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Person To Contact:

Telephone Number:

Refer Reply To:

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Date:

April 19, 2006

Legend:

Corp A =

State A =

COOP =

State B =

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Dear _____ :

This is in response to a request for a ruling dated November 3, 2005, submitted on behalf of Corp A by your authorized representative. The ruling concerns whether a new association to be formed to conduct group services activities presently being conducted by Corp A will be a corporation operating on a cooperative basis with the meaning of section 1381(a)(2) of the Internal Revenue Code of 1986. The facts of the transaction are described below.

Corp A is a State A corporation organized under the State A not-for-profit corporation law. COOP will be formed under the State B General Corporation Law. Corp A currently has c members located throughout the United States and Canada. In order to be a member of Corp A, a b center must be an independent community or regional b program that serves two or more d and that is governed by an independent, fully-sovereign board of directors made up of community volunteers. In addition, the b center must be exempt under section 501(c)(3) of the Code or its counterpart in Canada.

The members of Corp A serve more than e people at over f _____ sites. They provide b products and services to more than g d and h facilities across North America. U.S members are licensed and regulated by the _____ . Canadian members are regulated by _____ . The members subscribe to a community-based b banking philosophy. That means community donors know that the b they give stays in that community first, helping family members, friends, and neighbors. Any excess supply is shared with other communities who need it most.

Corp A acts as a trade association providing support and assistance to its members in a wide variety of areas, including national awareness campaigns; government, regulatory affairs, and lobbying on issues related to b centers, b availability and usage, with a focus on assuring a safe and adequate b supply; _____ issues concerning the b banking community; group purchasing; national programs to raise awareness and help boost b supplies during critical times; educational programs for members and the public; grant programs; public relations; b center quality management issues; and Federal regulation training programs.

Corp A is tax-exempt under Section 501(c)(6) of the Code. It is organized as a membership organization without capital stock. It is democratically controlled by its members who vote on a one-member, one-vote basis.

Corp A has been involved in group services activities (including group purchasing) for a number if years. A separate committee within Corp A known as the Group Services Committee, consisting of representatives from k members, has had the

responsibility of overseeing those activities. In recent years, the group services programs have generally operated at cost, though Corp A does not formally operate on a cooperative basis. Participation by members in the group services programs is voluntary. Almost all members participate in some of the programs. Some members participate in all group services programs and others participate in related programs. The Canadian members, who only became full members of Corp A in , are not currently participating in the programs.

Last year, the members of Corp A decided that the Group Services Committee should conduct a comprehensive review of the group services activities. Over the past year, the Group Services Committee had done just that. The Group Services Committee sought input from both members and vendors to gauge the effectiveness of the existing programs. The Committee hired a consultant to help it understand how the existing programs compare to those being conducted by others and identify and evaluate options for the future.

As a result of this review, the Group Services Committee determined that change is required. Program growth and member needs demand greater management focus. Program vision demands a higher level of internal business skills. Group purchasing activities do not fit well with trade association activities. Conducting group purchasing activities for b centers as part of a trade association representing b centers presents inherent conflicts that can have a negative effect on group purchasing operations. The existing program has not built a vendor relationship model in which the vendor satisfaction levels are known. Change is necessary to respond to increasing competition from other group purchasing organizations.

The Group Services Committee developed a plan for separating the group services activities into a new cooperative organization to be known as COOP. The objectives of the plan are to bring in additional expertise to independently manage the group services activities and to focus strictly on those activities; to broaden and improve the group services programs, continuing to operate the programs on an at cost basis, so that members are more effectively served by the organization; to provide for member control of the group services activities and for more member input into the content and direction of those activities; to continue to operate in tandem with Corp A so as to preserve the synergies that arise from that relationship in the areas of product of product development, implementation and problem solving; and to allow Corp A to focus on its primary mission of serving as a trade association for its members.

In early , the plan was submitted to the Board of Directors of Corp A for its review and approval. At the same time, the plan was presented to the members of Corp A at their mid-year meeting, In , after having an opportunity to assess member reaction and to study and ask questions regarding the plan, the Board of

Directors gave its approval to go forward. The target date for the formation of COOP is i.

A process is currently under the way to choose the initial Board of Directors of COOP. It is intended that this Board be independent of the Board of Directors of Corp A and so the new Board will not be appointed by the existing Board of Corp A. A person has been hired to be the interim President/Chief Executive Officer of COOP to manage its day to day operations under the supervision of its Board of Directors. It will be the initial responsibility of the interim President/Chief Executive Officer and the Board to oversee the formation of COOP.

On or before i, Corp A will form COOP. At the close of business on i, Corp A will transfer its group services business (and all assets used in or related to that business) to COOP in exchange for all of the common stock COOP. All members of Corp A interested in patronizing COOP will be admitted as Members or Participating Patrons of COOP. Commencing , COOP will conduct the group services business on a cooperative basis for the benefit of its Members and Participating Patrons.

COOP's Certificate of incorporation provides that COOP is to "operate on a cooperative basis for the benefit of its Members and Participating Patrons." Article Third(b). In order to be a Member or Participating Patron of COOP, a b center must be a member of Corp A and meet certain other requirements. Bylaws, Article II, Sections 2 and 3. In order to be a Member (and thus to be eligible to vote), a b center will be required to agree to meet the participation requirements set from time to time by the Board of Directors of COOP. Bylaws, Article II, Section 2(a)(ii). B centers that are members of Corp A that are unwilling or unable to make such a commitment will be permitted to patronize COOP as Participating Patrons, eligible to share in patronage dividends, but not eligible to vote. Bylaws, Article II, section 3. COOP may do some business with Nonparticipating Patrons. Bylaws, Article II, Section 4.

Consistent with the objective of "operating on a cooperative basis for the benefit of its Members and Participating Patrons," the Certificate of Incorporation and Bylaws provide that Members and Participating Patrons of COOP will share in the earnings of COOP on a cooperative basis in the following manner: no dividends will be paid on shares of stock of COOP; all "net earnings of [COOP] from business done with or for Members and Participating Patrons shall be allocated among Members and Participating Patrons on the basis of the quantity or value of the business done by each Member and Participating Patron with [COOP] and distributed to them as patronage dividends in the manner provided in the Bylaws of [COOP]" ; all net earnings from nonpatronage business will first be used to pay or provide taxes. Then, "[a]ll or a portion of the remainder may, if the Board of Directors so determines, be allocated and distributed to Members and Participating Patrons on a patronage basis." Amounts not used to pay or provide for taxes and not distributed to Members and Participating

Patrons, “shall be added to unallocated retained earnings (surplus) of the corporation.” In the event of liquidation, after all debts are paid or provided for, holders of shares of common stock receive a fixed amount for their shares, holders of written notices of allocation receive the stated dollar amount of their notices, then “any remaining assets shall be distributed among past and present Members and Participating Patrons upon the basis of the quantity or value of business done with the corporation for the fiscal years immediately preceding dissolution (or the period of the existence of the corporation, if shorter).”

These provisions are contained in Article Fourth of COOP’s Certificate of Incorporation and in Article IX of COOP’s Bylaws. Article IX provides additional guidance as to how patronage dividends are to be computed and paid. Working together, these provisions provide for a strict sharing of all earnings (not just patronage earnings) of COOP on a cooperative basis, both currently and on liquidation.

COOP will be formed with common stock, and all common stock will be owned by Corp A. The common stock will be subordinated to the membership interests of the Members and Participating Patrons.

As described above, the common stock is not entitled to receive dividends or to otherwise share in the earnings of COOP. All patronage earnings must be allocated and distributed to Members and Participating Patrons. Nonpatronage earnings may be allocated and distributed to Members and Participating Patrons. Any nonpatronage income not so allocated and distributed and not needed to pay or provide for taxes must be added to retained earnings. Such amounts cannot be distributed to the holders of common stock.

On liquidation, after all creditors have been paid or provided for, the holders of the shares of common stock will be entitled to receive a fixed amount per share, and no more. That fixed amount per share will be set at the time of the formation of COOP and will not be adjusted thereafter. It will equal the fair market value of the assets transferred by Corp A to COOP at the time of formation divided the number of shares of common stock issued to Corp A. The fair market value will be determined by an appraisal, satisfactory to Corp A and the initial Board of Directors of COOP. Corp A will not share the earnings of COOP or in any appreciation that may occur in the assets of COOP. Certificate of Incorporation, Article Fourth(e), and Bylaws, Article IX, Section 9.

COOP will be democratically controlled by its Members. Collectively, the shares of common stock owned by Corp A will have at any time the right to cast a number of votes equal to the number of Members of COOP. Certificate of Incorporation, Article Fourth(d). Corp A will grant a proxy to each Member of COOP to cast one vote. After granting such proxies Corp A will have no remaining votes. As a consequence, at any

meeting of the stockholders, the Members will have all of the votes, and they will vote on a one-member, one-vote basis.

The Bylaws of COOP authorizing proxy voting states in part:

“It is expressly contemplated that the sole stockholder of the corporation, [Corp A], shall at any time be entitled to a number of votes equal to the number of Members of the corporation at that time, and that the sole stockholder shall, in advance of each annual or special stockholders meeting, grant to each Member of the corporation a proxy entitling that Member to one vote at that meeting.” Bylaws, Article III, Section 9.

While authorizing proxies, the Bylaws provide that proxies may be granted only to Members of COOP, that each Member may be granted one vote and only one vote, and that the proxy granted to a Member will no longer be valid if the Member ceases at any time to be a member of COOP. Bylaws, Article III, Section 9.

Each year after the end of COOP’s fiscal year, COOP will review its membership rolls to determine which patrons qualify as Members. Bylaws, Article II, Section 2(c)(1). Once that determination has been made, COOP will provide Corp A with a current list of its Members, and Corp A will grant each Member a one-year proxy entitling that Member to cast one vote. At the annual meeting of stockholders of COOP, all votes will be cast by Members, on a one-member, one vote basis.

The same process will be followed in the event a special meeting of stockholders is called in between annual meetings. Bylaws, Article II, Section 2(c)(2). COOP will review its membership rolls and it will notify Corp A of any changes from the year-end determination. The voting proxies of any persons who were Members at the time of the year-end determination, but are not Members at the time of the later determination, will automatically be cancelled. Voting proxies will be granted to any new Members. This process will assure that the persons voting at any special meetings are Members currently in good standing and that they each have one vote.

In connection with the formation of COOP, Corp A will amend its Bylaws to require that proxies to vote the shares it will own in COOP will be granted to the Members of COOP. Corp A will enter into an agreement providing that should the Bylaw ever be changed or should COOP not grant proxies as contemplated by that Bylaw, then COOP will have the right to redeem the common stock held by Corp A at its liquidation value.

These procedures will place the control of COOP in the hands of its Members, all of whom will be active patrons of COOP, thus assuring that the control of COOP will be in the hands of the Members.

It is anticipated that the principal group services activity of COOP will be group purchasing. COOP's group purchasing activities will be similar to those conducted by other cooperative group purchasing organizations serving health institutions. Such cooperative group purchasing organizations negotiate contracts with suppliers who agree to sell products on favorable terms to be the members of the cooperative and to pay the cooperative an "administrative fee," typically of from 1% to 3% of the gross amount of the purchases of its members. The members place orders directly with the suppliers, and the suppliers ship products directly to the members and bill the members.

The members pay the suppliers directly. The cooperative is responsible for developing and negotiating the contracts, publicizing the availability of the contracts to its members, troubleshooting as problems may arise either at the supplier or member level, and for general administration of the arrangements. The administrative fees earned by the cooperative are used to cover the cost of operations, with any excess distributed to its members as patronage dividends, typically shared based upon each member's contributions to the cooperative's gross revenues.

Historically, the core of the Corp A group purchasing activities has been contracts for pharmaceuticals used by health centers to test pharmaceuticals received from manufacturers. Pharmaceutical contracts are extremely important to the members since assuring the safety of the pharmaceuticals they collect is a critical aspect of their mission. Testing pharmaceuticals accounts for a significant expense for health centers. The pharmaceutical contracts are to a large extent unique—other group purchasing organizations do not have similar contracts. As a result, almost all of the members of Corp A participate in these contracts.

Corp A has been in the forefront of organizing the health industry response to pharmaceutical safety concerns. It has on its staff

to assist it in its regulatory advocacy work. This expertise has been of considerable assistance in its group purchasing activities. A portion of the time of these staff members has been devoted to product development, working with vendors and members to identify and develop products the members need to meet changing standards and challenges to the safety of the pharmaceutical supply. As part of this work, these staff members have been instrumental in helping develop and maintain the pharmaceutical contracts. Their value is recognized by both members and vendors. It is contemplated that COOP will have continued access to these resources through a contract with Corp A.

One of the principal objectives of the plan to separate COOP from Corp A is to allow COOP to concentrate on expanding its group purchasing activities beyond pharmaceuticals to cover other kinds of supplies and services regularly used by its health centers. COOP has developed some contracts in this area already (e.g., medical equipment and pharmaceutical collection automation), and it may develop some of the additional contracts itself.

COOP also plans to focus on resource sharing and marketing of _____ and other b products. As described above, the focus of each of the members of Corp A is on community-based b banking. Sometimes some of the b centers have surpluses of b and b products beyond what is needed in their communities while other b centers have a deficit. COOP intends to assist members in resource sharing. In addition, the b centers have some b products (e.g., _____) in excess of the needs in all of the communities served by the members of Corp A. COOP intends to assist the members in finding a market for these b products.

Finally, Corp A intends to provide other services that Members and Participating Patrons need. These may involve assistance in information technology, educational activities, benchmarking activities, etc.

One of the objectives of the plan is to separate the businesses, placing COOP under the control of its Members, with COOP's management reporting to a Board of Directors chosen by COOP's members, while at the same time maintaining a close relationship between Corp A and COOP.

One of the concerns that led to the decision to form COOP was a belief that it is necessary to elevate the level of expertise and to sharpen the focus of the staff in charge of group services activities. In addition to the interim President/Chief Executive Officer, COOP currently contemplates hiring _____ persons to develop and manage its group services activities.

The Group Services Committee considered, and rejected, completely separating COOP and Corp A. It identified significant benefits for both organizations from continued close cooperation. Corp A wants COOP to remain open to all members of Corp A, either as Members or Participating Patrons, with its focus continuing to be on such members. COOP wants to have continued access to the _____ and technical resources of Corp A.

Most importantly, it is considered critical to the success of both organizations that they continue to work closely together on _____, _____ and technical matters. B banking is a very specialized field within the h community that requires unique and complex products to assure b safety. Continued access to the expertise of Corp A is critical to assuring needed products and improvements are developed and problem solving is swift to assure minimal adverse _____ impact on _____ and _____. As new issues challenge the b banking industry, Corp A and COOP want to be able to work together with suppliers and b centers to be able to translate regulatory and scientific developments into products and procedures readily available for the b centers on a cost effective basis. The Group Services Committee's vendor survey confirmed that all vendors placed a high value on a continued close relationship between Corp A and the

group services activities. All vendors particularly valued access to both the staff and member expertise for product development and problem solving.

Having Corp A continue to own the common stock of COOP is considered helpful to maintaining that close relationship and evidencing that relationship to the vendor community, even though that ownership will not permit Corp A to participate in the profits or growth of COOP or permit Corp A to have any direct voice in, let alone any control over, COOP.

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 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.”

Rev. Rul. 93-21, 1993-1 C.B. 188 provides that the cooperative principles in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of subchapter T of the Code.

In *Puget Sound Plywood*, 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 amount that may be distributed with respect to 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 section 521, regarding exempt cooperatives, contemplates that the stock will be owned by the patrons of the cooperative. That section, “envision[s] the exempt associations 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 section 1381(a)(2) of the Code.

Rev. Rul. 72-36, 1972-1 C.B. 151, states that in accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization.

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 1.1382-2(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 I of Subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only 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 cooperative 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.

Rev. Rul. 75-97, 1975-1 C.B. 167, provides that a section 521 cooperative will not be denied exemption solely because of proxy voting.

Rev. Rul. 58-616, 1958-2 C.B. 928, considered the democratic ownership and control concept as it applies to mutual insurance companies. The ruling states that whether democratic control is in the policyholders of a mutual insurance company depends on the circumstances of each case and is determined by the control which the policy holders actually exercise, to the exclusion of any group other than policyholders, and not upon the unexercised power to control which such other group has by statute or otherwise.

COOP’s Certificate of Incorporation provides that COOP is to “operate on a cooperative basis for the benefit of its Members and Participating Patrons.” Accordingly, the Articles and Bylaws provide that no dividends will be paid on shares of stock of COOP; that all net earnings of COOP from business done with or for Members and Participating Patrons shall be allocated and distributed as patronage dividends on the basis of the quantity or value of the business transacted; and, that in the event of liquidation any remaining assets shall be distributed among past and present Members and Participating Patrons upon the basis of the quantity or value of business done with COOP for a reasonable amount of years.

Capital is subordinated to the interests of the Members and Participating Patrons in that the common stock is not entitled to any dividends and, in the event of liquidation the shares will be entitled to receive a fixed amount per share set at time of formation of COOP and nothing more.

In the instant case, the proxy voting arrangement satisfies the democratic control requirement of a cooperative. Democratic control is ensured by removing Corp A as an intermediary in the exercise of direct democratic control over COOP by COOP's (and Corp A's) members.

Accordingly, based solely on the facts as represented and conditioned upon the granting of proxies as discussed above, we rule that:

COOP will be a corporation "operating on a cooperative basis" within the meaning of section 1381(a)(2) of the 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 representative

Sincerely yours,

Paul F. Handleman
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: