Corporate Reorganization Opportunities and Planning for Cooperatives

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Objectives

- Identify the Potential Benefits of Corporate Reorganizations for Cooperatives
- Identify Issues to Consider Relative to Potential Reorganizations
- Outline the Process and Timeline of a Corporate Reorganization for a Cooperative

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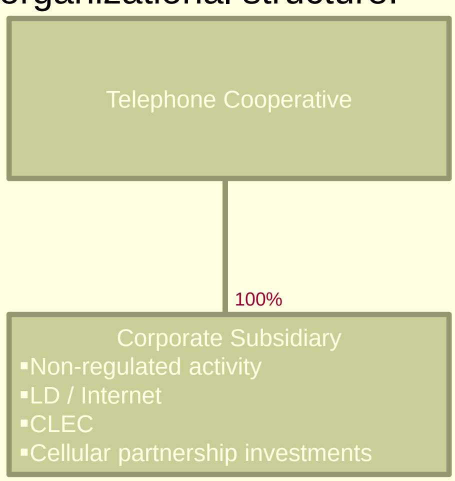
Background

Historical organizational structure:



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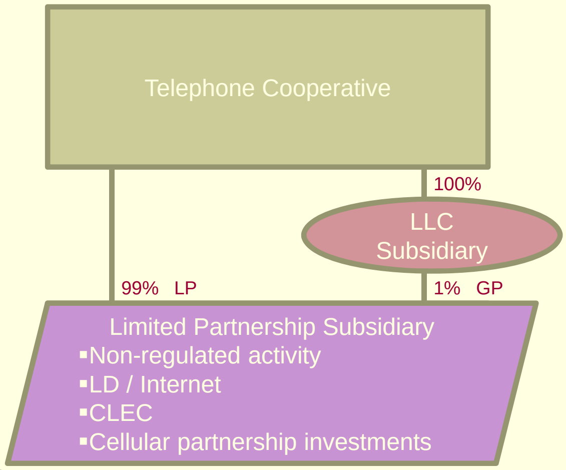
Background

Typical organizational structure:



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Background

- Reasons for typical structure
  - To provide Asset Protection / Limited Liability
    - Protect traditional Coop from liability related to nonreg ventures, technology, or services
    - Prevent cross–liability between activities of subsidiaries
  - To obtain external financing for subs without RUS loan accommodation
    - Coop or other subsidiary could still guarantee debt if necessary
  - To prevent adverse effects on ILEC Coop membership
    - Dilution of benefits attributable to new members
  - To prevent gross receipts of subsidiary being attributed to the Coop (85% test)
  - In some instances, to preserve Coop tax exempt status
  - To separate “for-profit” activities from the Coop
  - To avoid franchise tax on subsidiary income (formerly LPs were exempt)
  - To accommodate regulatory requirements or reporting
  - To minimize regulatory oversight on bundling of services
  - Could recognize full or partial benefit of losses of subsidiaries
    - Potential immediate tax benefit of losses if consolidated with other profitable subsidiaries

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Background

Structure reorganization: Simplest Form

Telephone Cooperative
- ILEC
- Non-regulated
- LD / Internet
- CLEC
- Cellular partnerships

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Background

Structure reorganization: Alternate Form

Telephone Cooperative
- ILEC
- Non-regulated activity
- LD / Internet
- CLEC

100%

Disregarded LLC Sub
- Misc assets
- Cellular partnerships

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Background

- Changes in the industry: Why are we revisiting this now?
  - Tax law evolving –
    - More clarity in IRS administrative rulings and case law
    - More favorable IRS rulings regarding patronage income
    - Potential opportunity to avoid tax on gains from sales of cellular partnership investments
    - Potential opportunity to avoid tax on annual income from cellular investments
    - Could possibly apply to certain other investments as well
    - Expansion of "like organization" services covered under exemption guidelines
      - More services could be considered "member" for 85% test – TV, security, cellular, internet
    - Limited Partnerships no longer exempt from Texas Franchise Tax
  - Tax Exempt Status (85% test)
    - Many Cooperatives may no longer benefit from being tax-exempt
    - Failing 85% test
    - Losses from traditional landline services

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Background

- Changes in the industry: Why are we revisiting this now?
  - Financing changes –
    - Financing needs may no longer require the current structure
  - Regulatory changes –
    - Greater need to review business efficiency and cost savings
    - Universal Service reform – potentially reduced settlements from high cost loop fund
    - Intercarrier compensation reform – reduced access rates, diminishing intrastate bill and keep access, and shrinking NECA revenue requirement
    - Regulators no longer require separation of certain businesses

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Benefits of Reorganization

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Benefits of Reorganization

- Strengthens Cooperative
  - Adds more members with “ownership” mentality
  - Minimizes risk of “takeover” by outside parties
  - Increases long term viability of cooperative
- Simplifies Corporate Structure
  - Utilizes LLCs to provide asset protection and limited liability

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Benefits of Reorganization

- Promotes Efficiency
  - Eliminates duplication of certain internal processes
    - Possibly reduces intercompany accounting
    - May eliminate many intercompany contracts and agreements
    - May simplify employee timekeeping
    - Potentially streamlines billing
  - Eliminates duplication of certain external processes
    - Eliminates need for certain professional consulting fees (Cost allocation model, audit report, cost consultants)
  - Provides potential savings through attrition or reduction in labor costs/benefits

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Financial Benefits of Reorganization

- Increases Marketability of Services
  - Utilizes capital credits as a marketing tool
- Offers Sales Tax Savings
  - Cooperatives are exempt from Texas sales tax
  - Eliminates sales tax on certain future subsidiary expenditures if incurred as part of Cooperative activities
- Offers Income Tax Savings
  - Eliminates income tax expense on future subsidiary taxable income
    - Internet, long-distance, CLEC, paging, cellular, cable TV, etc…
    - Must provide services on a cooperative basis
    - Must allocate income equitably under a preexisting legal obligation
    - Bylaws must be structured to accommodate this treatment

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Financial Benefits of Reorganization

- Income Tax Savings (continued)
  - Potential tax free gain from sale of cellular partnership investments
    - Farmland Industries, Inc. (1999) and various other PLRs and tax court cases
    - Farmland determined that capital gains from the sale of property are not "per se" nonpatronage
    - To be patronage sourced the income/gain must be "directly related" to the cooperative enterprise and facilitate its marketing, purchasing, or service activities

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Financial Benefits of Reorganization

- Income Tax Savings (continued)
  - Determination of patronage sourcing is twofold:
    - (1) Purpose of formation should NOT be solely to make a profit from investing in technology, but instead to facilitate the accomplishment of service goals such as:
      - Provision of "modern" telephone service to patrons
      - Remain competitive to protect existing business for members
      - Enhance service offering of the Cooperative
      - Commitment to providing the best telephone technology available to the Cooperative's members
    - (2) Suitable reason for disposition such as:
      - Insufficient resources to fulfill the purpose of the investment
      - Technology becoming obsolete and therefore no longer serving Cooperative's members as it had before
      - Purpose of investment accomplished (such as building cellular network) so more beneficial to members to utilize resources for maintaining or improving other patronage activities

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Financial Benefits of Reorganization

- Income Tax Savings (continued)
  - Potential opportunity to exclude cellular partnership earnings as patronage income
  - Three views on this treatment:
    - No K-1 income is eligible for the patronage deduction
      - Case law does not necessarily address K-1 income
      - Arguments for exclusion of gain do not necessarily apply to K-1 income
    - Only K-1 income directly related to serving the Cooperative's members is eligible
      - May be difficult to measure or obtain information
      - Determined by customer geographical footprint or actual customer base?
    - All K-1 income is eligible
      - Relies on Farmland, PLRs and court cases
      - Reasoning: If all the gain on sale would be excluded, then all of the annual income should be excluded
  - Requires equitable allocation of partnership income
  - Request IRS Private Letter Ruling?
  - Tax savings can be substantial at a 34% tax rate

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Financial Benefits of Reorganization

- Income Tax Savings (continued)
  - Texas margin tax savings
    - Cooperatives are exempt from the Texas Franchise Tax
  - Other states income tax savings

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Issues to Consider

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Issues to Consider

- Organizational structure
- Lender obstacles
- Legal issues
- Income tax concerns
- Patronage allocation considerations
- Regulatory matters
- Cost/benefit arguments

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Issues to Consider

- Organizational structure
  - Will the reorganized structure:
    - Accomplish desired asset protection and limited liability goals?
    - Complicate or simplify accounting for distinct profit centers (local service, long distance, internet)?
    - Allow for desired tax savings (sales tax, franchise tax, income tax)?
    - Provide the desired efficiencies (internal and external)?

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Issues to Consider

- Lender obstacles
  - May need lien accommodation by lender(s)
  - Can debt be retired to avoid this issue?
    - Consider paying off debt so that only one lender remains

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Issues to Consider

- Legal issues
  - Bylaw provisions
    - Can the Board initiate an action to reorganize on its own authority?
    - Does membership have to approve the action?
  - Additional Member Patrons
    - Diluted allocations to the present cooperative members
      - Older members potentially receive smaller capital credit allocations for the same amount of business previously conducted with the Coop
    - Potential decrease in voting power of present membership

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Issues to Consider

- Legal issues (continued)
  - Cooperative membership
    - Member vs. Nonmember
      - Bylaw considerations – can you deny membership to a person taking telephone/communication service?
      - Texas Telephone Cooperative Act – (Sec. 162.065)
        - Allows cooperative to establish qualifications and limitations with respect to membership
        - Can this be utilized to refuse membership to certain customers?
      - Ratio of members to nonmembers – if too low, is this a problem?
    - Nonmember Patron
      - Patrons are entitled to receive an allocation of net margin
      - Bylaw considerations – can a patron receiving telephone service, internet, or long distance be denied membership?
      - Texas Telephone Cooperative Act – (Sec. 162.003(3), (4); 162.065; 162.066)
        - Does Texas Law allow nonmember patron status?
        - Act defines member as "…a person admitted to membership in a telephone Cooperative…"
        - Act defines patron as "…a **member** who is eligible to receive patronage dividends or to earn capital credits as a result of purchasing certain services…"
        - Act says "A **member** is a patron … if the **member** purchases local telecommunications service or toll telecommunications service or pays end user access charges…"

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Issues to Consider

- Legal issues (continued)
  - Cooperative membership (continued)
    - Multiple Classes of Members
      - Does Texas law allow this? – yes
      - Not addressed in federal tax law
      - Courts and IRS have accepted multiple classes of members
      - Generally used to segregate customers by activity, define voting rights, and apportion Director seats
      - In general, it is deemed **inappropriate** to use multiple classes of membership to:
        - Deny voting rights,
        - Deny representation on the Board of Directors, or
        - Deny capital credits
    - Voting vs. Nonvoting Members
      - Bylaw considerations – do the bylaws contemplate non-voting members?
      - Texas Telephone Cooperative Act – (Sec. 162.070(c))
        - Does Texas law allow a Cooperative to have nonvoting members?
        - Act says "Each member present at a meeting … is entitled to one vote…"
      - IRS considers nonvoting members as nonmembers
      - Generally, voting rights can be phased-in over a five to ten year period

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Issues to Consider

- Legal issues (continued)
  - Cooperative Governance and Board of Directors
    - How will new cooperative members be represented on the board?
    - May require bylaw changes and redistricting
    - Resist the urge to increase the number of board members
      - What is the cost of additional board members (meeting fees, health insurance, travel, seminars)
    - Address board member concerns
      - Risk losing board seat and substantial benefits (health insurance)
      - Risk new cooperative members taking control of cooperative
    - Effect of additional members on quorum and voting requirements

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Issues to Consider

- Income tax concerns
  - Organizational Structure
    - Potential income tax benefits require Coop ownership of assets and provision of service
      - Coop direct ownership or through disregarded LLCs
      - Coop ownership of cellular partnership interest
      - Coop provision of telephone services, internet, long distance, etc.
    - Coop bylaws only govern Cooperative members (not subsidiary patrons)
  - 85% member income test
    - Member vs. nonmember status of former subsidiary subscribers
    - Voting vs. nonvoting status

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Issues to Consider

- Income tax concerns (continued)
  - Patronage income, allocation, and exclusion
    - Is income from former subsidiaries considered patronage sourced?
    - Bylaw considerations: pre-existing legal obligation to allocate?
    - If LLCs are used, do bylaws require allocation of subsidiary income?

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Issues to Consider

- Income tax concerns (continued)
  - Tax free reorganization
    - General rule: gain is recognized on transfer of assets from subsidiary to parent
    - Structure the transaction for tax free treatment (IRC 337)
    - Tax status of the Coop (taxable vs. tax exempt) is critical
    - Anti-abuse rules
    - Request a Private Letter Ruling?
  - Nonmember status
    - Texas Telephone Cooperative act may not allow "nonmember patron" status
    - Nonmembers may not be considered patrons and would not be entitled to an allocation
    - Profits from these subscribers would not be patronage sourced, thus taxable
    - A high ratio of "for profit" to "nonprofit" business may jeopardize the organization's cooperative status

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Issues to Consider

- Patronage allocation considerations
  - Equitable allocation
    - Multiple allocation pools
      - Use of multiple allocation pools is generally considered more equitable
        - Planning point: liquidating subsidiaries would allow allocations to be made in separate pools for each service (such as internet or long distance), and result in a more equitable allocation
      - Consider how to allocate particular margins among new member base
        - Consider that original members may have provided the original capital invested in subsidiary services, so may be entitled to receive the allocations of these profits over any new members
    - Complexity
      - Accounting for separate allocation pools, notices, and rotation cycles
      - Increased costs attributable to separate allocation pools offsets efficiencies gained elsewhere
      - May need to develop a method to address allocation of losses from certain services
  - Inequitable allocation
    - Coop status is jeopardized

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Issues to Consider

- Regulatory matters
  - If a subsidiary is a regulated ILEC, do you really have sales tax savings by merging them into the cooperative?
    - Will sales tax continue to be recovered from pool settlements?
    - What would be the impact as pool settlements decrease?
    - Would the sales tax savings from merging into the cooperative outweigh the benefits of pooling the sales tax in a subsidiary?
      - In today's environment, more than likely
  - Are separate books and records required for any regulatory reporting?

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Issues to Consider

- Cost/Benefit arguments
  - Upfront reorg costs are non-recurring but potential savings are ongoing
  - Reorganization costs should not exceed potential savings
    - This analysis will depend heavily on forecasts
    - Some of the efficiencies gained might be lost if separate profit centers are maintained
      - Management may need this information for decision making
      - This detailed reporting level may be necessary for patronage allocations
  - Costs to consider
    - Legal/accounting fees
    - Consulting fees
    - Potential tax filings such as a private letter ruling
  - Non-financial factors
    - Membership dissatisfaction from potential dilution

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Process and Timeline

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Process and Timeline

- Varies – company specific circumstances
- Consult with your attorney
- Consult with your CPA

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Process and Timeline: Tax Matters

- Traditional planning
  - Liquidation of taxable subsidiary into exempt Cooperative:
    - For a few years prior to liquidation, sub pays dividend to Coop to make it a taxable entity
    - Reorganize, liquidating subsidiaries into parent for desired entity structuring
    - Remain taxable for a few years in attempt to avoid anti-abuse rule application
  - Anti-abuse rules – Concern?
    - Perhaps not applicable because of 501(c)(12) carve out
    - Manipulation to become taxable entity still violates spirit of the anti-abuse rules
    - In year of liquidation, sub dividend considered liquidating distribution
      - Cooperative may still be exempt prior to liquidation
  - Liquidation of taxable subsidiary into taxable Cooperative:
    - Must still evaluate expected tax status after reorganization
      - Will the additional member income cause the Coop to pass the 85% test?
      - Tax status will depend on the ultimate structure sought and memberships granted
    - Manipulation to remain taxable entity may violate spirit of the anti-abuse rules

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Process and Timeline: Tax Matters

- Evolving methods
  - Reorganization of Coop that will remain taxable indefinitely
    - PLR **201145012, 11/10/2011**
    - Nonmember income from cellular partnership investments moved to Coop are significant
    - IRS does not want to rule on the effect of dividends paid in year of liquidation
    - Specifically requested PLR waiving anti-abuse rules
    - Liquidation performed on January 1 and entity was immediately taxable after liquidation
      - No business conducted or income earned while still a tax exempt Cooperative
    - IRS also ruled that since the Coop reasonably expected to remain taxable, the conversion would not be considered to have had a principal purpose of avoiding the application of the anti-abuse rules should the company unexpectedly become tax-exempt again

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Questions?

Opportunities & Planning for
Corporate Reorganization for Cooperatives

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