year in any allocation unit, the corporation may at the discretion of the board of directors, carry such loss

forward to subsequent years within such allocation unit, or apportion such loss among the Member Shareholders and Non-member Patrons participating in such allocation unit on a cooperative basis and recoup the amount due from each Member Shareholder and Non-Member Patron by offsetting it, in whole or in part, against patronage due such person in future years or against written notices of allocation of such person.

- Under the Plan of Reclassification, in operating in compliance with the amendments to the Bylaws, the Taxpayer will maintain books and records such that at the end of each fiscal year the amount of capital accumulated as a result of patronage is clearly reflected and may be credited to the Member Shareholder's and Non-Member Patron's account.

- Under the Plan of Reclassification, the Bylaws were amended to provide the Member Shareholder's and Non-Member Patrons participating in the cooperative consent that the amount of any distributions made to them, which are made in qualified written notices of allocation and are received by them, will be taken into account at their stated dollar amounts in the manner provided in section 1385(a) of the Code in the taxable year in which such qualified written notices of allocation are received by the Member Shareholder or Non-Member Patron.

- Under the Plan of Reclassification, the Bylaws were amended to provide that in the event of withdrawal, retirement, death, or expulsion, or other termination of the membership of a Member Shareholder or Non-Member Patron, any voting stock held by such Member Shareholder will be forfeited and cancelled and the Taxpayer shall pay such person or entity an amount per share in cash equal to the par value of such share of voting stock, plus the stated value, in cash, of the amount of any written notices of allocation held by such person or entity, and the additional capital amount paid for or with respect to such voting stock, if any. Such payments in the sole discretion of the board of directors may be extended, such that redemption of written notices of allocation will be paid at such times as such written notices of allocation would otherwise be paid in the ordinary course or make any or all payments with an unsecured five (5) year promissory note of the Taxpayer providing for interest, at the rate of five (5) year U.S. Treasury notes. Further, each Member Shareholder expressly has agreed that in the event of termination,the value of a member's voting stock, prior to dissolution, merger or consolidation of the Taxpayer, will be the par value plus the additional capital amount paid for such stock, if any, as well as the stated value of any written notices of allocation issued to such Member Shareholder. The Member Shareholder will not be entitled to be paid anything else for the value of its Voting Stock or other membership rights.

- Under the Plan of Reclassification, The Articles of Incorporation were amended to provide that upon any liquidation, dissolution, or winding up of the Taxpayer ("Liquidation Event"), any remaining assets and funds of the Taxpayer, after

payment of all debts, redemption of outstanding non-voting common stock at par value, redemption of outstanding written notices of allocation at their stated amount, and redemption of voting common stock at par value plus any paid-in capital with respect to such stock, will be distributed to Member Shareholders and Non-Member Patrons on the basis of the value of the business done with the Taxpayer during the fiscal years immediately preceding the Liquidation Event, as shown on the records of the Taxpayer, or if a shorter period, the period over which the Member Shareholder held Voting Stock or the Non-Member Patron did business with the Taxpayer, as applicable.

STATEMENT OF LAW

Section 1381 of the Code provides that Subchapter T shall apply to "any corporation operating on a cooperative basis…" (with certain exception not here relevant). Section 1.1381-1(a) of the 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. 19661 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* 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 section 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*, 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 deduction from the gross income of any cooperative to which part 1 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 other than a qualified written notice of allocation, or a qualified check 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 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) 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.

Subordination of Capital

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 non-patron equity investors in the cooperative. The purpose of the limitation is to insure that the gain that accrues 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.

Numerous provisions of the Taxpayer’s Articles of Incorporation and Bylaws ensure that it will meet the requirement of subordination of capital. Taxpayer’s Articles of Incorporation and Bylaws both have provisions that mandate that it operate on a cooperative basis for the benefit of its Member Shareholders. To ensure that control of Taxpayer remains in the hands of its Member Shareholders, its Bylaws also mandate that each of its Member Shareholders shall have one and only one vote on any matter subject to voting of the Member Shareholder and unless otherwise provided the vote of the majority shall control. Member Shareholders must also be parties to a franchise agreement with the Taxpayer. Further, the Taxpayer’s Bylaws prohibit payment of dividends on any equity capital furnished by its Member Shareholder and Non-Member Patrons, with exception on the par value of outstanding non-voting common stock. During Taxpayer’s first fiscal year operating as a cooperative under the Code, dividends shall accrue at the rate of four percent per annum of the par value of the Non-Voting

Stock and be paid by the last day of such fiscal year out of funds legally available therefore (estimated to be $ out of $ million of patronage taxable income for the first year of operation). Thereafter, the holders of Non-Voting Stock have no right to any dividends. Dividends shall be paid on each share of Non-Voting Stock only when and if declared by the Taxpayer's Board of Directors, provided, however, that such dividend shall not exceed eight percent per annum of the par value of the Non-Voting Stock. Further, the Bylaws obligate the cooperative to return all benefits arising from business combined with or for its Member Shareholders of Non-Member Patrons (excluding any earnings distributed as dividends on Non-Voting Stock) to those whose participation gave rise to the benefits. Pursuant to Section 6.05(c) of the Taxpayer's Bylaws, the Board of Directors have obligated the Taxpayer to account to Non-Member Patrons for all of the patronage activities with the corporation by such Non-Member Patron in the same manner, share and share alike, with Member Shareholders participating in the same activity. A Non-Member Patron must be a party to a franchise agreement and Non-Member Patron Agreement with the corporation and not be in default thereunder. In addition to the mandate to operate on a cooperative basis, the Articles specifically provide that Member Shareholders and Non-Member Patrons shall be entitled to any net proceeds that are distributed after dissolution "upon the basis of the value of the business done with the Corporation" by the Member Shareholder or Non-Member Patron. Thus, the Taxpayer's Articles of Incorporation and Bylaws satisfy the subordination of capital requirement for cooperative operation.

Democratic Control

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 principle of democratic control was further discussed in *Etter Grain Co. v. United States*, 462 F.2d 259, (1972), in which the Court noted at 263, that section 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 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 organization.

The Taxpayer's Bylaws provide that each Member Shareholder shall be entitled to one, and only one, vote on all members of business that require member approval as prescribed by the Taxpayer's Bylaws. Only Member Shareholders can hold voting stock, and all Member Shareholders must be franchises. Thus, the Bylaws satisfy the democratic control requirement for cooperative operation.

Operation at Cost

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 p. 308.

The Taxpayer operates on a service at cost basis with respect to its Member Shareholders and Non-Member Patrons who are its only patrons/franchisees. The Taxpayer's Articles of Incorporation and Bylaws ensure that the net earnings or savings are distributed to the Member Shareholders and Non-Member Patrons in proportion to the "value of business done with the corporation" by the Member Shareholder and Non-Member Patrons during said fiscal year, and amounts so allocated shall be distributed within the payment period set forth in Section 1382(d) of the Code. Moreover, in carrying out the purpose and effect of Sections 6.05 and 6.07 of the Taxpayer's Bylaws, the Taxpayer will:

1. Account on a patronage basis to all Member Shareholders and Non-Member Patrons for amounts collected from such patrons in excess of the cost of service.

2. Make payment of all amounts collected in excess of cost from Member Shareholders and Non-Member Patrons in the form of patronage dividends, and allocated on a dollar value basis.

3. Maintain books and records such that at the end of each fiscal year the amount of capital furnished by patronage is clearly reflected and may be credited to the Member Shareholder's and Non-Member Patron's account.

In respect of any loss sustained by the Taxpayer for any fiscal year in any allocation unit, the corporation may, at the discretion of the board of directors, carry such loss forward to subsequent years within such allocation unit, or apportion such loss among the Member Shareholders and Non-Member Patrons participating in such allocation unit on a cooperative basis and recoup the amount due from each Member Shareholder and Non-Member Patron by offsetting it, in whole or in part, against patronage due such person in future years or against written notices of allocation of such person.

Finally, the Articles of Incorporation mandate that upon dissolution or liquidation of the organization any remaining net assets and funds of the

Taxpayer will be distributed to Member Shareholders and Non-Member Patrons on the basis of their historic participation in the cooperative (generally, computed on the basis of the value of the business done with the cooperative during the immediately preceding ten fiscal years).

Thus, the Articles of Incorporation and Bylaws satisfy the operation at cost requirement for cooperative operation.

Liquidating Distributions

The Taxpayer's Articles of Incorporation provide that, upon any liquidation, dissolution or winding up of the Taxpayer ("Liquidation Event"), any remaining assets and funds of the Taxpayer after payment of all debts, redemption of outstanding non-voting common stock at par value, redemption of outstanding written notices of allocation at their stated amount, redemption of voting common stock at par value plus any paid-in capital with respect to such stock, will be distributed to Member Shareholders and Non-Member Patrons on the basis of the value of the business done with the Taxpayer during the fiscal years immediately preceding the Liquidation Event, as shown on the records of the Corporation, or if a shorter period, the period over which the Member Shareholder held Voting Stock or the Non-Member Patron did business with the Corporation, as applicable.

The Taxpayer's Bylaws further provide that in the event of withdrawal, death, or expulsion, or other termination of the membership of a Member Shareholder or Non-Member Patron, any voting stock held by such Member Shareholder will be forfeited and cancelled and the Taxpayer shall pay such person or entity an amount per share in cash equal to the par value of such share of voting stock, plus the stated value, in cash, of the amount of any written notices of allocation held by such person or entity, and the additional capital amount paid for or with respect to such voting stock, if any. Further, each Member Shareholder expressly has agreed that, in the event of termination, the value of a member's voting stock, prior to dissolution, merger or consolidation of the Taxpayer, will be the par value plus the additional capital amount paid for such stock, if any, as well as the stated value of any written notices of allocation issued to such Member Shareholder. The Member Shareholder will not be entitled to be paid anything else for the value of its Voting Stock or other membership rights.

As such, the intent of the Taxpayer's Bylaws, as approved by the shareholders in adopting the Plan of Reclassification, is that current Member Shareholders and Non-Member Patrons will receive a distribution of the remaining assets and funds of the Taxpayer on the basis of the value of business done with the Taxpayer over the period of their historic participation in the cooperative. The Bylaws contemplate that Member Shareholders and Non-

Member Patrons that withdraw, retire, or otherwise terminate their membership or Non-Member Patron status will receive the full value of their equity interest in the cooperative at the effective time of the terminating event. Each Member Shareholder and Non-Member Patron has expressly agreed to those provisions under the terms of their executed Membership Agreement or Non-Member Patron Agreement.

On the effective date of the Plan of Reclassification, all of the Taxpayer's franchisees were received into membership or non-member patron status upon their express agreement and upon the condition that the value of their equity interest and membership rights, prior to dissolution, merger or consolidation of the corporation, is limited to the value of their equity interest on the date of their membership termination and will not be entitled to be paid anything else for the value of their equity interest or membership rights. As part of their approval of the Plan of Reclassification adopting cooperative status, the franchisee shareholders with full knowledge, disclosure and opportunity for objection, approved these provisions as part of their approval of the restated Articles of Incorporation and Bylaws.

All of the Taxpayer's Member Shareholders and Non-Member Patrons are required to be franchisees of the Taxpayer, each with a geographically defined franchise territory. All of the territories within have been fully subscribed and the Taxpayer anticipates a very stable group of franchisees with immaterial changes from year to year in the identity of franchisees or their respective proportion of business with the Taxpayer. Termination or withdrawals of particular franchisees are anticipated to be a rare occurrence. Generally, most franchise agreements are held by incorporated entities and thus, such Member Shareholders and Non-Member Patrons would be unaffected by the death or retirement of any particular individual. Past experience indicates that there is about one transfer of a franchise every three or four years, often to an entity that already holds another franchise. The Board of Directors must approve the acquisition of a franchise (such approval not be unreasonably withhold) and would reject an acquisition where there was evidence that the acquirer's ability to run the business would be impaired (such as in an acquisition heavily leveraged with debt). In the case where a corporate franchisee is acquired, the existing franchise and membership agreements would likely remain unchanged as the Member Shareholder or Non-Member Patron remains the same. In the case of an asset acquisition, a new franchise and membership agreements would be executed with the new Member Shareholder or Non-Member Patron. As such, it is anticipated all of the franchisees will remain the same from year to year.

In view of the foregoing, the Taxpayer's liquidation distribution provisions contained in the Articles of Incorporation satisfy the equitable allocation and operation at cost requirement for cooperative operation.

Accordingly, based solely on the foregoing we rule that the Taxpayer is a corporation operating on a cooperative basis within the meaning of section 1381(a)(2) of the Internal Revenue Code.

This ruling is directed only to the taxpayer that requested it. Under section 6110 (k) (3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representatives.

Sincerely yours,

Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of the Assistant Chief Counsel
Passthroughs and Special Industries

cc: