COOPERATIVE TAXATION BRIEF

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Exchanging Preferred Stock for QWNAs

As shown in prior posts, the most interesting rulings are those that involve the interplay of cooperative taxation (including Subchapter T) and other tax laws governing traditional corporations. A recent ruling by the Service addressed the applicability of sections governing taxation of distributions of preferred stock in the context of Subchapter T patronage dividends. More specifically, it involved a cooperative's exchange of preferred stock for qualified written notices of allocation ("QWNAs") under Subchapter T.

- Background

Cooperative is a Subchapter T cooperative that provides goods and services to patrons and non-patrons. It had annually distributed QWNAs. Cooperative proposed to exchange preferred stock for certain outstanding QWNAs (the "Exchange"). The Exchange would be mandatory and transacted on a first-in, first-out basis. Cooperative inquired whether the Exchange would result in a taxable distribution to its patrons. In addition, the preferred stock would be exchanged for QWNAs with a face value equal to the closing value of a share of preferred stock as of ten days prior to the Exchange.

- The Ruling

Subject to limited exceptions, patrons must recognize patronage dividends, including QWNAs, as taxable income. Under I.R.C. § 301, distributions of money, securities, or other property by a corporation will constitute gross (taxable) income to shareholders to the extent they are considered dividends (as defined in I.R.C. §

316). However, subject to various exceptions, under I.R.C. § 305, distribution of stock by a corporation to its shareholders does not constitute gross income.

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Cooperative represented to the Service that (i) the Exchange would constitute a recapitalization under I.R.C. § 368; (ii) none of the preferred stock would be "non-qualified preferred stock" under I.R.C. § 351(g)(2); (iii) none of the QWNAs or preferred stock would be "Section 306 Stock"; (iv) all of Cooperative's QWNAs and other equity interests constitute equity interests for federal income tax purposes; (v) after the Exchange, Cooperative will continue to operate as a Subchapter T cooperative; and (vi) the Exchange is not part of a plan to periodically increase the proportionate interest of any equity holder in the assets or earnings and profits of Cooperative.

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Based on these representations, the Service concluded that, pursuant to I.R.C. § 305, the Exchange would not result in gross income to the holders of QWNAs. The Service concluded that the Exchange resulted in a distribution of stock to shareholders that qualified under I.R.C. § 305(a). In addition, it implicitly concluded that the exception of I.R.C. § 305(c) did not apply to the Exchange – that the issuance did not result in a change in conversion ratio, change in redemption price, or a difference between redemption price and issue price, or other similar scenarios that result in distributions subject to I.R.C. 301. As a result, the Service ruled that the Exchange will not cause the holders of QWNAs to be treated as receiving a taxable distribution.

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David is a member of the firm's cooperative tax practice group. He started his career as a C.P.A. and auditor for electric and telephone cooperatives. After attending law school, he worked as an international tax consultant at Deloitte Tax LLP until joining the firm. As part of his cooperative law practice, David advises electric, telephone, agricultural, Subchapter T, and other cooperatives on their cooperative tax and corporate questions, power-supply and other commercial transactions, governance, and various cooperative law issues.

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