

Cooperatives and Income Tax Principles

Individuals who conduct a business have numerous business forms to select from when determining the most appropriate way in which to conduct the particular business of interest. Sole proprietorships, partnerships (general or limited), corporations, and other arrangements may be chosen. The choice will depend on the desired characteristics of the business, including income tax implications. Several forms of partnerships are recognized in the tax law, as are different forms of corporate business (C corporation or S corporation). Increasingly popular is the unincorporated businesses with desirable characteristics of a corporate entity (particularly limited liability) but with the tax consequences of a partnership – limited liability companies (LLC).

In the following material we will assume that the cooperative is in the business form of a corporation, whether incorporated under a cooperative statute or a non-cooperative business corporation statute.¹ The focus will be on the tax implications of basic cooperative operations that distinguish them from other types of businesses.

I. The Single Tax Principle

Corporate entities are taxed as either “C Corporations” or as “S Corporations.” S Corporations are taxed much like a partnership, with the corporate entity itself paying no tax but with the stockholders recognizing their proportion of the corporation’s income as their own. The benefits of the S Corporation are limited to organizations that can meet the requirements and limitations. C Corporations pay income tax on their entity taxable income. When net income is distributed as a dividend on capital stock, the corporation takes no deduction and the stockholder recipient recognizes the amount received as income. Thus, “double taxation” occurs.

Cooperatives make distributions of their net margins based on cooperative principles described in detail previously. Distributions based on use of the cooperative – patronage – are made as patronage refunds. Under circumstances described below, the cooperative may deduct the amounts so paid and the recipient patrons recognize the income. Unfortunately, the term “patronage dividend” was used in the tax code rather than patronage refund, leading to some initial confusion about dividends and refunds. Cooperatives may make distributions to their member stockholders on an other-than-patronage bases in which case they are treated generally like C corporations. Distributions made as refunds that fail to meet the statutory requirements for a patronage refund will generally be treated as dividends paid on capital stock.²

A. A Simple Rationale for Cooperative Tax Treatment

1. Basic Cooperative Tax Rules

¹ Limited liability companies may be given essentially cooperative characteristics by design. Farmers are increasingly adopting the LLC form for various collaborative efforts often with some characteristics not associated with a cooperative such as outside investments. These issues are addressed elsewhere. The partnership tax treatment of LLC’s seems nearly irresistible at first glance because of the tax-free character of the entity. Research is underway to understand all of the implications of using an LLC form rather than a cooperative.

² *People’s Gin Co. v. Comm’r*, 41 B.T.A. 343 (1940), *aff’d*, 118 F.2d 72 (5th Cir. 1941); *Juneau Dairies, Inc. v. Comm’r*, 44 B.T.A. 759 (1941).

The Tax Code lets any corporation "operating on a cooperative basis" pay patronage refunds without paying tax on income it distributes to patrons. Patrons pay income tax on all amounts received as patronage refunds.

The Code gives strict qualifications for patronage refunds, a definition closely tracking the principle that a cooperative's benefits are distributed to users in proportion to use. The Code defines a patronage refund as a payment to a patron --

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and,
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

The Code goes on to emphasize that a true patronage refund does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for other patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

2. The Single Tax Principle

Tax rules applied to patronage refunds are quite simple, although in practice some complications can occur. A single rule summarizes the key to cooperative income taxation -- when a cooperative pays patronage refunds it can deduct them from its taxable income. When patrons receive patronage refunds, they must take them into account for tax purposes.

The result of this simple rule is that income flowing into the cooperative and through to patrons, according to fundamental cooperative principles summarized in the Code, is taxed but once. Only the final recipient of the income, the cooperative's patron, receives income on which tax is to be paid. This tax concept is usually called the "single tax" principle.

B. Basis for Cooperative Tax Rules

Basic cooperative tax principles can best be understood by analyzing their logic rather than treating them as arbitrary rules unrelated to the scheme of Federal income taxation. Cooperatives are given different tax treatment because they operate differently, not because they are thought to deserve special privileges, with the exception of very limited additional deductions given farmer cooperatives qualifying under section 521. A simple analysis is given here to place the technicalities and considerable complexity of cooperative taxation in perspective.

Cooperatives' right to deduct patronage refunds from taxable income is, of course, now a matter of statutory law and requires no further justification or explanation of underlying rationale for that system. However, an inquiry into some of the reasons for the single tax treatment afforded cooperatives' patronage refunds demonstrates the close association between patronage refund taxation and general principles common to taxation generally. It also suggests the foundation for many requirements and definitions found in Subchapter T, and why they are important.

From 1913 to 1962 exclusion or deduction of patronage refunds from a cooperative's income was based on interpretation of generally applicable tax principles to patronage refunds. During this time all the major requirements and definitions of what eventually became subchapter T were developed without separate statutory authority. Rather, the patronage refunds payment system, including noncash refund distribution, was found to have characteristics such that they deserved single tax treatment by general application of tax principles.

Several reasons were proffered to explain and require exclusion or deduction of patronage refunds paid by cooperatives. Discussions of cooperative tax rationale, especially deduction of patronage refunds paid, are found in numerous legal sources, many predating any statutory recognition of patronage refund deductions.

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Dr. P. Phillips Cooperative v. Comm'r
15 T.C. 1002 (1951)

Although the Commissioner has held that the petitioner is not exempt under section 101(12) [the predecessor of section 521 of the 1954 Code], nevertheless he has allowed the petitioner as a cooperative to exclude from income for tax purposes the amounts which it has distributed in cash as patronage dividends. There is no express statutory authority for this action but for many years the practice has been followed by the Treasury Department and it has received judicial sanction. The theory is that the cooperative is merely a conduit for the patronage dividends....

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Harbor Plywood Corp. v. Comm'r
14 T.C. 158, 161 (1950), *aff'd without opinion*, 187 F.2d 734 (9th Cir. 1951)

The reason for this rule is that the patronage dividends or rebates are at all times the property of the member stockholders, and nonmembers, and that the selling association is an agent or trustee or mere conduit for the income.

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I.T. 3208
1938-2 C.B. 127

Under long established Bureau practices, amounts payable to patrons of cooperative corporations as so-called patronage dividends have been consistently excluded from the gross income of such corporations. The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation or an additional consideration due the patron for goods sold by him through the corporation. As such they are not includible in gross income of the corporation, they are obviously not deductible by it, though, where they have been erroneously included in gross income in the first instance, the correcting adjustment is sometimes loosely termed a deduction. Where patronage dividends are payable only to members or stockholders (or the members received larger patronage dividends than nonmember patrons on identical transactions), the excess of the payments over the amounts due them on a patronage basis represents ordinary income to the corporation from business carried on by it for the joint

profit of the members, and, consequently, distributions thereof to the members are essentially ordinary dividend payments.

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Rev. Rul. 83-135
1983-2 C.B. 149

[T]hese patronage dividends represent either an additional consideration due the patron for goods sold through the cooperative or reduction in the purchase price of supplies or equipment purchased by the patron through the cooperative.

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Although several reasons were used to explain patronage refund deductions prior to specific Code provisions, two show how the logic of tax law led to a single tax treatment for cooperatives. The "price adjustment" concept viewed patronage refunds as adjustments to prices cooperatives paid patrons for product delivered to the cooperative for marketing or prices received for supplies provided patrons. For example, a cooperative may receive product and make an advance payment. Then, following its sale of the product, it pays an additional amount to the patron as a patronage refund. Under fundamental tax rules applying to all businesses, a business can deduct expenses incurred, a large part of which may be costs of goods purchased. The price adjustment concept simply said the price the cooperative had to pay for goods received, for which it could take a deduction as any other business, was the advance paid immediately and the refund paid later. The total cost of goods to the cooperative included all payments to patrons for the product delivered. Thus, a logical application of fundamental tax rules applied to all businesses required deduction for patronage refunds.

A second justification for patronage refund deduction (or, more accurately, exclusion) was based on rights patrons had in any income the cooperative might receive. In general, an agent who receives money for sale of someone else's property only on behalf of the property owner does not earn income. The income belongs to the seller, not the seller's agent. This idea was applied to cooperatives obligated to return any income to patrons, circumstances similar to an agent. As a result, if a cooperative was obligated to return all income to patrons the cooperative did not actually receive money as income on its own behalf, but only as an agent acting on behalf of patrons. The patron, not the cooperative, was obligated to recognize income for tax purposes. This concept was the main basis for the legal obligation requirement contained in present tax laws.

C. Taxes and Cooperative Finances

Tax laws recognize financing methods cooperatives use that other kinds of businesses do not. This does not mean "special treatment" applied to those methods gives cooperatives "tax breaks." Instead, these rules establish treatment for capital additions to cooperatives similar to that for noncooperative businesses, though additions to a cooperative's capital are made in a different way than are purchases of equity in a noncooperative business.

To put these concepts in perspective, basic tax principles and terminology for cooperatives can be summarized. Then cooperative tax principles can be compared with those for other kinds of

businesses to see how the principles are fundamentally similar, though applied in quite different situations. At the same time, it becomes clear that the simple single tax principle for patronage refunds is preserved when investment and refunds are combined in more complicated arrangements common to cooperatives.

Most cooperatives use one of two methods by which patrons invest in the cooperative based on the amount of business each patron does with it. Part of the patronage refund due each patron may be paid in the form of equity in the cooperative rather than in cash. This is generally called "retained patronage refund" financing. A cooperative may also retain from its proceeds a certain amount per unit of product as a patron investment. These are called "per unit capital retains." In either method, patrons finance their cooperative in proportion to use. Tax treatment of per unit capital retains closely tracks that of patronage refunds.

The single tax treatment for patronage refunds applies to refunds even when part is retained by the cooperative, but only if a number of tax law requirements are satisfied. When patronage refunds are not paid entirely in money, the cooperative issues "written notices of allocation" to patrons indicating the amount of refund being retained as patron equity in the cooperative. This is often referred to as the "noncash portion" of the patronage refund. In a typical cooperative financing system, this is added to the cooperative's equity each year and older equity is redeemed as new equity comes in.

D. Taxing Retained Patronage Refunds

Tax rules applied to these arrangements depend on whether a written notice of allocation is "qualified" or "nonqualified." To be "qualified," at least 20 percent of the total refund must be paid in money. Many cooperatives pay more than 20 percent in cash. The average for all cooperatives is about 42 percent.³

Tax law also requires, as a condition for qualification, that each patron consent to take the entire amount of the patronage refund into account as income for tax purposes although as much as 80 percent is not received in cash. Required consent can be given in three ways. A patron may give consent in writing, usually on a form the cooperative provides. An example is a marketing agreement signed by the patron. A second form of consent is through a cooperative's bylaws. Bylaws may contain a consent provision that says anyone who becomes a member agrees to take the entire patronage refund into income for tax purposes, although part is paid in cash and part in written notice of allocation. A copy of the bylaw consent provision must be given patrons when they become members. Bylaw consent is effective only for members.

The third consent form is a "qualified check." At least 20 percent of a patronage refund must be paid in money if a written notice of allocation is to be qualified. The cooperative may write a check for the money portion in "qualified check" form. A qualified check is simply a check upon which consent is printed. If the patron endorses and cashes the check, the patron agrees to include the refund's noncash portion, of which the qualified check is part, in the patron's income for tax purposes. If the patron does not endorse and cash the check, consent is not given and the patronage refund is nonqualified.

³ For this and other excellent information on cooperative finance, see Rathbone, Robert C., and Roger A. Wissman. *Farmer Cooperatives' Financial Profile, 1997*. USDA, Rural Business-Cooperative Service, RBS Research Report 171 (April 2000).

If a patronage refund, part of which is paid in cash or qualified check and part of which is paid through a written notice of allocation, is in "qualified" form, the single tax principle for patronage refunds applies. The cooperative may deduct from its taxable income the entire amount of the patronage refund, including both the cash and noncash portions. At the same time, the patron is taxed on the entire amount of the patronage refund, whether received in cash or noncash form. As a result, only a single entity, the patron who receives the patronage refund, accounts for the income for tax purposes. When the cooperative eventually redeems the equity, it gets no further deduction and equity holders have no taxable income from the cash received at redemption.

A two-step system is used if a written notice of allocation is in "nonqualified" written notices of allocation. The cooperative does not deduct amounts paid in nonqualified form, and patrons do not take them into account in income for tax purposes. This means the cooperative pays income tax on that income at corporate tax rates in the year the income is received. When the retained refund is redeemed, the process is reversed. The cooperative does not deduct amounts paid in nonqualified form, and patrons do not take them into account in income for tax purposes. This means the cooperative pays income tax on that income at corporate tax rates in the year the income is received. When the retained refund is redeemed, the process is reversed. The cooperative then deducts redemption amounts from its income according to alternatives described in the tax law, and patrons pay tax on the amount received upon redemption. This two step system still results in a single tax applied to the refund, with the final burden falling on the recipient patron.

E. Comparison With Other Businesses

The assertion is sometimes made that cooperatives receive tax advantages as compared to noncooperative business corporations because they may keep part of a patronage refund without paying tax on it. Corporations, on the other hand, must pay corporate tax on profits generated by the corporation.

Retained patronage refunds and per unit capital retains should not be equated with corporation profit by a cooperative. Rather, they are capital investments in the cooperative by patrons. This concept helps clarify the reason cooperative may deduct patronage refunds even when not all is paid in cash.

For any individual or corporation, taxes apply to "earned income." Contributions to capital occur when investors purchase stock from a corporation. This inflow of money into a corporation is not classified as earned income. When noncooperative corporations receive money for an equity interest in the corporation, it is not taken into account as taxable income.

This is the situation when a cooperative issues written notices of allocation to patrons telling them a certain portion of their patronage refund has been applied as equity in the cooperative. The patrons have effectively received the patronage refund, then invested part of it back in the cooperative's equity structure. No part of the refund, including that retained by the cooperative, is kept as cooperative profit. Rather, the refund is paid by the cooperative and is an investment made by the patron. Just as noncooperative corporations do not recognize money received in exchange for equity purchases as taxable income, so cooperatives do not recognize patronage based exchanges for equity as taxable income.

Even more dramatic is the comparison of a cooperative and an LLC. From the entity viewpoint, the LLC has clear tax advantages over the cooperative. All LLC income is passed through without taxation at the LLC level, whereas the single tax treatment for cooperatives is limited and cooperatives in fact pay Federal income taxes.

When the patronage refund process is viewed this way, it is clear that tax rules for cooperative patronage based financing are, in fundamental substance, no different from those for noncooperative corporations.

II. Operating on a Cooperative Basis

A. Subchapter T and Section 521

The history of cooperative taxation and the development of subchapter T in 1962 relating to cooperative taxation is not summarized here.⁴ You will be able to piece most of it together from descriptions in judicial decisions.

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1382(b) Tax on Certain Farmers' Cooperatives. - An organization described in subsection (a)(1) shall be subject to the taxes imposed by section 11 or 1201.

1381(a) In General. - This part shall apply to -

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) any corporation operating on a cooperative basis other than an organization -

(A) which is exempt from tax under this chapter,

(B) which is subject to the provisions of -

(i) part II of subchapter H (relating to mutual savings banks, etc.),

or

(ii) subchapter L (relating to insurance companies), or

(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

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Subchapter T applying to “any corporation operating on a cooperative basis” is a general cooperative provision not restricted to agricultural cooperatives (as is Section 521, discussed below.) Examples of other kinds of cooperatives using Subchapter T are too numerous to describe. Decisions and opinions relating to such cooperatives include the following:

Certified Grocers of California, Ltd. v. Comm’r, 88 T.C. 238 (1987).

Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983).

⁴ An excellent summary with extensive references is given in Frederick, Donald A., and John D. Reilly. *Income Tax Treatment of Cooperatives: Background*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 1 (Oct. 1993).

United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962), *aff'd*, 186 F. Supp. 724 (N.D. Cal. 1960).

Cotter and Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985), *rev'd*, 6 Ct. Cl. 219 (1984).

Washington-Oregon Shippers Cooperative, Inc. v. Comm'r, 52 T.C.M. 1406 (1987).

Harbor Plywood Corp. v. Comm'r, 14 T.C. 158 (1950), *aff'd without opinion*, 187 F.2d 734 (9th Cir. 1951).

Linnton Plywood Ass'n v. United States, 410 F. Supp. 1100 (D. Ore. 1976).

Stevenson Co-Ply, Inc. v. Comm'r, 76 T.C. 637 (1981).

Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. ¶ 9197 (D. Ore. 1979).

Puget Sound Plywood, Inc. v. Comm'r, 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 3.

Seiners Ass'n v. Comm'r, 58 T.C. 949 (1972).

Rev. Rul. 66-98, 1966-1 C.B. 200.

Rev. Rul. 70-481, 1970-2 C.B. 170.

Rev. Rul. 74-160, 1974-1 C.B. 245.

Rev. Rul. 74-84, 1974-1 C.B. 244.

Rev. Rul. 71-439, 1971-2 C.B. 321.

PLR 8006112 (Nov. 20, 1979).

PLR 7731017 (May 4, 1977).

PLR 8129050 (Apr. 22, 1981).

PLR 9313016 (Dec. 23, 1992).

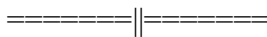
TAM 8118012 (Jan. 28, 1981).

TAM 8130001 (Mar. 24, 1981).

TAM 7746003 (Aug. 2, 1977).

B. Foundations

The following decision has been, and still is relied on heavily by the IRS for basic statements of what "operating on a cooperative basis" means. The decision followed a period during which IRS said that a worker cooperative could not be a Subchapter T cooperative. As noted in text following the *Puget Sound* quote, the IRS has continued to use the *Puget Sound* description of cooperatives as the touchstone of cooperative definition.



Puget Sound Plywood, Inc. v. Comm'r
44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6

PIERCE, Judge:

* * *

The sole issue for decision herein is whether the petitioner, which is a cooperative association of the type commonly known as a workers cooperative association, that was incorporated and operated in accordance with a statute of the State of Washington that pertains particularly to the formation and regulation of associations operating on a cooperative basis: (1) Is entitled to be classified and treated for Federal income tax purposes as a "nonexempt cooperative association," within the meaning of that term as employed in the Federal income tax statutes, the long-established rulings and practice of the Internal Revenue Service, and various judicial decisions; and (2) is entitled as such, to exclude from the proceeds of the association's operations, for Federal income tax purposes, the "patronage dividends" which were, pursuant to a preexisting legal obligation, allocated to the worker-members in proportion to the hours worked by them in producing and marketing the products of their joint efforts.

The only other issue raised in the pleadings is an alternative one which has been settled by the parties through a written stipulation. Effect will be given to this stipulation to the extent that the provisions thereof are pertinent after disposition of the previously stated issue.

FINDINGS OF FACT

Some of the facts have been stipulated. This stipulation of facts and all exhibits identified therein are incorporated herein by reference; subject however to agreement of the parties that certain words employed therein, such as "shareholder," "member," or "margins," are not conclusive as to the true character of the organization and transactions here involved.

Petitioner was incorporated in 1941 under a statute of the State of Washington (hereinafter cited) that pertains particularly to the formation and regulation of associations operating on a cooperative basis. It filed a Federal income tax return for each of the years involved with the district director of internal revenue at Tacoma, Wash.

Facts re History and Characteristics of Cooperative Associations

A "cooperative association" has been defined in Income Tax Regulations, sec. 1.522-1(b)(1), as follows:

The term "cooperative association" includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons * * * [with certain exceptions not here relevant.] [Emphasis supplied.]

Another and more detailed definition is this: 1/

[1/ 7 Ency. Amer. 639 (1959 ed.).]

A cooperative is an organization established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor. The means of production and distribution are those owned in common and the earnings revert to the members, not on the basis of their investment in the enterprise but in proportion to their patronage or personal participation in it. Cooperatives may be divided roughly into consumer cooperatives and producer cooperatives.

Consumer [cooperative] organizations operate for the benefit of the members in their capacity as individual consumers. * * *

Producer [cooperative] organizations operate for the benefit of the members in their capacity as producers. Their function may be either the marketing or processing of goods produced individually (as in fishermen's or farmers' marketing associations, or associations which make butter or cheese from farm products received from farmer members), or the marketing of goods processed or produced collectively (as in the so-called workers' [cooperative] productive associations operating factories or mills). [Emphasis supplied.]

The history and characteristics of cooperative associations may be summarized as follows. 2/

[2/ In the instant case, the history and characteristics of cooperative associations were developed extensively in the testimony of Dr. Edwin G. Nourse. Dr. Nourse was formerly Chairman of the Council of Economic Advisers, established in the Executive Office of the President of the United States under the Employment Act of 1946; and he also was formerly a director, later vice president, and more recently a consultant at the Brookings Institution in Washington, D.C. He is one of the outstanding authorities on the subject of cooperative associations in the United States and foreign countries. Also, additional helpful testimony on this subject was presented by Kelsey Gardner, formerly associated for many years with the Bureau of Cooperative Marketing of the U.S. Department of Agriculture.]

One of the earliest examples of cooperative associations as they exist today was the Rochdale Cooperative, which was founded in England in 1844 by 28 textile weavers who associated themselves together for the purpose of operating a retail store. The objectives which the members of that association sought to attain were: (1) For themselves to own and manage the store, as distinguished from having it owned and managed by outside equity investors; and then (2) to have their association turn back to the members the excess of the receipts from the store sales over the cost of the goods sold and the expenses of operation. This general form of cooperative organization thereafter spread from England to other nations including the United States, where it has since been utilized not only by consumer cooperatives, but also by producing and marketing cooperatives. Thus in the United States for example, in years immediately preceding and following the War Between the States, various types of cooperative enterprises were organized, including those composed of farmers, dairymen, shoemakers, textile and clothing manufacturers, coopers, and ironworkers.

The worker type of cooperative (which included many of those above mentioned) was intended to provide an alternative to the corporation-for-profit form of organization for conducting manufacturing enterprises. Under the corporation-for-profit form of organization, the profit of the enterprise is vested in outside parties who supply the equity capital which is placed at the risk of the business; who select the management and assume the direction over the enterprise; whose separate corporate entity employs workers that derive only those wages which they are able to obtain through bargaining with the representatives of the equity owners; and which equity owners then receive directly or indirectly the benefit of such net profits as the corporation-for-profit form of organization may produce. Under the cooperative association form of organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as coowners, in proportion to the amounts of their active participation in the cooperative undertaking.

The founders of the above-mentioned Rochdale Cooperative formulated three guiding principles, which still persist as the core of economic cooperative theory:

(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their

cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

Implementation of the first of these three principles, relating to the subordination of capital contributions in determining the right to the pecuniary benefits, is effected through the statutes under which the cooperatives are organized, and also by the charters and bylaws of the cooperatives themselves--all of which contain limitations upon the amounts that may be distributed to members in respect of the stock which represents the necessary capital that the members themselves supply. Indeed in the case of many cooperatives, distributions in respect of the worker-members' stock are forbidden entirely. Also, implementation of the subordination of capital as regards control over the management and direction of the cooperative, is achieved through bylaw provisions which vest in the members themselves the right and power to elect the trustees and the officers of the cooperative.

Implementation of the second of the above principles, relating to democratic control, is effected by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted; and these workers there deal personally with all problems affecting the conduct of the cooperative.

And finally, the third of the above-mentioned principles of cooperatives, relating 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 associations 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.

Cooperatives--including workers cooperatives--are, and have been for many years, authorized by statutes of many of the States. Typical of these statutes is one which was enacted by the State of Wisconsin in 1911 (Wisc. Laws 1911, ch. 368), which has since provided the pattern for similar statutes of other States, including the statute of the State of Washington here involved.

Thus, the basic and distinguishing feature of a workers cooperative association, as compared with a corporation-for-profit, is that in the case of a workers cooperative association the fruits and increases which the worker-members produce through their joint efforts are vested in and retained by the workers themselves, rather than in and by the association, as such, which functions only as an instrumentality for the benefit of the workers; and that these fruits and increases of the cooperative effort are then allocated among the active workers as patronage dividends, in proportion to their participation in producing the same. In the case of the corporation-for-profit, on the other hand, the fruits and increases of such organization belong to the corporate entity itself; and these increases (called net profits) are then either distributed or retained for the benefit of the equity owners, not in proportion to their personal efforts but rather in proportion to the amounts of capital which they supply. And also these same equity owners, acting either directly or indirectly, also select the management and control the functions and policies of their entity--not on a one-person one-vote basis without use of proxies, but rather through multiple voting in proportion to the number of shares of capital stock which they hold.

Facts re Organization of the Petitioner

In 1913, the legislature of the State of Washington enacted a statute (Wash. Laws 1913, ch. 19) entitled "Co-Operative Associations--An act providing for the formation and carrying on of co-operative associations and providing for the rights, powers, liabilities and duties of the same." Said chapter of the session laws (as amended in respects not here material) is now codified as chapter 23.86 of the Code of Washington. 3/

[3/ The Revised Code of Washington makes provision, in other chapters and sections thereof, for corporations of several types other than that here involved. See, for example, ch. 23.01--Private Business Corporations Act; ch. 24.04--Nonprofit, Nonstock Corporations; and ch. 24.32--Agricultural Cooperative Associations.]

Those provisions of said code which are here material, are as follows:

[Detailed incorporation statute provisions omitted]

After the present petitioner had been so organized as a cooperative association, each of the members contributed \$1,000, of which \$500 was to be paid immediately and the balance was paid over a period of time. They then hired an engineer, and as worker-members they built the association's plywood plant from the ground up. This plant was located in Tacoma, Wash.; and it included a plywood mill, and an office which was the association's principal place of business. While building the plant, the worker-members received compensation of 90 cents an hour; and at one time a collection of \$5 apiece was taken up to buy paint for use in painting the plant.

The principal activity of this cooperative association, at all times material including the years here involved, was the manufacture and sale of plywood and related wood products.

The number of members of the association during the years involved was approximately 270; and of those an average of 260 were regular full-time workers in the association's plant. Typical reasons for a member not working were: (1) Military service; (2) prolonged illness; and (3) departure from Tacoma with expectation of returning.

Each member was the owner of 10 shares--no more or less--of the association's stock. The holding of such shares entitled the member to one--and only one--vote at any meeting of the association. Ownership of such 10 shares also entitled the owner to work as a member of the association.

The trustees investigated and passed upon all applicants for membership in the association, including transferees of the association's shares. These trustees required, among other things: (1) That any person applying for membership be less than 45 years of age; (2) that he submit to a physical examination and obtain the physician's report thereon, showing that he was in good health; and (3) that the applicant be competent to hold a job in the association's plant. After the applicant had met these tests, he presented himself to the trustees for questioning; and there he was required to agree that he would acquire his shares of the association in good faith, for membership purposes only; that he would sign the association's membership agreement and observe its bylaws, rules, and regulations; that when called upon to work in the plant, he would accept and be capable of handling satisfactorily the work assigned to him; and that he would comply with the usual conditions of such employment.

No shares were issued or transferred until the applicant for membership in the association had received the approval of the trustees. After receiving such approval, the president of the association and the new member signed a membership agreement which provided in material part, as follows:

(1) The Association will afford the member employment and refund to him his proportionate share of all margins arising from the production and marketing of wood products in accordance with its Articles of Incorporation and Amended By-Laws.

(2) The member will cooperate with the other members to the end that by their joint efforts the maximum production and efficiency be attained.
[Emphasis supplied.]

Meetings of the association's worker-members were held at least semiannually in accordance with the bylaws. At these meetings various business and operating problems were discussed and dealt with by majority vote. The average attendance at these meetings during the years here involved was 224, or about 83 percent of the entire membership. The matters there dealt with included such things as election of trustees, capital expenditures, production efficiency, new methods of operation, claims, and purchases of timber.

During the years involved, almost all the workers in the association's plant were members (being 260 in number). But there also were employed from five to seven nonmembers, who were chiefly young women in clerical positions, and the plant superintendent.

About two-thirds of the logs used by the association in the manufacture of plywood and other wood products, were acquired through purchase of standing timber from the Forestry Service of the U.S. Department of Agriculture; and the balance was acquired from timber-owners or on the open market. The products manufactured by the association were sold to commercial dealers or users of such products.

Facts re Allocation of Margins among Worker-Members

Participating payments in respect of the fruits and increases from the worker-members' cooperative efforts were made to the active worker-members on the basis of the number of hours worked by each as follows:

(1) On about the 20th of each calendar month, a so-called draw check in the uniform amount of \$100 was issued to each worker. These amounts were in the nature of drawing-account payments to provide the worker-members with current living expenses.

Thereafter, as of the end of each calendar month, a so-called advance check was issued to each worker in an amount representing the hours worked by him during the month multiplied by a uniform hourly rate, and less the amount previously distributed to him as a draw check. The said hourly rate was fixed by the trustees in an amount which more or less approximated the average union rate in the area where the association's plant was located. With minor exceptions, hereinafter noted, the payments and distributions received by each worker-member were uniform in relation to the number of hours worked by him, regardless of the character of the services which he contributed to the cooperative endeavor (i.e., regardless of whether he swept the floors of the plant or was in charge of an operating department). The exceptions were: (1) That the trustees received no compensation for their services as such, except a token payment of \$1 per year; (2) that the general manager (a worker-member selected by the trustees) received a differential of \$2,500 in 1958 and of approximately \$6,000 in 1959 and 1960; and (3) that the officers of the association received no compensation for their services as such, except a token payment of \$1 per year.

The amounts represented by the foregoing checks were issued pursuant to section 11 of the bylaws, and they were considered to be advances against the "patronage dividends" thereafter allocated.

(2) At the close of each quarter of a particular calendar year, a patronage dividend check was issued to each worker-member who had participated during that period. For each of the first three quarters, 75 percent of the fruits and increases of the association (called margins) for that quarter, were distributed to the worker-members on the basis of the hours worked by each in that quarter. And then at the end of the year, the total margins for the year were computed and allocated to all worker-members on a pro rata basis according to the hours worked for the full year, less the amounts of the previously mentioned draw checks, advance checks, and patronage dividends which had been distributed for the preceding three quarters of such year.

In the event that the trustees determined, in accordance with section 14(c) of the bylaws, that it was essential to retain portions of the margins for necessary association purposes, then certificates of indebtedness in lieu of cash would be issued to the worker-members for the portions so retained.

The amounts of the aggregate margins for each year that were distributed to the worker-members as patronage dividends, represented the net proceeds realized by the association from the sale of plywood and related wood products, after elimination therefrom of that portion of these proceeds which was attributable to the participation of employed nonmember workers--and less the amounts previously advanced to the worker-members through the above-mentioned draw checks and advance checks.

The petitioner association instructed the worker-members to file, for each year, individual declarations of estimated tax based on the anticipated patronage dividends to be allocated to them for such year, and to pay Federal income taxes on all such patronage dividends which they received, either in cash or in certificates of indebtedness. In accordance with the requirements of section 6044 of the 1954 Code, the amounts of all margins allocated to worker-members as patronage dividends were reported by the association to the Internal Revenue Service on Form 1099.

The nonmember workers who were employed at the plant during any taxable year did not receive any patronage dividends from the margins so allocated; and also any member who did not work during any particular year likewise did not receive any patronage dividend with respect to margins attributable to such year.

The petitioner association filed a Federal income tax return (Form 1120) for each of the taxable years involved; and it paid tax on the amount of taxable income reported therein. The taxable income so reported was from sources that were not related to any cooperative efforts of the worker-members; and these sources included the following: That portion of the income from mill operations which was attributable to the services of nonmember workers employed at the plant; miscellaneous interest income; small capital gains in 1958 and 1959 only; and other miscellaneous items such as income from the sale of scrap materials, taxable income in respect of fire insurance recoveries, and income from cold-drink machines in the plant. On said Federal income tax returns, the petitioner association excluded from income the amounts of the margins allocated and distributed to its worker-members as patronage dividends.

The Commissioner, in his notice of deficiency herein, disallowed the exclusion of all patronage dividends in respect of margins.

FINDINGS OF ULTIMATE FACT

The petitioner association operated in each of the taxable years involved on a cooperative basis for the mutual welfare of its worker-members.

The right to all fruits and increases from the cooperative efforts of the worker-members (represented by its so-called margins) was vested in and retained by the worker-members themselves, and not in and by the association as a separate entity--which association functioned only as an instrumentality through which the worker-members carried on their cooperative endeavors.

Said margins were allocated among the worker-members as patronage dividends, pursuant to a preexisting legal obligation created by the statutes of the State of Washington, the association's bylaws, and the agreements entered into between the association and the workers at the times when these workers became members. Such margins distributed as patronage dividends, arose out of transactions between the cooperative association and its worker-members. And the same were equitably allocated among the worker-members in proportion to the amount of service which each such worker contributed to the total cooperative effort that produced said margins.

OPINION

The problem here presented is a novel one, insofar as this Court is concerned. The petitioner, as we have hereinbefore shown, is a workers cooperative association located in the State of Washington, which was formed, incorporated, and operated by the worker-members on a cooperative basis, for their mutual benefit in producing and marketing plywood and related wood products; and this petitioner, acting in accordance with the cooperative plan and pursuant to a preexisting legal obligation, allocated the patronage dividends to its worker-members in proportion to the hours worked by them in their joint endeavor.

The specific question to be here answered is: Whether this petitioner, as so formed and so operated, should be regarded for Federal income tax purposes, as a "nonexempt cooperative association" within the meaning of that term as used in the Federal income tax statutes, in numerous rulings of the

internal Revenue Service, and in various judicial decisions (all hereinafter identified); and thus be entitled to exclude from the income which is taxable to itself (and leave for taxation to the individual worker-members) the patronage dividends which were so allocated during the taxable years involved.

After considering and weighing all the evidence in the light of the relevant authorities, we are convinced that this question should be answered in the affirmative, for the following reasons.

1. Since the year 1926, the Federal income tax statutes have accorded exemption from income taxes to certain cooperative associations composed of farmers, fruitgrowers, and the like--which engage in the marketing of farm products or the buying of farm equipment for both members and nonmembers, and which then turn back to such participants the net proceeds of the cooperative activities. The provision for such tax exemption is presently embodied in section 521 of the 1954 Code. The parties to the present case agree that the instant petitioner does not qualify for exemption under said section.

Notwithstanding this exemption which is accorded a limited type of cooperatives which are able to qualify therefor, the Internal Revenue Service has recognized for many years, in numerous rulings published since at least as early as 1922, that there are many other cooperative associations which, even though they do not qualify for exemption under the above statute, are nevertheless entitled (in their capacity as nonexempt cooperative associations) to exclude from their gross incomes, patronage dividends that are equitably allocated to their participating members pursuant to preexisting legal obligations. Several examples of these administrative rulings, which recognized the right of nonexempt cooperatives to exclude patronage dividends, are: I.T. 1499, I-2 C.B. 189, 191 (1922); A.R.R. 6967, III-1 C.B. 287 (1924); S.M. 2595, III-2 C.B. 238 (1924); G.C.M. 12393, XIX-2 C.B. 398 (1933); G.C.M. 17895, 1937-1 C.B. 56; I.T. 3208, 1938-2 C.B. 127; Rev. Rul. 57-59, 1957-1 C.B. 24.

This same principle that nonexempt cooperatives are entitled to exclude true patronage dividends from their gross incomes has also been recognized by the courts in several reported decisions. See, for example, Pomeroy Cooperative Co., 31 T.C. 674, affirmed on this point 288 F.2d 326 (C.A. 8); Smith & Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341 (C.A. 5), affirming 37 T.C. 861; United States v. Mississippi Chemical Co., 326 F.2d 569 (C.A. 5); Clover Farm Stores Corporation, 17 T.C. 1265, 1277; Dr. P. Phillips Cooperative, 17 T.C. 1002, 1010; United Cooperatives, Inc., 4 T.C. 93, 106; Midland Cooperative Wholesale, 44 B.T.A. 824, 830; Fruit Growers Supply Co., 21 B.T.A. 315, 326, affd. 56 F.2d 90 (C.A. 9); and Farmers Cooperative Co. v. Birmingham, 86 F.Supp. 201 (N.D. Iowa). In the case of Dr. P. Phillips Cooperative, supra, this Court said:

Although the Commissioner has held that the petitioner is not exempt under section 101(12) [the predecessor of section 521 of the 1954 Code], nevertheless he has allowed the petitioner as a cooperative to exclude from income for tax purposes the amounts which it has distributed in cash as patronage dividends. There is no express statutory authority for this action but for many years the practice has been followed by the Treasury Department and it has received judicial sanction. The theory is that the cooperative is merely a conduit for the patronage dividends * * *

Also in Harbor Plywood Corporation, 14 T.C. 158, 161, this Court stated:

The reason for this rule is that the patronage dividends or rebates are at all times the property of the member stockholders, and nonmembers, and that the selling association is an agent or trustee or mere conduit for the income.

The mere fact that the cooperative may have been organized as a corporation under local law is not significant as regards its right to exclude patronage dividends. Indeed, most cooperatives are incorporated and regulated under the laws of some State; and all the above-cited judicial decisions in which the right to exclude patronage dividends was recognized, involved incorporated cooperatives; and at least one of them (United Cooperatives, Inc.) was incorporated under the general corporation statute of Indiana.

Also, the particular name by which a cooperative's distributions are designated (such as "patronage dividends," "refunds," or "rebates") is not in our opinion determinative of the cooperative's right to exclude the same. Dr. Nourse (the expert witness above mentioned) pointed out during the course of his testimony that the term "patronage" originated with the above-described Rochdale Cooperative that was founded in England in 1844 and operated a retail store--and in that cooperative endeavor, the participants were of course patrons. He further pointed out that the designation "dividends" had its origin in the fact that most distributions out of corporations are called dividends (even though they may not constitute distributions from the corporation's profits--as for example, so-called dividends on mutual life insurance policies). Dr. Nourse suggested that the more accurate designation for amounts allocated by cooperative associations is "participating distributions."

2. In 1951 the Federal tax statutes, for the first time, gave express recognition to the principle that both exempt cooperative associations and also nonexempt cooperative associations are entitled to exclude true patronage dividends from their gross incomes. In that year, Congress, in section 314 of the Revenue Act of 1951, amended section 101(12) of the 1939 Code by inserting a provision relating to the exclusion of patronage dividends by exempt cooperatives; and in this provision, it was stated that such patronage dividends "shall be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt." (Emphasis supplied.) And thereafter, this same language was carried forward into section 522 of the 1954 Code, as it existed throughout all the taxable years here involved.

In 1962, President Kennedy brought to the attention of Congress that the above-mentioned provisions of the 1951 Act had proved inadequate in several respects; and he recommended that supplemental provisions be enacted, so that the purpose of Congress, which had been intended to be reflected in the 1951 Act, might be achieved. 4/

[4/ H. Rept. No. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 405, 482-483; S. Rept. No. 1881, 87th Cong., 2d Sess., 1962-3 C.B. 707, 817.]

This resulted in the enactment of subchapter T (secs. 1381-1388) of the 1954 Code; and in these new supplemental provisions, Congress again gave express recognition (in sec. 1381(a)) to the fact that the new and more comprehensive provisions would be applicable, not only to exempt cooperatives but also to "any corporation operating on a cooperative basis other than * * * [one] which is exempt."

3. Neither the above-cited Federal statutes nor any published judicial decision relating thereto have restricted to any particular type of cooperatives the basic principle that corporations operating on the cooperative basis are entitled to exclude from their gross incomes true patronage dividends or participating distributions allocated by them.

As heretofore shown, section 1.522-1(b)(1) of the Income Tax Regulations defines a "cooperative association" to be "any corporation operating on a cooperative basis." (Emphasis supplied.) This obviously is sufficiently broad to cover both marketing cooperatives and also producing cooperatives.

Furthermore in 1962, when the Congress had under consideration the matter of making more effective the cooperative provisions of the 1951 Act through the enactment of the supplementary provisions which later became subchapter T of the 1954 Code, a question arose as to whether the phrase "business done with or for patrons," which was contained in these new provisions, was sufficiently broad to cover services done with or for patrons--so as to cover participating distributions of a cooperative association engaged in the manufacture of plywood. In this connection, the following colloquy was had in the Senate between Senator Kerr (floor manager of the bill), Senator Magnuson of Washington, and Senator McCarthy of Minnesota:

Mr. MAGNUSON. Mr. President, I wish to ask the distinguished Senator from Oklahoma [Senator Kerr] a question.

On pages 295 and 296 of the bill, in the definition of the term "patronage dividend," it is stated that a patronage dividend is a payment "determined by reference to the net earnings of the organization from business done with or for its patrons."

In a case which has been called to my attention--it involves the manufacture of plywood in the Pacific Northwest, and many of the companies are cooperative organizations--the cooperative renders services for the patron. I wanted to be sure that in the opinion of the Senator from Oklahoma the phrase "business done with or for its patrons" includes services with or for patrons.

Mr. KERR. I think it is clear, both under the interpretation of a patronage dividend under present law and also under the words "business done with or for its patrons," that services rendered with or for patrons are included. Business done is not necessarily limited to products sold to or purchased for patrons. Business done also includes services performed for patrons, as well.

Mr. MAGNUSON. I thank the Senator from Oklahoma.

Mr. McCARTHY. Mr. President, if the Senator will yield, let me say I think this is a reasonable and desirable interpretation of the language; and I believe that any other interpretation would create an impossible distinction.
[108 Cong. Rec. 18322. Emphasis supplied.]

4. The most recent development in this field is the decision of the U.S. District Court for the District of Oregon, in the case of Linnton Plywood Association v. United States, 236 F.Supp. 227 (decided Oct. 30, 1964), on appeal (C.A. 9). That court is located in the heart of the plywood industry; and said decision was written by Chief Judge Solomon of that court. Both the issue there involved and the facts found by the court were substantially the same as those in the instant case. The opinion of the court, which was in favor of the taxpayer, states in material part as follows:

The Government admits that retained patronage dividends are excludible from gross income of non-exempt cooperatives provided they are either purchasing or marketing cooperatives. It insists that the exclusion is not applicable to workers' cooperatives.

Workers' cooperatives are among the oldest forms of cooperatives and exist in many countries of the world. Many people regard a worker's cooperative as the basic type of cooperative. The Government concedes that if the members had individually created the plywood products and then brought them to the cooperative for marketing, the cooperative would be entitled to the exclusion, but claims that since the members collectively manufacture the products as well as market them, the cooperative is not entitled to the exclusion. I think that this is an illogical and absurd distinction. In my view, [nonexempt] workers' cooperatives are entitled to exclude retained patronage dividends from gross income to the same extent as purchasing or marketing cooperatives.

To avail itself of the exclusion, a cooperative must satisfy three requirements, (1) The allocation must be made pursuant to a legal obligation existing when the patron transacted business with the cooperative. (2) The allocation must be made out of profits or income realized from transactions with its patrons. (3) The allocations must have been equitably made. United States v. Mississippi Chemical Co., 326 F.2d 569, 573-574 (5th Cir. 1964); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326, 328 (8th Cir. 1961). Plaintiff has met all these requirements.

We agree with the views expressed by Chief Judge Solomon in the above case. We have found no published court decision to the contrary.

5. The Internal Revenue Service in 1961, which was subsequent to the taxable years here involved, issued a ruling (Rev. Rul. 61-47, 1961-1 C.B. 193) to the effect that amounts distributed by a nonexempt cooperative association to its worker-members, are not patronage dividends excludible from such cooperative's gross income. Such ruling is in direct conflict with the above-mentioned decision of the Oregon District Court in the Linnton Plywood case; is unsupported by citation of any statutory provision or judicial authority; and is out of harmony with the basic distinguishing principles of cooperative organizations generally. In our opinion, the ruling is erroneous.

In the instant case, we have found as an ultimate fact that the petitioner association was organized and operated on a cooperative basis by the worker-members, who joined together for their mutual benefit in not only marketing their products cooperatively, but also in producing them cooperatively. If, as suggested in the Linnton Plywood case, these worker-members had manufactured wooden products (such as chairs or tables) in their own individual workshops and then had marketed the same through their cooperative association, there could be no dispute that the participating distributions in respect of the marketing function would, when allocated to the members pursuant to a preexisting legal obligation, be excludible from the gross income of the cooperative. Here however, because of the nature of the plywood product, the character of the necessary machinery, and the intricacy of the skills required, the members joined in working under a common roof, rather than in separate workshops, to both produce and market their products cooperatively. We perceive of no warrant in law, fact, or logic why these two methods of cooperative endeavor should not be accorded equal treatment for Federal income tax purposes.

We have hereinbefore found as an ultimate fact, and we here hold, that the right to the fruits and increases of the cooperative efforts of petitioner's worker-members (i.e., margins) was vested in and retained by such workers, and not in and by the cooperative association as a separate entity. And we further hold that the amounts of such margins, which for the taxable years here involved were equitably allocated to the worker-members as patronage dividends pursuant to a preexisting legal obligation, are excludible from the petitioner-association's gross income for Federal income tax purposes.

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IRS application of *Puget Sound* has been evidenced by numerous ruling that accept *Puget Sound* as is or modify the key characteristics therein described.⁵

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I.T. 1499
I-2 C.B. 189 (1922)

"This office has consistently held that, under the Treasury decision and articles of the regulations referred to, cooperative associations, even though not exempt from taxation, may deduct from gross income for the years 1917, 1918, 1919, and 1920 the amounts returned to their patrons, whether members or nonmembers, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them. In the case of purchases, instead of allowing a discount at the time of the purchase, the full price is collected and the discount is allowed by way of rebate. In the case of sales of produce furnished by patrons, the refunds based upon the quantity of produce furnished are in reality only part payment for the produce furnished. If the association is organized in accordance with the laws governing farmers' and other cooperative associations in the State in which it

⁵ For a collection of references, see Frederick, Donald A., and John D. Reilly. *Income Tax Treatment of Cooperatives: Background*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 1 (Oct. 1993), fns 70 - 72.

operates and if its constitution or by-laws provides for refunds or rebates to its patrons, whether members or nonmembers, upon the basis of goods purchased or produce furnished, or if it actually conducts its business upon such basis, the refunds or rebates so made may be deducted by the association in computing net income under the Revenue Acts of 1917 and 1918. It is to be understood, of course, that any profits made on business with nonmembers which may be distributed to members in the guise of rebates are taxable to the association and the members."

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Cooperatives designed and organized with tax advantages as their main reason for creation typically do not succeed. The main task facing the IRS, of course, is to separate the legitimate from the illegitimate with the paucity of specific, objective rules given in subchapter T. A number of IRS espoused rules have been struck down recently, leaving some concern about enforceability. However, as *Mississippi Valley Portland Cement* and Rev. Rul. 82-51 show, application of economic realities tests can be effective methodologies to judge business arrangement purposes and effects.

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Mississippi Valley Portland Cement Co. v. United States

408 F.2d 827 (5th Cir. 1969)

GOLDBERG, Circuit Judge:

The taxpayer, a nontax-exempt cooperative incorporated in Mississippi, sought to deduct distributions to its shareholders from its corporate income tax as "patronage dividends." 1/

[1/ See generally Clark and Warlich, *Taxation of Cooperatives: A Problem Solved*, 47 Minn.L.Rev. 997 (1963); Comment, *Taxation of Cooperatives Under 1962 Revenue Act*, 41 Tex.L.Rev. 908 (1963); cf. Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 Tex.L.Rev. 250 (1965).]

These payments were made from the corporation's net profits during the tax years in question. The district court, 280 F.Supp. 393, agreeing with the Commissioner, said that notwithstanding the cooperative camouflage, these payments were in reality no more than dividends paid to the corporation's shareholders, and held that they were not deductible as patronage dividends. 2/

[2/ Internal Revenue Code of 1954:

SEC. 1381. ORGANIZATIONS TO WHICH PART APPLIES.

(a) In General--This part shall apply to--

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) any corporation operating on a cooperative basis other than an organization--

(A) which is exempt from tax under this chapter.

(B) which is subject to the provisions of--

(i) part II of subchapter H (relating to mutual savings banks, etc.), or

(ii) subchapter L (relating to insurance companies), or

(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas

(26 U.S.C.A. s.1381)

SEC. 1382. TAXABLE INCOME OF COOPERATIVES.

(a) Gross Income--Except as provided in sub-section (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization.

(b) Patronage Dividends--In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year; or

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred. * * * For purposes of this title, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and as a deduction therefrom.

(26 U.S.C.A. s.1382).]

We, like the district court, cannot sanction a masquerade wherein a dividend is costumed in the habiliments of a patronage dividend. The judgment of the court below is affirmed.

I.

The relevant facts have been stipulated by the parties and may be summarized as follows:

The Mississippi Valley Portland Cement Company, the taxpayer, was incorporated in the State of Mississippi in 1956. Initially it issued 500,000 shares of stock, of which approximately 417,000 shares were issued to eight individuals, and the balance to their friends, relatives, and employees.

In 1957 it issued an additional 1,400,000 shares which it sold to the general public in four southern states, with approximately ninety percent being sold in Mississippi.

The taxpayer was organized as a cooperative under Mississippi law to manufacture and sell cement. Its charter, as amended, provided that the record owner of every five shares of stock had a preferred patronage right to purchase one barrel of cement during each fiscal year. ^{4/}

[^{4/} In the period of its corporate existence during which stock was being sold, the taxpayer filed registration statements with the Securities and Exchange Commission and with corresponding agencies of the State of Mississippi and several surrounding states. The prospectus, as included in the registration statements, stated that every stockholder had a patronage right to purchase cement in proportion to the amount of stock held and that such patronage rights were assignable.]

The stockholders and their assigns would have to buy the cement at the prevailing market price; but, to the extent that the sales price exceeded the cost of production and sale, patronage refunds would be paid to the stockholders annually in proportion to the amount of cement allocated to them or to their assignees.

Pursuant to authority conferred upon it by the corporate charter, the taxpayer's board of directors adopted resolutions in January of each relevant year, prior to the February 1 beginning of the taxpayer's fiscal year, allocating the plant's entire production of cement to the stockholder-patrons or their assigns on the basis of their stock ownership. These board resolutions also provided that any profit margins from the production

of cement should belong to the stockholder-patrons of record at the end of each fiscal year, and that they would be refunded as a patronage rebate, either in cash or reserve certificates. The taxpayer's obligation to produce cement and to allocate it to the shareholders was to be enforceable as a contract.

The resolutions additionally provided that sales of cement would be made to or for the account of Valley Cement Sales, Inc. 5/

[5/ The resolution adopted at the board meeting on January 17, 1962, provides in part as follows:

"7. Sales of cement will be made to or for the account of Valley Cement Sales, Inc., a Corporation organized as a sales agency for the benefit of stockholder-patrons who assign to it their patronage rights, at the market price to consumers less a quantity discount to be negotiated between the two Companies and the Company will rebate to Valley Cement Sales, Inc. in accordance with the total patronage rights of its assignors as covered in said assignments.

"8. Any cement produced and not taken by stockholders or their assignee by the 30th day of the month following production may be sold on the open market by Mississippi Valley Portland Cement Company for the account of its stockholder-patrons, as their interests may appear, or the Company may deliver such unclaimed cement to Valley Cement Sales, Inc. on the terms aforesaid."]

Valley Sales is a separate nontax-exempt cooperative corporation organized by several of Mississippi Valley Portland Cement Company's officers, directors, and stockholders as a sales agency for the stockholder-patrons. The taxpayer subsequently entered into contracts with Valley Sales whereby it assigned to the latter all patronage rights to cement produced by the taxpayer during the forthcoming fiscal year and not purchased by the stockholder-patrons or others. During the relevant year, all of the cement produced by the taxpayer was delivered to Valley Sales to be sold to the general public.

At the conclusion of each tax year, the net receipts from sales of cement over and above production costs were allocated and distributed by the taxpayer to its stockholders of record in proportion to each person's stock ownership as of the year's end. It was not shown that the taxpayer had any stockholders other than those designated by it as stockholder-patrons, or that it did any business except on behalf of its stockholder patrons.

In its income tax returns for its fiscal years ending January 31, 1962, 1963, and 1964, the taxpayer excluded the following amounts from its gross income as patronage dividends either allocated or paid to its stockholder-patrons:

* * *

As a result of these exclusions, the taxpayer reported no taxable income for these years. The Commissioner, in reviewing the taxpayer's return, determined that the distributions to share-holders did not qualify as patronage payments, and therefore that the taxpayer owed a total tax of \$505,561.97 for the three years in question.

The taxpayer paid the assessment and then sued in the district court for a refund of that amount. In holding that the Commissioner's assessment was correct and that the taxpayer was not entitled to a refund, the district court wrote as follows:

There is nothing in the method of doing business by the taxpayer in this case that distinguishes it from the average or normal corporation doing business for profit, no matter that the taxpayer is called a cooperative, or that the dividends to stockholders are referred to as patronage rebates. Other characteristics of this taxpayer akin to that of a corporation

for profit is that the dividends were payable only to stockholders of record at the end of each fiscal year, leaving stockholders, who might have sold their shares prior thereto, with no entitlement to a rebate on the basis of earnings during the fiscal year; and the fact that, as stipulated, actually no stockholder used the cement produced. All allocations were assigned to a sales agency or sold by that agency. As further stipulated, any allocations and delivery of cement to a patron were discouraged.

It is the opinion of this Court, after carefully scrutinizing the structure of this taxpayer and its method of doing business, that it was not doing business with its consumer patrons or assigns in the historical sense of a consumer cooperative, but that its stockholders are in no different category from that of any corporation interested in profits, no matter whether the source of that profit be from the production of cement or any other product, and that accordingly the sums paid here are not excludible from taxable income.

II.

The sole question presented by this appeal is whether the district court erred in holding that the taxpayer's distribution of its net profits in the years in question could not be categorized as patronage dividends. 6/

[6/ We agree with the taxpayer's argument that a patronage dividend is an item which is "excluded" rather than "deducted" from the taxpayer's gross income. This distinction, while peripheral to the merits of this case, is not unimportant. A taxpayer has a far more difficult burden in trying to prove that he is entitled to a deduction, which is allowed as a matter of legislative grace, than he does in showing that a distribution is not income. See Davis v. United States, 2 Cir. 1937, 87 F.2d 323, cert. denied, 301 U.S. 704, 57 S.Ct. 937, 81 L.Ed. 1359.

We find that both the cases and a literal reading of the Code to support the taxpayer's contention that patronage payments are properly termed "exclusions." In Farmers Cooperative Co. v. Birmingham, N.D. Iowa, 1949, 86 F. Supp. 201, 217, we read:

Some confusion apparently exists as to whether a patronage dividend is properly termed a 'deduction' or an 'exclusion' from cooperative gross income. It is in fact considered by the Treasury Department as an exclusion from gross income. G.C.M. 17895, C.B. 1937-1, 56; I.T. 3208, C.B. 1938-2, 127. It is believed that the use of the term 'exclusion' instead of 'deduction' makes for clarity. See Bradley, Taxation of Cooperatives, Harvard Business Review 576, 577 (Autumn, 1947).

See also United States v. Mississippi Chemical Co., 5 Cir. 1964, 326 F.2d 569, 574-575; cf. Pomeroy Cooperative Grain Co. v. Commissioner of Internal Revenue, 8 Cir. 1961, 288 F.2d 326.

Section 1382 of the Code, enacted in 1962, generally incorporates prior case law regarding patronage payments and in particular incorporates the judicial labeling of such distributions as exclusions. Section 1382 in relevant part provides that "the gross income of any organization to which this part applies shall be determined without any adjustment * * * by reason of any allocation or distribution to a patron out of the net earnings of such organization." The intent to treat these payments as exclusions could not be clearer if Congress had used the word "exclusion." We therefore approach the question sub judice in full recognition of the burden of proof arising out of the exclusionary nature of patronage dividends.]

To answer this question we look first to the statutory definition of a "patronage dividend." Section 1388(a), as added by the Revenue Act of 1962, provides:

(a) Patronage Dividend.--For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies--

(1) on the basis of quantity or value of business done with or for such patron.

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. [Emphasis added.] [26 U.S.C.A. s.1388]. 7/

[7/ Sections 1381 et seq. did not become operative until December 31, 1962. Thus, technically speaking, s.1388 is applicable only to the last of the three tax years involved in this appeal. With respect to the definition of a patronage distribution, however, sections 1381 et seq. are merely a codification of prior case law. See 1962 U.S. Code Cong. and Adm. News, p.3414 ff; cf. Pomeroy Cooperative Grain Company v. Commissioner of Internal Revenue, 8 Cir. 1961, 288 F.2d 326 (discussion of prerequisites to excludability of patronage payments); Farmers Cooperative Co. v. Birmingham, N.D. Iowa 1949, 86 F. Supp. 201 (discussion of prerequisites to excludability of patronage payments and history thereof). Our construction of s.1381 will, therefore, be made in light of the preexisting case law; and our result, although discussed in statutory terms, should be considered as based on pre-section 1388 case law insofar as the first two tax years are concerned. In short, the statutory and the preexisting judicial expositions of the necessary elements of a patronage dividend are identical, and the result in this case would be the same under either.]

Of particular importance to the disposition of this case is the language requiring that the distribution be made out of earnings from "business done with or for patrons." The Commissioner would have us construe the words "with or for" to mean that the patrons must physically handle the products of the cooperative. The taxpayer, on the other hand, argues that neither the statute nor the cases have imposed such a physical contact requirement. We note that in most bona fide cooperative arrangements the patron does in some manner actually touch the subject matter of the transactions. For example, a marketing cooperative usually sells to the general public commodities or products of the patron, and a purchasing cooperative usually purchases items to be used or consumed by the patron. cf. American Box Shook Export Ass'n v. Commissioner of Internal Revenue, 9 Cir. 1946, 156 F.2d 629; Farmers Cooperative Co. v. Birmingham, N.D. Iowa 1949, 86 F. Supp 201, 210-217. Extending the syllogism, a manufacturing cooperative should usually, but not always, consume or otherwise physically use the product of the cooperative. cf. Fruit Growers' Supply Co. v. Commissioner of Internal Revenue, 9 Cir. 1932, 56 F.2d 90. Thus, evidence that the patron actually used the product points logically to the conclusion that the business was conducted "with or for" such patron. Conversely, the absence of such evidence would support, but not compel, a conclusion to the contrary.

Since the absence of patron contact with the cement is not decisive, we must delve more deeply into the record. All of the cement produced by the taxpayer was allocated to the shareholder-patrons at the beginning of each fiscal year by a resolution of the board of directors. These resolutions gave the shareholder-patrons the option of either physically taking the cement or, by inaction, allowing their share to be assigned to a sales agency which would sell the cement to the general public in their behalf. In practice, instances of shareholder-patrons actually taking cement from the plant were almost non-existent and virtually all of the cement was assigned to the sales agency. Counsel for the taxpayer explained this circumstance by

saying that the patrons had to be discouraged from picking up cement at the plant because their small orders were too disruptive of plant operations.

Thus, generally speaking, the stockholder-patrons never had any actual use for or contact with the product of their corporation. The closest they came to the cement was to receive a right to X-number of barrels of cement which was semi-automatically assigned to a sales agency. 8/

[8/ In the record we find the following stipulations:

"11. Approximately 90% of the stock of Mississippi Valley Portland Cement Company was represented by executed assignments to Valley Cement Sales in 1960, when the company began production of cement. All stockholders received the same pro-rata distributions whether assignments were executed or not, at times pertinent to this suit.

"12. In the years ended January 31, 1962-1964, inclusive, the entire amount of production had by Mississippi Valley Portland Cement Company was, in accordance with properly executed assignments on the part of its stockholder-patrons, or in accordance with the provisions of the Charter and resolutions of its Board of Directors as aforesaid, delivered by Mississippi Valley Portland Cement Company to Valley Cement Sales, Inc."]

Pointing to this circumstance, the Commissioner contends that the stockholder-patrons used the cement only for the purpose of gaining a return on their investment in the corporation and that such returned earnings are in economic substance no different from the dividends paid by a typical corporation to its shareholders. He argues that the allocations and assignments of cement were merely paper transactions devoid of economic substance and that their only function was to enable the taxpayer to pass its net profits on to its shareholders without such profits ever being included in the corporation's gross income under s.61 of the Code. 9/

[9/ s.61. Gross income defined [26 U.S.C.A. s.61]

(a) General definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- similar items;
- (1) Compensation for services, including fees, commissions, and
 - (2) Gross income derived from business;
 - (3) Gains derived from dealings in property;
 - (4) Interest;
 - (5) Rents;
 - (6) Royalties;
 - (7) Dividends;
 - (8) Alimony and separate maintenance payments;
 - (9) Annuities;
 - (10) Income from life insurance and endowment contracts;
 - (11) Pensions;
 - (12) Income from discharge of indebtedness;
 - (13) Distributive share of partnership gross income;
 - (14) Income in respect of a decedent; and
 - (15) Income from an interest in an estate or trust.]

The thrust of the Commissioner's argument is that this Court should characterize these transactions as sham transactions, and should hold that the taxpayer's profits were really earned from sales of cement to the general public. The result of such a holding would be that the corporation's profits would not be from

business done "with or for" its patrons, and therefore that such dividends would not be excludible from its corporate income as patronage dividends. 10/

[10/ In the legislative history of the Revenue Act of 1962 we find the following commentary on the meaning of "business done with or for patrons":

It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend. 1962-3 Cum. Bull. 707-721; 1962-2 U.S. Code Cong. and Adm. News, p.3620.]

See Rev. Rul. 57-59.

11/ We have lifted the cooperative veil and have unmasked the economic realities of these transactions.

[11/ It is well established that "our income tax law is premised on fact and not fiction." Blackstone Realty Co. v. Commissioner of Internal Revenue, 5 Cir. 1968, 398 F.2d 991, 996. While a taxpayer is free to arrange his business with an intent to avoid or minimize taxes, his transactions are to be analyzed for their pragmatic realities. *Id.* As we stated in Redwing Carriers, Inc. v. Tomlinson, 5 Cir. 1968, 399 F.2d 652, 657, "both the Supreme Court and our Court have on numerous occasions stated that when the realities of a transaction differ from its paper shell, the Internal Revenue Service and the courts may open the shell and look inside to determine the substance of the transaction." In Higgins v. Smith, 1940, 308 U.S. 473, 60 S. Ct. 355, 358, 84 L.Ed. 406, 411, the Supreme Court wrote:

A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.

On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.

Thus in the case at bar we must examine the record to determine the economic substance of the allocations of cement to the stockholder-patrons. While the taxpayer's transactional documentation including registration statements is relevant, it is not a controlling indicant of economic reality.]

Our conclusion is that the taxpayer's shareholders were no more than paper patrons, and "that the distribution to stockholders was nothing more than a dividend paid out of profits of the corporation." Peoples Gin Co., Inc. v. Commissioner of Internal Revenue, 5 Cir. 1941, 118 F.2d 72, 73. The corporate conspectus and prospectus show that the taxpayer's business was selling cement to the general public. Its shareholders were merely investors and non-essential links in a conduit to the outside, not consumers of the corporate product. The distributions to these shareholders, therefore, represented profits from corporate dealings with

the general public and should be taxed accordingly. See Smith & Wiggins Gin, Inc. v. Commissioner of Internal Revenue, 5 Cir. 1965, 341 F.2d 341, 347-351.

Although our finding that the taxpayer's shareholders were pseudo-patrons is based upon an examination of the record as a whole, we find two factors in this case to be particularly elucidative of the true nature of the distributions. First, the resolutions adopted by the taxpayer's board of directors, which is quoted in part in footnote 5, supra, shows the corporate intent and potential for open market operations. By providing for pre-packaged semi-automatic assignments of the taxpayer's entire production, these corporate documents showed that the corporate purpose was not to supply its shareholders with cement at a reduced cost but to supply them with a return on their invested capital. Although they contained words which allocated the cement in kind, the resolutions had the practical effect of both channeling the cement to its ultimate consumers and declaring a dividend on the basis of such sales. These allocations were phantoms, and the shareholders were pseudo-purchasers. Thus, the true measure of the so-called patronage dividend was not how much cement the paper patron consumed, but rather how much the taxpayer earned by selling to others.

The second revealing circumstance is the absence of horizontal similitude among the stockholder-patrons. In the usual manufacturing cooperative situation, the patrons have a fraternal commercial relationship with respect to the business of the cooperative and its products other than as investors. For example, in Fruit Growers' Supply Co. v. Commissioner of Internal Revenue, supra, the cooperative "manufactured lumber and shook for the manufacture of packing boxes for the marketing of the fruit" for its patrons. 56 F.2d at 91. The patrons were fruit growers who had formed the cooperative to facilitate the procurement of fruit packing boxes at a minimum cost, and they clearly had a fraternal commercial relationship. In the case of a cement manufacturing cooperative it would be logical to expect that its patrons would be contractors, builders, and others with related occupations. Here, however, the businesses and professions of the principal shareholders are diverse: accounting, law, automobiles, construction, engineering, public relations and textiles. It would be a travesty to regard this variegated and disparate conglomerate of shareholders as being cement oriented and connected. The only thing these shareholders had in common was an investment in what they hoped would be a money making venture, and in this respect their relationship to each other and to the corporation was no different from that of shareholders in any other publicly held corporation.

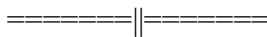
Notwithstanding the preceding, the taxpayer argues that this Court's opinion in United States v. Mississippi Chemical Co., 5 Cir. 1964, 326 F.2d 569, compels a holding that its distributions to its shareholders were "patronage dividends". We have carefully studied both the opinion of our Court and that of the lower court in that case, 197 F.Supp. 490, and we have found nothing in either opinion which deals with what constitutes a bona fide patronage dividend, the issue at bar. In fact the Court's opinion begins with the assumption that the distributions to shareholders were bona fide patronage dividends. The only issue raised in Mississippi Chemical was the manner in which patronage dividends were to be computed. That issue was summarized by Judge Hutcheson as follows:

"The basic contention of the appellant [The Commissioner}, which was decided against it in the district court, is that the sole method of computation of the patronage dividends claimed in this case is that prescribed in the formulas laid down in Bureau rulings, decisions, and memorandums, and that no other method may be used."

Thus, we conclude that Mississippi Chemical is not controlling here.

The taxpayer attempted to clothe its shareholders as patrons and its corporate dividends as patronage payments. Like the district court, we find that the patronage vestments do not fit and therefore the taxpayer's distributions of net profits to its shareholders did not result from "business done with or for patrons." The generation of business is usually the result of positive action, but here the transactions attributed to the paper patrons resulted from inaction. The taxpayer's shareholders never had any actual contact with their allocations of cement; they arranged the corporate apparatus to sell cement to the general public; and they had no commercial fraternal relationship other than as investors. In economic substance the taxpayer's

distributions were the same as ordinary corporate dividends, and consequently they could not be excluded from the taxpayer's gross income.



Revenue Ruling 82-51
1982-1 C.B. 117

ISSUES

1. Is the taxpayer described below operating on a cooperative basis within the meaning of section 1381(a)(2) of the Internal Revenue Code?
2. Must the taxpayer include in gross income any amounts returned to its members according to their marketing agreement?

FACTS

The taxpayer is a corporation engaged in an integrated poultry operation. The taxpayer, organized to function as a nonexempt cooperative, was established by seven individuals who merged and consolidated their poultry production activities. The seven individuals received common stock in exchange for their farming assets. As a result of this exchange, the shareholders no longer directly engage in the active conduct of poultry operations with regard to functions being carried on by the taxpayer.

The taxpayer owns a breeder flock from which it sells chicks to its shareholder-members in proportion to their stock ownership. Only shareholders may be members of the cooperative and only members may purchase the chicks. The taxpayer retains a security interest in the flocks sold and uses personal recourse notes received as payment from its members as security for bank loans and operating funds.

When the chicks are sold, they are segregated and identified according to the member who has legal title to them. The taxpayer delivers the chicks to independent contract growers who have contracts with the individual members. These contracts are negotiated by the taxpayer, which also supervises and pays the contract growers.

The feed, medicine, and fees provided by the taxpayer to the contract growers are charged to the members' accounts. The taxpayer operates this supply function at cost.

At the end of the grow out period, the taxpayer repurchases the chickens from the members at a price equal to the current market quotation. The taxpayer receives the chickens from the contract growers and processes them for their final sale. Until the chickens are delivered to the taxpayer, the risk of loss, according to the marketing agreement, remains with the member who purchased the chicks.

After the taxpayer markets the chickens, the member receives a settlement sheet showing the total sales price. This figure is offset by the amount of advances recorded on the taxpayer's books as having been made to members for their particular flock. The taxpayer's method of operation usually results in a small profit or loss over the settlement sheet amounts determined during the year. Losses are allocated on a patronage basis to members and are used to offset any profits in the next grow out period. Profits are allocated by the taxpayer on its books and are used to offset advances to the members in the next grow out period. The taxpayer has never declared or paid a patronage dividend to its members.

LAW AND ANALYSIS

Section 1381(a)(2) of the Code provides that subchapter T applies to any corporation operating on a cooperative basis, with certain enumerated exceptions.

Section 1382(a) of the Code provides that, except as provided in section 1381(b), the gross income of any organization to which this part applies is determined without any adjustment by reason of any allocation or distribution to a patron out of the net earnings of the organization or by reason of any amount paid to a patron as a per-unit retain allocation.

Section 1381(b) of the Code provides that patronage dividends, as defined in section 1388(a), paid during the payment period for the tax year are not taken into account in determining taxable income.

Section 1388(a) of the Code defines a patronage dividend as an amount paid to a patron: (1) on the basis of the quantity or value of business done with or for the patron; (2) under an obligation of the organization to pay such an amount, the obligation having existed before the organization received the amount so paid; and (3) that is determined by reference to the net earnings of the organization from business done with or for its patrons. A patronage dividend does not include any amount paid to the patron to the extent (A) such an amount is out of earnings other than from business done with or for patrons, or (B) such an amount is out of earnings from business done with or for patrons to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.

Section 1.1388-1(e) of the Income Tax Regulations states that the term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association.

In Mississippi Valley Portland Cement Company v. United States, 408 F. 2d 827 (5th Cir. 1969), the court denied a purported cooperative a deduction from its corporate income tax for patronage dividends. The taxpayer's method of doing business was indistinguishable from the normal corporation doing business for profit, even though the taxpayer was called a cooperative, and the dividends were referred to as patronage rebates. The payments were in reality no more than dividends paid to the taxpayer's shareholders, who were no more than paper patrons. The shareholders never had any actual contact with the cement sold by the cooperative. Therefore, the taxpayer's distribution did not result from business done with or for patrons.

In determining whether a distribution is made out of the earnings from business done with or for patrons, the court in Mississippi Valley noted that in most bona fide cooperative arrangements the patron does in some manner actually touch the subject matter of the transaction. Thus, evidence that the patron actually used or produced the commodities points logically to the conclusion that the business was conducted with or for this patron. Conversely, the absence of this type of evidence would support a conclusion to the contrary.

The court in Mississippi Valley, in reaching the conclusion that the taxpayer's shareholders were no more than paper patrons and that the distributions to its shareholders were nothing more than a dividend paid out of profits of the corporation, indicated that the shareholders were nonessential links in a conduit to the outside, not customers of the corporation, and that the distributions to these shareholders represented profits from corporative dealings with the general public and should be taxed accordingly.

Although in the present situation the member-stockholders were all involved in poultry production prior to the formation of the taxpayer, whereas in Mississippi Valley the member-stockholders came from diverse occupations and professions, the two cases are otherwise similar. The taxpayer initially owns the chicks that are sold to its members who are also shareholders. Although legal title to the chicks belongs to these member-shareholders, the sales transaction lacks economic substance. The member-shareholders take no action with respect to the chicks. Rather, it is the taxpayer who contracts and supervises the growth of the chicks done by the contract growers. The taxpayer even provides the necessary supplies to the contract growers. In addition, the taxpayer handles the subsequent sale of the chickens. The functions performed by the taxpayer are consistent with a corporation-shareholder relationship but not consistent with a cooperative-patron relationship. There is no business or economic reason to sell the chicks to the member-shareholders other than to try to secure for the member-shareholders the status of a patron. The member-shareholders are nonessential links to the outside and not consumers of the corporate products. In reality, the taxpayer's method of doing business is indistinguishable from the normal corporation doing

business for profit, even though the taxpayer calls itself a cooperative. Any distributions to the member-shareholders are merely dividends paid to its shareholders.

HOLDING

1. The taxpayer described above is not operating on a cooperative basis within the meaning of section 1381(a)(2) of the Code.
2. The taxpayer is subject to tax at the corporate level on any amounts returned to its members according to their marketing agreement.

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Given that the main interest of the Code is the determination of taxes to be paid related to earned income and how that income is distributed, it is not surprising that the focus of cooperative definition is on its income distribution characteristics. The following section on the 50 percent rule addresses the issue in a somewhat different context. See also *Ford-Iroquois FS, Inc. v. Comm'r*, 74 T.C. 1213 (1980) and the decisions on cooperative losses below.

C. The 50 Percent Rule

For many years the IRS went unchallenged in its proposition that to be operating on a cooperative basis a cooperative had to conduct at least 50 percent of its business with members. Litigation led to the following opinion.

=====||=====

Conway County Farmers Ass'n v. United States

588 F.2d 592 (8th Cir. 1978), *rev'g*, 1978-1 U.S.T.C. P.9334 (E.D. Ark. 1978)

Appeal by plaintiff, Conway County Farmers Association (CCFA), from summary judgment of the District Court for the Eastern District of Arkansas (The Honorable Myron H. Bright, Circuit Judge, sitting by designation) favoring the United States (government), and dismissing with prejudice CCFA's complaint for refund of federal income taxes of \$8,020.31, plus interest, paid for fiscal years 1970 and 1971. 1/

[1/ Reported at 78-1 U.S.T.C. P.9334 and 41 AFTR 2d 78-1052. The district court held a hearing on cross motions for summary judgment, dictated findings and conclusions from the bench, and entered written findings and conclusions after receipt of post-hearing briefs.]

CCFA, a nonexempt cooperative, was denied deduction of patronage dividends because it did more than 50% of its business with nonmembers. We reverse.

Background

The material facts appear in the uncontested findings of the District Court and the parties' fact stipulation.

CCFA is an Arkansas agricultural cooperative association engaged primarily in the sale of agricultural supply products. It was organized in 1949 under Act 153 of 1939, as amended (Ark. Stat. Ann. s.s.77-1001 through 1027) (the enabling legislation for agricultural cooperative associations), with its principal place of business in Morrilton, Conway County, Arkansas. CCFA is not now "exempt" from federal income taxation as a farmers' cooperative organization under Internal Revenue Code (I.R.C.) s.521 (26 U.S.C. s.521). 2/

[2/ s.521. Exemption of farmers' cooperatives from tax

(a) Exemption from tax

A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) Applicable rules

(1) Exempt farmers' cooperatives

The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

* * * *

(4) Transactions with nonmembers

Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.]

CCFA had been exempt before November 30, 1969 (the end of its fiscal year), but it voluntarily surrendered that status and now operates as a "nonexempt" cooperative.

Though the stipulated facts describe CCFA as "an agricultural supply cooperative," its Amended Articles of Incorporation describe it as both a purchasing and marketing cooperative:

ARTICLE II

THE ASSOCIATION IS FORMED FOR THE FOLLOWING PURPOSES:

To purchase, acquire, distribute, and sell for and to members any or all agricultural products produced by the members or any products derived from processing of agricultural products produced by the members and to engage in any activity in connection with the picking, gathering, harvesting, receiving, assembling, handling, grading, standardizing, packing, preserving, drying, processing, transporting, storing, financing, advertising, selling, marketing and distributing of any agricultural products delivered by its members or any of the products derived therefrom. To purchase for its members seed, feed, [etc.] and to conduct any other business authorized or allowed to associations organized under [enabling Act], all on a cooperative basis for the mutual benefit of members, and other patrons as producers of agricultural products. 3/

[3/ Article II also provides:

This Association may handle any or all of the above products, either by purchases or sale, of non-members of the Association provided that the Association shall not deal in the products of non-members to an amount greater in value than such as are handled by it for its members.

That CCFA did not amend its Articles, following surrender of its tax-exempt status, and that it may have operated beyond its charter in 1970-71, are not relevant to the issue here.]

Membership in CCFA may be obtained, on application, by any agricultural producer or person having a farm income from crop rent. Members must (1) purchase a \$10 common stock certificate, (2) refrain from competing with CCFA, and (3) trade with CCFA. Members must also agree that distributions with respect to patronage or volume of business conducted with CCFA shall be treated as required by I.R.C. ss.1383 and 1385 (26 U.S.C. ss.1383 and 1385).

The authorized capital stock of CCFA consists of common stock, owned by the members, and two classes of preferred, noncumulative, nonvoting stock. Net income is first allocated to preferred stock in an amount not to exceed 6% of its par value. Income attributable to business with nonmembers is set aside as a tax-paid reserve. Remaining net income is allocated to member patrons in proportion to the volume of business each conducted with CCFA during the fiscal year.

For fiscal years ended November 30, 1970, and November 30, 1971, CCFA conducted a greater volume of business with nonmembers than with members: 4/

[4/ Nothing said in the course of determining the statutory requirement for treatment of patronage dividends in this tax-refund suit bears any relation to compliance with federal antitrust laws by cooperatives whose members agree not to compete, and which fail to meet the quantitative requirement for exemption of marketing cooperatives under 7 U.S.C. s.291. Such circumstances would indicate, however, that the fact situation giving rise to the present case is likely to be extremely rare.

Fiscal Year Ended	Nonmember Business	Member Business	Total Business	% Nonmember Business
-----	-----	-----	-----	-----
11/30/70	\$493,196	\$320,303	\$813,499	61%
11/30/71	\$564,176	\$354,968	\$919,144	62%

For 1970 and 1971, CCFA filed corporation income tax returns (IRS Form 1120) claiming deductions for patronage dividends paid to members in the amount of \$14,520 and \$5,465, respectively. Upon audit, the Internal Revenue Service (IRS) ruled that CCFA was not entitled to deductions for patronage dividends and assessed deficiencies of \$6,818 for 1970, and \$1,202.31, for 1971.

CCFA paid the assessed deficiencies, plus interest. Its administrative claims for refund having being denied, it instituted this suit under 28 U.S.C. s.1346(a)(1).

The District Court

The district court concluded that "[t]he question whether [CCFA] is entitled to the tax benefits available to organizations under Part I of Subchapter T of the Internal Revenue Code of 1954 depends on the interpretation of the term 'operating on a cooperative basis'" in I.R.C. s.1381(a)(2) (26 U.S.C. s.1381(a)(2)). 5/

[5/ s.1381. Organizations to which part applies

(a) In general

This part shall apply to--

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) any corporation operating on a cooperative basis other than an organization--* * * [Emphasis added.]]

Citing Revenue Ruling 72-602, 1972-2 Cum. Bull. 511, 6/

[6/ Rev. Rule 72-602 states in part:

Section 1381(a)(2) of the Code indicates that Part I of Subchapter T of the Code, which governs the taxation of cooperatives, applies to any corporation "operating on a cooperative basis." Fundamental to "operating on a cooperative basis" is a mutual joinder of interests in the risks and benefits of the organization. Subchapter T does not preclude a nonexempt cooperative from dealing with nonmembers on a for-profit basis. There is no requirement that in order for an organization to obtain the benefits of a non-exempt cooperative under Subchapter T that both members and nonmembers be treated equally. If, however, a cooperative does operate on a for-profit basis with its nonmembers then in order for it to be considered a corporation "operating on a cooperative basis" for purposes of section 1381(a)(2), it must do more than 50 percent in value, of its business with members. [Emphasis added.]]

the district court held that to be considered a "corporation operating on a cooperative basis" under s.1381(a)(2) an organization must do more than 50% of its business with members. On the basis of that Ruling and the historical nature of "cooperatives," the lower court concluded that CCFA, by conducting the majority of its business during fiscal years 1970 and 1971 with nonmembers, failed to qualify as a cooperative for federal income tax purposes and, therefore, the patronage dividends 7/

[7/ The term "patronage dividend" is defined in I.R.C. s.1388(a) (26 U.S.C. s.1388(a)):

s.1388. Definitions; special rules

(a) Patronage dividend

For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies--

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.]

paid to its member-stockholders were not deductible under I.R.C. s.1382(b) (26 U.S.C. s.1382(b)). 8/

[8/ s.1382. Taxable income of cooperatives

* * *

(b) Patronage dividends and per-unit retain allocations

In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d))) with respect to patronage occurring during such taxable year; * * * *

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) * * *, be treated in the same manner as an item of gross income and as a deduction therefrom, * * *.]

The district court further concluded that "[i]nasmuch as [CCFA] does not qualify for treatment as a cooperative organization under the federal income tax laws, [CCFA] must be treated for tax purposes as an ordinary for-profit corporation."

CCFA had argued that, if all of its operations were to be taxed as though made for profit, the "patronage dividends" 9/

[9/ The government's brief concedes that the payments CCFA made to its member-patrons "met the requirements for deductibility contained in Code Sections 1382 and 1388," and were thus "true patronage dividends."]

should be deductible as "ordinary and necessary business expenses" under I.R.C. s.162 (26 U.S.C. s.162). The district court denied that claim, "inasmuch as there is no evidence of any profit-making intention of [CCFA] in making such payments."

The Issue

The dispositive question of law on appeal is whether CCFA was an organization "operating on a cooperative basis" within the meaning of Subchapter T, I.R.C. s.1381(a)(2), supra, note 3. 10/

[10/ We need not reach the question of whether the patronage dividends were deductible as "ordinary and necessary expenses" under I.R.C. s.162. The apparent anomaly is noted, however, in a denial of tax treatment of particular transactions as patronage dividends because of the nature of the organization, regardless of the nature of the transaction, and denial of tax treatment of the same transactions as ordinary and necessary expenses because of the nature of the transaction, regardless of the nature of the organization. A nonexempt cooperative doing 51% in value of its transactions with members, has the 49% of its transactions with nonmembers taxed on a for-profit basis. In the present case, the 60% of business done with nonmembers will be taxable on a for-profit basis. A nonexempt cooperative doing 99% in value of its business with nonmembers would have all of those transactions taxed on a for-profit basis. Tax treatment based on the nature of a cooperative's transactions would have at least the merit of placing substance over form. See, in another context, Frank Lyon Co. v. United States, 435 U.S. 561, 572-73, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978).]

OPINION

As the district court stated from the bench, this "case is really one of first impression" involving a "close question." The business transactions of the earliest cooperatives were conducted entirely with or for their members alone, and none of those transactions was taxed. When cooperatives began to do some business with nonmembers, the tax-exemption of all their transactions was continued for a few years. Congress then enacted the predecessor of 26 U.S.C. s.521, * * * limiting total tax-exemption to cooperatives meeting certain criteria, including a requirement that they do more than 50% of their business in value with members. Nonexempt cooperatives thereafter had their transactions with nonmembers taxed on a for-profit basis and their transactions done with members taxed on a cooperative basis, *i.e.*, patronage dividends to members were deducted (on the apparent theory that the moneys involved had never in reality belonged to the organizations). 11/

[11/ The government says "policies behind the taxation of tax-exempt cooperatives are relevant to measuring legislative intent behind taxation of nonexempt cooperatives" in arguing that the intent is the same. We find to the contrary.]

It is uncontested that Congress intended "patronage dividends" to be deductible. I.R.C. s.1382(b), *supra* note 8.

In 1972, a cooperative marketing a single product for 10 members and 90 nonmembers sought a revenue ruling. Because the 10 members were large producers, the value of the member business comprised over 75% of the total. The specific question was whether the cooperative qualified under Subchapter T, in view of its doing 90% of its business transactions with nonmembers. The IRS, in Revenue Ruling 72-602, * * * found the number of transactions irrelevant, the criteria being the value of business done. The cooperative was found qualified because 75% of its business in value was done with members. The IRS, however, went beyond the facts presented to it and, by way of dictum, interpreted the words "operating on a cooperative basis" in s.1381(a)(2) as a requirement that a cooperative must do more than 50 percent in value of its business with members.

Thus, determination of the issue requires statutory interpretation. That function was described by the Court in *United States v. Amer. Trucking Ass'ns.*, 310 U.S. 534, 542 (1940): "It is to construe the language so as to give effect to the intent of Congress."

In giving effect to congressional intent, the relevant provisions of the same revenue act, here Subchapter T, 12/

[12/ Subchapter T was added to the Internal Revenue Code of 1954 by s.17 of the Revenue Act of 1962, Pub.L. 87-834, 76 Stat. 960, 1045 (October 16, 1962).]

must be considered as an entirety, not in isolation. * * * We begin with the unquestioned congressional intent that admittedly true patronage dividends, such as those here involved, should be deductible by an organization "to which this part applies." s.1382(b). The issue is whether that intent is broad enough to include such patronage dividends when an organization does more business in value with nonmembers than with members, *i.e.*, whether Congress intended that circumstance alone should render Part I inapplicable and make patronage dividends actually paid non-deductible.

In determining whether an exception was intended by Congress to the deductibility of patronage dividends, the relevant provisions of Subchapter T are the two paragraphs of s.1381(a) making Part I of that subchapter applicable to two types of organizations: s.1381(a)(1) defines the first type as "any organization exempt from tax under section 521 * * * ;" s.1381(a)(2) defines the second type as "any corporation operating on a cooperative basis other than an organization [specifying exceptions immaterial here]." (Emphasis added.) 13/

[13/ On different facts, courts have faced the "operating on a cooperative basis" question. *Brookings Plywood Corp. v. United States*, 78-1 U.S.T.C. P.9103, 40 AFTR 2d 77-6119

(D.Ore. 1977), involved a nonexempt worker-owned cooperative, contending it was not "operating on a cooperative basis" because no patronage allocations to stockholder-employees were made in its records, no patronage dividends were paid, and the by-law requiring patronage dividends had been retroactively abolished. The court agreed. Farmers Union Marketing & Processing Assn. v. United States, 77-1 U.S.T.C. P.9213, 39 AFTR 2d 77-9631 (D.Minn.1977), involved an agricultural cooperative, contending it was not "operating on a cooperative basis" because during two years in which it had net losses, no patronage dividends were paid. The court disagreed, holding that the test is not whether the cooperative actually paid patronage dividends but whether it would have been obligated to do so if it had made a profit. In both cases the phrase "operating on a cooperative basis" was interpreted without reference to the relative amount of business in value done with members and nonmembers. Indeed, both cases turned on whether patronage dividends were paid or owed.]

To meet the "exempt from tax under section 521" language of s.1381(a)(1), an organization must meet certain organizational, operational, and quantitative requirements. The s.521 organization is required to be: (1) "organized * * * on a cooperative basis" (s.521(b)(1)), (2) "operated on a cooperative basis" (s.512(b)(1)), and (3), with respect to the quantitative requirement (transactions with nonmembers), "[e]xemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members * * * " (s.521(b)(4)).

The s.1381(a)(2)-type organization is defined solely in terms of an operational requirement: "operating on a cooperative basis." In marked contrast to s.1381(a)(1)'s incorporation of s.521, Congress did not require that s.1381(a)(2)-organizations transact more business with members than with nonmembers. 14/

[14/ The government erects a straw man in arguing that AT&T and General Motors could deduct payments to their customers or suppliers who are also stockholders if its position is not upheld. Such payments would not be to "members" and would not be the "true patronage dividends" involved here. Moreover, AT&T and General Motors are to no extent "operating on a cooperative basis." Nor are they likely, in view of federal antitrust law, to enter exclusive-dealing and non-competing agreements with any customers or suppliers. In all events, the IRS and the courts would have no difficulty in finding that such corporations were not "operating on a cooperative basis." See, for examples of cases denying claims to cooperative status by organizations at least ostensibly so operating, Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827 (5th Cir.), cert. denied, 395 U.S. 944, 89 S.Ct. 2015, 23 L.Ed.2d 462 (1969), and Druggists' Supply Corp. v. Commissioner, 8 T.C. 1343 (1947).]

That CCFA is "organized" on a cooperative basis is unquestioned. That it is "operating" on a cooperative basis is unquestioned, except for the amount of business done with nonmembers. If "operated" on a cooperative basis required that over 50% of business be done with members, the third requirement of s.521 would be superfluous. It is well established that statutes will not be interpreted as though Congress enacted superfluous provisions.

Significance resides not only in Congress' inclusion of a quantitative requirement in s.1381(a)(1), and the absence thereof from the very next paragraph of the statute, but in the facility with which Congress has often stated quantitative requirements when it so intended. See, e.g., (1) 7 U.S.C. s.291 (quantitative requirement in definition of cooperative in Capper-Volstead federal antitrust exemption); (2) 12 U.S.C. s.1141j(a) (quantitative requirement in definition of cooperative for farm credit purposes); (3) 12 U.S.C. s.2129 (quantitative requirement in definition of cooperative for borrowing from bank for cooperatives); (4) 49 U.S.C. s.303(b) (quantitative requirement in definition of cooperative for ICC exemption); and (5) 12 U.S.C. s.3015 (s.105(a), Pub. L. 95-351, 92 Stat. 499, 506 (August 20, 1978)) (quantitative requirement in definition of cooperative in National Consumer Cooperative Bank Act).

The sole basis for the government's contention that CCFA was not "operating on a cooperative basis," lies in CCFA's having conducted more than 50% of its business with nonmembers in fiscal years 1970 and 1971. The government further argues that its Rev. Rul. 72-602, correctly interpreted s.1381(a)(2), because a "true cooperative" must operate "primarily" on a cooperative basis to obtain the Subchapter T patronage dividend deduction, that is, "the cooperative must do over 50 percent in value of its business with members on a patronage dividend (i.e., nonprofit) basis."

The words of statutes, including the tax laws, "should be interpreted where possible in their ordinary, everyday senses." Crane v. Commissioner, 331 U.S. 1, 6 (1947) (footnote omitted). Absent a contrary indication somewhere in the statute, the ordinary meaning of "operating on a cooperative basis" includes the conduct of some operations on a cooperative basis. In its dealings with its members, CCFA was necessarily "operating on a cooperative basis." That it was also operating on a for-profit basis, in its dealings with nonmembers, does not change the nature of its cooperative-type operations. The wording of s.1381(a)(2) is broad and comprehensive, reflecting a broad intent of Congress. It would do violence to that intent to read the statute, as the government would have us do, as though it contained words not present, i.e., as though it read "operating primarily on a cooperative basis." 15/

[15/ Congress employed the very term defining cooperatives eligible for loans from the National Consumer Cooperative Bank:

* * * chartered or operated on a cooperative, not-for-profit basis for producing or furnishing goods, services or facilities, primarily for the benefit of its members *
* * . [Emphasis added.]

Sec. 105(a), National Consumer Cooperative Bank Act, supra.]

Congress having inserted no quantitative requirement in s.1381(a)(2), after having done so in s.1381(a)(1) and in so many other acts dealing with cooperatives, neither we nor the IRS are at liberty to make that insertion in s.1381(a)(2).

Determination that the language of the statute itself imposes no quantitative requirement may be viewed as putting an end to inquiry. The statutory language appears unambiguous. Nonetheless, an illumination of congressional intent may on occasion be gleaned from legislative history. In this regard, the Supreme Court, in deciding tax questions, has frequently referred to legislative committee reports. See, e.g., Don E. Williams Co. v. Commissioner, 429 U.S. 569, 97 S.Ct. 850, 51 L.Ed.2d 48 (1977); Neuberger v. Commissioner, 311 U.S. 83, 61 S.Ct. 97, 85 L.Ed. 58 (1940); Hassett v. Welch, 303 U.S. 303, 58 S.Ct. 559, 82 L.Ed. 858 (1938).

In the instant case, the House and Senate Reports referring to s.1381 state: "The tax treatment outlined here applies to the so-called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis." 16/

[16/ H.R. Rep. No.1447, 87th Cong., 2d Sess. (1961), 1962-3 Cum.Bull. 405, 483; S.Rep.No.1881, 87th Cong., 2d Sess. (1962), 1962-3 Cum.Bull. 707, 819, U.S.Code Cong. & Admin.News 1962, pp. 3297, 3416.]

The recognition of different groups or classes of organizations, including three called "cooperatives" and one described as formed of "other corporations" which are "operating on a cooperative basis" casts an uncertain light. The classes may be differentiated on the basis of title, i.e., "tax-exempt," "other farm," "consumer" and "other." They may also be differentiated on the existence of a quantitative requirement thought to be inherent in the word "cooperatives," and the absence of a quantitative requirement for "other" corporations which are not total "cooperatives" but are "operating on a cooperative basis." 17/

[17/ The government nowhere asserts that CCFA is a "sham cooperative," or employs only "cooperative camouflage," or had "paper patrons" as members, or that fraud or dissembling

of any kind is involved. The sole basis for disallowing CCFA's admitted patronage dividends is the amount of business done with nonmembers.]

In all events, we find nothing in the legislative history of the applicable statutory provisions to indicate a congressional intent to insert a quantitative requirement in s.1381(a)(2).

The government also asserts, post-hoc, that the "primarily cooperative" test of Rev. Rul. 72-602 was "suggested by Congress" in enacting the tax return filing deadline for Subchapter T cooperatives. I.R.C. s.6072(d) (26 U.S.C. s.6072(d)) 18/

[18/ s.6072. Time for filing income tax returns

* * *

(d) Returns for cooperative associations

In the case of an income tax return of--

(1) an exempt cooperative association described in section 1381(a)(1), or

(2) an organization described in section 1381(a)(2) which is under an obligation to pay patronage dividends (as defined in section 1388(a)) in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons, or which paid patronage dividends in such an amount out of the net earnings from business done with or for patrons during the most recent taxable year for which it had such net earnings,

a return made on the basis of a calendar year shall be filed on or before the 15th day of September following the close of the calendar year, and a return made on the basis of a fiscal year shall be filed on or before the 15th day of the 9th month following the close of the fiscal year.]

allows a cooperative to file its tax return 9-1/2 months after the end of the tax year if it is "under an obligation to pay patronage dividends * * * in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons * * * ." From this provision for an extended filing deadline, the government constructs an argument concerning deductibility, saying s.6072(d) "strongly suggests that Congress expected that only corporations conducting at least half their business on a patronage, nonentrepreneurial basis would be entitled to such patronage deductions."

Section 6072(d), however, was passed simultaneously with Subchapter T and does not support the government's basic position in this case. That section grants an extended filing deadline to those organizations "described in section 1381(a)" which are under an obligation to pay, or did pay, patronage dividends equalling "at least 50 percent of its net earnings from business done with or for its patrons." Other organizations "described in section 1381(a)(2)" must meet the normal deadline. Thus s.6072(d) continues the distinction made in s.1381(a) between exempt and nonexempt earnings.

The legislative committee reports further demonstrate the absence of merit in the government's s.6072(d) argument. The House and Senate Reports state:

6. Returns of cooperatives.--Because tax-exempt cooperatives under present law are given until 8-1/2 months after the end of the year to allocate, or pay, patronage dividends, they also have been given the same period of time in which to file their tax returns. This additional time is necessary since whether or not there is an allocation or payment of the dividends, determines the size of the taxable income of the cooperative.

Allowing taxable cooperatives this same time in which to make cash and qualified allocations of patronage dividend distributions, and to redeem nonqualified allocations, has presented the same filing problem in the case of their returns as well. Therefore, the bill provides that the tax return filing date for cooperatives generally is to be 8-1/2 months after the end of their taxable year. However, to prevent an organization allocating relatively little of its income on a patronage basis from obtaining this postponement in the filing date for its return [emphasis added], the bill limits this postponement to those organizations which are either exempt cooperatives or (1) are under an obligation to allocate, or pay, at least 50 percent of their net patronage earnings in patronage dividends or (2) actually allocated, or paid, at least that percentage of their earnings in patronage dividends during the last year in which they had any such earnings. 19/

[19/ Id. 1962-3 Cum.Bull. at 486; 1962-3 Cum.Bull. at 822, U.S.Code Cong. & Admin. News 1962, p.3420.]

The quoted passage reflects the intent of Congress that an organization "allocating relatively little of its income on a patronage basis." i.e., less than 50%, would continue to be an organization under s.1381(a)(2)., i.e., an organization "operating on a cooperative basis," but that such organization would not be granted the extended filing date of 6072(d). Though the section concerns quantity of income, rather than quantity of business in value done, it reflects congressional recognition that a nonexempt cooperative under s.1381(a)(2) may be doing relatively little patronage business, and to that extent argues against the government's basic position in this case.

The phrase "operating on a cooperative basis," though not specifically defined in the statute, is not, for the reasons outlined above, ambiguous. Our task is not to substitute our judgment for that of the Commissioner, but to determine whether the Commissioner's rule "implement[s] the congressional mandate in some reasonable manner." United States v. Correll, 389 U.S. 299, 307 (1967).

The language of s.1381(a)(2), and the legislative reports consistent therewith, impel the conclusion, however, that Rev. Rul. 72-602, * * * is an unreasonable interpretation of the statute, making an unwarranted exception to the intent expressed s.1382(b) by adding as it does a quantitative requirement in conflict with the intent of Congress. A revenue ruling cannot narrow the scope of a statute when Congress has intended otherwise. * * *

The judgment is reversed and the case is remanded to the district court with instructions to enter judgment for plaintiff (CCFA). It is so ordered.

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The Conway case has been followed by other courts⁶ and the IRS has abandoned the 50 percent rule as an absolute trigger for "operating on a cooperative basis" but continues to use the rule as a factor in determining whether an organization is operating on a cooperative basis.⁷

⁶ *Columbus Fruit & Vegetable Cooperative Ass'n v. United States*, 7 Cl. Ct. 561 (1985); *Geauga Landmark, Inc. v. United States*, No. 81-942 (N.D. Ohio 1985).

⁷ Rev. Rul. 93-21, I.R.B. 1993-13, *modifying*, Rev. Rul. 72-602, 1972-2 C.B. 510.

III. Section 521 Qualification

A. Principles

As we will see later, section 521 cooperatives, called "exempt" farmer cooperatives, though not truly exempt, receive two deductions from taxable income that other organizations "operating on a cooperative basis" do not receive. This requires definition of section 521 qualifications. Because section 521 is an exception to the generally applicable rules, it is strictly interpreted.

Section 521, following, was used from 1926 to 1962 to define exempt cooperatives. In 1962, subchapter T redefined cooperative taxation generally, removing exemptions. Section 521 requirements remain essentially unchanged.

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Section 521(b) Applicable Rules. -

(1) Exempt farmers' cooperatives. - The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) Organizations having capital stock. - Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) Organizations maintaining reserve. - Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) Transactions with nonmembers. - Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) Business for the United States. - Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

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Cooperatives seeking Section 521 status file Form 1028 with the IRS along with specified documentation. When approved, the IRS issues a "letter of exemption."

Following decisions and rulings discuss some of the more common issues of section 521 qualification, among them ownership and control, limits on dividends on capital stock, the role of exemption letters and revocation, nonpatronage income, and the "substantially all" requirement and recent decisions.

B. The Patron-Cooperative Relationship

Section 1 of § 521(b) defines basic characteristics of the cooperative to which section 521 will apply. As may be expected, it emphasizes the business relationship of the cooperative and its patrons, including the flow of funds through the cooperative to its patrons. Although the language may seem straightforward, its interpretation has led to a substantial list of requirements and prohibitions. Following are the principle requirements as developed from the statute through IRS rulings and judicial decisions.

1. Membership Limited to Farmers

Section 521 can only be claimed by cooperatives whose members are farmers or fruit growers and "like associations." This requirement has led to discussions of the type of activity included in "farming" and whether "like associations" expanded the coverage beyond farming if the business was organized and operated on a cooperative basis.⁸ Regulations give general guidelines⁹ but specific examples are left to other rulings.

Section 521 status may be claimed by those producing fish on privately owned fish farms¹⁰ but not for supplying commercial fishermen.¹¹ It may be claimed by those engaged in grazing cattle¹² but not those engaged in the tree growing and lumber business.¹³ "Like associations" do not include cooperatives whose members are engaged in non-farming activities including the following:

Cooperative Central Exchange v. Comm'r, 27 B.T.A. 17 (1932) (consumer cooperative).

Garden Homes Co. v. Comm'r, 64 F.2d 593 (7th Cir. 1933) (housing cooperative)

⁸ See Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966) for further discussion

⁹ Treas. Reg. § 1.521-1

¹⁰ Rev. Rul. 64-246, 1964-2 C.B. 154.

¹¹ Rev. Rul. 55-611, 1955-2 C.B. 270.

¹² Rev. Rul. 67-429, 1967-2 C.B. 218; Rev. Rul. 75-5, 1975-1 C.B. 166.

¹³ Rev. Rul. 73-308, 1973-2 C.B. 193; Rev. Rul. 73-570, 1973-2 C.B. 194; Rev. Rul. 84-81, 1984-1 C.B. 135.

National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937) (signboard association).

Sunset Scavenger Co. v. Comm'r, 84 F.2d 453 (9th Cir. 1936) (garbage collectors).

Rev. Rul. 73-308, 1973-2 C.B. 193 (building supply cooperative).

2. Organized and Operated on a Cooperative Basis

Section 521 describes the process – marketing producer products and turning back to them the proceeds of sales, less necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by the producer or purchasing supplies and equipment for producers at actual cost plus necessary expenses.

IRS has applied the marketing and supply descriptions somewhat restrictively.¹⁴ However, activities that are an integral part of marketing can be included. The definition of marketing discussed in Rev. Rul. 66-108 “is broad enough to include all activities which are an integral part of the marketing function. Therefore, a cooperative may be exempt under section 521 of the code without actually handling the sale of a product.”¹⁵ Adding value to members’ products through a processing activity is a marketing function.¹⁶

3. Members or Other Producers

The “members or other producers” requirement has two implications. The first, addressed here, is that only producers (farmers, etc.) may be patrons. The second, discussed below, is that members and other producers must be treated alike.

Rev. Rul. 67-422, 1967-2 C.B. 217 describes the producer principle, requiring the producer to bear the “risks of production, cultivates, operates, or manages a farm for gain or profit – in short, if he is engaged in the trade or business of farming.” Similarly, one who merely purchases the product and sells it to the cooperative is not a producer because “he fails to take the risks and responsibilities of the owner of a growing crop. The requirement applies specifically to the product delivered and those who are primarily engaged in other activities will not be disqualified so long as the conditions apply to the product. Both landlords and tenants may be producers if they share in the risks of production.”¹⁷

Products delivered to the cooperative for marketing must be produced the entity delivering that product. Delivery by a non-producer, even if that producer is a member of the cooperative, will jeopardize the status of the cooperative.

For other examples see:

¹⁴ Rev. Rul. 66-108, 1966-1 C.B. 154 (grove caretaking and harvesting for groveowners not marketing.)

¹⁵ Rev. Rul. 67-430, 1967-2 C.B. 220.

¹⁶ Rev. Rul. 77-384, 1977-2 C.B. 198; Rev. Rul. 81-96, 1981-1 C.B. 360; see also Rev. Rul. 71-100, 1971-1 C.B. 159; Tech. Adv. Mem. 8705091 (Nov. 7, 1986).

¹⁷ Rev. Rul. 67-422.

Dr. P. Phillips Cooperative v. Comm'r, 17 T.C. 1002 (1951).

Farmers Cooperative Creamery Ass'n of Cresco, Iowa v. United States, 1981-1 U.S.T.C. (CCH) ¶ 9457 (N.D. Iowa 1981).

Land O'Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir. 1975), *cert. denied*, 423 U.S. 926.

Rev. Rul. 55-496, 1955-2 C.B. 268.

Ltr. Rul. 9310031 (Dec. 15, 1992).

Tech. Adv. Mem. 8750002 (July 23, 1987).

4. Limited Exceptions

A few very limited exceptions to the totally producer requirement have been developed over time. They include.

1. A *de minimis* rule for very small amounts of non-producer purchase, although the rule cannot be relied upon for any significant purchases.¹⁸

2. Emergency purchases made to meet binding contractual obligations “made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and nor for any purpose of investment or profit.”¹⁹ The emergency purchase will be strictly applied and a cooperative may lose its Section 521 status where the IRS determines that a true emergency did not exist.

For examples of approved and disapproved emergency non-producer purchases, see:

Rev. Rul. 76-388, 1976-2 C.B. 180.

Ltr. Rul. 9034043 (May 29, 1990).

Ltr. Rul. 9132038 (May 13, 1991).

Ltr. Rul. 9309012 (Dec. 1, 1992).

Tech Adv. Mem. 8705091 (Nov. 7, 1986).

Tech. Adv. Mem. 8047006 (July 29, 1980).

Tech. Adv. Mem. 7812004 (Oct. 31, 1977).

3. A cooperative qualifying for Section 521 that engages in processing may purchase ingredients for the process that are not purchased on a cooperative basis from producers. However,

¹⁸ Tech. Adv. Mem. (Dec. 29, 1975), extremely restrictive view, with somewhat more leeway granted in Tech. Adv. Mem. (Aug. 27, 1980) and Tech Adv. Mem. (March 4, 1986).

¹⁹ Rev. Rul. 69-222, 1969-1 C.B. 161.

the “ingredients” may not be products of the same kind produced by those delivering to the cooperative on a cooperative basis. Thus, the ingredients rule cannot be used to purchase non-producer products otherwise prohibited by Section 521.²⁰

4. “Incidental” purchases may be made by a Section 521 cooperative to fill out a product line or directly facilitate the marketing of member/producer products. While early decisions and rulings addressed the incidental purchases rule,²¹ the key guidance is given in Rev. Proc. 67-37, 1967-2 C.B. 668, discussed in *Land O’Lakes, Inc. v. United States*, 514 F.2d 134 (8th Cir. 1975), *rev.g.*, 362 F. Supp. 1253 (D. Minn. 1973), *cert. denied*, 423 U.S. 926.

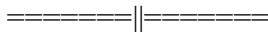
5. Equality of Treatment

The “members or other producers” terminology in Section 521 applies the cooperative relationship to members and non-members alike. As a result, a Section 521 cooperative must treat members and non-members alike with respect to all of its cooperative dealings, including returns of patronage refunds.



Treas. Reg. § 1.521-1(a)(1)

If the proceeds of the business are distributed in any other way than on such a proportional basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.



The variety of circumstances in which this requirement becomes an important consideration for and association considering Section 521 status is discussed in Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966).

C. Control and Membership

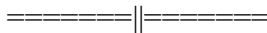
The stock ownership provisions of Section 521 have several implications. The limitation on returns to equity capital is an objective measure, though not necessarily simple in application.²² Of greater implication for policy considerations is the requirement for certain relationships between member (stockholder) and cooperative as a reflection of the organization’s cooperative character.

²⁰ Rev. Rul. 75-4, 1975-1 C.B. 165.

²¹ For discussion, see Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966).

²² For discussion, see Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966).

1. Stock Ownership



Etter Grain Co. v. United States

462 F.2d 259 (5th Cir. 1972), *aff'g*, 331 F. Supp. 283 (N.D. Tex. 1971)

SIMPSON, Circuit Judge:

A farmers' cooperative found eligible for federal income tax exemption under Section 521 of the Internal Revenue Code of 1954, Title 26, U.S.C., Section 521, * * * although required by Section 1381(b), Title 26, U.S.C. Section 1381(b), 2/

[2/ Title 26, U.S.C. s.1381(b): "Tax on certain farmers' cooperatives--An organization described in subsection (a)(1) shall be subject to the taxes imposed by section 11 or 1201."]

to pay the taxes imposed by Section 11, Title 26 U.S.C., Section 11 (corporate income tax), and Section 1201, Title 26, U.S.C., Section 1201 (capital gains tax), is entitled under Section 1381(a), Title 26, U.S.C., Section 1381(a), 3/

[3/ Title 26, U.S.C. s.1381(a): "In general.--This part shall apply to--(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax)"]

and Section 1382(c), Title 26, U.S.C. Section 1382(c), 4/

[4/ Title 26, U.S.C., s.1382(c): "Deduction for nonpatronage distributions, etc.--In determining the taxable income of an organization described in section 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter)--(1) amounts paid during the taxable year as dividends on its capital stock;"]

to deduct from its gross income, for federal income tax purposes, dividends paid on capital stock. The Internal Revenue Service determined that the Etter Grain Company, Inc. (taxpayer) did not qualify for tax exemption under Section 521. It therefore disallowed certain preferred stock dividend deductions and assessed deficiencies. The taxpayer paid the deficiencies and brought suit for a refund in the district court, which ruled in favor of the United States. Etter Grain Company, Inc. v. United States, N.D.Texas 1971, 331 F.Supp. 283. Upon this appeal from that decision, we affirm.

I. THE FACTS

In the 1940's, J.E. McAvoy and Monroe Terrell formed a partnership which constructed and began to operate a grain elevator at Etter, Texas. Additional partnership interests were acquired in 1948 by J.B. Waide, Jr., Jesse C. Cooper, and John W. Harris. Thereafter, the five partners formed the Etter Grain Company, Inc., a Texas business corporation, and transferred their partnership interests to it in exchange for \$80,000 worth of \$100 par value stock (800 shares). Subsequently, McAvoy and Terrell sold their stock to Waide, Cooper and Harris, the other shareholders. These shareholders purchased an additional 446 shares of \$100 par value stock for \$44,600.00 in cash and then sold some of their shares to other persons. In 1959, another grain firm, Schroeter Grain Company, Inc., was merged into the corporation and its owner Paulus F. Schroeter, was given 300 shares of Etter Grain Company, Inc. \$100 par value stock (\$30,000) in exchange for his Schroeter stock.

On September 28, 1962, an appraisal was made of the physical assets of the Texas business corporation, Etter Grain Company, Inc., which valued the physical assets and other possessions of the corporation at \$996,000.00. The taxpayer, then styled Etter Grain Elevators, was incorporated on or about

October 3, 1962, under the provisions of the Texas Marketing Association Act, Vernon's Texas Civil Statutes Annotated, Article 5737 et seq. Twenty days later, on October 23, 1962, a reorganization was effected whereby the stockholders of Etter Grain Company, Inc. (Waide, Harris, Cooper, Schroeter and Neal R. Allen, hereinafter the Waide group) exchanged all their stock for the preferred stock of the taxpayer, Etter Grain Elevators, of the par value of \$996,000.00. Etter Grain Company, Inc., the Texas business corporation, was then dissolved and the name of the Taxpayer, Etter Grain Elevators, was changed to Etter Grain Company, Inc.

In addition to the preferred stock issued to the Waide group, the taxpayer sold one share of its common stock to each of its farmer-patrons for the sum of \$1.00 per share. Each member of the Waide group was also a farmer-patron and each purchased a single share of common stock at the \$1.00 price. As a result of these stock issuances, the Waide group held, directly or indirectly, 15 of the taxpayer's common shares and 9,810 of its preferred shares. In addition, another 150 shares of preferred stock were issued in equal amounts to three other individuals.

Article 9 of the taxpayer's articles of incorporation provides that the holders of preferred stock are to receive eight percent of the par value of their stock each year in the form of dividends and that these dividends are to be paid out of profits prior to the distribution of patronage dividends to the farmer-members. Article 4 of the taxpayer's bylaws provides that each share of preferred stock is to have one vote while each common shareholder is given only one vote regardless of the number of common shares he may hold.

The dividend history of the taxpayer is set forth in the following table:

	Fiscal Year Ended	Preferred Stock Dividends	Patronage Dividends
April 30,	1963	\$41,035.18	\$66,571.96
	1964	79,630.00	39,453.50
	1964	39,839.96	39,333.56
	1966	39,839.96	NONE
	1967	24,900.00	15,106.71
	1968	24,900.00	NONE
	1969	79,680.00	NONE
	1970	24,900.00	NONE

* * *

II. THE DISTRICT COURT PROCEEDINGS

In the district court, the United States contended that:

1. The taxpayer was not organized and operated as a cooperative corporation entitled to an exemption under Section 521 of the Internal Revenue Code.
2. The eight percent ceiling on permissible dividends on preferred stock was due to be computed on the basis of the amount paid in by the taxpayer's shareholders on the formation of the Etter Grain Company, Inc. in 1948, and not upon the valuation employed with respect to the taxpayer's formation in 1962.
3. The Internal Revenue Service made a mistake of law concerning the taxpayer's eligibility for an exemption under Section 521, and accordingly the Service had the authority to revoke its October 10, 1963 letter of exemption and collect taxes retroactively for the period the letter was outstanding.

On cross-motions for summary judgment, the district court ruled in favor of the United States on each of its three contentions. On this appeal, the taxpayer argues that the court below erred with respect to each of its determinations.

III. THE TAXPAYER'S ORGANIZATIONAL STRUCTURE

Section 521(b)(1) of the Internal Revenue Code clearly reflects a legislative intent that exemptions granted under Section 521 be limited to entities "organized and operated on a cooperative basis". In addition, Section 521(b)(2) contemplates that the stock of exempt cooperatives will be owned by the producers who market their products or purchase their supplies and equipment through the association. These provisions envision tax 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.

The taxpayer in this case does not conform to such a model. As noted earlier in this opinion, the Waide group controlled 9,810 preferred shares in the taxpayer (each with one vote) and 15 common shares (each with one vote). Although the taxpayer's corporate articles provide for the issuance of 1,000 shares of common stock, only 23 shares were issued at the time of incorporation and at the time of this action only 182 shares of common stock were outstanding. Obviously, the common shares and the preferred shares not controlled by the Waide group are powerless to match the voting strength of the Waide group.

The taxpayer counters this point by asserting that since it exists by virtue of the Texas Marketing Association Act, it is thereby automatically qualified for exempt status under Section 521 of the Internal Revenue Code. In reply, the United States notes that Article 5750, Vernon's Texas Civil Statutes Annotated (part of the Texas Marketing Association Act), provides that "no member or stockholder shall be entitled to more than one vote", a provision never complied with.

Finally, the taxpayer refers us to a typewritten provision which was added to the Internal Revenue Service's form letter of October 10, 1963, granting an exemption under Section 521:

"Since your preferred stock carries the right to vote, the issuance of such stock should be restricted to producers who market their products or purchase their supplies and equipment through your association".

From this provision the taxpayer maintains that the government accepted the very view for which the taxpayer now contends: that preferred stock may be voting stock, and thus control the association, if it is owned by the producers who market their products through the association. We believe that the taxpayer has read too much into the additional provision in the letter of October 10, 1963. That letter should not be construed as giving the Internal Revenue Service's blessing to a capital structure whereby a relatively small group of preferred stockholders, each member of which is also a farmer-patron, may effectively control the workings of the cooperative through the device of vesting each share of preferred stock with a vote. Such a construction would constitute an unauthorized departure from the mandates of Section 521(b) and, in the absence of conclusive evidence, is not to be imputed to the Service.

The district court correctly decided that the taxpayer was not organized and operated as a cooperative corporation entitled to an exemption under Section 521 of the Internal Revenue Code.

IV. THE CONSIDERATION FOR THE PREFERRED STOCK

In the district court and here, the United States has argued that the proper value of the consideration given in exchange for the preferred stock of the taxpayer was at most \$154,600.00. This figure is derived by the addition of the \$80,000.00 in partnership assets contributed in 1948 to the old Etter Grain Company, Inc., the \$44,600.00 in cash subsequently invested by the Waide group, and the \$30,000.00 in stock paid by the old Etter Grain Company, Inc., for the stock of the Schroeter Grain Company, Inc. On this basis, the maximum annual preferred stock dividend which the taxpayer was permitted to pay under the eight percent

ceiling of Section 521(b)(2) would come to \$12,368.00. The United States asserts therefore that the statutory ceiling has been exceeded in every year of the taxpayer's history.

The taxpayer defends the \$996,000.00 valuation given to the assets of the old Etter Grain Company, Inc. in 1962 by the following reasoning: (a) In 1962, six individuals owned all of the stock of the old corporation; (b) at that date, that stock had a value; (c) such value (based on the old corporation's assets) was \$996,000.00; (d) the new cooperative association, formed in 1962, was legally separate and distinct from the old corporation and its shareholders; and (e) the consideration for which the preferred stock of the new cooperative association was issued was the stock of the old corporation which had such value of \$996,000.00. From these premises the taxpayer urges us to conclude that the value of the consideration for which the preferred stock of the new cooperative association was issued was \$996,000.00 and that dividends of up to eight percent paid thereon were within the statutory limits. We think this controversy was correctly resolved below:

"The question of valuation would not be presented if, as an example, a new cooperative corporation was formed and each stockholder invested cash for his preferred shares. But here, where stock is exchanged, the value to be used for Sec. 521 purposes is the investment value of each stockholder in the old corporation, not its re-evaluation as was used by Plaintiff in this case. *Laura Farmers Cooperative Elevator Co. v. United States*, 273 F.Supp. 1019 (S.D.Ill., 1967). To hold otherwise, would only open another door or afford another device and method for operating a co-op for the advantage of the stockholders rather than the member-producers." 331 F.Supp. at 286.

The district court was right in disregarding the \$996,000.00 valuation urged by the taxpayer for the assets which it acquired in 1962 from the old Etter Grain Company, Inc.

V. THE RETROACTIVE REVOCATION OF THE EXEMPTION LETTER

The taxpayer renews before us its contention below that the Internal Revenue Service exceeded its authority by revoking retroactively the October 10, 1963 exemption letter. In support of its argument the taxpayer cites Rev.Proc. 69-3, 1969-1 Cum. Bull. 389:

"Sec. 8. Revocation or Modification of Exemption Rulings or Determination Letters.

"01 An exemption ruling or determination letter may be revoked or modified by a ruling or determination letter addressed to the organization, or by a Revenue Ruling or other statement published in the Internal Revenue Bulletin. The revocation or modification may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented, or engaged in a prohibited transaction of the type described in Section 8.07."

The taxpayer urges that since it has never been accused of a material misstatement or omission 6/

[6/ We note in this regard that the Claim for Exemption form 1028 submitted to the Internal Revenue Service by the taxpayer June 24, 1963 disclosed no facts as to the genesis of the preferred stock. It simply listed in response to Question 6a: "State the number of shares of each class of Capital stock outstanding and the value of the consideration for which it was issued" the following:

"Preferred -- 9960 sh. -- \$100.00 per share
Common -- 90 sh. -- \$1.00 per share".]

in connection with any of its submissions to the Internal Revenue Service, the retroactive application of the revocation letter of February 19, 1971 is precluded by the Service's own policy statement. To this the United

States replies that the Internal Revenue Service made a "mistake of law" in granting the taxpayer a Section 521 exemption on October 10, 1963 and that mistakes of this nature may be rectified retroactively.

* * *

We agree with the United States that the Internal Revenue Service committed, in 1963, a "mistake of law" when it extended a federal income tax exemption under Section 521 of the Internal Revenue Code to the taxpayer and that no abuse of discretion took place when, in 1971, the Service retroactively revoked the 1963 exemption letter. Whether the taxpayer's organizational structure comported with the model envisioned in Section 521(b) and whether the valuation assigned in 1962 to the assets of the old Etter Grain Company, Inc., was appropriate are both questions of law within the meaning of the Supreme Court's decision in Automobile Club of Michigan, *supra*. The taxpayer having reaped the benefits of Section 521 for several years (with the Waide group maintaining effective control over the taxpayer's affairs), it was not an abuse of discretion for the Internal Revenue Service to take action to recoup its lost taxes for fiscal year 1966 and thereafter.

The district court properly entered summary judgment in this case. That judgment is in all respects affirmed.

GOLDBERG, Circuit Judge (concurring specially):

Entertaining no sympathy with the taxpayer's ploys to externalize a tax exempt status where the internal mechanism reveals only a cosmetic deception, I am nonetheless disturbed by the transcendental rule that every error accepted and escutcheoned by the Internal Revenue Service can later be transmuted into a mistake of law, thus making this taxpayer's letter of exemption simply a piece of paper to be blown away by any subsequent shifting wind. Were I sailing in uncharted seas, I would be inclined to conclude that the Government's admitted mistake in this case was not a "mistake of law." The Government held all of the facts in the taxpayer's case at the time of the application for the Section 521 exemption. Subsequent to that 1963 application there were neither changes in those facts nor alterations in the applicable law. Nevertheless, the Government insists that its error in granting the taxpayer a Section 521 exemption constitutes a "mistake of law" within the confines of Automobile Club of Michigan v. Commissioner of Internal Revenue, 1957, 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746. Given some clear steering point and a strong tailwind, I would be inclined to hold that an error by the Commissioner in the application of a clear and unchanged regulation to clear and unchanged facts should be binding upon the Government for purposes of any attempted retroactive revocation where the Commissioner's change of mind results wholly from a reassessment of the static facts under static law. The case law, however, is ambivalent, thus leaving me rudderless. *E.g.*, compare Martin's Auto Trimming, Inc. v. Riddel, 9 Cir. 1960, 283 F.2d 503; H.S.D. Co. v. Kavanagh, 6 Cir. 1951, 191 F.2d 831, with Tollefsen v. Commissioner of Internal Revenue, 2 Cir. 1970, 431 F.2d 511, cert. denied, 1971, 401 U.S. 908, 91 S.Ct. 867, 27 L.Ed.2d 806; Travis v. Commissioner of Internal Revenue, 6 Cir. 1969, 406 F.2d 987.

There is not a word to which I take exception in the majority opinion until I come to Section V, where I become perturbed when asked to subscribe to a thesis that the Government's solemn word is a nothing. However, buttressed only by my own perturbation, I concur, albeit reluctantly, in the majority opinion.

=====||=====

2. Active Members

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Farmers Cooperative Co. v. Comm'r

85 T.C. 601 (1985), *remanded*, 822 F.2d 774 (8th Cir. 1987)

GERBER, Judge: *

In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

* * *

[1/ Respondent initially characterized the grain storage income received by Farmers Cooperative Company (Company) in 1977 and 1978 as nonpatronage-sourced income. Pursuant to revocation of the Company's exemption, respondent disallowed the amount of the Company's patronage dividend deduction which represented a distribution of the "nonpatronage-sourced" income to its patrons. Respondent has conceded, however, that all of the Company's grain storage income was patronage-sourced income and therefore deductible.]

[2/ Respondent has conceded that he erroneously disallowed \$3,070.01 of the total patronage dividend deduction claimed by Farmers Cooperative Society (Society) for its 1979 tax year. Respondent originally determined that the Society's patronage dividends were made in the form of nonqualified, rather than qualified, written notices of allocation. While one of the definitional requirements for a qualified written notice of allocation is that the recipient patron must have consented to take the face amount of such notice into account in computing his own income (sec. 1388(c)(1) of the Internal Revenue Code of 1954, as amended), respondent overlooked the fact that the Society, prior to transacting any business with the recipient patrons, obtained such consent in one of the three permissible types of consent under sec. 1388(c)(2)(A) of the Internal Revenue Code of 1954, as amended. Accordingly, the deficiency amount for 1979 and 1980 will require recomputation. If we find for respondent on any issue, a decision will be entered under Rule 155, Tax Court Rules of Practice and Procedure.]

The issue for our consideration is whether petitioners are exempt cooperative associations under section 521 3/

[3/ All statutory references are to the Internal Revenue Code of 1954, as amended and in effect for the taxable years at issue unless otherwise indicated.

"Exempt" in this context is somewhat different from its use in sec. 501 because farmers' cooperatives which meet the requirements set out in sec. 521 are subject to the normal tax, surtax, and alternative tax imposed upon corporations in general by sec. 11 except that in computing taxable income they are given the advantage of deductions which are not shared by cooperatives that do not meet the requirements (sec. 1381). While all cooperatives, whether exempt or nonexempt, are entitled to deduct amounts paid or allocated to their patrons (i.e., patronage dividends) (secs. 1382 and 1388), exempt cooperatives may also deduct (1) amounts paid as dividends on capital stock and (2) amounts paid out of earnings from nonpatronage sources (secs. 1382(c)(1) and (2)). Thus, if a cooperative is exempt, such amounts are deductible regardless of whether they are paid out of patronage-sourced or nonpatronage-sourced income. Secs. 1382(c)(2)(A) and 1388(a)(3). If a cooperative is not exempt, however, such amounts are deductible only if paid out of patronage-sourced income. Sec. 1388(a)(3).]

because "substantially all of the capital stock" of each petitioner "is owned by producers who market their products or purchase their supplies and equipment through" the respective petitioners as described in section 521(b)(2).

FINDINGS OF FACT

All of the facts have been stipulated and are found accordingly. The stipulation of facts, second stipulation of facts and attached exhibits are incorporated herein by this reference.

Farmers Cooperative Company

Petitioner, Farmers Cooperative Company (Company), is a cooperative incorporated under the laws of the State of Nebraska with its principal office in Platte Center, Nebraska. The Company's fiscal year ends on September 30 each year. Utilizing the accrual method of accounting, the Company filed Federal income tax returns for fiscal years ended September 30, 1977 and 1978, on Forms 990-C (Exempt Cooperative Association Income Tax Returns) with the Internal Revenue Service Center, Exempt Organizations Section, Cornwells Heights, Pennsylvania.

The Company is a farmers' association organized and operated on a cooperative basis. Its purpose is to market the products of its members or other producers and remit to them the proceeds of sales less necessary marketing expenses on the basis of either the quantity or the value of the products furnished by them. The principal products are corn, milo, wheat, soybeans, and oats. The cooperative also purchases supplies and equipment for resale to its members or other persons. Such supplies and equipment are sold at actual cost plus operating expenses. The supplies and equipment principally involve fertilizer, agricultural chemicals, fuel, oil, tires, and equipment such as sprayers, tillage equipment and grain wagons.

The Company is a capital stock company. During 1977 and 1978, the Company's authorized capital stock consisted of 40,000 shares of \$12.50 par value common stock. Each shareholder was entitled to only one vote regardless of the number of shares owned.

In addition to its capital stock, the Company carried evidences of ownership interest known as certificates of participation and equity credits on its books. Such forms of ownership did not entitle the holder to vote or otherwise participate in the management of the Company's affairs.

During and after the two tax years in issue, the Company's Board of Directors limited the ownership of its common stock to eligible persons 4/

[4/ The Company's Articles of Incorporation and bylaws provided in pertinent part:

Only producers of agricultural products, including lessors and landlords in share tenancies and farmers within the trade territory of this cooperative corporation, who do business with the corporation annually, may own the common stock of this cooperative. (Emphasis added.)]

and regularly took action to purge nonpatronizing stockholders from its list of active, voting members. For example, the Company's bylaws provided a procedure for recalling stock from persons who had ceased to be eligible shareholders because (1) they moved from the Company's trade territory, (2) they failed to patronize the Company for a one-year period, (3) they had died, or (4) they voluntarily withdrew from membership. The Company does not require its patrons or shareholders to enter into membership agreements which require them to transact any particular annual quantity of their marketing or purchasing business with the Company.

As of September 30, 1977, 670 producers held at least one share of the Company's voting stock of whom 568 (or 84.78 percent of the total) transacted business with the Company during that year, by either marketing agricultural products through the Company, purchasing agricultural supplies and equipment from the Company, or a combination of the two. In addition, 32 producers began patronizing the Company during

its 1977 fiscal year and, during the course of that year, met all the qualifications to become shareholders of the Company. The Company's Board of Directors caused 31 of these 32 new members to receive one share of the Company's stock issued on January 31, 1978, the day of the Company's annual shareholders' meeting for its 1977 fiscal year.

Of the Company's 102 voting shareholders who did not transact any business with the Company during its 1977 fiscal year, only one shareholder had his stock either converted to nonvoting status or redeemed within 12 months after the end of the Company's 1977 fiscal year. Cumulatively, the Company either converted or redeemed two shareholders' stock within 18 months, 67 shareholders' stock within 24 months, and 75 shareholders' stock within 36 months, after the end of the Company's 1977 fiscal year.

During the tax years in issue the Company owned and operated a facility for the receipt, handling, drying and storage of grain produced by its patrons. This facility was licensed by the State of Nebraska as a grain storage warehouse having a capacity of 963,000 bushels. The total amount of grain handled by the Company in any given year depended upon a number of variables. Accordingly, its storage facility did not always have sufficient capacity to handle all the grain produced by all its patrons in any given year.

The Company's patrons delivered their grain to the Company's elevator facility, at which time the grain was weighed, dried (if necessary) and placed in storage. Unless the patron had made a prior contractual arrangement with the Company to deliver his grain for immediate sale, the patron had a period of time after the date of delivery to decide whether to sell the grain to the Company or leave the grain in "open storage." A patron was not credited with patronage on the date he delivered the grain to the Company but, rather, on the date the grain was sold. If on delivery the patron placed the grain in open storage, the Company accrued storage fees on its books, which it collected from the patron at the time the grain was sold. Only shareholders or those in the process of becoming shareholders were permitted to deliver grain to the Company for storage. During its 1977 fiscal year the Company received grain storage fees in the amount of \$66,643.80, which it classified as patronage-sourced income on its 1977 tax return. These grain storage fees were paid to the Company by its member-patrons (i.e., not by nonmembers) and only such member-patrons (not the Company) held title to the grain stored.

As of September 30, 1978, 698 producers held at least one share of the Company's voting stock. Of this number, 576 (or 82.52 percent of the total) transacted business with the Company during that year by either marketing agricultural products through the Company, purchasing agricultural supplies and equipment from the Company, or a combination of the two. In addition, 33 producers began patronizing the Company during its 1978 fiscal year and, during the course of that year, met all the qualifications to become shareholders of the Company. The Company's Board of Directors caused one share of the Company's stock to be issued to 31 of the 33 new members as follows: (1) One on March 14, 1979; (2) 29 on March 15, 1979; and (3) one on September 18, 1981.

Of the Company's 122 voting shareholders who did not transact any business with the Company during its 1978 fiscal year, four had their stock either converted to nonvoting status or redeemed within six months after the end of the Company's 1978 fiscal year. Cumulatively, the Company either converted or redeemed 93 shareholders' stock within 12 months, 95 shareholders' stock within 18 months, 102 shareholders' stock within 24 months, and 117 shareholders' stock within 36 months after the end of the Company's 1978 fiscal year.

During its 1978 fiscal year, the Company received grain storage fees in the amount of \$70,751.50 which it classified as patronage-sourced income on its 1978 tax return. Of these grain storage fees, \$68,998.61 was paid to the Company by its member-patrons (not by nonmembers) who held title to the grain stored, with the remaining \$1,752.89 paid by Commodity Credit Corporation.

The Internal Revenue Service recognized the Company as an exempt cooperative association under section 521 beginning April 24, 1956. On March 31, 1982, however, the District Director of the Internal Revenue Service at St. Louis, Missouri, notified the Company of respondent's determination to revoke the Company's section 521 exemption for all tax years beginning on or after October 1, 1976. Respondent determined that the Company had "not sufficiently limited the ownership of its common stock to active

producers to meet the requirements of section 521(b)(2) * * *." Respondent revoked the Company's exemption after the Company requested respondent (1) to apply the 85-percent test thus allowing the Company a two-year period of "lead time" after the close of its taxable year, to recall and cancel stock held by ineligible shareholders and (2) to recognize and give effect to the Company's cancellation of the voting privileges of ineligible shareholders prior to cancelling their stock.

Farmers Cooperative Society

Petitioner, Farmers Cooperative Society (Society), is a cooperative incorporated under the laws of the State of Iowa with its principal office in Sioux Center, Iowa. The Society's fiscal year ends November 30 each year. Utilizing the accrual method of accounting, the Society filed Federal income tax returns for the two tax years at issue on Forms 990-C (Exempt Cooperative Association Income Tax Returns) with the Internal Revenue Service Center at Kansas City, Missouri.

The Society is a farmers' association organized and operated on a cooperative basis. Its purpose is to market the products of its members or other producers and remit to them the proceeds of the sales less necessary marketing expenses on the basis of either the quantity or the value of the products furnished by them. The products are principally grain and hogs. The Society also purchases supplies and equipment for the use of its members or other persons and turns such supplies and equipment over to them at actual cost plus necessary expenses. The supplies and equipment are principally feed, seed, fertilizer, agricultural chemicals, and lumber products.

The Society's authorized stock during 1979 and 1980 consisted 40,000 shares of \$10 par value common stock. The Society limited ownership of its capital stock to eligible persons. 5/

[5/ The Society's Articles of Incorporation provided:

The ownership of the capital stock of the corporation shall be limited to individual farmers, persons deriving income from their farms, or corporations engaged primarily in farming operations, substantially all of whose stockholders, officers and directors are farmers or share in the productivity of the farm.]

Each shareholder was entitled to one vote regardless of the number of shares owned. The Society issued two classes of common stock: voting and nonvoting. Only agricultural producers could own shares of the Society's voting stock. Nonagricultural patrons of the Society (such as townspeople, college professors and administrators, housewives, etc. who patronized the Society's farm and home center or its lumberyards) were issued nonvoting stock.

A nonmember could become a member and shareholder in one of two ways. First, the nonmember could purchase a share of the Society's stock by paying the \$10 membership fee. The Society determines whether such person is an agricultural producer, in which case a share of voting common stock is issued, or a nonproducer, in which case a share of nonvoting common stock is issued. Shares of stock can be purchased at any time during the course of the Society's fiscal year. Second, a nonmember can choose not to purchase a share of stock, but rather earn it by patronizing the Society. In that case, the Society cannot issue the share of stock until after the end of its fiscal year, at which time it determines whether such person had sufficient patronage to earn a share of stock. The Society's bylaws provide that if a nonmember fails to do sufficient business to earn a share of stock he may contribute the balance in cash and receive a share of stock.

The Society's Board of Directors regularly took action to control the transfer of its stock by shareholders thus insuring that only producers held its voting stock. For example, the Society would redeem a member's share of stock or convert a voting shareholder's stock to nonvoting status if a voting shareholder moved out of the Society's trade territory, or failed to patronize the Society for a period of two consecutive years. The shareholders were given the option of having their shares redeemed in cash or converted to nonvoting shares. If a shareholder did not respond within a reasonable period of time, his voting stock was converted to nonvoting status.

The Society's Articles of Incorporation and bylaws prohibited shareholders from transferring their shares without the Society's Board of Directors' consent. 6/

[6/ The Society's Articles of Incorporation also contained the following provision for recalling stock from persons who ceased to be eligible or desirable as shareholders of the Society:

Any stockholder who ceases to be a cooperator, or becomes an undesirable stockholder in the opinion of the Board of Directors, may be expelled as a stockholder member, upon a two-thirds vote of the Board of Directors, whereupon said stockholder shall surrender his certificate and shall receive [in] full payment therefor the par value of such certificate.]

When a share was transferred to a nonproducer it was converted to nonvoting status. The bylaws also provided a means for shareholders to voluntarily withdraw from membership. In addition, the Society, based on the required credit application of each membership applicant, determined whether that person was a producer or a nonproducer. Voting stock was issued to producers only.

From its books and records, the Society could distinguish between business transacted with or for member-patrons, and business transacted with or for nonmembers. The Society maintained a record of all transactions (even though insignificant) and patronage dividends were paid on all accounts, no matter how small. The Society was unable to determine from its records whether a patron was transacting more or less than 50 percent (or any other percentage) of his total marketing or purchasing business with the Society during the year.

As of November 30, 1979, 5,158 persons held at least one share of the Society's capital stock which includes both voting and nonvoting shareholders. Of these shareholders, 3,580 held voting shares of which 2,849 (or 79.58 percent of the total) transacted business with the Society during that year, either by marketing agricultural products of the Society, purchasing agricultural supplies and equipment from the Society, or a combination of the two. As of the same date, 1,578 held nonvoting shares with 885 (or 56.08 percent of the total) transacting business with the Society during that year by purchasing supplies and equipment from the Society.

Of the Society's voting shareholders who did not transact any business with the Society during its 1979 fiscal year, 104 shareholders had their stock redeemed within 12 months after the end of the Society's 1979 fiscal year. The Society redeemed, in the cumulative, 190 shareholders' stock within 18 months, 221 shareholders' stock within 24 months, 283 shareholders' stock within 30 months, and 329 within 36 months after the end of the Society's 1979 fiscal year.

As of November 30, 1980, 5,552 persons held at least one share of the Society's capital stock which includes both voting and nonvoting shareholders. Approximately 3,734 shareholders held voting shares of which 2,864 (or 76.70 percent of the total) transacted business with the Society during that year. Of the 1,818 nonvoting shareholders, 1,012 (or 55.67 percent of the total) transacted business with the Society during that year by purchasing supplies and equipment from the Society.

Of the Society's voting shareholders who did not transact any business with the Society during its 1980 fiscal year, 117 shareholders had their stock redeemed within 12 months after the end of the Society's 1980 fiscal year. The Society redeemed, in the cumulative, 179 shareholders' stock within 18 months, 225 shareholders' stock within 24 months, 263 shareholders' stock within 30 months, and 292 shareholders' stock within 36 months after the end of the Society's 1980 fiscal year.

Beginning September 17, 1929, the Society was recognized as an exempt cooperative association under section 521 and predecessor statutes. However, on March 8, 1979, the District Director of the Internal Revenue Service Center at St. Louis, Missouri, notified the Society of respondent's determination to revoke the Society's section 521 exemption effective for all tax years beginning on or after December 1, 1972. Using a "random sampling to determine the amount of stock held by producers," respondent, in revoking the

Society's exemption, determined that the Society "did not comply with the stock ownership requirements" of section 521(b)(2).

OPINION

The general question for consideration is whether petitioners are exempt cooperatives under section 521. Section 521 provides that certain farmer cooperative organizations are exempt from taxation. 7/

[7/ Sec. 521(b) provides:

(1) Exempt farmers' cooperatives.--The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) Organizations having capital stock.--Exemption shall not be denied any such association because it has capital stock, if * * * and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.]

With respect to cooperatives that issue stock, in order for the cooperative to be exempt 8/

[8/ The "substantially all" test does not apply to nonvoting preferred stock if the owners of the stock are not entitled or permitted to participate, either directly or indirectly, in the profits of the cooperative beyond the fixed dividends. Sec. 1.521-1(a)(2), Income Tax Regs.]

"substantially all" of the capital stock must be owned by producers 9/

[9/ A "producer" is a person who bears the risks of agricultural production and who cultivates, operates, or manages a farm, i.e., one who is engaged in the business of farming. Rev. Rul. 67-422, 1967-2 C.B. 217, as amplified, Rev. Rul. 72-589, 1972-2 C.B. 282. Examples of "producers" are farmers, landlords in share tenancy, or tenant farmers. See sec. 175(a) and sec. 1.175-3 Income Tax Regs. On the other hand, a "nonproducer" is one who is not engaged in the business of farming but who may have acquired agricultural commodities by other means, such as sale or exchange.]

who market their products or purchase their supplies and equipment through the cooperative. Sec. 521(b)(2). In addition, the farmers' cooperative must demonstrate that the ownership of its capital stock has been restricted "as far as possible." Sec. 1.521-1(a)(2), Income Tax Regs.

The term "substantially all" as used in section 521 is not defined in that statute or the underlying regulations. We have held, however, that 91 percent satisfies the "substantially all" requirement (Farmers Co-Operative Creamery v. Commissioner, 21 B.T.A. 265, 269 (1930)) while neither 78 percent nor 72 percent satisfies the requirement. Co-Operative Grain & Supply Co. v. Commissioner, T.C. Memo. 1973-164, on remand 407 F.2d 1158 (8th Cir. 1969), revg. in part and remanding T.C. Memo. 1967-132; Petaluma Co-Operative Creamery v. Commissioner, 52 T.C. 457, 465 (1969). The Commissioner has published the

position that the "substantially all" test is considered to have been satisfied if at least 85 percent of such capital stock is held by producers. Rev. Rul. 73-248, 1973-1 C.B. 295. 10/

[10/ The Commissioner apparently issued Rev. Rul. 73-248, 1973-1 C.B. 295, in light of the Eighth Circuit Court's mandate to issue guidance in this area. Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1164 (8th Cir. 1969). It should also be noted that the Commissioner published the 85 percent test in a ruling at least four years prior to the first reporting year involved in these consolidated cases.]

In addition, this Court (Co-Operative Grain & Supply Co. v. Commissioner, T.C. Memo. 1973-164) and the Eighth Circuit (Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d at 1162) have interpreted section 521(b)(2) to require that "substantially all" of a stock cooperative's shareholders not only be producers, but also be current and active patrons. While neither Court quantified this current patronage concept by defining what amount or quantity of business a producer-shareholder must transact with the cooperative in order to qualify as a current and active patron, the Commissioner has issued Rev. Proc. 73-39, 1973-2 C.B. 502, that attempts to define the quantum of business required.

The Revenue Procedure provides that a patron is a current and active patron only if he markets through that cooperative each year "more than 50 percent" of the products he produces and markets, or only if he purchases through that cooperative each year "more than 50 percent" of the supplies and equipment he purchases of the type handled by that cooperative. 1973-2 C.B. at 502-503. However, a person could be considered a current and active patron if, under all the facts and circumstances of his particular case, it was determined that he was unable to comply. 1973-2 C.B. at 503.

This is the first case where we have been asked to draw a bright line as to what percentage of stock ownership will satisfy the "substantially all" test of section 521(b)(2). Respondent, relying on the two administrative interpretations of the "substantially all" requirement, argues that petitioners are not exempt under section 521(b)(2) because "substantially all" of the capital stock is not "owned by producers who market their products or purchase their supplies and equipment through" the respective petitioner. Petitioners, on the other hand, argue that no court has decided exactly what percentage of stock ownership by such producers is sufficient in all cases to constitute compliance. In order to determine whether petitioners are exempt cooperatives under section 521(b)(2), we must address each respective test in turn.

A. 85-Percent-of-Stock-Held-by-Producers Test.

Petitioners have asked this Court to determine exactly what percentage of stock ownership will be sufficient. Petitioners argue that respondent's attempt to quantify the "substantially all" test plainly ignores this Court's prior holdings and, more fundamentally, contradicts the respondent's own regulations that impose the only additional mandate that the farmers cooperative must restrict ownership of the stock "as far as possible" to actual producers. Sec. 1.521-1(a)(2), Income Tax Regs. Thus, we are asked to determine whether the "substantially all" test has been satisfied based upon a factual weighing and balancing of all the factors to determine whether the cooperative has restricted the ownership of the stock as far as possible and not on a mechanical or quantitative test.

Petitioners contend that a quantitative test ignores this Court's opinions in both Co-Operative Grain & Supply Co. v. Commissioner, *supra*, and Petaluma Co-Operative Creamery v. Commissioner, *supra* at 465, where we stated that it was not necessary to determine what percentage would constitute compliance. Therefore, according to petitioners, this court has not, nor should it now, hold that a mechanical, quantitative test is the appropriate standard to determine whether the "substantially all" requirement is satisfied. Rather, petitioners argue, determining what constitutes "substantially all" is essentially a question of fact, depending on the particular circumstances of each case. Accord, Farmers Co-Operative Creamery v. Commissioner, *supra*; Farmers' Co-Operative Milk Co. v. Commissioner, 9 B.T.A. 696 (1927).

Respondent, on the other hand, argues that the 85-percent test embodied in Rev. Rul. 73-248, *supra*, is a reasonable interpretation of section 521(b)(2). Respondent relies in his brief upon an unreported District Court's opinion in West Central Cooperative v. United States, No. 1C 81-3029 (N.D. Iowa 1983). In that

case the taxpayers appealed after the District Court found that the 85-percent test is reasonable and in keeping with the congressional mandate embodied in the language of section 521(b)(2) (citing United States v. Correll, 389 U.S. 299, 307 (1967)). Based on the 85-percent test, the District Court concluded that the cooperative did not qualify for exemption because only 83.75 percent of the cooperative's shareholders were producers who marketed some of their products or purchased some of their supplies and equipment through the cooperative. Since the briefs in this case were filed, the Eighth Circuit Court of Appeals affirmed the District Court's opinion and conclusion that the 85-percent test in Rev. Rul. 73-248, supra, is a reasonable interpretation. West Central Cooperative v. United States, 758 F.2d 1269 (8th Cir. 1985), affg. per curiam an unreported District Court opinion. Because an appeal in these consolidated cases lies in the Eighth Circuit, we are bound by the Eighth Circuit's affirmation that the 85-percent test is reasonable. Golsen v. Commissioner, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

Nevertheless, we agree in concept with the Internal Revenue Service's 85 percent test and find it an appropriate measure in light of various court opinions interpreting the "substantially all" language of section 521(b)(2). Prior to the Eighth Circuit's affirmation of the holding that 83.75 percent does not satisfy the "substantially all" requirement, the highest percentage found to be less than "substantially all" was 78 percent (Co-Operative Grain & Supply Co. v. Commissioner, supra) while 91 percent was the lowest amount held to constitute "substantially all" (Farmers Co-Operative Creamery v. Commissioner, supra at 269). Based upon the 85-percent test, petitioners do not qualify for exemption because only 84.78 percent of the Company's producers in fiscal year 1977 and only 82.52 percent in fiscal year 1978 transacted business with the Company. The figures are less favorable with respect to the Society; 79.58 percent of the Society's producers in fiscal year 1979 and 76.70 percent in fiscal year 1980 transacted business with the Society.

The favorable tax treatment afforded cooperatives is intended to benefit the member-producers, not the cooperative as a business entity. Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d at 1163. That policy focus provides a reason, if not a compulsion, to strictly construe the "active participation" and "substantially all" requirements of the statute. Tax statutes permitting special exemption are to be strictly construed against the taxpayer. Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46 (1940); Luehrmann's Estate v. Commissioner, 287 F.2d 10 (8th Cir. 1961). Accord (with respect to cooperatives seeking exemption under section 521), Land O'Lakes, Inc. v. United States, 514 F.2d 134, 139 (8th Cir. 1975), cert. denied 423 U.S. 926 (1975); Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d at 1162; Farmers Union Co-Op. Co. v. Commissioner, 90 F.2d 488, 493 (8th Cir. 1937). In ordinary usage or specialized tax parlance, 85 percent is an appropriate and possibly a liberal meaning of "substantially all," considering the policy objectives of the statute. In other areas of the Code dealing with an exemption from taxation, for example, in the tax exempt bond area, the regulations contain a 90-percent "substantially all" test with respect to the use of proceeds of bonds issued to provide for certain facilities. Sec. 1.103-8(a)(i), Income Tax Regs. Accordingly, we are in agreement with the recent judicial approval of the 85-percent standard for stock cooperatives. West Central Cooperative v. United States, supra.

We do not believe, however, that the Eighth Circuit intended to support or fashion a rigid standard which would, under all circumstances, not achieve the congressional intent of the statute. If, for example, a cooperative had 90 percent of its shareholders patronize the cooperative for three successive years and then shareholder participation dropped to 84.75 percent for one year, the congressional intent would not be served by revoking the cooperative's exempt status for the year that participation fell below 85 percent. In such a situation, the cooperative has not become the focal point or reason for its own existence, thereby being transformed into a business enterprise separate from its shareholders or members. Accordingly, we believe the cooperative would have satisfied the "substantially all" requirement. On the other hand, a cooperative with 78 percent patronization for three successive years and then 84.75 percent for one year does not comply with the "substantially all" test and has not restricted the ownership of its capital stock "as far as possible" to active shareholders. To that extent, we agree with petitioners that a facts-and-circumstances approach should be utilized to temper the possibility of a harsh result that could occur from the use of the bright line test of Rev. Rul. 73-248, supra.

Petitioners argue that Co-Operative Grain & Supply Co. v. Commissioner, supra, and Petaluma Co-Operative Creamery v. Commissioner, supra, support their argument, but the percentages used therein should

not be controlling because the taxpayers therein did not argue, nor did this Court determine, that the cooperatives had restricted their stock ownership, as far as possible, to active shareholders. Petitioners argue that those cases are factually distinguishable because petitioners have attempted to restrict the ownership of their stock "as far as possible" to active patrons. With respect to the Company, it reduced the period of nonpatronage from two years to one year (i.e., the period of time after which a shareholder could be asked to redeem his voting stock because he had not patronized the Company during that time). This reduction in time could, arguably, have improved the percentage participation in the Company. On brief and by stipulation, petitioners presented schedules showing the increase that would occur if we were to consider and delete those nonparticipating shareholders from the computation who were actually purged from voting membership after the year in question. In some instances, considering subsequently purged shareholders, petitioners would have met the 85-percent test. A close scrutiny of petitioners' schedules reflects, however, that, generally, nonparticipating shareholders were not purged for about 12 to 24 months after the close of the measuring year. Additionally, many nonparticipating shareholders were not purged for as long as 36 months after the close of the measuring year.

The Company's failure to purge nonparticipating shareholders until generally one to three years after the close of the measuring year, in essence, more than negates any benefit that could have ensued by reducing their nonparticipation period from two years to one. Petitioners request that we favorably consider their delayed action and permit credit for efforts as much as 36 months later to help them meet the 85-percent test. The case law is clear, however, that current patronage on an annualized basis is the standard. Co-Operative Grain & Supply Co. v. Commissioner, *supra*. Based upon the record in this case, we find that the Company has failed to restrict stock ownership, as far as possible, to participating shareholders. The Society's bylaws and efforts are even less effective than those of the Company, and accordingly, we find that the facts and circumstances of these cases do not warrant variance from the 85-percent standard. In so finding, we disagree with petitioners' attempt to distinguish Co-Operative Grain & Supply Co. v. Commissioner, *supra*, and Petaluma Co-Operative Creamery v. Commissioner, *supra*. In those cases, as here, we considered whether the taxpayers restricted stock ownership to eligible patrons by evaluating the effect of a shareholder's death, a shareholder's move from the cooperative's trade territory, and the effect of joint stock ownership between husband and wife.

Petitioners also urge this Court to include persons who became members of the cooperative by patronizing during the course of each year, but did not become shareholders until after the end of the fiscal year. While such "members" were not shareholders, they were entitled to participate in the management and profits for those years. If we were to include such persons in the computation, the Company's percentages would increase to 85.45 percent and 83.26 percent, respectively. Petitioners have not provided the figures nor are we able to compute the percentages with respect to the Society by including those nonshareholders who transacted business with the Society. Petitioners admit that the Society's percentages may not be much improved by adding after-admitted members but argue that the Society is five to seven times larger than the Company and sheer size alone should be sufficient to provide the basis for a different result. We hold that only shareholders who transact business with the cooperative during the year are to be included each year just as shareholders who no longer patronize the cooperative must be removed from the computation. Both inclusion and removal of such "members" are determined after the end of the cooperative's fiscal year when the cooperative determines whether such person had sufficient patronage to earn or to lose a share of stock. The test is whether at least 85 percent of a cooperative's capital stock is held by producers. This test presumes that the producers are shareholders during the year. See Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d at 1162. Similar types of arguments have been previously raised before this Court and rejected because "[a] mere continuing business relationship without actual yearly participation is not a sufficient basis upon which to find current shareholder participation of business with the cooperative." (Emphasis added.) Co-Operative Grain & Supply Co. v. Commissioner, *supra*.

B. 50-Percent-Current-Patronage Test.

In addition to requiring that "substantially all" of the shareholders be producers, this Court and the Eighth Circuit have interpreted section 521(b)(2) to require that the shareholders be current and active patrons. Co-Operative Grain & Supply Co. v. Commissioner, T.C. Memo. 1973-164, on remand 407 F.2d 1158, 1160 (8th Cir. 1969). However, neither court quantified this current patronage concept by defining

what amount or quantity of business a producer-shareholder must transact in order to qualify as a current and active patron. Petitioners argue that any producer who has transacted any or some business with the cooperative may be considered an active and current producer of the cooperative during the year. Respondent, on the other hand, argues that a producer can be considered an active or current patron only if he markets or purchases more than 50 percent of his products or supplies through that cooperative during the year relying on Rev. Proc. 73-39, supra. We need not decide this quantum of business test because neither petitioner has reached the prerequisite 85-percent test. 11/

[11/ We note that consideration of this area is fraught with many difficulties and problems. Does respondent contemplate that cooperatives will keep track of shareholders' transactions outside the cooperative in order to police the 50-percent test of Rev. Proc. 73-39, 1973-1 C.B. 502? Would cooperatives effectively serve their congressionally intended purpose if patrons were required by contract to transact a minimum amount of business with the cooperative?]

C. Patronage-Sourced/Nonpatronage-Sourced.

All cooperatives, whether exempt or nonexempt, may deduct amounts paid or allocated to their patrons (patronage dividends). Sec. 1382(b). If a cooperative is exempt, such amounts are deductible regardless of whether they are paid out of patronage-sourced or nonpatronage-sourced income. Secs. 1382(c)(2)(A) and 1388(a)(3). If a cooperative is not exempt, however, such amounts are deductible only if paid out of patronage-sourced income. Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), rev. and remanding 31 T.C. 674 (1958); sec. 1388(a)(3). Because we have found that petitioners were not exempt cooperatives during the taxable years at issue and because of concessions made by the parties, we need not address whether the Company may deduct the grain storage income they distributed to the patrons.

The parties agree that all but \$1,752.89 of the Company's 1978 grain storage income was patronage-sourced income. All patronage-sourced income was properly deductible by the Company without regard to its tax exempt status. With respect to the \$1,752.89 amount that both parties agreed is nonpatronage-sourced, the Company may not deduct this amount because we have found that the Company was not exempt for the taxable years at issue.

WHITAKER, J., dissenting: I do not believe there is any basis in the statute or the regulations thereunder for the adoption of a "bright line" test at the level of 85 percent as articulated by respondent in Rev. Rul. 73-248, 1973-1 C.B. 295. The majority opinion effectively adopts this bright line test and applies it to the facts before us. While arguably the majority felt impelled to reach this result by the rule of Golsen v. Commissioner, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971) and the opinion of the 8th Circuit in West Central Cooperative v. United States, 758 F.2d 1269 (8th Cir. 1985), affg. per curiam an unreported District Court opinion, I do not agree that approval of Rev. Rul. 73-248 is so required. And certainly Golsen does not mandate independent adoption of that test by this Court.

Insofar as pertinent, respondent's regulations provide as follows:

(2) An association which has capital stock will not for such reason be denied exemption (i) * * *, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the

association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. [Section 1.521-1(a)(2), Income Tax Regs.]

The statute and regulations have been in effect, substantially unchanged, since the Revenue Act of 1926. ^{1/}

[^{1/} The legislative history of this statute is fully described in Co-Operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, (8th Cir. 1969), revg. in part and remanding T.C. Memo 1967-132.]

In fact, insofar as here pertinent, the regulations have been little changed since the version approved on December 20, 1924. See Article 22, Regulation 65, as amended by T.C. 3658, III-2 C.B. 242. The statute has consistently imposed on cooperatives having capital stock the requirement that "substantially all" voting stock must be owned by producers who market through the cooperative.

The term "substantially all" now appears in the Internal Revenue Code over 50 times and is used in regulations over 100 times. In varying contexts, the term has been defined as a fixed percentage ranging from 99 percent (section 1.103-15(d)(2), Income Tax Regs.) to a combination of 70 and 90 percent (section 1.279-5(d)(2), Income Tax Regs.). Both 85 percent and 80 percent also have been adopted by respondent many times to define "substantially all." If there is any rationale for the varying percentages, it is not readily discernable.

If one concentrated solely on section 521(b)(2), with its emphasis upon voting control, one might logically be led to the Congressionally enacted voting control test in section 368(c)(1) which requires "at least 80 percent of the total combined voting power * * * and at least 80 percent of the total number of shares * * * ." Rather than focusing on defining "substantially all," however, we should grant great deference to respondent's regulations which are about to acquire "senior citizen" status. ^{2/}

[^{2/} As stated in Helvering v. Winmill, 305 U.S. 79, 83 (1938):

Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law.]

The crucial import of those regulations is to be found in the following two sentences:

Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. [Sec. 1.521-1(a)(2), Income Tax Regs.]

This is a facts and circumstances, not a bright line, test. The examples given--an officer required to have capital stock in order to qualify and a restriction on the ability of the association to recapture stock of a nonproducer--show that respondent, and we must now presume the Congress, intended that each cooperative should essentially be owned and controlled by its producers, and that "substantially all" was not intended to be reflected as a percentage. The regulations allow that amount of nonproducer ownership, and only that amount, reasonably required by the particular circumstances. Thus, the issue which should have been addressed by the majority is whether the cooperatives reasonably justified the extent of stock ownership by nonactive producers.

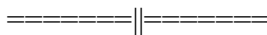
This Court has in earlier cases recognized the propriety of failing to establish a bright line. We have simply defined outer limits. See Farmers Co-Operative Creamery v. Commissioner, 21 B.T.A. 265, 269

(1930) where we held that 91 percent satisfies the requirements of section 521 and Co-Operative Grain and Supply Co. v. Commissioner, T.C. Memo. 1973-164, on remand 407 F.2d 1158 (8th Cir. 1969), revg. in part and remanding T.C. Memo. 1967-132, where we held that neither 78 percent or 72 percent satisfies the requirement. Between those outer limits, at least until respondent promulgated Rev. Rul. 73-248, *supra*, the test was entirely one of facts and circumstances, as demanded by respondent's regulations. While the majority suggests that the 85-percent test is not entirely rigid, the regulations are in fact largely abrogated, first by respondent and now by the majority.

The majority commits another error of policy by according to a revenue ruling substantially the stature normally accorded to a regulation. "[A] 'Revenue Ruling' is an official interpretation by the Service, issued only by the National Office and published in the Internal Revenue Bulletin for the information and guidance of taxpayers, Service personnel, and others concerned." Rogovin, "The Four R's: Regulations, Rulings, Reliance, and Retroactivity--A View From Within," 43 Taxes 756, 764 (1965). As Mr. Rogovin points out, revenue rulings and letter rulings are merely part of respondent's rulings program. While certainly useful, these statements of respondent's position "are not entitled to any particular weight." Anselmo v. Commissioner, 80 T.C. 872, 883 n.13 (1983) affd. 757 F.2d 1208 (11th Cir. 1985). The Fifth Circuit has well said: "A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on the Secretary or the courts. It does not have the effect of a regulation or a Treasury Decision." Stubbs, Overbeck & Associates, Inc. v. United States, 445 F.2d 1142, 1146-1147 (5th Cir. 1971).

The majority speculates (see note 10) that Rev. Rul. 73-248 was issued in response to the evident displeasure of the Eighth Circuit in Co-Operative Grain & Supply Co. v. Commissioner, *supra* at the lack of specific guidance in the form of "regulations or rulings." If respondent wished to establish a bright line test, at 85 or any other percentage, the only appropriate way to do so would be by the promulgation of an amending regulation which would have allowed interested cooperatives to comment at a public hearing. The fixing of a safe harbor or perhaps establishment of outer limits (if wide enough) by revenue ruling may be appropriate since more easily accomplished than by regulation promulgation. In any event, such a bright line test is justified largely for administrative convenience. Its establishment is an appropriate function for the Congress or the Treasury Department by regulation but not for this or any other Court. The majority simply encourages avoidance of the regulation process.

STERRETT, J., agrees with this dissent.



Farmers Cooperative Co. v. Comm'r
822 F.2d 774 (8th Cir. 1987), *remanding*, 85 T.C. 601 (1985)

HEANEY, Circuit Judge:

Farmers Cooperative Company (Farmers) appeals a decision of the tax court that it did not qualify as an exempt cooperative association under Section 521 of the Internal Revenue Code, 26 U.S.C. s.521 (hereinafter section 521), during the 1977 and 1978 tax years because substantially all of its capital stock was not owned by producers who market their products or purchase their supplies through Farmers. We affirm in part, reverse in part, and remand to the tax court.

Farmers is a cooperative incorporated under the laws of the State of Nebraska with its principal office in Platte Center, Nebraska. It is an association organized and operated as a cooperative to market the products of its farmer members and others and to sell supplies to members and others. During the tax years relevant to this case, Farmers' authorized capital stock consisted of 40,000 shares of \$12.50 par value common stock. Each shareholder of the common stock was entitled to only one vote regardless of the number of shares owned. In addition to the capital stock, Farmers carried certificates of participation and

equity credits on its books. Neither the certificates nor the credits entitled the holder to vote or otherwise participate in the management of Farmers.

Beginning in 1956, the Internal Revenue Service (IRS) recognized Farmers as an exempt cooperative under section 521. In March 1982, however, the IRS notified Farmers of its determination to revoke its exemption for all tax years beginning on or after October 1, 1976. The IRS stated that it did so because it believed Farmers had not adequately limited the ownership of "substantially all" of its capital stock to producers who patronized the cooperative during the tax year as required by section 521(b)(2). On July 2, 1982, Farmers filed a petition for redetermination with the Tax Court. The Tax Court held that, on the basis of the facts stipulated, Farmers did not qualify as a tax-exempt farmers' cooperative during the tax years at issue. Farmers appeals.

ANALYSIS

Section 521 provides a tax exemption for qualifying farmers' cooperatives. In order to qualify for the exemption a cooperative must be "organized and operated on a cooperative basis *** for the purpose of marketing the products of members or other producers *** or *** for the purpose of purchasing supplies and equipment for the use of members or other persons." 26 U.S.C. s.521(b)(1). It addition, if the cooperative issues capital stock, it is not entitled to the exemption unless "substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the [cooperative], upon dissolution or otherwise, beyond the fixed dividend) is owned by producers who market their products or purchase their supplies and equipment through the [cooperative]." ^{1/}

[^{1/} A "producer" is defined as a person who bears the risks of agricultural production and who cultivates, operates, or manages a farm. See Rev. Rul. 67-422, 1967-2 C.B. 217; Rev. Rul. 72-589, 1972-2 C.B. 282.]

26 U.S.C. s.521(b)(2).

The exemption allowed by section 521 is over and above the exemption allowed for other nonqualifying cooperatives. Even nonexempt farmers' cooperatives can deduct from gross income amounts collected from patrons and allocated and distributed to patrons out of the net earnings of the cooperatives. See 26 U.S.C. s.1382(b). Exempt cooperatives may, in addition, deduct amounts paid during the tax year as dividends on capital stock and earnings paid to patrons, on a patronage basis, derived from nonpatron sources. See 26 U.S.C. s.1382(c).

The ability of exempt cooperatives to deduct nonpatronage income allocated to patrons on a patronage basis has often been used by cooperatives to allocate income from government grain storage to their patrons, distributing the minimum amount required in cash and carrying the remainder on its books as a credit. Although this arrangement requires patrons to recognize their full allocation for federal tax purposes, the "flow through" arrangement has enabled cooperatives to accumulate sufficient capital to build grain storage and handling facilities not otherwise possible if the nonpatronage income were taxed at the cooperative level. See Affidavit of Stanley A. Wells, Exhibit 123, pp. 27-28. Such facilities allow the cooperative to exercises greater bargaining power on behalf of member farmers by giving them the power to make larger purchases and sales and to better control the timing of such purchases and sales. Thus, the exemption is one method by which Congress sought to enhance the bargaining power of small farming operations. See Liberty Warehouse Co. v. Burley Tobacco Growers' Co-operative Marketing Association, 276 U.S. 71, 92-96 (1928).

In limiting the exemption, however, Congress sought to benefit only the members of the cooperative, not the cooperative as a business entity. Accordingly, Congress granted the exemption only to those cooperatives in which [a]dvantages *** accrue to a member of a cooperative *** primarily because of his patronage with the association and not because of any financial investment he may have made therein." Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158 (8th Cir. 1969) (quoting Paul, The

Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes, 29 Minn. L. Rev. 343, 344 (1945).

It is to this end that section 521 requires a farmers' cooperative to limit the ownership of "substantially all" of its capital stock to producer who market their products or purchase their supplies through the cooperative. The degree to which a cooperative must limit ownership of its capital stock in order to qualify for the exemption, however, is not defined in the Internal Revenue Code or the regulations. 2/

[2/ Section 1.521(a)(2) of the Income Tax Regulations states:

An association which has capital stock will not for such reason be denied exemption *** (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers.

Id. (emphasis added).]

In Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1164 (8th Cir. 1969), Judge Matthes, speaking for this Court, held that qualification for the exemption requires substantially all of the shareholder producers to patronize the cooperative on a current basis. In addition, the Court in Co-operative Grain & Supply urged the IRS to promulgate regulations clarifying the requirements of section 521(b)(2). After Co-operative Grain & Supply Co., the IRS issued a revenue ruling stating:

In deciding whether a farmers' cooperative meets the "substantially all" test of section 521(b)(2) of the Code, all of the capital stock of the cooperative (other than nonvoting preferred) must be counted. Once all of the capital stock has been counted, at least 85 percent of such capital stock should be held by producers before it can be said that the "substantially all" test of section 521(b)(2) of the Code has been satisfied.

Rev. Rul. 73-248, 1973-1 C.B. 295.

This Court has since upheld the 85% test as a reasonable interpretation of the "substantially all" requirement of section 521. See West Central Cooperative v. United States, 758 F.2d 1269, 1271 (8th Cir. 1985).

In this case, we do not understand Farmers to challenge the 85% test in the revenue ruling. Instead, Farmers challenges the manner in which it was applied. In particular, it argues that two groups were treated erroneously: (1) those who, by sufficiently patronizing the cooperative, became entitled to a share of capital stock during the tax year (Farmers contends that those in this group should have been counted as shareholders for the tax year in which they became entitled to the stock); 3/

[3/ It is undisputed that Farmers' tax and fiscal year ends on September 30.]

and (2) those who did not patronize Farmers during the tax year (Farmers argues that those in this group should not have been counted as shareholders).

The consequences of accepting Farmers' contentions with respect to each group and each tax year are important. For tax year 1977, the IRS contends that Farmers had 670 shareholders, 568 or 84.78% of whom patronized it during the tax year. Alternatively, Farmers argues that if those who became entitled to a share of capital stock during the 1977 tax year are counted as shareholders (and by definition patrons) it would have had 702 shareholders, 600 or 85.47% of whom patronized it during the year.

For tax year 1978, Farmers' argument with respect to those who became entitled to a share is less helpful. The IRS contends that during tax year 1978, Farmers had 698 shareholders, 576 or 82.52% of whom

patronized it. Accepting Farmers' argument as to those who became entitled to a share during the tax year, Farmers would have 731 shareholders, 609 or 83.31% of whom patronized it during the tax year.

Of course, accepting Farmers' contention that those who failed to patronize it during the tax year automatically ceased to be shareholders results in 100% of Farmers' shareholders being patrons during the tax year because nonpatrons automatically become nonshareholders. Thus, Farmers would be entitled to the exemption for both tax years at issue.

In support of its argument as to the first group, Farmers contends that under general corporate law principles the right to a share of stock accrues upon performance of the necessary prerequisites (in this case sufficient patronage during the year). Thus, since Farmers could not and has not denied a share of stock to one who became entitled to it, any formalities required for issuance of the share should be irrelevant and the patron counted as a shareholder for the year in which the right to it accrued.

In support of its argument as to the second group, Farmers cites the Court to its by-laws which state: "Only producers of agricultural products *** within the trade territory of this corporation, who do business with the corporation annually, may own the common stock of this cooperative." Farmers also points out that it regularly took action to "purge" nonpatronizing shareholders from its list of active, voting shareholders and that its by-laws provided a procedure for taking such action.

The IRS responds to Farmers' contentions arguing that, as to the first group, under Farmers' by-laws, entitlement to the stock does not accrue until Farmers has closed its books for the year; determined that a patron has done sufficient business to qualify for stock ownership; the patron has made application for membership; and has been accepted by the board of directors at the annual meeting of shareholders. Since none of these actions could have been taken during Farmers' tax year, the IRS argues that those in this group were properly excluded from the 85% computation.

With respect to the second group, the IRS contends that Farmers' by-laws are not self-executing but require affirmative action to convert nonpatrons' shares to nonvoting stock. Since Farmers failed to determine whether a person's shares should be converted or redeemed for failure to patronize it until after the end of the tax year and since the stock of nonpatronizing shareholders was not normally converted or redeemed until quite some time after the close of the tax year, 4/

[4/ The stipulated record in the case shows that for the tax year ending on September 30, 1977, of the 102 shareholders who failed to patronize Farmers, none had their shares converted or redeemed within six months of the close of the tax year, one shareholder's stock was converted or redeemed within one year, two shareholders had their stock converted or redeemed within eighteen months, 67 shareholders had their stock converted or redeemed within twenty-four months, and 75 shareholders had their stock converted or redeemed within thirty-six months.]

the IRS contends that Farmers' bylaws are not sufficient evidence of the substantive action required on an annual basis to prevent nonpatronizing shareholders from owning capital shares.

While we agree with the IRS's position that Farmers "cannot permanently perpetuate its exempt status simply by declaring in its articles of incorporation or by-laws that nonpatronizing shareholders are not eligible to continue to own shares in the cooperative," we cannot agree with the alternative it offers to ensure that cooperatives qualifying for the exemption are run for the benefit of their patrons and not for the benefit of their nonpatron investors. Apparently, the government would require Farmers and other similar cooperatives to convert or redeem the shares of nonpatronizing shareholders before the end of the tax year for which the exemption is sought. This approach ignores both practical administrative limitations and the purpose served by the limitation on the exemption.

Common sense tells us that Farmers cannot possibly know whether a shareholder will patronize it during the tax year until the close of business on the last day of the tax year and the end of the tax year. 5/

[5/ The affidavit of Stanley A. Wells, admitted in evidence at trial, states:

Even with the best internal controls and reporting systems available, a cooperative must complete its bookkeeping for its year end, get a printout of the last data processing that was done in the last week of its fiscal year and, after that printout is received, compare it with a list of outstanding stockholders to determine if any of those failed to patronize it during the year. Following that the cooperative must update and amend its stockholder list to show who are eligible stockholders. Even under the best of circumstances, this process takes the period of time between the cooperative's year end and its next stockholders' meeting to update its records and show who is now eligible to vote.

Exhibit 123 at p. 14.]

Moreover, we can discern no purpose to be served by requiring that which is practically impossible.

The purpose of the limitation on the exemption is to restrict it to those cooperatives organized and operated for the benefit of patrons as patrons and not for the benefit of investors. To this end, the section 521(b)(2) exemption is available only to those cooperatives in which participation in the direction and decision making process of the cooperative is strictly limited to patrons. 6/

[6/ We note that, in light of the facts in this case, the "substantially all" requirement of section 521 may address a problem that is more perceived than real. During the tax years at issue, the by-laws of Farmers limited ownership of capital stock to one share (par value \$12.50). In addition, as in most cooperatives, each shareholder was entitled to only one vote. Finally, under applicable law, the dividend rate of capital shares was limited to the greater of the legal rate of interest in the state of incorporation or eight percent per annum. Given these facts, we find it hard to believe Farmers' capital stock represented a particularly attractive investment of one not interested in patronizing it.]

Of primary importance, therefore, is a shareholder's right to vote. Thus, in addition to the practical difficulties of the standard advanced by the IRS, the standard also ignores the primary distinction between passive investors in the cooperative and shareholders - the right to vote. 7/

[7/ Section 521(b)(2) recognizes this distinction by excluding from consideration nonvoting preferred stock. 26 U.S.C. s.521(b)(2).]

The standard the IRS suggests has this effect because, for all practical purposes, although the right to vote may accrue or be lost during the tax year, it is normally exercised only at the annual shareholders' meeting that is ordinarily held several months after the close of the year.

Thus, we hold that, for purposes of applying the 85% test, the relevant consideration is whether the right to vote has actually accrued or been terminated by the time of the annual shareholders' meeting following the close of the tax year. In other words, if a producer who sufficiently patronizes a cooperative during the tax year to become entitled to a share of capital stock is actually entitled to vote that share at the annual shareholders' meeting following the close of that tax year, that producer should be counted both as a shareholder and as a patron for the tax year in which the right to the share accrued. Conversely, if a shareholder, by failing to patronize a cooperative, ceases to be entitled to own a share and thereby actually loses the right to vote at the annual shareholders' meeting following the close of the tax year, that shareholder should not be counted as a shareholder or a patron for the tax year in which the right to the share was lost. 8/

[8/ This must be distinguished from those who actually attended the shareholders' meeting and voted. Minutes of the Company's annual shareholders' meeting for the years in issue reflect that of the 94 persons who attended the shareholders' meeting following the close of the 1977 fiscal year, 76 were capital stockholders entitled to vote. Of the 70 persons who attended the shareholders' meeting following the close of the 1978 fiscal year, 67 were capital shareholders entitled to vote.

The actual attendance records of the meetings are not sufficient evidence that a cooperative has taken steps to ensure that control of its affairs remains with its patrons for two reasons.

First, we are concerned with the rights of nonpatrons to direct the affairs of a cooperative. The fact that the right may not have been exercised in a specific instance does not mean that the right does not exist or will not be exercised at some point in the future. Second, as a practical matter, unless a cooperative can show that its list of those entitled to vote is updated prior to the annual shareholders' meeting to reflect nonpatrons' loss of voting rights, the statement that a certain percentage of those attending a shareholders' meeting were entitled to vote does not indicate that a cooperative took action to remove the voting rights of nonpatron shareholders.]

Applying the standard to the stipulated record, we note that the "[s]tatutory language exempting farmers' cooperatives from the full burdens of taxation is to be strictly construed." Land O'Lakes, Inc. v. United States, 514 F.2d 134, 139 (8th Cir. 1975) (quoting Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1162 (8th Cir. 1969); Farmers Union Co-op Co. v. Commissioner, 90 F.2d 488, 493 (8th Cir. 1937)). Moreover, Farmers had the burden of demonstrating that it is entitled to the exemption. Farmers Union Co-op, 90 F.2d and 493. In this light, we consider separately those patrons who became entitled to a capital share during the tax year and those who failed to patronize Farmers during the tax year.

1. Patrons entitled to a share. With respect to those patrons who became entitled to a capital share during tax year 1977, the uncontradicted affidavit of James A. Beiermann, a manager with Farmers states: "Each of the 31 new shareholders of the Company [Farmers], whose shares had been issued to them on the annual meeting date, were entitled to participate in that meeting and to vote on all matters requiring action by the shareholders." Exhibit 24 at p. 12. Thus, the tax court erred in failing to include in the total number of Farmers' shareholders and in the number of patrons for tax year 1977, those who became entitled to a share of capital stock during that tax year.

With respect to those patrons who became entitled to a capital share during tax year 1978, the record similarly indicates that they were entitled to participate as voting shareholders in the annual meeting following the close of the tax year. Exhibit 24 at p. 31. Thus, they should have been included in the total number of Farmers' shareholders and patrons for tax year 1978.

2. Nonpatronizing shareholders. Whether those shareholders who failed to patronize Farmers during the tax year preceding the annual shareholders' meeting could have voted at the meeting presents a more difficult question. The uncontradicted affidavit of James A. Beiermann states:

The Company [Farmers] follows specific procedures with respect to the conduct of its annual meetings so that only shareholders are allowed to vote. Every patron who attends is required to register in at the front door. That patrons name is checked against the Company's most recent investment listing, or shareholder list. It is then determined whether the patron is a stockholder and, thus, entitled to vote or whether he is the holder of a certificate of participation and not entitled to vote. This procedure was observed at the annual meeting following the Company's 1977 fiscal year, at the annual meeting following its 1978 fiscal year, and at the annual meeting following each subsequent fiscal year since 1978.

Exhibit 24 at pp. 12-13.

That Farmers followed certain procedures in limiting the right to vote at its shareholders' meetings to record owners of capital shares is not, of course, proof that those who failed to patronize Farmers during the fiscal year could not have voted at the meeting. It does no good to follow such procedures if the lists used to determine a person's right to vote do not reflect conversion or redemption of shares for failure to patronize the cooperative. Thus, the question is whether the investment listing referred to in the above quoted passage reflected the cancellation of the voting rights of those who failed to patronize it during the preceding tax year.

Review of the record reveals no evidence that the list reflected such action. To the contrary, the affidavit of Stanley A. Wells stated:

[A]fter the end of its 1978 tax year, [Farmers] again updated its bylaws and added a provision which now enables it to effectively cancel a voting share even though the share has not been physically called in and redeemed. Its bylaws now provide that an inactive patron immediately ceases to be eligible to hold stock or exercise any of the rights or privileges of a stockholder.

Exhibit 123 at 12.

Thus, it appears that during the tax years at issue, Farmers believed it could not cancel the voting rights of a nonpatron without first calling in and obtaining physical possession of the nonpatron's stock. The logical conclusion, therefore, is that the nonpatrons would have been included among those eligible to vote on the lists of such persons at the time of the shareholders' meeting. In sum, since Farmers failed to show that those shareholders who failed to patronize it during the tax year could not have voted at the annual shareholders' meeting following the tax year, the tax court correctly counted such nonpatrons as shareholders for the tax years at issue.

As a final matter, the tax court, due to its disposition of this case, accepted as a patron every person who did business with Farmers during the tax year regardless of the quantity of such business. The tax court expressly reserved questions as to the validity of the position taken by the IRS that section 521(b)(2) requires producers to market 50% of their production or to purchase 50% of their supplies from the cooperative during its tax year to be considered patrons. See Rev. Proc. 73-39, 1973-2 C.B. 502. This Court has not squarely addressed this issue. ^{9/}

[^{9/} We note, however, this Court's comment in Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d at 1164 n.10:

Neither the taxpayer nor amicus has discussed the question of the amount or quantity of products which currently must be sold or supplies purchased through the cooperative. *** The Commissioner in brief, however, assumes that substantially all of the shareholder-producers must market substantially all of their products and purchase substantially all of their supplies through the cooperative. *** We do suggest, however, that imposition of the standard proposed here by the Commissioner could produce impractical and perhaps oppressive results. We believe the Tax Court, on remand, should resolve this question, if it becomes an issue, by application of a reasonable and realistic standard.]

Thus, it is appropriate to remand the case to the tax court for consideration of this issue.

CONCLUSION

Under the rules set forth in this opinion and accepting (as did the Tax Court) as a patron every shareholder who did business with Farmers during the relevant tax year, we affirm the finding of the tax court with respect to tax year 1978 that Farmers failed to show that 85% of its shareholders were patrons. With respect to tax year 1977, however, we reverse the tax court and remand the case for a determination of the validity and applicability of the patronage requirements found in Rev. Proc. 73-39, 1973-2 C.B. 502.

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Farmers Cooperative Co. v. Comm'r

89 T.C. 682 (1987), *on remand from*, 822 F.2d 774 (8th Cir. 1987)

GERBER, Judge: This opinion is necessitated by a mandate, issued July 22, 1987, from the United States Court of Appeals for the Eighth Circuit affirming in part, reversing in part and remanding for proceedings consistent with their opinion rendered regarding an appeal from our opinion in Farmers Cooperative Co., et al. v. Commissioner, 85 T.C. 601 (1985) (Farmers I).

* * *

Section 521(b)(2). Respondent quantified the "substantially all" requirement in a revenue ruling (Rev. Rul. 73-248, supra) and the patronage test in a revenue procedure. In Rev. Proc. 73-39, 1973-2 C.B. 502, respondent published an examination guideline of 50-percent patronage. 3/

[3/ The Rev. Proc. 73-39 guideline is expressed as follows:

In the examination of returns, the Service will consider stock owned by persons who market more than 50 percent of particular products they have produced and marketed through the cooperative, or who purchase from the cooperative more than 50 per cent of their supplies and equipment of the type handled by the cooperative, during the cooperative's taxable year, as being owned by "producers who market their products or purchase their supplies and equipment through the association" * * * (1973-2 C.B. 502.)

The revenue procedure goes on to outline three situations where the 50-percent standard is not met and the exempt status will be permitted by respondent. The specific exceptions include crop failure, sickness or death and where the cooperative sells high price items which are not usually purchased on an annual basis (farm machinery).]

Respondent, for litigating purposes in a case presented and briefed prior to the issuance of Rev. Proc. 73-39 argued "that substantially all of the shareholder-producers must market substantially all of their products and purchase substantially all of their supplies through the cooperative," but the Eighth Circuit suggested "that imposition of the [the substantially all standard for patronage purposes] could produce impractical and perhaps oppressive results." Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1164 n.10 (8th Cir. 1969), remanding on another issue a Memorandum Opinion of this Court. In declining to address this issue in Farmers I, we noted "that consideration of this area is fraught with many difficulties and problems. Does respondent contemplate that cooperatives will keep track of shareholders' transactions outside the cooperative in order to police the 50-percent test * * * ? Would cooperatives effectively serve their congressionally intended purpose if patrons were required by contract to transact a minimum amount of business with the cooperative?"

Petitioner's records reflect the amount of marketing or purchasing business transacted by each patron with petitioner each year, but not the amount of a patron's total marketing or purchasing business with or from all entities or sources for the same year. It would be impossible for petitioner to determine from its records whether any patron met the 50-percent test.

With this background, we must consider whether the respondent's "50-percent patronage test" comports with the plain language of the statute or the underlying congressional intent. If not, we must determine whether any minimum annual quantity of patronage is statutorily required or intended.

Statutory Background

Exempt status for cooperative associations within the context of Federal taxing statutes is a concept which has been in existence for more than 65 years, beginning before the Revenue Act of 1921, 42 Stat. 227. The "substantially all" requirement has been a part of the statutory scheme since the Revenue Act of 1926, 44 Stat. 9, 40, 4/

[4/ Sec. 231(12) of the Revenue Act of 1926, 44 Stat. 9, and sec. 103(12) of the Revenue Act of 1928, 45 Stat. 791, 813, both contained language identical to that contained in current sec. 521, as follows:

Exemption shall not be denied any such association because it has capital stock * * * if substantially all such stock * * * is owned by producers who market their products or purchase their supplies and equipment through the association.]

under circumstances where the cooperative was "owned" by means of capital stock. Permitting cooperatives to be corporate entities and to act for the benefit of individuals other than cooperative members was a liberalization permitted in Treasury Department regulations under the Revenue Act of 1921. Congress permanently codified this liberalization in section 231(12) of the Revenue Act of 1926 which is essentially unchanged in its present form in section 521. The Senate Committee on Finance in discussing the need for this codification as part of the Revenue Act of 1926, commented:

Section 231(12): The existing law, strictly construed, allows exemption only to those farmers', fruit growers' or like associations which act as sales or purchasing agents for producer members and which return to such members the entire proceeds of their operations, except necessary sales or purchasing expenses. However, in order that any such association, not operated for profit, and which is a true cooperative association, shall get the benefit of this exemption, the Treasury Department in its regulations has construed the existing law with great liberality, enlarging the term "member" to mean any producer whether or not a member, if treated by such an association on the same basis as a member; exempting such an association not acting as an agent, but taking title to products or supplies; allowing such associations to have outstanding capital stock and to pay dividends on such stock (subject to certain limitations); permitting such associations to build up reserves for State requirements or other necessary purposes; and allowing such associations to manufacture their products, to change the form of raw materials, and in some cases to operate subsidiaries, so long as the operations are not conducted on an ordinary profit-making basis. [Emphasis supplied. Senate Committee on Finance, S. Rept. 52, 69th Cong., 1st Sess. at 23 (1926); 1939-1 C.B. (Part 2) 332, 350.]

Respondent, in Mim. 3886, X-2 C.B. 164, declared obsolete by Rev. Rul. 74-268, 1974-1 C.B. 367, expressed his understanding of the purposes of the exempt cooperative provisions in conjunction with the liberalization contained in the Revenue Act of 1926. In that context respondent observed that exempt cooperatives could retain their non-profit status and have dealings with non-members so long as the net proceeds of transactions were passed back through to members and non-members alike. This, obviously, would maintain the non-profit and conduit-like existence of the cooperative. Continuing in this vein, respondent further observed:

If an association is permitted to have nonproducers as stockholders and accumulate a surplus at the same time, the principle that a producer shall have returned to him the proceeds of the sale of his products less only necessary operating expenses is violated. This follows as a result of the established principle of law that the surplus of a stock corporation inures to the benefit of its stockholders. * * * Therefore, where associations are permitted by law to organize with capital stock, it is essential to exemption that the ownership of capital stock which carries the right to participate in the surplus and reserves of the association be restricted, as far as possible, to actual producers. [Mim. 3886, X-2 C.B. 164, 167, declared obsolete by Rev. Rul. 74-268, 1974-1 C.B. 367].

From this type reasoning the respondent formulated the regulations which were eventually codified into the "substantially all" requirement of section 521.

The central concern in the commentary surrounding the enactment of these statutory provisions was to insure that the cooperative operated as an aid to farmers and others who sought to improve their effectiveness by joining to market and store products or to purchase equipment and supplies, rather than to operate on a profit-making basis. Clearly, congressional intent was to permit such cooperative efforts and, in addition, to provide certain tax exemptions. Conceptually, the means to regulate these goals was to maintain the "conduit-like" operation of exempt cooperatives. The "substantially all test" focused upon the cooperative entity's exempt (non-profit) and conduit-like status and not upon the member's status. We are at a loss to understand respondent's concern about the percentage or amount of their total business activity that each member or patron conducts with each cooperative. We are unable to perceive, and respondent has not suggested, any evil that may arise from patrons or members belonging to many cooperatives or only

conducting a small portion of their total business activity with a cooperative. Presumably, the members or patrons are taxable and profit seeking activities 5/

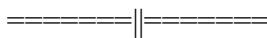
[5/ Although the possibility of cooperative membership within another cooperative may exist, the ultimate patron or member would be a taxable entity or within the existing statutory framework there may be an incidence of tax to a cooperative entity that does not operate as a "conduit."]

and respondent's proposed minimum patronage requirement may restrict patrons' flexibility and ability to seek and generate profits. Moreover, we are unable to find any meaningful purpose for a minimum patronage requirement in fulfilling congressional intent regarding cooperative associations. Respondent's patronage concerns or requirements did not surface until nearly 50 years after the statute was enacted. Respondent's publication of the 50-percent patronage requirement in a 1973 revenue procedure is the first mention of a percentage patronage requirement. 6/

[6/ Respondent's publication of the 50-percent patronage requirement in a revenue procedure for audit purposes, rather than publishing it as a ruling or regulation, suggests that it has not been offered as a rule or law. Although the 85-percent "substantially all test" has been judicially approved even though originally published in a revenue ruling, no such judicial approval has been afforded to the 50-percent test of the revenue procedure. We think it inappropriate for respondent to include these standards in pronouncements which have less stature than regulations which do have the force and effect of law. Revenue rulings and procedures are nothing more than the position of the respondent and for the most part are treated accordingly by taxpayers and courts.]

Respondent contends, on brief, that disregarding "the 50% Test in Rev. Proc. 73-39 would be to negate the plain intent of the Congress as stated in Code [section] 521(b)(2) to the effect that the stock must be owned by producers 'who market their products or purchase their supplies and equipment through the association.'" Respondent carries his analysis a step further by arguing that Congress would have used a modifier (such as "some of") in conjunction with the "who market [some of] their products" or "who purchase [some of] their supplies." We do not agree with respondent's analysis or interpretation of the statute. The patronage requirement of section 521(b)(2) is itself a modifier of the principal requirement that "substantially all such stock * * * is owned by producers." We find the purpose of the patronage requirement to be qualitative and not quantitative. Obviously, the omission of a patronage requirement would not facilitate the non-profit or conduit-like quality that was congressionally intended. We find that the congressional intent would be served if "substantially all such stock * * * is owned by producers who market [any] of their products or purchase [any] supplies and equipment through the association."

The patronage dividend concept would return to the producer a proportionate percentage return based upon any amount purchased or marketed during the year. The statutory requirement is that substantially all of that patronage be from active stock-holding (voting) patrons. Although respondent considers his 50-percent patronage requirement to be liberal, we hold that it is congressionally unintended. Because respondent has not seen fit to promulgate this "requirement" in a regulation, there is no need for an invalidation holding. Considering the holding of the Eighth Circuit Court of Appeals and the foregoing, we hold that the petitioner is exempt within the meaning of section for its 1977 taxable year.



The above decisions include consideration of the "substantially all" test for the membership measure and the "substantially all" test for the proportion of business a patron must do with the cooperative to be considered an active member. As a result of judicial expressions of doubt about

the proportion of business rule proposed by the IRS, the requirement was dropped with the revocation of earlier rulings.²³

D. Numerical Requirements and Restrictions

Section 521 specifies several quantitative limitations that are generally strictly interpreted. Among them are the 50 percent member business rule for both marketing and supply functions and the 15 percent rule allowing limited purchases for persons who are neither members nor producers.²⁴

IV. Patronage Refunds Defined

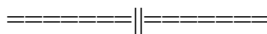
A. Principles

The substance of all cooperative taxation is contained in the following definition of a patronage refund. Payments to patrons that qualify for this definition are afforded cooperative tax treatment reflecting the single tax principle.

1388(a) Patronage Dividend. - For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies -

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.



Rev. Rul. 57-59
1957-1 C.B. 24

Patronage dividend distributions, made by a nonexempt farmers' cooperative to its members who owned the crop at the time delivered to the cooperative, are excludible from the gross

²³ Rev. Proc. 73-93, 1973-2 C.B. 502 was revoked by Rev. Proc. 90-29, 1990-1 C.B. 533; Rev. Rul. 90-42, 1990-1 C.B. 117, revoked Rev. Rul. 77-440, 1977-2 C.B. 199. For discussion of the progress and end of this attempted rule, see Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966).

²⁴ For discussion of the rules and their application, see Frederick, Donald A. *Income Tax Treatment of Cooperatives*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966)

income of the cooperative if made in accordance with a pre-existing agreement. Similarly, if a nonexempt cooperative sells part of its products to members and the remainder to nonmembers, but pays such dividends to members only, such dividends, to the extent attributable to sales to members, are excludible from the gross income of the cooperative, but any such dividends distributed to members, attributable to sales made to nonmembers, are taxable to the cooperative and to its members.

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Section 1388(a) contains several requirements. Those that pose issues that address the nature of the cooperative are noted below in several contexts. Two requirements are specific.

The first is that the refund be paid to the patron whose business generated the income. The second specific requirement for a patronage refund, and thus a prerequisite for Subchapter T tax treatment, is that the patronage refund must be paid pursuant to a "pre-existing legal obligation" to make the payment. The source of obligation (bylaws, contract, state law) and the timing of its existence require legal analysis.²⁵

A cooperative typically grants its board of directors the authority to make certain types of decisions about patronage distribution and there may be good reason to allow this flexibility after the cooperative's performance is assessed. For example, a cooperative with multiple functions may wish to adjust the relative distribution of patronage refunds given the relative performance of the functions. Another expression of flexibility may be where the board of directors may determine how much dividend to pay on capital stock and, by definition, how much remains to be paid as patronage refunds. The objective is to give the board of directors the necessary flexibility to make good decisions on behalf of the cooperative's members and preserve the obligation required in Subchapter T.²⁶

B. Equitable Allocation

As demonstrated in the following two cases, acceptable calculation methods are not mechanical. The term "equitable allocation" incorporates a number of considerations that go to some fundamental principles of operating on a cooperative basis and the refund process.

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²⁵ See discussion and references in Frederick, Donald A. *Income Tax Treatment of Cooperatives: Patronage Refunds*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 2 (December 1993).

²⁶ See discussion and references in Frederick, Donald A. *Income Tax Treatment of Cooperatives: Patronage Refunds*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 2 (December 1993).

Lamesa Cooperative Gin v. Comm'r
78 T.C. 894 (1982)

WHITAKER, Judge:

The Commissioner determined a deficiency in the Federal income tax of petitioner for the taxable year ending July 31, 1974, in the amount of \$21,232.11. The issues to be decided are: (1) Whether part of the patronage dividend deduction 1/

[1/ For convenience, we will refer to patronage dividends as deductions. We offer no comment, however, on whether patronage dividends are deductions or exclusions. See sec. 1.1382-1(a), Income Tax Regs.]

claimed by petitioner, an exempt cooperative, should be disallowed on the ground that gain from the sale of equipment in taxable year 1974 was not properly allocated among current and former patrons, and (2) whether the patronage dividend deduction should be disallowed to the extent allocable to petitioner's purchasing function.

FINDINGS OF FACT

The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

Petitioner, an agricultural cooperative incorporated under the laws of the State of Texas, had its principal place of business in Lamesa, Texas, when it filed its petition in this case. For all the relevant periods, petitioner has been an exempt farmers' cooperative under section 521. 2/

[2/ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended.]

The primary business of petitioner has been to gin cotton furnished to it by patrons in the general vicinity of Lamesa, Texas, and to market cottonseed, one of the two products resulting from the ginning operation, the other being baled cotton. Most customers sell the cottonseed derived from their cotton to petitioner. Cottonseed was sold to a cooperative regional oil mill of which petitioner was a member patron. Apparently, any farmer who does business with petitioner becomes a member of petitioner.

From 1964 through 1974, petitioner acquired 389 cotton trailers, seven tractors and one stick machine, which were used by its patrons in the harvesting of cotton. According to petitioner's books and records, the 389 trailers were initially acquired at prices ranging from \$197 to \$754. None of the trailers were identified by serial number or otherwise. Hence, after a trailer was added to the equipment pool, petitioner could not correlate it with any entry on its books, either cost, acquisition or disposition data, or depreciation claimed for tax purposes.

Throughout the period petitioner owned the trailers, tractors and stick machine, this equipment was subject to depreciation, which was shown by petitioner on its books and records and claimed on its tax returns. The bases of the equipment for purposes of depreciation included the initial purchase prices as well as amounts expended for capital improvements made to some of the trailers.

In the taxable year 1974, petitioner, with the support of a majority of its patrons, decided to dispose of the cotton trailers, tractors and stick machine. Pursuant to this decision, during the taxable year 1974 petitioner auctioned off all of this equipment then on hand. There were only 285 trailers sold by auction. The discrepancy between the number of trailers initially acquired (389) and the number sold at auction is explained by the fact that during the period 1964 through 1974 many of the trailers were lost, destroyed by fire, or stripped to obtain spare parts. The trailers were sold in 111 lots containing one to ten trailers per lot, at prices ranging from \$175 to \$1,425. The tractors were sold in two lots for \$2,585 and \$1,236.50, and the stick machine was sold for \$1,000.

Petitioner could not determine the identity of any single cotton trailer. Hence it could not determine the date of purchase, the original cost, the amount of capitalized repairs or the amount or timing of depreciation deductions taken with respect to each trailer. Thus it was not possible to determine gain or loss on any one trailer. Petitioner reported the entire \$57,622.78 gain from the sale of the 285 cotton trailers as depreciation recapture under section 1245. The gains from the sales of the other equipment were \$372.72 for the stick machine, \$2,445 for one lot of tractors, and \$641 for the other lot of tractors. Because of depreciation allowed with respect to each of these assets exceeded the realized gains, these gains were also reported as depreciation recapture under section 1245. Petitioner and respondent have stipulated that the total \$61,081.50 gain from the sale of the equipment was properly reported as section 1245 gain.

Petitioner's bylaws require the annual net savings or margins resulting from the transaction of the business of the association in excess of reserve fund requirements and after the payment of dividends on outstanding capital stock to be allocated among its patrons on a patronage basis. The bylaws also require that accurate patronage records be maintained on a departmental basis to comply with this allocation requirement.

Other than minor purchases of chemicals and supplies for some patrons, which petitioner handled at cost as an accommodation, petitioner's revenues were generated by the charge for ginning of cotton and resales of cottonseed purchased from patrons. Records were kept of the numbers of bales of cotton ginned and the pounds of seed purchased from each patron, and patronage dividends were allocated to each customer based separately on the cotton ginning and seed purchase volume of that patron.

The \$61,081.50 gain from the sale of the trailers, tractors and the stick machine in taxable year 1974 was allocated by petitioner to its current year's patrons in proportion to their patronage that year, and a deduction was claimed by petitioner for the amount so allocated to the patrons.

Petitioner's membership tends to remain stable with little variation from year to year, although the amount of patronage for each member may vary significantly each year. Petitioner has an annual meeting of its membership, usually in August, which is normally attended by 300 to 500 persons. It expends great effort to secure large attendance at this meeting. Past as well as current patrons are encouraged to attend. Most of the 300 persons who attended the annual meeting in 1974 had been members of petitioner in prior years.

At the 1974 annual meeting, as in past years, petitioner's certified public accountant explained the financial report. He discussed the fact that the current year's gain included a substantial sum from the sale of the cotton trailers, but he did not specifically explain that the gain would be allocated only on the basis of patronage in taxable year 1974. This was, however, the customary method for allocating gains received by petitioner. No patron raised any question as to allocation of the gain from the sale of equipment.

On audit, respondent determined that the allocation of gain from the sale of equipment on the basis of only patronage during taxable year 1974 was improper. Respondent's position is that section 1245 gain on machinery and equipment of a cooperative is patronage sourced but must be allocated to members and nonmembers in the prior years in which the related depreciation deductions with respect to the equipment were claimed. See Rev. Rul. 74-84, 1974-1 C.B. 244.

Petitioner maintains an equity ledger showing the status of each patron's equity or ownership account in each year, but these ledgers were not usually retained by petitioner in complete form. Petitioner also compiled in at least some of the years during which the equipment was being depreciated an alphabetized ledger showing patrons' equity account balances, and a separate dividend allocation list was maintained on an annual basis showing each patron's then current balance of all prior unpaid equities. In 1974 petitioner could have retrieved dividend allocation lists for the taxable years 1967 through 1974.

There is no way to determine simply from the current balances in the equity ledgers or dividend allocation lists precisely how much of a patron's equity is due to patronage in a particular year, although the balances do give a general indication of patrons' cumulative proportions of patronage. The balances do not correlate exactly to past patronage for two primary reasons. First, the amount of gain per unit of patronage

varies greatly from year to year. Second, the addition to the equity balance in each year is not the same amount as the total amount of the patronage dividend but is only the retained portion of the patron's patronage dividend for that year. Thus, the equity ledger records only that portion of a patronage dividend not paid to the patron in cash. The percentage of the patronage dividends paid in cash varied between taxable years 1964 through 1974 from 25 percent to 100 percent. Although the gain from the sale of equipment could be allocated back to prior years on the basis of equity ledger balances, the amount so allocated to each year would not precisely correlate to actual patronage in each year because of the wide variations in the amount paid in each year in cash, and the variations from year to year in the amount of profit and thus in the patronage dividend and resulting equity per unit of patronage.

To arrive at a more accurate computation of how patrons benefited from past depreciation, the annual additions to each patron's equity, which were also shown on the equity ledgers, could be examined. By comparing each patron's increase in equity in a given year to the total increases in equity in that year, each patron's proportionate share of patronage in each year could be computed. The amount of depreciation deductions taken in each year could also be computed, and by correlating these two computations, the extent to which each patron benefited from past years' depreciation on all equipment on petitioner's books for that year could be determined. This would not be an easy computation, however, and if made would not produce an accurate result since it was not possible to relate the gain on any trailer to the depreciation deduction actually claimed in any prior year with respect to that trailer.

During the taxable year 1974, petitioner sold to its patrons, on a voluntary basis, seed, chemicals, and other farm products used in cotton farming. The patrons who purchased supplies from petitioner were generally also patrons of the ginning and cottonseed sales function. Petitioner's purpose in furnishing these agricultural supplies was to accommodate patrons by selling these goods approximately at cost. Petitioner did not account for these sales as a separate purchasing department. Rather, it reported as income all the amounts received from the sale of chemicals, seed and other farm products, together with the amounts it received from the ginning function of the cooperative and the patronage dividends received from the regional cotton oil mill. From this total amount, petitioner subtracted the various deductions, including its cost of purchasing items sold to members through the purchasing function, to arrive at a net profit or net margin. This net profit was then allocated to the patrons of petitioner's gin on the basis of current patronage, that is the number of bales of cotton ginned and the pounds of seed purchased.

During the audit, at the request of the revenue agent, petitioner projected a profit on these sales of supplies of \$1,868.73. However, this amount was arrived at by simply applying the same rate of profit to expenses associated with the supplies function as petitioner made on its overall operation. No attempt was made to determine whether this particular purchasing function was actually more or less profitable than the overall operation.

OPINION

Under subchapter T, both exempt and nonexempt cooperatives are subject to tax as corporations. Section 1381. Section 1382(a) dictates that the gross income of a cooperative shall not be reduced on account of any allocation or distribution to a patron out of the net earnings of the cooperative except as provided in section 1382(b) for patronage dividends and per-unit retain allocations. Patronage dividends are defined in section 1388(a) as an amount paid to a patron (1) on the basis of quantity or value of business done with or for the patron; (2) under a legal obligation that existed before the organization received the amount so paid; and (3) that is determined by reference to the net earnings of the organization from business done with or for its patrons. The last sentence of section 1388(a) specifies that patronage dividends do not include any amount paid to a patron to the extent that the amount of earnings other than from business done with or for patrons, or is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. This embodies the equitable allocation principle, i.e., that earnings must generally be allocated ratably to the patrons whose patronage created the earnings from which the allocation was made. This principle was recognized as a fundamental characteristic of patronage dividends even before the enactment of subchapter T. Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213, 1218-1219 (1980).

Petitioner and respondent have stipulated that the depreciation recapture caused by the sale of the trailers, tractors, and the stick machine in taxable year 1974 was income derived from patronage 3/

[3/ In the only case to date to consider this issue, St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041, 1053-1054 (Ct.Cl. 1980), the Court of Claims in a per curiam opinion held that section 1245 gain on the sale of a business asset is patronage sourced income, noting that the Commissioner takes the same position. See Rev. Rul. 74-84, 1974-1 C.B. 244. We accept the stipulation of the parties to this effect for the purposes of this case only, but no inference should be drawn from that fact, or from the contents of this footnote, as to the position of this Court on the issue, which will await development in a proper case. We note that the third element in the statutory definition of a patronage dividend (sec. 1388(a)(3)) requires that a patronage dividend relate to earnings of the cooperative "from business done with or for" its patrons. Sec. 1.1382-3(c)(2), Income Tax Regs., applies this standard by requiring patronage income to be derived from sources "directly related" to the cooperative's marketing, purchasing or service activities. At first blush, the nexus between sales of surplus business machinery and "business done with" a patron seems strained. Arguably, any favorable business transaction would to some extent benefit current patrons and might thus be said to constitute "business done * * * for" current patrons. Rev. Rul. 74-84, supra, does not discuss this part of the regulations.]

and that, under section 1382(f), the taxable year 1974 is the proper year for the treatment of this gain by the cooperative. The disagreement centers on whether the equitable allocation requirement has been satisfied, respondent contending that such gain must be allocated to patrons in the years in which the recaptured depreciation was claimed.

Clearly, the gain from the sale of the equipment was realized in 1974. It is fundamental to the principle of annual tax accounting that gain is generally reported in the year received or accrued. Furthermore, section 1382(f) requires that a cooperative's earnings should be treated as currently received even though attributable to patronage business of a prior year. Thus, absent a statutory requirement that patronage dividends in some specific circumstances must be allocated to prior years' patrons, one would expect such gain to be includible in current patronage dividend distributions.

On the basis of two principles, viz., operation at cost and equitable allocation, respondent maintains that the gain should have been allocated in proportion to patronage that occurred during the years in which the equipment was being depreciated. On a theoretical basis respondent's position has some appeal in the sense that if depreciation had not been claimed, dividend distributions in prior years would have been increased. However, minor inequities are often permitted in our tax system. In this case it cannot be demonstrated that the allocation suggested by respondent would result in a significantly more accurate allocation of patronage dividends than the method used by petitioner. In maintaining that petitioner could have allocated on the basis of equity ledger balances or annual additions to such balances correlated to annual depreciation deductions, respondent ignores the fact that it was impossible to determine how much of the section 1245 recapture income was attributable to depreciation taken in any particular year because neither the original cost nor past basis adjustments of any particular trailer or group of trailers could be determined.

Petitioner argues that even if the gain were attributable to prior years' patronage, it was not inequitable for it to allocate the gain on the basis of the taxable year 1974 patronage, given the substantial similarity of petitioner's membership over the years, the size of the gain relative to earnings over the period in which the equipment had been depreciated and the practical difficulties involved in allocating the gain in proportion to the benefits patrons derived from the depreciation of the equipment in prior years. We agree with petitioner. Exact equity cannot be accomplished here even if we were endowed with sufficient Solomon-like attributes to be able to divine its parameter. Allocation to current patrons does reasonable equity.

Respondent cites little case law in support of his position but relies largely upon the theoretical basis for the special tax treatment of cooperatives, focusing particularly upon the concept of "operation at cost," which treats the excess of a cooperative's operating revenues over its cost of operations (net margins) as the

property of the patrons of the cooperative. Respondent reasons that this concept implies that the net margins are the property only of the particular persons whose patronage caused the excess income and only in direct proportion to their patronage. It appears inferentially that this concept may be the rationale underlying Rev. Rul. 74-84 supra. We have heretofore rejected respondent's concept of the "operation at cost" principle. This concept simply means that a cooperative was organized for the purpose of rendering economical services, without gain to itself, to shareholders or to members who own or control it; it is not a codified requirement of tax accounting. Ford-Iroquois FS, Inc. v. Commissioner, supra at 1219, 1222; Assoc. Milk Producers v. Commissioner, 68 T.C. 729, 740 (1977). It does not require that the net margins be allocated precisely in proportion to the patronage that generated them.

Respondent also argues the "equitable allocation" principle, citing a number of cases, including four decisions of this Court, Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397 (1972), affd. 481 F.2d 812 (10th Cir. 1973), cert. denied 414 U.S. 1028 (1973); Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457, 466 (1969); Farmers Cooperative Co. v. Commissioner, 33 T.C. 266 (1959), rev'd. on other grounds 288 F.2d 315 (8th Cir. 1961); and Pomeroy Cooperative Grain Co. v. Commissioner, 31 T.C. 674 (1958), affd. in part and rev'd. in part 288 F.2d 326 (8th Cir. 1961). He contends that the basic requirement that earnings be allocated ratably to the patrons responsible for them was not satisfied in this case, on the assumption that the section 1245 income was earned at the time the depreciation deductions were claimed. We believe, however, that, like the concept of "operation at cost," the requirement of "equitable allocation" should not be seen as a strict accounting requirement but as only a general principle to prevent inequitable treatment to some patrons at the expense of others. As a principle of equity, the overall scheme of allocation should be examined, including the practicalities of making allocations, the democratic nature of cooperatives, and the extent of patronage to the cooperative by nonmembers, who have no say over how patronage dividends are distributed.

The cases that have found violations of the "equitable allocation" requirement have generally dealt with cooperatives that have allocated to members some or all of the net margins attributable to nonmembers' patronage. E.g., Petaluma Co-operative Creamery v. Commissioner, supra; Farmers Union Cooperative Co. v. Commissioner, 90 F.2d 488 (8th Cir. 1937), affg. 33 B.T.A. 225 (1935). Similarly, the only example of inequitable allocation mentioned in the regulations deals with allocations between members and nonmembers. 4/

[4/ Sec. 1.1388-1(a)(2)(ii), Income Tax Regs., sets forth the following example, which is identical to that contained in the legislative history (H. Rept. 1447, 87th Cong., 2d Sess. A133 (1962); S. Rept. 1881, 87th Cong., 2d Sess. 317 (1962)):

* * * if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.]

When one focuses on the nature of a cooperative as an organization run by a management democratically elected by the members, 5/

[5/ See generally, Packel, The Organization and Operation of Cooperatives, sec. 24, pp.106-109 (4th ed. 1970), for a discussion of the basic principle that a cooperative must be democratically controlled by its members. Under Texas law, each member of a cooperative has one vote regardless of the amount of patronage or stock held. Tex. Agric. Code Ann. secs. 51.013 and 52.085 (Vernon 1982).]

the paucity of cases involving allocations other than those between members and nonmembers is explained. The greatest risk of inequitable allocation, and the most pressing need for oversight, concerning a cooperative's allocation of net margins arises when the cooperative allocates net margins between members and nonmember patrons. Because the management of the cooperative is elected by members only, nonmember patrons have no way of preventing allocations that are disproportionate as to them. 6/

[6/ Although members have indirect, as well as direct, means of control over the cooperative's management, e.g., the rights to inspect books and records and to bring representative suits, these indirect means of control are not available to nonmember patrons. See Packel, supra at sec. 29, pp.121-124.]

In contrast, the members of the cooperative directly elect the management and it should generally be presumed the management is acting on their behalf in making allocations. From a conceptual viewpoint, if the cooperative accumulates reserves or allocates net margins to members at the expense of nonmembers, it is not rebating or refunding to its members the excess receipts attributable to commodities they produced and that were sold through the cooperative; rather, the cooperative is allocating to members profits from business transacted with and for nonmembers.

In Assoc. Milk Producers v. Commissioner, supra, we held that net operating losses could be carried forward to future years and charged against future income. We specifically recognized that the carrying over of losses could affect the allocation of the losses among the cooperative's past and future member-patrons because the loss carryover would reduce income and patronage dividend allocations in later years so that the patrons of such later years, many of whom were not patrons during the loss years, would effectively bear the losses. We stressed that the allocation had been performed by the cooperative's board of directors in accordance with the bylaws, and we rejected respondent's reliance on the operation at cost concept. 68 T.C. at 739.

In Farm Service Cooperative v. Commissioner, 70 T.C. 145 (1978), revd. 619 F.2d 718 (8th Cir. 1980), we followed Assoc. Milk Producers and refused to find an inequitable apportionment of losses when the cooperative had allocated losses from one department against taxable gain from another department in the same year. Although the Eighth Circuit found the particular allocation to be inequitable, its opinion does not help respondent with respect to the question of how the gain from the sale of the equipment in this case should have been allocated. The Court of Appeals stressed that the vertical (i.e., chronological) allocation problem presented in Assoc. Milk Producers was quite distinct from the horizontal allocation problem caused by Farm Service Cooperative's allocation of losses from patronage activities to its nonpatronage, hence taxable, activities. Insofar as the recapture income in this case is concerned, we have a vertical allocation problem.

Ford-Iroquois FS, Inc. v. Commissioner, supra, involved a cooperative with a net operating loss carryover. Relying on the same type of theoretical arguments he advanced in this case, respondent argued that the net operating loss carryover should be allocated only to offset income in other years of the same patrons whose business had produced the loss and that allocable portions of the loss would have to be recovered currently from members who terminated their business. On the basis of our reasoning in Farm Service Cooperative and Assoc. Milk Producers, we disagreed with respondent's reasoning. We said that "The allocation of losses among a cooperative's past, continuing and future members is properly the concern of the membership and its board of directors." 74 T.C. at 1222.

In this case, the key factor is that the identity of the patrons has remained stable enough so that there is no reason to assume that petitioner's management would be prone to take actions discriminatory against past patrons. The basic controversy here concerns petitioner's allocation of the earnings among its members; nonmember patrons have not been subjected to discriminatory treatment.

A primary factor influencing petitioner's decision to allocate the gain only to the taxable year 1974 patrons was that it had no records from which it could have determined what the patronage in the past years had been and how such patronage related to depreciation claimed in such years. Much of the testimony in this trial concerned respondent's contention that an allocation to past years based on balances on the equity ledgers could have been made. However, the equity ledger balances do not in themselves identify a particular patron's patronage in any prior year and they do not relate the amount of past patronage to depreciation deductions taken by the cooperative. Furthermore, respondent admits that use of the equity ledger balances would not have led to a mathematically precise allocation; he only contends that it would have more closely allocated the gain to the particular patrons who got the benefit of the depreciation than petitioner's method, which did not even look at past patronage. As we have pointed out, a mathematically

precise allocation could not have been made. We are not convinced that respondent's suggested method of allocation is more equitable than petitioner's or even that petitioner's method is materially inequitable. One of the factors that must be taken into consideration is the practicality of making a particular type of allocation.

Moreover, the trailers were acquired and utilized over a period of ten years. Petitioner's abbreviated record keeping in this regard is not unreasonable, as respondent recognizes. Even if each dollar of this gain could have been related to a particular dollar of depreciation, it is likely that petitioner could not have located all of the patrons over the ten-year span and the cost of the exercise seems disproportionate to the benefit.
7/

[7/ We are not unmindful of Burnet v. Houston, 283 U.S. 223 (1931), and the general principle that petitioners cannot be excused from satisfying their burden of proof simply because accurate records are unavailable. However, the absence of records precisely correlating each patron's share of the prior years' patronage to depreciation deductions claimed in each year is not material here. We have found that under all the circumstances petitioner acted within its discretion when it based the allocations on current patronage only. As we have explained, the equitable allocation requirement does not require net margins to be allocated precisely in proportion to the patronage that generated them; all that is required is that the allocation not unduly benefit some patrons at the expense of others, particularly nonmember patrons.]

Boards of directors of cooperatives do not have carte blanche to make whatever allocations they choose, but we believe respondent should recognize that directors have some discretion, some flexibility, in the exercise of business judgment. Only when unreasonable exercise of that discretion appears should the board's weighing of the equities be overturned by this Court.

The second issue in this case concerns respondent's disallowance of an additional \$1,868.73 of the patronage dividend deduction claimed by petitioner in taxable year 1974. Respondent maintains that this \$1,868.73 was the net margin of a separate supplies purchasing function of the petitioner and that it was inequitable for petitioner to have allocated this net margin to all the patrons of its marketing function. Petitioner contends, first, that it has no such separate purchasing function, and that even if it were seen as having a separate purchasing function, the distribution should not be considered inequitable. We agree, largely for the reasons discussed in the prior portion of this opinion.

On its books and records and on its return for taxable year 1974, petitioner did not segregate its activities into two separate departments. It made no separate profit or loss allocations to its activities in purchasing supplies but simply included the income and expenses in computing its gross profit and determining the amount to allocate as patronage dividends among all its taxable year 1974 patrons.

Respondent contends that section 521 and section 1.521-1(c), Income Tax Regs., require that a cooperative engaged in both a marketing function and a purchasing function account separately for the amounts derived from each function because the law requires it to operate at cost with respect to each function. See Rev. Rul. 65-223, 1967-2 C.B. 214, for a general statement of respondent's position. However, nothing in section 1.521-1(c), Income Tax Regs., explicitly refers to any separate accounting requirement for cooperatives engaged in both purchasing and marketing; all that is required is that the Code requirements, including equitable allocation, be satisfied with respect to each function. We have previously discussed why we believe the "operation at cost" and "equitable allocation" concepts do not mandate particular forms of accounting.

Although it is obviously easier to determine if the "equitable allocation" requirement is satisfied with respect to both the marketing and purchasing functions when separate accounts are maintained, we do not believe the failure to account separately should automatically cause a patronage dividend deduction to be disallowed. In the cases discussed below, courts have not required separate accounting by each of the different functions of a cooperative. Although none of these cases involved the regulation cited by respondent here (section 1.521-1(c), Income Tax Regs.), we believe they are instructive because they

recognize the discretion of the cooperative's board of directors and the importance of factors such as the overlap of the patronage of the different functions and the practicality of separately accounting for each function.

In Ford-Iroquois FS, Inc. v Commissioner, *supra*, and Farm Service Cooperative v. Commissioner, *supra*, this Court specifically approved the use of losses from one department to offset gains from another department of a cooperative. In both these cases we recognized the discretion of the cooperatives' board of directors concerning how to make allocations. Additionally, in Ford-Iroquois FS we focused on the similarity in the identity of the patrons of the two departments, which guarded against the possibility that the board of directors might unjustly favor the patrons of one department at the expense of the patrons of the other department.

In Juniata Farmers Cooperative Association v. Commissioner, 43 T.C. 836 (1965), we refused to find an inequitable allocation when an exempt cooperative, which had two purchasing departments and a marketing department, allocated its nonpatronage income on the basis of only marketing patronage. We emphasized that substantially all the patrons of the marketing department were also patrons of the two purchasing departments and that all the patrons were fully cognizant of the method of allocation and deemed it acceptable to them. We stated that the regulation dealing with the deduction allowed to exempt cooperatives distributing nonpatronage income (section 1.522-2(d), Income Tax Regs.) wisely adopted a practical approach.

Furthermore, in Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d at 331-333, the Eighth Circuit refused to require a cooperative to account separately for gains derived from its storage and marketing functions, even though the patronage of these two functions differed somewhat. The Court of Appeals found some merit in the cooperative's argument that it would be impractical to distribute storage profits on the basis of members' particular storage business because it would require an expensive and complicated method of accounting to do so. Because the storage and marketing functions were integrated and because there was no statute or regulation setting up reasonable standards for the allocation of profits, the court found that it was not inequitable to allocate both the storage and marketing profits on the basis of the quantity of grain delivered for marketing. In so holding, the court remarked that "the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members." 288 F.2d at 333.

Farm Service Cooperative was reversed by the Eighth Circuit on appeal because that court did not agree that it was acceptable for the losses of the cooperative's broiler pool function to offset gain the cooperative realized from taxable activities of another function. Respondent maintains that we should follow the Eighth Circuit's approach in the Farm Service Cooperative case and that we should require separate accounting for the purchasing and marketing functions. We believe, however, the Eighth Circuit's Farm Service Cooperative opinion is inapplicable here. The Court of Appeals was careful to define the issue before it relatively narrowly. Although it did refer to the distinction between horizontal and vertical allocations, it stated that the particular problem before it was that the taxpayer was seeking to avoid taxation on income for which no patronage dividend deduction was available by offsetting such income with losses from patronage operations. Here, in sharp contrast, both the purchasing and marketing functions are patronage sourced.

In determining whether respondent erred by disallowing the patronage dividend deduction that it attributed to gains from the purchasing function, our inquiry should simply be whether the allocation was inequitable in view of the board of directors' considerable discretion. Several factors lead us to conclude that the allocation here was not inequitable. First of all, we have no evidence that the patrons of the purchasing function were significantly different than the patrons of the marketing function or than any patron ever objected to the method of allocation. The small size of this supplies purchasing function relative to the marketing function and the minimal amount of gain attributed to the purchasing and resale of supplies by respondent (\$1,868.73) ^{8/}

[^{8/} The \$1,868.73 gain allocated to the purchasing function was computed by petitioner's accountant upon being requested during the audit to come up with some profit figure

separately allocable to the purchasing function. Respondent argued that since petitioner's own agent came up with this \$1,868.73 figure then it must be assumed that petitioner admits that this amount of gain is clearly allocable to only the purchasing function. We do not agree with this contention. The amount allocated to the purchasing function was an arbitrary amount based not upon the gain derived from the purchasing function itself but computed simply on the basis of the overall gain from all petitioner's operations.]

also support the board of directors' decision not to require separate records for the purchasing function. Indeed, to have maintained accounting records with respect to the separate functions may well have cost petitioner almost as much as it is charged with having derived as gain from the purchasing function. ^{9/}

[^{9/} Cf. Producers Gin, Inc. v. Commissioner, T.C. Memo. 1959-106, in which we recognized that a cooperative did not have to keep complicated records of patronage if the distributions might vary over the years by only a de minimis amount from those that would have been made had exact records been kept.]

In summary, we find that the patronage dividend allocations made by petitioner with respect to both the gain from the sale of the equipment in taxable year 1974 and with respect to any gain that it might have derived from its supplies purchasing function were not inequitable. This is not to say that the particular method of allocation employed by petitioner would have been the only proper way of allocating these gains. We hold merely that petitioner's board of directors did not unjustly discriminate against one group of patrons at the expense of another group, given the practicalities of the allocation, the substantial similarity in the identity of patrons over the years, the absence of any indication that any of the patrons complained about such allocations, and, with respect to the profit from the purchase and resale of supplies, the de minimis nature of the item.

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Kingfisher Cooperative Elevator Ass'n v. Comm'r
84 T.C. 600 (1985)

COHEN, Judge: Respondent determined a deficiency of \$59,724.97 in petitioner's Federal income tax for the taxable year ended March 31, 1981, based on disallowance of part of the patronage dividend deduction ^{1/}

[^{1/} Patronage dividends are referred to herein as deductions for convenience only, without regard to whether technically they should be characterized as deductions or exclusions. See sec. 1.1382-1(a), Income Tax Regs.]

claimed by petitioner, a farmers' cooperative subject to the provisions of subchapter T (secs. 1381 through 1388). ^{2/}

[^{2/} Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.]

The issue to be decided is the equitability of petitioner's allocation to its members of patronage dividends received from regional cooperatives according to its members' patronage in the year of receipt. Because "equitability" is the principle to be applied, our findings necessarily contain substantial detail. The facts, however, are essentially undisputed.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner, a local marketing and supply cooperative association organized and incorporated under the Oklahoma Cooperative Marketing Association Act, had its principal place of business in Kingfisher, Oklahoma, at the time it filed its petition herein. Petitioner filed a Federal corporate income tax return on an accrual basis as a nonexempt cooperative for its fiscal year ended March 31, 1981. 3/

[3/ Certain farmers' cooperatives are tax exempt under sec. 521, except as otherwise provided in subch. T.]

At all times relevant to this case, petitioner was engaged in the business of marketing and storing grain, selling agricultural supplies, including feed, fertilizer, and other products, and providing storage facilities and services to its members and nonmembers. Petitioner served a geographic area extending approximately 20 miles north, south, and east, and approximately 35 miles west, of Kingfisher, Oklahoma.

Petitioner's Membership and Operations

Under petitioner's bylaws, in effect during the year in issue, membership in the cooperative was open to any producer of agricultural products handled by or through petitioner, who resided, farmed, or owned land in any territory served by petitioner, who agreed to comply with petitioner's bylaws, and who purchased the par value of 1 share of petitioner's capital stock. Membership was subject to the approval of an applicant's written application by petitioner's board of directors. Generally, each member was entitled to one vote, irrespective of the number of shares held, subject to certain exceptions for jointly held stock and votes to change the authorized capital stock.

Petitioner's business activities were managed by its board of directors. The board was composed of five members who were elected to staggered 3-year terms by the members at annual membership meetings. Candidates for vacancies on the board were selected by an independent nominating committee that attempted to select active members who were committed to petitioner and the cooperative way of doing business. The committee made an effort to select nominees so as to insure geographic diversity on the board over the area serviced by petitioner. Petitioner's directors maintained frequent informal contacts with the members in their areas. The Directors were actively involved in the computation of petitioner's patronage dividends and were aware of how regional patronage dividends entered into the computation.

Petitioner's membership grew considerably after its founding in 1934 with 48 original stockholders. Ordinarily, once a farmer became a member-patron of petitioner, he maintained his membership until he retired or died, at which time other family members often took over the farming operation and continued membership in petitioner.

The amount of patronage for each member varied each year depending on crop conditions and price considerations. Petitioner's membership, however, remained relatively stable. Petitioner's membership turnover for fiscal years 1979, 1980, and 1981 was as follows:

	FY 1979	FY 1980	FY 1981
Membership on Apr. 1	1,125	1,131	1,142
Add: New Members	59	49	54
Less: Terminated members	53	38	39
	-----	-----	-----
Membership on Mar. 31	1,131	1,142	1,157

The percentages of members terminating their membership for the fiscal years 1979, 1980, and 1981 were 4.7 percent, 3.4 percent, and 3.4 percent, respectively. Most of the terminations were the result of the retirement or death of a member.

At all relevant times, petitioner was a member of four cooperatives from which it received services, financing, and farm supplies, and through which it marketed products and rendered services.

Among these cooperatives were Union Equity Cooperative Exchange (Union Equity), a regional grain marketing cooperative of Enid, Oklahoma, to which petitioner sold grain purchased from members and nonmembers for sale and storage, and Farmland Industries, Inc. (Farmland), a regional supply cooperative of Kansas City, Missouri, from which petitioner acquired agricultural supplies for sale to its members and nonmembers. As a local cooperative, petitioner received patronage dividends from the regional cooperatives of which it was a member, including Union Equity and Farmland.

Petitioner, Union Equity, and Farmland utilized the basic cooperative principle of patronage refunds--i.e., the annual net income of the cooperative from business done with or for its member-patrons was allocated to member-patrons on the basis of the relative amount of patronage during the year. This income was then distributed as patronage dividends within 8 1/2 months of the cooperative's yearend.

Petitioner's bylaws required apportionment of petitioner's net earnings at least annually by the directors, subject to revision by the members at an annual or special meeting. Petitioner held annual meetings of its membership, attended by approximately 545, 600, and 470 persons in 1979, 1980, and 1981, respectively. During these meetings, members were apprised of the business of petitioner, nominations and elections of directors were conducted, and, after an opportunity for discussion by petitioner's members, the apportionment of earnings recommended by the directors was ratified.

Petitioner's members were informed on a regular basis of the cooperative's business and the allocation of all components of the patronage dividends, including those received from Union Equity and Farmland. This information was disseminated by petitioner in the annual report, monthly newsletters, yearly patronage statements accompanying dividend payments, and on an informal basis through discussions among the members, directors, and general manager. Petitioner's members thus had notice and presumptively were aware for many years that patronage dividends received from Union Equity and Farmland were included in petitioner's income in the year of receipt and assigned to petitioner's pertinent allocation units. They presumptively were aware that those patronage dividends were a part of the net earnings in each of petitioner's allocation units that were distributed to petitioner's members in proportion to the business those members did with petitioner in each of its allocation units in the year the particular patronage dividend was received.

Petitioner's Business Operations and Transactions with its Members

Petitioner's members had substantial flexibility in selling their wheat to, or storing it with, petitioner upon harvest. Upon delivery for sale or storage, petitioner commingled the wheat with its wheat inventory then on hand. Members sold their crops to petitioner at various times depending on market conditions and available Government programs.

As required under Federal warehouse licensing requirements, petitioner maintained records on a daily basis showing beginning inventory, wheat purchases and sales, and closing wheat inventory. Petitioner maintained a daily grain position of grain stored with it, either in open storage or in other warehouses for which petitioner received a receipt, and of grain purchased from its members.

Petitioner's grain purchases exceeded its sales. Petitioner's sales to Union Equity occurred at various times during the year depending on the size of petitioner's owned inventory and market conditions. Because of the fungible nature of wheat, petitioner could not identify particular sales to Union Equity with particular purchases from members. Neither the source of grain shipped by petitioner to Union Equity nor the year such grain was harvested and delivered to petitioner could be identified.

Petitioner also sold member wheat from time to time to corporations that were not organized as cooperatives. During the year in issue, petitioner sold 2,182 bushels of wheat to private entities that were not organized as cooperatives. In April and May 1980, petitioner sold 70,000 bushels of wheat to the Commodity Credit Corp. These sales did not generate any patronage dividends from the purchasers nor from Union Equity. Petitioner could not identify which purchases from its members generated these sales.

Petitioner purchased various items of equipment and supplies used by its patrons in their farming operations. These goods were purchased primarily from Farmland and held in inventory by petitioner for sale to its members. Petitioner frequently made purchases from Farmland in anticipation of member needs, often in the off-season in order to secure a price advantage. Thus, items were held in inventory by petitioner for varying lengths of time depending on its inventory and member demand for a particular item. Many items were held in inventory beyond the close of the fiscal year of the entity from which petitioner purchased the item and/or beyond the close of the fiscal year in which petitioner acquired the item. The sale of a particular item could not be identified with the prior purchase of that item by petitioner. Although petitioner conducted an annual inventory of its merchandise, it could not determine the period for which a particular item had been held in inventory.

Because of the seasonal nature of farming, petitioner's month-to-month profitability varied significantly during its fiscal year. Some periods of time during the year were associated with losses, while others were associated with higher than average profits. Petitioner's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied substantially from month to month during its 1979, 1980, and 1981 fiscal years. Thus, petitioner's net earnings available for payment of patronage dividends were not generated evenly over its fiscal year.

Nonmargin items such as shrinkage, interest expenses, salaries, overhead, taxes, and depreciation affected the amount of petitioner's net earnings available for distribution to its members. These items were not identified with any particular transactions in computing petitioner's patronage dividend.

Union Equity's Business Operations and Transactions With Petitioner

At all relevant times, petitioner's transactions with Union Equity related solely to sales and storage of wheat. Union Equity purchased wheat from members in quantities ranging from 600 to 3,300 bushels. Grain purchased from petitioner and others was commingled by Union Equity in its inventory of owned grain from which Union Equity thereafter made its sales. Union Equity maintained a grain inventory that was valued at market (realizable value adjusted for freight) determined from open sale contracts or Houston bid price, adjusted for net gains or losses on open commodity contracts. Union Equity ordinarily sold its grain in vessel quantities ranging from 1 million to 2.5 million bushels. Because of the fungible nature and the commingling of grain, sales could not be identified with particular prior purchases.

Union Equity's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied substantially from month to month during the years ended December 31, 1979, 1980, and 1981. During calendar year 1979, Union Equity's grain inventory ranged from \$18 million on June 1, to \$130 million on November 1; monthly sales ranged from \$43 million in May to \$113 million in December. These variations were due primarily to whether and market conditions. The grain market price often fluctuated significantly between the purchase of a specific quantity of grain and the sale of a similar quantity by Union Equity. Thus individual transactions were not equally profitable.

Union Equity's net earnings available for payment of patronage dividends to petitioner and other local cooperatives were not generated evenly over 1979. Some periods during the year were associated with losses, while others were associated with higher than average profits.

Nonmargin items such as overhead expenses, interest expenses, hedging income and loss, patronage dividends from other cooperatives, and depreciation affected the amount of Union Equity's net earnings available for distribution to petitioner and other members. These items were not identified with any particular grain transaction nor with particular months.

Union Equity classified each transaction by patron account number and commodity on a daily basis. This information was used by Union Equity at yearend to allocate net earnings in each allocation unit between patrons and nonpatrons, and as the basis upon which the portion of member net earnings in each allocation unit was allocated to business done with or for patrons according to Union Equity's bylaws.

In computing its net earnings for each of its allocation units, Union Equity based its calculations on averages. It did not look to specific transactions, nor was it possible to determine to which grain purchases the net earnings in a particular year or month were attributable. Union Equity determined its total patronage dividend paid on May 31, 1980, by reference to the net earnings reflected in its financial records for the year ended December 31, 1979. Union Equity allocated the total patronage dividends to the patrons of its grain marketing and grain storage allocation units according to the quantity of wheat sold to Union Equity and the amount of storage fees incurred with Union Equity by each patron in the year ended December 31, 1979.

Farmland's Business Operations and Transactions With Petitioner

At all relevant times, Farmland purchased, produced, and processed various farm supplies, added them to bulk inventories and made sales from inventories to its members. Because of the fungible nature of its supplies, sales could not be identified with particular purchases or production. Farmland maintained inventories valued on a lower of cost or market basis for each of its product lines.

Farmland's sales, cost of sales, inventories, gross margins, and net earnings in each of its allocation units varied substantially from month to month during the years ended August 31, 1979, 1980, and 1981. Due to the seasonal nature of farming, Farmland's supply inventory levels fluctuated. Farmland's sales of a single product in an allocation unit were not all equally profitable due to the impact of market demand, transportation costs, and weather conditions.

Farmland's net earnings available for payment of patronage dividends to petitioner and other local cooperatives were not generated evenly over Farmland's fiscal year ended August 31, 1980. Some periods during the years ended August 31, 1979, 1980, and 1981, were associated with losses, while others were associated with higher-than-average profits. During fiscal year 1980, Farmland's monthly net earnings ranged from approximately \$1 million in December to approximately \$51.6 million in August.

Nonmargin items such as warehousing, general overhead, and corporate expenses affected the amount of Farmland's net earnings available for distribution to petitioner and other members. These items were not identified with particular transactions between Farmland and its members.

Farmland classified each transaction by patron account number and commodity on a daily basis. This information was used by Farmland at yearend to allocate net earnings in each allocation unit between patrons and nonpatrons, and as the basis upon which the portion of member net earnings in each allocation unit was allocated to business done with or for patrons according to Farmland's bylaws.

Farmland made no attempt to determine whether particular transactions were profitable. Rather, it determined annually whether there were earnings in each of its allocation units. In computing net earnings for each of its allocation units, Farmland did not look to specific transactions, nor was it possible to determine to which sales the net earnings in a particular period were attributable. To the extent a unit had net earnings, they were distributed ratably to the Farmland members who patronized that unit.

Farmland determined its total patronage dividend paid on December 31, 1980, by reference to the net earnings reflected in its financial records for the year ended August 31, 1980. Farmland allocated the total patronage dividends to the patrons of each of its allocation units according to the dollar amount of products of that unit purchased from Farmland by each patron during the fiscal year.

Computation of Petitioner's Patronage Dividends

For its cooperative accounting purposes since at least fiscal year 1973, petitioner allocated its annual patronage dividend among seven allocation units: wheat; other grain; grain storage; feed, seed, and farm supplies; service income; anhydrous ammonia fertilizer; and other fertilizer. Petitioner followed this allocation method with respect to its patronage dividend for fiscal year 1981.

Petitioner's directors made an annual allocation of petitioner's net earnings from its seven allocation units upon recommendation of its auditors and general manager. Pursuant to petitioner's bylaws, net earnings accrued on business transacted with or for members, in excess of reserve fund and tax requirements, were required to be apportioned among all members on the basis of patronage and distributed in cash, merchandise, credits on capital stock, member equity credits, special reserves, certificates of equity, or any form of non-interest-bearing instrument without due date.

During fiscal year 1981, petitioner received patronage dividends from cooperatives of which it was a member-patron as follows:

* * *

The patronage dividend distribution received by petitioner from Union Equity in 1980 was allocated and distributed on the basis of business done by petitioner with Union Equity in Union Equity's year ended December 31, 1979. It included petitioner's share of patronage dividend distributions received by Union Equity in 1979 from other cooperatives of which Union Equity was a member. The patronage dividend distribution received by petitioner from Farmland in 1980 was allocated and distributed on the basis of business done by petitioner with Farmland during Farmland's fiscal year ended August 31, 1980. It included petitioner's share of patronage dividend distributions received by Farmland during its 1980 fiscal year from other cooperatives of which Farmland was a member.

In computing the amounts of its net earnings distributable to member-patrons on a patronage basis for its 1981 fiscal year, petitioner included in gross income the patronage distributions received from Union Equity and Farmland in 1980. Of the \$68,553.56 patronage dividend received from Union Equity, \$64,939.40 was attributable to wheat marketing and \$3,614.16 was attributable to storage. Petitioner included \$64,939.40 in its 1981 gross income in its wheat marketing allocation unit and \$3,614.16 in its 1981 gross income in its storage allocation unit. After determining the percentage of 1981 fiscal year wheat purchases by hundredweight from members and nonmembers, petitioner allocated the portion of its 1981 fiscal year net earnings of its wheat marketing allocation unit relating to member business in proportion to the volume of wheat marketing business transacted with or for each of its members in fiscal year 1981. Petitioner allocated the portion of its 1981 fiscal year net earnings of its storage allocation unit relating to member business in proportion to the dollar value of the storage business transacted with or for each of its members in fiscal year 1981.

The \$131,425.93 patronage dividend paid by Farmland was allocable to each of the Farmland allocation units of which petitioner was a member as follows:

* * *

Farmland allocated the total patronage dividends to its patrons of each of its allocation units according to the dollar amount of products of that unit purchased from Farmland by each patron in Farmland's fiscal year ended August 31, 1980.

In determining its net earnings for fiscal year 1981, petitioner added the Farmland patronage dividend received during this period to its gross income in its ammonia fertilizer, other fertilizer, and feed, seed, and farm allocation units. After determining the portion of fiscal year 1981 sales in each allocation unit attributable to members and nonmembers, petitioner allocated the member portion of its fiscal year 1981 net earnings in each unit to its members in proportion to the dollar amount of sales to members during the fiscal year.

Petitioner had followed these allocation and distribution practices since at least fiscal year 1973.

During a meeting of petitioner's directors on March 17, 1981, a motion was made and carried, subject to approval of the members, for distribution of earnings for the 1981 fiscal year as follows:

The surplus account be credited with an amount approximating 10% of the net earnings in keeping with the provisions of the by-laws.

The remainder of the net earnings are to be distributed on the basis of patronage to all members and patrons who are eligible for membership, at least 25% in cash, and the remainder in capital stock and stock credits. All patronage amounts of 99¢ or less to be deleted; all patronage amounts from \$1.00 through \$3.99 to be paid 100% in cash; stockholders with birthdate of 12/31/1903 or before to receive 100% in cash and all others to receive 25% in cash and the remainder in stock and stock credits.

On April 22, 1981, the directors determined that 25 percent of the patronage dividend would be paid in cash, subject to approval of the members and the Wichita Bank for Cooperatives, and that anyone having attained his 76th birthday would be paid 100 percent in cash.

On May 1, 1981, the directors approved payment of a patronage dividend of \$321,079.93 for the 1981 fiscal year according to the following schedule:

* * *

At petitioner's annual stockholders' meeting on May 16, 1981, the financial report was presented by the general manager and, after an opportunity for discussion by petitioner's members, the apportionment of earnings recommended by the directors was ratified.

Petitioner distributed its 1981 fiscal year member net earnings of \$321,079.93 in cash and written notices of allocation to its patrons on and immediately after May 17, 1981. Petitioner allocated and distributed its 1981 patronage dividend in its wheat, other grain, and storage allocation units on the basis of quantity of business done with or for its patrons during the 1981 fiscal year. The patronage dividend was distributed within petitioner's anhydrous ammonia, other fertilizer, feed, seed, and farm supplies and service income allocation units on the basis of the value of business done with or for its patrons during the 1981 fiscal year. Petitioner provided its members with a patronage statement detailing the sources of their individual patronage dividend and a letter setting forth the basis upon which the patronage dividend was calculated. Petitioner claimed a patronage dividend deduction of \$321,079.93 on its corporate income tax return for fiscal year 1981.

In his notice of deficiency, respondent disallowed \$133,864.30 of petitioner's patronage dividend deduction by disallowing all of the amount attributable to the patronage dividend petitioner received from Union Equity and seven-twelfths of the amount attributable to that received from Farmland. The disallowance was explained as follows:

It is determined that you incorrectly computed your patronage dividend deduction for the year by allocating to current year patrons the Regional Patronage Dividends received during the year. These Regional Patronage Dividends were earned on business done by prior year patrons.

OPINION

Generally, subchapter T permits cooperatives to deduct from gross income amounts paid to patrons as patronage dividends, and subjects the patrons to tax on these dividends to the extent they arise out of the patrons' business transactions with the cooperative. Secs. 1381 through 1388. Thus the foundation of subchapter T is a single level of tax. See Riverfront Groves, Inc. v. Commissioner, 60 T.C. 435, 440-441 (1973).

Although section 1382(a) requires a cooperative to treat patronage dividends as an item of gross income, a corresponding deduction from gross income is allowed under section 1382(b) to the extent that the patronage dividends are properly distributed within the terms of the statute.

The statutory standard for determining the deductibility of patronage dividends is set forth in section 1388(a). This section embodies the equitable allocation principle surrounding this controversy and defines "patronage dividend" as an amount paid to a patron:

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Section 1388(a) further provides that patronage dividends do not include any amount paid to a patron to the extent that the amount is out of earnings other than from business done with or for patrons, or is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

The concept of equitable allocation--that earnings must be allocated ratably to the particular patrons whose patronage created the earnings from which the allocated dividend was made--was a judicially recognized requirement for the deductibility of patronage dividends prior to the enactment of subchapter T. Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894, 900 (1982); Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 403 (1972), affd. 481 F.2d 812 (10th Cir. 1973). Respondent contends that petitioner's method of allocating regional patronage dividends according to its patronage in the year of receipt violates this principle. Respondent argues that these patronage dividends were properly allocable to those patrons who contributed to the earning of the dividends. Asserting that the regional dividends were earned on business done by prior years' patrons, respondent reduced the patronage dividend deduction claimed by petitioner for the year in issue by advancing a simplistic formula which he claims will result in an equitable allocation: prorate the earnings to the months earned and allocate those prorated earnings ratably to the members of the allocation unit to which the prorated earnings are assigned. Under this formula respondent determined that the entire patronage dividend received by petitioner from Union Equity and 7/12 of that received from Farmland were attributable to business done prior to April 1, 1980, and, therefore, were not properly allocable to petitioner's patrons in the year the dividends were received.

Petitioner contends that in view of the stability of its membership and the fact that the transactions between petitioner, its members, Union Equity, and Farmland span various accounting periods, the allocation method chosen by its democratically elected board of directors, ratified annually and employed consistently for many years, was equitable and reasonable. We agree with petitioner.

Section 1382(f) prescribes the treatment of earnings received after patronage occurred:

If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then for purposes of applying * * * [section 1382(b)] the patronage shall, to the extent provided in regulations prescribed by the Secretary, be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income. 5/

[5/ Sec. 1.1381-6, Income Tax Regs., provides that patronage will be deemed to have occurred in the year in which the income is includible in the cooperative's gross income.]

Despite the express language of section 1382(f) and the absence of a statutory requirement that patronage dividends in some specific circumstances must be allocated to prior years' patrons, 6/

[6/ Cf. sec. 1.1382-3(c)(3), Income Tax Regs., which requires nonpatronage-sourced income realized by an exempt cooperative from the sale or exchange of capital assets held

more than one taxable year to be paid "insofar as is practicable" to the persons who were patrons during the taxable years in which the assets were owned in proportion to the amount of business done by such patrons during such taxable years.]

respondent maintains that the requirement of equitable allocation necessitates tracing to those patrons whose business generated the earning of the regional dividends.

In support of his theory, respondent relies on a variation of the same type of theoretical arguments he advanced in other cases involving vertical allocations, focusing on the characterization of a cooperative as a conduit or agent. See Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982); Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213 (1980); Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977). Vertical allocation involves allocation among continuing patrons from year to year, whereas, horizontal allocation involves allocation between patrons and nonpatrons in the same year. See Lamesa Cooperative Gin v. Commissioner, *supra*.

In Lamesa Cooperative Gin v. Commissioner, *supra*, we considered respondent's equitable allocation argument in his attempt to allocate gain on the sale of equipment that had been leased over a 10-year period to members of an exempt cotton gin cooperative to its member-patrons in the years in which the recaptured depreciation was claimed. We concluded that the cooperative's allocation of the gain to its current year patrons was not inequitable under the circumstances. Rejecting respondent's equitable allocation argument, we stated:

[T]he requirement of "equitable allocation" should not be seen as a strict accounting requirement but as only a general principle to prevent inequitable treatment to some patrons at the expense of others. As a principle of equity, the overall scheme of allocation should be examined, including the practicalities of making allocations, the democratic nature of cooperatives, and the extent of patronage to the cooperative by nonmembers who have no say over how patronage dividends are distributed. [Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 903.]

We concluded that the concept of equitable allocation does not require that net margins be allocated precisely in proportion to the patronage that generated them, nor mandate a particular form of accounting. Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 902, 907.

Respondent's objections to petitioner's allocation method in this case are not unlike those we rejected in cases involving his past attempts to require tracing with respect to cooperatives' net operating loss deductions through the principle of "operation at cost." The concept of operation at cost means that a cooperative was organized for the purpose of rendering economic services, without gain to itself, to shareholders or to members who own and control it. Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213, 1219 (1980); United Grocers, Ltd. v. United States, 186 F.Supp. 724, 733 (N.D. Cal. 1960), *affd.* 308 F.2d 634 (9th Cir. 1962). We initially rejected respondent's operation at cost argument in Associated Milk Producers, Inc. v. Commissioner, *supra*, where he argued that because of this principle, a cooperative by its very nature could not have a net operating loss for tax purposes. Respondent reasoned that in any year in which expenses exceed gross income, the loss must be recovered from the members who were patrons for that period--"i.e., the exact converse of a patronage dividend allocation when income exceeds expenses." We disagreed with respondent's reasoning and concluded that his position constituted "an unwarranted tinkering with the tax structure applicable to cooperatives." Associated Milk Producers, Inc. v. Commissioner, 68 T.C. at 735-736.

We subsequently rejected respondent's further refined position in Ford-Iroquois FS, Inc. v. Commissioner, *supra*, where he sought to deny the net operating loss carryforward only for terminated members, and not for all members as he had proposed in Associated Milk Producers. In Ford-Iroquois FS, Inc., we examined the cooperative's bylaws and articles, its overlapping membership in its marketing and supply operations, the contacts between the managers and directors of the cooperative and its members, the actual allocations, and the apparent approval of the cooperative's allocation method by its members. We concluded that the cooperative's method of allocation was practicable, nondiscriminatory,

and equitable, and stated that "[t]he allocation of losses among a cooperative's past, continuing, and future members is properly the concern of the membership and its board of directors." Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. at 1220-1222.

Focusing our inquiry on whether the allocation was inequitable in view of the board of directors' considerable discretion, we note that the board's weighing of the equities should be overturned by this Court only when the exercise of that discretion appears to have been unreasonable. Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 906.

Respondent recognizes that the Government should not ordinarily interfere with a cooperative's method of allocating earnings, but insists that there are limits beyond which a cooperative may not go without sacrificing operation on a cooperative basis. He acknowledges also that there may be various acceptable methods of allocation. See Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 910. Respondent insists, however, that petitioner's allocation method is "ipso facto discrimination" and does not comport with the provisions of subchapter T.

As we noted in Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 903, the cases that have found inequitable allocations have generally involved allocations between member and nonmember patrons. E.g., Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457 (1969); Farmers Union Cooperative Co. v. Commissioner, 90 F.2d 488 (8th Cir. 1937), affg. 33 B.T.A. 225 (1935). Focusing on the democratic nature of a cooperative, we emphasized that the greatest risk of inequitable allocation arises when a cooperative allocates net margins to members at the expense of nonmembers who have no voice in the election of management. Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 903-904. In the case of a vertical allocation problem, however, the management has been directly elected by the members of the cooperative and "the key factor is that the identity of the patrons has remained stable enough so that there is no reason to assume that * * * [Lamesa's] management would be prone to take actions discriminatory against past patrons." 78 T.C. at 905.

Here, as in Lamesa Cooperative Gin v. Commissioner, *supra*, the controversy centers around petitioner's allocation of earnings among continuing patrons from year to year, and thus, the key factor is the stability of petitioner's membership. The parties stipulated that petitioner's membership turnover was less than 5 percent during its 1979, 1980, and 1981 fiscal years. Moreover, most of the terminations in membership involved the death or retirement of a member whose membership was subsequently continued by another family member. Thus it appears that substantially all of petitioner's patrons remained the same from year to year.

Respondent failed even to consider petitioner's overlapping membership. In view of the continuity in petitioner's membership, it is apparent that respondent's proposed adjustment incorrectly disallows amounts that would have been paid to the same patrons under either petitioner's or respondent's allocation method.

Respondent presented no evidence of objections to petitioner's allocation method, nor of any particular instances of discrimination. Petitioner's net earnings were apportioned annually by its directors as required under its bylaws. The directors employed various means of communications to apprise the members of petitioner's business and the allocation of patronage dividends, including newsletters, annual reports, and informal and formal meetings. Although the members were given the opportunity to discuss and object to the director's allocation of earnings, the evidence establishes that the director's recommendations were consistently ratified since at least 1979. Because of the stability in petitioner's membership and the total lack of evidence of discrimination against past patrons, we have no reason to suspect any discriminatory action on the part of petitioner's management with respect to its allocation of patronage dividends. To the contrary, it appears that petitioner's directors made a concerted effort to insure that all members were treated fairly.

Another factor to be considered is the practicality of making a particular type of allocation. Lamesa Cooperative Gin v. Commissioner, 78 T.C. at 906. Much of the evidence and testimony presented by petitioner relates to the seasonal nature of farming and its effect on transactions among

petitioner, its members, Union Equity and Farmland, including the computation and distribution of patronage dividends. Factors such as the effect of commingled and carryover inventories, the timing of purchases and sales, unequal profitability among transactions, and sources of net earnings are extremely relevant to our inquiry as to whether petitioner's allocation method was equitable. In our view these factors are indicative of the practical and conceptual problems underlying the period tracing method advocated by respondent and the need for the seasoned judgment of petitioner's members and their elected board of directors in adopting an equitable allocation method. It is obvious that the net earnings from a particular period in a regional cooperative's business cycle do not necessarily relate to the local transactions during the identical time period.

The evidence also establishes that the transactions among petitioner, its members, Union Equity and Farmland overlap the various accounting periods of each entity. The regional cooperatives in turn receive patronage dividends from upper-tier cooperatives of which they are members, each potentially with a different fiscal year. Respondent's method ignores the fact that a patron's transactions necessarily overlap annual accounting periods. The complex calculations that would be required to trace the earnings through the various levels and fiscal years in order to determine which patrons generated the earnings would necessitate tracing of individual transactions despite respondent's claim to the contrary. Such tracing would be costly and cumbersome and is not required by subchapter T, prior precedent, or principles of cooperative accounting.

Petitioner's witnesses, experienced in the cooperative farming business, testified that petitioner's allocation method was in accordance with generally accepted cooperative principles. Petitioner followed this method consistently, apparently without objection, for many years. Respondent has ignored the realities of the cooperative way of business and substituted a method of period tracing that revolves around the fiscal year of the regional cooperative from which the patronage dividend was received. Respondent presented no evidence, however, to indicate that the regional dividends were in fact attributable to petitioner's patronage during such earlier periods, nor to demonstrate that his method would result in a more accurate and equitable allocation of regional dividends to the local transactions which generated such earnings than that of petitioner.

Considering the stability of petitioner's membership, the practicalities of the allocation, and the apparent approval of petitioner's allocation method by its members, we find petitioner's method to be fair and equitable and within the statutory framework of subchapter T.



Other decisions relating to the equitable allocation issue include the following:

Ford-Iroquois FS, Inc. v. Comm'r, 74 T.C. 1213 (1980).

Rev. Rul. 74-84, 1974-1 C.B. 244.

Union Equity Cooperative Exchange v. Comm'r, 58 T.C. 397 (1972), *aff'd*, 480 F.2d 812 (10th Cir. 1973), *cert. denied*, 414 U.S. 1028.

Petaluma Co-operative Creamery v. Comm'r, 33 T.C. 216 (1959), *rev'd*, 288 F.2d 315 (8th Cir. 1961).

Pomeroy Cooperative Grain Co. v. Comm'r, 31 T.C. 674 (1958), *aff'd in part and rev'd in part*, 288 F.2d 326 (8th Cir. 1961).

Juniata Farmers Cooperative Ass'n v. Comm'r, 43 T.C. 836 (1965).

Farmers Union Cooperative Co. v. Comm'r, 90 F.2d 488 (8th Cir. 1937), *aff'g*, 33 B.T.A. 225 (1935).

Some of the above cases (and other related materials not included in the list) discuss allocation between member and nonmember business, with somewhat different principles and substantially different implications. Equitable allocation has played a central role in the handling of losses issue, discussed in some detail below, and the intracooperative or interunit netting disputes, also summarized below.

The issue of cooperative losses combined with a view of "equitable allocation" and cooperative principles to yield an additional discussion of taxation and operating as a cooperative. While materials seem to go into somewhat excessive detail, discussions address basic cooperative principles and law. The *Farm Service* case deals with losses but the principles it highlights another application of the equitable allocation concept.

=====||=====

Farm Service Cooperative v. Comm'r
619 F.2d 718 (8th Cir. 1980), *rev'g*, 70 T.C. 145 (1978)

BRIGHT, Circuit Judge: The Commissioner of Internal Revenue (Commissioner) appeals from a decision of the United States Tax Court in favor of Farm Service Cooperative (taxpayer). 1/

[1/ *Farm Service Cooperative v. Commissioner*, 70 T.C. 145 (1978).]

The Tax Court determined that taxpayer, a nonexempt farm cooperative, 2/

[2/ As explained more fully below, the term "nonexempt" means that taxpayer does not satisfy the criteria set forth in I.R.C. s.521 for exemption from taxation. Nonetheless, taxpayer comes within the purview of subchapter T, I.R.C. s.s.1381-88, as a "corporation operating on a cooperative basis." I.R.C. s.1381(a)(2).]

could offset losses suffered in patronage activities against its taxable income. For the reasons set forth below, we conclude that this determination was erroneous. Accordingly, we reverse.

I. Background. Taxpayer is an agricultural cooperative incorporated under the laws of Arkansas, with its principal place of business in Fayetteville. During the years in question, taxpayer divided its business activities into four categories: a broiler pool, a turkey pool, a regular pool, and taxable activity. 3/

[3/ Taxpayer maintained separate books and records for each of the three pools and the taxable activity. The results of the accounts were combined, however, on taxpayer's federal income tax return.]

The regular pool was a supply operation; taxpayer owned four stores that sold mostly farm supplies to cooperative members (patrons) and nonmembers alike. 4/

[4/ In contrast to the practice of some cooperatives, taxpayer allocated patronage dividends only to its members. Membership was restricted to agricultural producers. In this opinion we use the terms "patron" and "member" interchangeably to refer to taxpayer's member-patrons.]

Taxable activity encompassed various sources of taxable income, including gains from the sale of taxpayer's property, dividends on taxpayer-owned stock, the cancellation of outstanding dividend checks payable to former patrons who could not be located, and other miscellaneous items of cooperative income.

The broiler and turkey pools engaged in hatching, growing, and marketing chickens and turkeys, respectively. It is the broiler pool that chiefly concerns us here. Taxpayer owned hatcheries where eggs were hatched and baby chicks were raised until twenty-four hours old. At that point, taxpayer transported the chicks to approved grower-members, who contracted to care for the chicks until they were of marketable size (about eight weeks). During this time taxpayer supplied feed, medical care, and supervision, while grower-members supplied housing, fuel, equipment, and services. When the chickens became mature, taxpayer picked them up and delivered them to its processing plant.

At the time of pickup, taxpayer paid its grower-members according to a formula that took into account the delivery weight of the chickens (less that of any chickens condemned by the U.S. Department of Agriculture), current market prices, and the efficiency with which chicken feed had been converted into meat. The contracts between taxpayer and grower-members also provided for a minimum payment, irrespective of variations in wholesale market prices. Taxpayer characterizes these grower payments as cash "per-unit retain allocations." See I.R.C. s.1388(f). 5/

[5/ s.1388. Definitions; special rules

* * *

(f) Per-unit retain allocation.--For purposes of this subchapter, the term "per-unit retain allocation" means any allocation, by an organization to which part I of this subchapter applies to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.]

Broilers sell on a highly volatile market; as a result, growing and marketing broilers can be a risky venture. The broiler pool earned reasonable profits in some years, but it sustained significant losses in others. Most of taxpayer's earnings on broiler sales in profitable years were returned to pool members as patronage dividends and deducted from taxpayer's gross income pursuant to I.R.C. s.1382(b). 6/

[6/ s.1382. Taxable income of cooperatives

* * *

(b) Patronage dividends and per-unit retain allocations.--In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d))) with respect to patronage occurring during such taxable year;

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred;

(3) as per-unit retain allocations (as defined in section 1388(f)), to the extent paid in money, qualified per-unit retain certificates (as defined in section 1388(h)), or other property (except nonqualified per-unit retain certificates, as defined in section 1388(i)) with respect to marketing occurring during such taxable year; or

(4) in money or other property (except per-unit retain certificates) in redemption of a nonqualified per-unit retain certificate * * *.

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) and (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income.]

A substantial portion of the dividends (approximately eighty percent) were in the form of "qualified written notices of allocation." 7/

[7/ s.1388. Definitions; special rules

* * *

(b) Written notice of allocation.--For purposes of this subchapter, the term "written notice of allocation" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

(c) Qualified written notice of allocation.--

(1) Defined.--For purposes of this subchapter, the term "qualified written notice of allocation" means--

(A) a written notice of allocation which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation; and

(B) a written notice of allocation which the distributee has consented, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

Such term does not include any written notice of allocation which is paid as part of a patronage dividend or as part of a payment described in section 1382(c)(2)(A), unless 20 percent or more of the amount of such patronage dividend, or such payment, is paid in money or by qualified check.]

These notices of allocation were considered to be paid out to the members and hence taxable to them upon issue, even though taxpayer actually retained the funds and added them to a reserve account maintained for the broiler pool. By 1971 this account held \$448,744.

The broiler pool sustained significant losses in the fiscal years ending June 30, 1971, and June 30, 1972. In fiscal 1971 broiler pool expenditures (including grower payments) exceeded gross receipts by \$572,634.37. During the same period taxpayer realized income from its other activities as follows:

Patronage Income from Turkey Pool	\$ 4,088.80
Income from Regular Pool	
Patronage-sourced	51,510.37
Nonpatronage-sourced	20,528.75
Taxable Activity	156,497.56

Total	\$ 232,625.48

Taxpayer distributed or allocated to its turkey pool members the net patronage income derived from the turkey pool activities. It similarly distributed or allocated to its regular pool members the net patronage income derived from the sale of farm supplies to its regular pool members. After taxpayer had done this, taking the deductions authorized by I.R.C. s.1382(b), there remained \$177,026.31 of income subject to taxation. 8/

[8/ The Commissioner has raised no objection to taxpayer's allocation of patronage-sourced income in this case, and he has not challenged the deductions taken under I.R.C. s.1382(b). The parties have stipulated to the accuracy of taxpayer's accounting figures.]

Taxpayer reduced its taxable income for fiscal 1971 to zero by setting this \$177,026.31 off against part of the \$572,634.37 broiler pool deficit. Taxpayer then timely filed Form 1139 requesting refunds for the carryback of \$165,469.67 of the remaining broiler pool deficit. Taxpayer also requested a carryback of its unused investment credits for the fiscal years ending June 30, 1970, 1969, and 1968. * * *

Taxpayer charged this loss carryback to an unallocated, general reserve account maintained for receipts from its taxable activities.

By carrying back its unused investment credits for the same period, taxpayer was able to obtain tax refunds for the fiscal years ending June 30, 1967, 1966, and 1965. These refunds were likewise credited to taxpayer's unallocated, general reserve account.]

After this offsetting of four years' taxable income, taxpayer allocated the balance of the 1971 broiler pool deficit to its broiler pool reserved account, reducing it from \$448,744 to \$218,605.61. This change was reflected in the cancellation of \$230,138.39 in members' qualified written notices of allocation.

For the fiscal year ending June 30, 1972, the broiler pool's expenditures exceeded broiler pool receipts by \$72,040.65. Taxpayer offset the entire amount of this broiler pool deficit against its taxable income for fiscal 1972 (*i.e.*, nonpatronage-sourced income from the regular pool and taxable activity income), leaving taxable income of \$5,122 for the year.

The Commissioner disagreed with taxpayer's method of accounting. Specifically, he determined that taxpayer was required to pay tax on all income not allocable to patrons; taxpayer could not use the losses generated by business done with patrons (*i.e.*, the broiler pool deficit) to offset its taxable income. In pertinent part, the Commissioner's notice of deficiency to taxpayer states:

(a) Deductions of \$572,634.37 and \$72,040.65 claimed for broiler pool losses on your returns for June 30, 1971 and June 30, 1972 are not allowable offsets to current taxable income but are charges against the broiler pool reserve.
* * *

(c) As a result of the above adjustments to your return for June 30, 1971, the net operating loss for that year which was carried back to taxable years June 30, 1968, June 30, 1969 and June 30, 1970 and tentatively allowed is eliminated.

Further, since the net operating loss is eliminated, the carryback of unused investment credits to June 30, 1965 and June 30, 1966 from June 30, 1968 and to June 30, 1967 from June 30, 1970 and tentatively allowed are also eliminated.

II. Analysis. A. The Statutory Scheme: Taxation of Cooperative Income and Patronage Dividends. By virtue of consistent administrative practice, all cooperatives have been permitted to treat patronage payments as a deduction from gross income (under specified conditions) since 1914. T.D. 1996, 16 Treas. Dec. Int. Rev. 100 (1914); Logan, Federal Income Taxation of Farmers' and Other Cooperatives, 44 Tex. L. Rev. 250, 285-86 (1965). The theory underlying this tax treatment is clear, although stated in various ways: the cooperative is merely an agent for the patron, a patronage dividend constitutes a rebate or price adjustment for the patron; or the money returned in fact always belonged to the patron. See Des Moines County Farm Service Co. v. United States, 324 F.Supp. 1216, 1219 (S.D. Ia.), aff'd per curiam, 448 F.2d 776 (8th Cir. 1971).

The deductibility of patronage dividends first received explicit legislative recognition and approval in the Revenue Act of 1951, ch. 521, s.314(a)(2), 65 Stat. 492 (repealed 1962). See Des Moines County Farm Service Co. v. United States, supra, 324 F.Supp. at 1219. It was generally thought at that time that the earnings of cooperatives would be currently taxable either to the cooperative or to its patrons. Subsequent court decisions, however, held that noncash allocations of patronage dividends, though deductible by the cooperative, were not taxable to the patron.

The enactment of subchapter T, section 17(a) of the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, was intended to overturn these decisions. S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted in [1962] U.S. Code Cong. & Ad. News 3304, 3414. Subchapter T, I.R.C. s.s.1381-88, permits cooperatives to deduct amounts allocated in cash or scrip as patronage dividends, and it makes patrons currently taxable on these patronage dividends to the extent that they arise out of the patrons' business transactions with the cooperative. "Exempt" cooperatives, those satisfying the criteria of I.R.C. s.521(b), may allocate to their patrons and deduct not only earnings derived from patronage activities, but also dividends on capital stock and earnings derived from such business done for the United States or from nonpatronage sources. I.R.C. s.1382(c). See generally Land O'Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir.), cert. denied, 423 U.S. 926 (1975); Logan, Federal Income Taxation of Farmers' and Other Cooperatives, 44 Tex. L. Rev. 250 (1965). Nonexempt cooperatives may allocate and deduct only income arising from business done with patrons, and then only under additional conditions specified in I.R.C. s.1388(a). 10/

[10/ s.1388. Definitions; special rules

(a) Patronage dividend.--For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies--

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.]

I.R.C. s.1382(b).

Because of this restriction on the scope of allowable deductions, nonexempt cooperatives must separate patronage- from non-patronage-sourced income. A nonexempt cooperative is a hybrid business organization, taxed like an ordinary corporation with respect to nonpatronage-sourced income (see subchapter C, I.R.C. s.301 et seq.), but like a partnership with respect to patronage-sourced income. See

Conway County Farmers Ass'n v. United States, 588 F.2d 592, 596 (8th Cir. 1978). That is to say, nonpatronage-sourced income is fully taxable to the cooperative and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxes only once, usually to the patron.

This disparity in tax treatment, as might be expected, has given rise to several tax-accounting issues involving the proper allocation of expenses and income. For example, in Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), this court addressed the question of how payments to the cooperative for storing government-owned grain should be characterized. We held that such payments were not derived from patronage activities and thus could not be allocated to patrons; rather, they remained taxable to the cooperative. In Des Moines County Farm Service Co. v. United States, *supra*, 324 F.Supp. at 1219, the court held that capital stock dividends are presumed to be attributable to patronage and nonpatronage business pro rata. This follows, the court reasoned, because both kinds of business give rise to the income on which the stock dividends are based. *Id.* at 1220. If the cooperative were permitted to pay these stock dividends solely out of its taxable income, the result would be an improper inflation of the patronage income available for patronage dividend deductions and, correspondingly, an improper reduction in taxable income. *Accord*, Union Equity Cooperative Exchange v. Commissioner, 481 F.2d 812 (10th Cir.), *cert. denied*, 414 U.S. 1028 (1973); FCX, Inc. v. United States, 531 F.2d 515 (Ct. Cl. 1976).

From these cases the Commissioner derives a "cooperative tax accounting principle" that, he argues, invalidates taxpayer's method of allocating losses in this case. Because common overhead expenses cannot be allocated to offset solely nonpatron income, it follows *a fortiori* that expenses allocable solely to patron business may not be offset against nonpatron income. Taxpayer argues, however, that this is so only where patronage dividends result; Des Moines County Farm Service Co. and its progeny are irrelevant to the allocation of net operating losses. ^{11/}

[^{11/} Taxpayer also argues that the Commissioner's "cooperative tax accounting principle" presents an issue that was not raised below, and hence one that should be disregarded here. See, e.g., Wright v. United States, 482 F.2d 600, 610 (8th Cir. 1973); Hormel v. Helvering, 312 U.S. 552, 556-58 (1941). We cannot, however, accept taxpayer's premise. Although the "principle" was not denominated as such below, it simply restates the Commissioner's argument before the Tax Court that patronage losses may not be offset against nonpatronage income. See Farm Service Cooperative v. Commissioner, *supra*, 70 T.C. at 154-55.]

We turn now to consider these conflicting contentions in greater detail.

B. Losses and Expenses. Taxpayer argues initially that its treatment of operating losses conforms with the Code. Subchapter T says nothing about the appropriate treatment of net operating losses, and so, according to taxpayer, the general rules of corporate taxation apply. Because corporations can aggregate gains and losses for their various divisions, taxpayer contends that it should be allowed to do the same thing. The Tax Court agreed with taxpayer, holding that under taxpayer's bylaws ^{12/}

[^{12/} Article X, s.3 of taxpayer's bylaws provides in relevant part:

If a loss occurs in any activity, it shall be borne, insofar as practicable, on an equitable basis by each activity that operated in the black. Any loss that is not wiped out in this way shall be borne by the general reserves heretofore accumulated. In computing its income taxes and for all accounting purposes this cooperative may use carrybacks and carryforwards as provided by law.]

its board of directors could allocate the broiler pool losses as they saw fit. 70 T.C. at 155. In so holding, the Tax Court relied upon its decision in Associated Milk Producers, Inc., v. Commissioner, 68 T.C. 729 (1977).

In Associated Milk Producers, the Tax Court held that a nonexempt cooperative could employ the net loss carryover provisions of I.R.C. s.172 to reduce current patronage earnings by past operating losses. Rejecting the Commissioner's argument that a loss must be recouped from capital reserves in the year in which it is incurred, the Tax Court ruled that the cooperative could determine whether its past, present, or

future patrons should bear the loss. Id. at 738-39. The loss would, in any event, be borne by the patrons and would be charged against the cooperative's capital reserves. See id. at 738. Cf. Rev. Rul. 65-106, 1965-1 C.B. 126 (cooperative can choose which year's patronage income to offset with a patronage loss).

In our view, the vertical (i.e., chronological) allocation problem presented in Associated Milk Producers is quite distinct from the essentially horizontal allocation problem in this case. That patronage losses are involved in both cases should not obscure the significant differences between them. Whereas in Associated Milk Producers the losses were borne by patrons, in this case taxpayer is trying to shift the broiler pool losses from the broiler pool patrons to itself and, more significantly, to the United States Treasury. Whereas the cooperative in Associated Milk Producers decided to forego its current patronage dividend deduction in charging off past losses, taxpayer in this case is seeking to avoid taxation on income for which no patronage dividend deduction is available.

Nor are we persuaded by taxpayer's contention that its losses can and must be considered apart from the dictates of subchapter T. Losses mean simply that expenditures exceed revenues. If taxpayer's method of calculating expenditures or revenues runs afoul of subchapter T, the presence of a net loss will not save it.

We come then to the nub of this case: was taxpayer's method of accounting proper under subchapter T? Taxpayer insists that it was. From its gross receipts taxpayer deducted its costs of goods sold, including grower payments (i.e., per-unit retain allocations paid in cash), 13/

[13/ This term is defined in I.R.C. s.1388(f) quoted at note 5 supra.]

to arrive at gross income. 14/

[14/ I.R.C. s.1382(b) provides in pertinent part:

For purposes of this title, any amount not taken into account under the preceding sentence [relating to patronage dividends and per-unit retain allocations] shall, * * * in the case of [per-unit retain allocations], be treated as a deduction in arriving at gross income.]

From that figure taxpayer deducted its ordinary and necessary expenses, interest, taxes, and depreciation (deductions allowed all corporations) plus its patronage dividends on profitable activities, which are deductible under subchapter T. 15/

[15/ I.R.C. s.1382(b) provides in pertinent part:

For purposes of this title, any amount not taken into account under the preceding sentence [relating to patronage dividends and per-unit retain allocations] shall, in the case of [patronage dividends], be treated in the same manner as an item of gross income and as a deduction therefrom * * * .]

When the result was a net operating loss, taxpayer simply utilized the loss carryback provisions authorized by I.R.C. s.172 for all corporations, including cooperatives.

The Commissioner does not contest the proposition that a cooperative can have a net operating loss, or that it can carry such losses forward and back as provided in I.R.C. s.172. See Associated Milk Producers, Inc. v. Commissioner, supra. The Commissioner objects rather to taxpayer's initial calculation of gross income. Specifically, the Commissioner argues that it is impermissible to lump together grower payments and expenses incurred in taxable activities as deductions in arriving at gross income, at least when the cooperative incurs a net loss on its patronage activities. 16/

[16/ By the same token, the Commissioner argues, it is impermissible to use a net loss on patronage activities to offset taxable income, separately calculated. Both methods of calculation produce the same result.

The practice of combining expenses and grower payments may not be objectionable when patronage activities yield positive net earnings, for then the patronage dividends deductible by the cooperative are limited to the earnings on those activities. I.R.C. s.1388(a)(3), quoted at note 10 supra. That is to say, the Code requires a nonexempt cooperative to separate its patronage from its nonpatronage accounts when it calculates deductions from gross income. See note 15 supra.

Likewise fewer problems are presented when a cooperative incurs a loss on its nonpatronage activities. The Commissioner has held that, in such a case, a cooperative need not reduce its patronage income to cover the loss. Rev. Rul. 74-377, 1974-2 C.B. 274. No avoidance of tax would result from either course of conduct; indeed, if the cooperative chose to offset the loss with current patronage income, it would have to forego the deduction for otherwise allowable patronage dividends.]

By reducing overall gross income, the Commissioner argues, taxpayer's method of accounting has the effect of transferring to the growers income properly taxable to the cooperative without taxation at the cooperative level. The Commissioner notes that this effect is precisely the same as that which would be produced if taxpayer allocated its patronage expenses so as to reduce taxable income, or if it issued patronage dividends on the earnings from taxable activities. Both of these courses of action are expressly forbidden by the Code. Des Moines County Farm Service Co. v. United States, supra; I.R.C. s.1388(a).

Whether these strictures should be extended to grower payments of per-unit retain allocations turns upon the character of these payments. Taxpayer argues that these payments are like ordinary and necessary expenses and quite different from dividends; the Commissioner notes that they, like dividends, are distributions to patrons. In order to answer taxpayer's claims, we must consider the nature of grower payments or per-unit retain allocations and their place in the statutory scheme. We rely for illumination in part upon the legislative history of subchapter T. Cf. Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977) (relying upon legislative history to explicate statutory intent underlying I.R.C. s.404).

C. Per-Unit Retain Allocations. As originally enacted, subchapter T dealt solely with patronage dividends in their various forms, including qualified written notices of allocation. Many cooperatives, however, issued per-unit retain certificates instead of or in addition to notices of allocation. These certificates reflected the retention by the cooperative (pursuant to authorization) of a portion of the proceeds from products marketed for the patron. The amounts retained were calculated on the basis of units of products marketed, rather than earnings as in the case of patronage dividends.

Uncertainty about the tax status of these certificates led to amendment of subchapter T in 1966. Pub. L. No. 89-809, s.211, 80 Stat. 1539. This amendment was intended "to provide tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends." S. Rep. No. 1707, 89th Cong., 2d Sess., reprinted in [1966] U.S. Code Cong. & Ad. News 4446, 4515-16. That is to say, per-unit retain allocations were to be taxable at face value to either the cooperative or the patron, typically the latter, even though the market value of the scrip was often very low. Under the amendment, both qualified written notices of allocation and qualified per-unit retain certificates were considered to represent amounts distributed to patrons and reinvested in the cooperative as capital. 17/

[17/ The extent of the parallelism in tax treatment between patronage dividends (i.e., notices of allocation) and retain certificates under the 1966 amendment is striking. For example, the statute prescribes nearly identical methods for "qualifying"--i.e., obtaining the consent of agreement of patrons. I.R.C. s.1388(c)(2), (3); (h)(2), (3). The procedures set forth for computing tax where the cooperative redeems nonqualified notices or certificates are precisely the same. I.R.C. s.1383. Moreover, a companion amendment to I.R.C.

s.6044(b)(1) imposed comparable reporting requirements on cooperatives for patronage dividends and retain certificates.

Differences in the nature of retain certificates and notices of allocation produced slight variations in the statutory scheme. Thus, for example, the requirement that twenty percent of qualified written notices of allocation be paid out in cash (I.R.C. s.1388(c)(1)), which was aimed at facilitating the patron's payment of income tax on the whole, was eliminated for per-unit retain certificates: Imposing such a requirement in the case of retain certificates would probably have been counterproductive: the cooperative could keep the same amount of capital as needed by simply electing to "retain" twenty percent more of the patron's proceeds and then paying out that increment in cash. See H.R. Rep. No. 91-413, 91st Cong., 1st Sess., reprinted in [1969] U.S. Code Cong. & Ad. News 1645, 1821. The definition of a per-unit retain allocation--namely, an allocation fixed without reference to net earnings, I.R.C. s.1388(f), and hence akin to payments for production costs--produced one other variation: the cooperative was to treat per-unit retain allocations as deductions in arriving at gross income. Under the original statute, by contrast, amounts deducted as patronage dividends were to be treated as items of gross income and deductions therefrom. I.R.C. s.1382(b).

While this latter difference in statutory treatment explains taxpayer's method of calculating gross income, see text at notes 14 and 15, supra, it is not sufficient to justify taxpayer's combination of patronage and nonpatronage accounts. The reasons underlying this small variation in the statutory accounting procedure remain somewhat obscure, 18/

[18/ Although patronage dividends are based upon net (patronage) earnings, it would be possible after ascertaining their amount to treat them for tax-accounting purposes as deductions from gross receipts as retain allocations later were treated. Cf. I.R.C. s.1382(a) ("Except as provided in subsection (b), the gross income of [a cooperative] shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any [patronage dividend or per-unit retain allocation].")

Apart from the possible confusion such an approach would entail, however, Congress might have had other reasons for rejecting it. The 1962 Senate Finance Committee Report observed with respect to I.R.C. s.1382(b):

Subsection (b) also provides that amounts described in such subsection which are not taken into account in determining taxable income are to be treated for purposes of the 1954 Code in the same manner as items of gross income and corresponding deductions therefrom. Thus, for example, in determining the amount omitted from gross income for purposes of section 6501(e) (relating to period of limitations where there are omissions from gross income), amounts paid as patronage dividends (though not required to be taken into account in determining taxable income) are to be treated as amounts properly includible in gross income. [S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted in [1962] U.S. Code Cong. & Ad. News 3304, 3615.]]

but there is no indication that Congress foresaw, much less intended, taxpayer's use of per-unit retain allocations to reduce nonpatronage income. Rather, the underlying congressional aim was parallel treatment for patronage dividends and per-unit retain allocations, both of which represent distributions to patrons. Congress had already limited the former to the proceeds of patronage activities. I.R.C. s.1388(a). In our view, the statutory scheme requires comparable treatment of per-unit retain allocations. 19/

[19/ Taxpayer argues that the absence of any express limitation on per-unit retains suggests the opposite conclusion. Taxpayer relies in part on the 1969 defeat of the Ribicoff amendment to support this argument. See 115 Cong. Rec. 37054 et seq. (1969).

While the Ribicoff amendment would have taken away certain tax advantages enjoyed by farm cooperatives, a close reading reveals that the Ribicoff amendment is not

relevant here. It did not address the offsetting of patronage expenses or losses against nonpatronage income. Rather, it would have disallowed cooperative patronage deductions for income unrelated to marketing and supply functions, even if the activities giving rise to that income were conducted on a patronage basis.]

We hold, then, that subchapter T requires a nonexempt cooperative to segregate its patronage and nonpatronage accounts in calculating its gross income, at least in those cases where grower payments or per-unit retain allocations contribute to net operating losses in patronage activities. 20/

[20/See note 16 supra.]

Likewise, subchapter T forbids a nonexempt cooperative to aggregate patronage losses with its income from taxable activities, if the two are separately calculated. A non-exempt cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income. Taxpayer's accounting procedures cannot supersede this statutory principle. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). 21/

[21/ Our holding applies both when retain allocations are paid in scrip (i.e., certificates), in which case the cooperative retains the funds to cover its losses on patronage activities, and when (as in this case) "retain" allocations are paid out in cash. The payment of cash retain allocations was first authorized in s.911 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. The Senate Finance Committee explained the reasons for this change as follows:

Problems have arisen under present law where cooperatives desire to make cash payments to patrons with respect to cooperative pools, but cannot make them before the end of the year because their accounting records are not closed at that time. Patronage dividends often cannot be paid during the 8 1/2 month payment period following the taxable year because the net earnings of the pool cannot be determined until the pool is closed, which may occur much later. However, the payments can be made as per unit retain allocations if they are paid as qualified per unit retain certificates. The Code does not presently permit a deduction (or exclusion) in the prior taxable year for a direct payment of cash, as opposed to the issuance of per unit retain certificates during the payment period. There seems to be no reason why a cooperative should be able to deduct per unit retain allocations paid as qualified certificates during the 8 1/2 month period following the close of the taxable year, but not per unit retain allocations paid in money during the same period. [S. Rep. No. 91-522, 91st Cong., 1st. Sess., reprinted in [1969] U.S. Code Cong. & Ad. News 2027, 2331-32.]

It should be noted that this amendment served to make complete the parallelism in subchapter T's treatment of per-unit retain allocations and patronage dividends, which have always included payments in cash. See id. at 2331.]

D. Other Considerations. Apart from the clear thrust of the legislative intent under lying subchapter T, the relationship of subchapter T to I.R.C. s.521 convinces us that our interpretation of the statute is correct. Section 521(b) sets forth strict criteria to be satisfied by a cooperative in order to qualify for "exemption" from taxation. Most notably, exempt cooperatives are limited in the amount of business they can do with nonmembers. As noted above, cooperatives that do qualify under section 521 are allowed not only the ordinary deductions for patronage dividends and qualified per-unit retain allocations, but also deductions for capital stock dividends and patronage dividends derived from nonpatronage business. I.R.C. s.1382(c). Hence, virtually all income earned by a section 521 cooperative escapes taxation at the cooperative level. A nonexempt cooperative, by contrast, operates as a hybrid; only its patronage income enjoys this kind of treatment.

Sustaining taxpayer's position here would result in obliterating this statutory distinction. If patronage losses could be used to offset nonpatronage-sourced income, then a nonexempt cooperative could gain the tax advantages of an exempt cooperative without meeting the qualifications set forth in I.R.C. s.521(b). Not only would taxpayer itself gain the benefits of exemption--notably, the exclusion of nonpatronage-sourced income from taxation--but all other cooperatives could do so as well. That is, any nonexempt cooperative could avoid tax on nonpatronage-sourced income by the simple expedient of operating at a loss on its patronage activities.

It is not a sufficient answer to say, as taxpayer does here, that this abuse is possible only where losses are deliberate. To be sure, the Tax Court specifically found that taxpayer did not intend to incur its losses. 70 T.C. at 155 n. 4. But the distinctions drawn between an exempt and a nonexempt cooperative, and between the deductions allowed to each, do not turn on subjective factors. Nor do we regard as workable the proposition that the Commissioner must examine the motivations underlying each cooperative's pricing and remunerative policies in order to fix its tax liability. Rather, the statutory structure mandates the result we reach.

Taxpayer argues that our holding runs counter to the express legislative policy favoring cooperatives. Taxpayer's argument is misplaced. The Internal Revenue Code distinguishes between three forms of business organization: the exempt cooperative, the nonexempt cooperative, and the ordinary corporation. Practically all income earned and distributed by an exempt cooperative is taxed only once, *i.e.*, to the shareholder or patron. Only that portion of the nonexempt cooperative's income attributable to patronage activities is taxed once, *i.e.*, in the hands of the patron. Finally, all income distributed by the corporation is taxed both to it and to the shareholder. Requiring taxpayer to segregate its patronage and nonpatronage accounts does render it (for tax purposes) a corporation, except with respect to activities that are essentially corporate in nature. Patronage income remains free of double taxation. 22/

[22/ More specifically, patronage income is not taxed to the cooperative if the conditions for a deduction set forth in I.R.C. s.1382(b) are satisfied. Taxpayer contends that a large portion of its taxable activity income--namely, that derived from the cancellation of outstanding dividend checks from prior years--should be tax-free because it is patronage-sourced. This contention is specious. Under the provisions of subchapter T, patronage-sourced income that is not distributed or allocated to patrons remains taxable to the cooperative. No patronage dividend deduction is available if the cooperative decides to disburse that income to patrons in subsequent years. See Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457, 466, (1969); I.R.C. s.1388(a)(2) and (a)(B).]

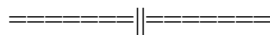
Nor does our holding deprive taxpayer of any tax advantages normally enjoyed by a corporation. In particular, taxpayer may carry its losses forward and back to the extent permitted by law, but patronage-sourced losses must in all events be offset against patronage-sourced income or reserves. 23/

[23/ The Commissioner argues that other tax provisions support this conclusion. For example, he argues that patronage losses resulting from excess advances are analogous to constructive dividends received by corporate shareholders. He also contends that the business done by a cooperative with its patrons is effectively tax-exempt and hence akin to other types of tax-exempt activities. We do not feel it necessary to discuss these arguments in any detail, as we consider subchapter T itself dispositive of the issue before us. Nor need we reach the Commissioner's argument that, with respect to fiscal year 1972, I.R.C. s.277 requires taxpayer to carry forward its patronage-sourced losses to offset future patronage income.]

III. Conclusion. For the foregoing reasons, the decision of the Tax Court is reversed. The case is remanded for further proceedings to determine taxpayer's tax liabilities in conformity with this opinion.

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The “netting issue” caused considerable consternation among cooperatives both from a principles perspective and as a matter of practicality. Concerns about the IRS positions limiting cooperatives' internal netting choices led to legislation that specified the leeway cooperatives could exercise in making internal allocations determinations.²⁷



1388(j) Special Rules for the Netting of Gains and Losses by Cooperatives. - For purposes of this subchapter, in the case of any organization to which part I of this subchapter applies -

(1) Optional netting of patronage gains and losses permitted. - The net earnings of such organization may, at its option, be determined by offsetting patronage losses (including any patronage loss carried to such year) which are attributable to 1 or more allocation units (whether such units are functional, departmental, geographic, or otherwise) against patronage earnings of 1 or more other such allocation units.

(2) Certain netting permitted after section 381 transactions. - If such an organization acquires the assets of another such organization in a transaction described in section 381(a), the acquiring organization may, in computing its net earnings for taxable years ending after the date of acquisition, offset losses of 1 or more allocation units of the acquiring or acquired organization against earnings of the acquired or acquiring organization, respectively, but only to the extent -

(A) such earnings are properly allocable to periods after the date of acquisition, and

(B) such earnings could have been offset by such losses if such earnings and losses had been derived from allocation units of the same organization.

(3) Notice requirements. -

(A) In general. - In the case of any organization which exercises its option under paragraph (1) for any taxable year, such organization shall, on or before the 15th day of the 9th month following the close of such taxable year, provide to its patrons a written notice which -

(i) states that the organization has offset earnings and losses from 1 or more of its allocation units and that such offset may have affected the amount which is being distributed to its patrons,

(ii) states generally the identity of the offsetting allocation units, and

(iii) states briefly what rights, if any, its patrons may have to additional financial information of such organization under terms of its charter, articles of incorporation, or bylaws, or under any provision of law.

²⁷ For a complete and informative discussion of equitable allocation and netting issues, see Frederick, Donald A., and John D. Reilly. *Income Tax Treatment of Cooperatives: Patronage Refunds*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 2 (December 1993).

(B) Certain information need not be provided. - An organization may exclude from the information required to be provided under clause (ii) of subparagraph (A) any detailed or specific data regarding earnings or losses of such units which such organization determines would disclose commercially sensitive information which -

(i) could result in a competitive disadvantage to such organization,
or

(ii) could create a competitive advantage to the benefit of a competitor of such organization.

(C) Failure to provide sufficient notice. - If the Secretary determines that an organization failed to provide sufficient notice under this paragraph -

(i) the Secretary shall notify such organization, and

(ii) such organization shall, upon receipt of such notification, provide to its patrons a revised notice meeting the requirements of this paragraph.

Any such failure shall not affect the treatment of the organization under any provision of this subchapter or section 521.

(4) Patronage earnings or losses defined. - For purposes of this subsection, the terms "patronage earnings" and "patronage losses" means earnings and losses, respectively, which are derived from business done with or for patrons of the organization.

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The preceding cases and references cited therein cover a variety of issues when analyzed carefully (as they must be). The overall subject "equitable allocation" includes issues relating to "tracing" income through a cooperative system, at one time a disputed subject and still not completely settled, and the allocation of expenses. For further discussion see Frederick, Donald A. *Income Tax Treatment of Cooperatives: Patronage Refunds*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 2 (December 1993).

C. Who is a Patron?

The following case demonstrates just a few of the issues related to what at first glance seems a simple question--who is the patron?

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Iberia Sugar Cooperative, Inc. v. United States
360 F. Supp. 967 (W.D. La. 1972), *aff'd*, 480 F.2d 548 (5th Cir. 1973)

HUNTER, Judge:

This suit seeks the refund of federal income taxes and interest paid by Iberia Sugar Cooperative, Inc., pursuant to an assessment made by the Internal Revenue Service against Iberia Sugar Cooperative, Inc., for additional federal income taxes and interest for the fiscal years ended March 31, 1963, and March 31, 1964.

QUESTION PRESENTED

Whether the disputed portion of the patronage dividends distributed by taxpayer to its member patrons, which portion was attributable to the non-member tenants' shares of the sugar cane crop, constitutes excludible patronage dividends which may be deducted for federal income tax purposes.

FACTS

The facts have been established by the pleadings, by stipulation, or have been set forth in plaintiff's answers to interrogatories.

Iberia operated on a cooperative basis as a non-tax-exempt corporation, processing and marketing sugar cane during its fiscal years ending March 31, 1963, and March 31, 1964. Taxpayer's members included only persons, firms, or corporations engaged in the production of sugar cane, as landlords or tenants or lessors or lessees. During the period in issue, sugar cane from lands covered by marketing agreements between taxpayer and its members was brought to taxpayer. For all cane that is received and accepted, the taxpayer would pay an immediate cash advance to the landowners and tenants as their names appeared on Marketing Lists furnished by Department of Agriculture or as per division arrangements made by the member landlord. At the end of the taxpayer's fiscal year, when its profit or loss from operations was determined, taxpayer distributed its net earnings, all of which it termed patronage dividends, to its members. The patronage dividends were paid only to members of taxpayer, and included all savings or earnings realized in excess of taxpayer's cost of doing business. The patronage dividends were distributed to the taxpayer's members in the same proportion as the number of tons of cane furnished by each member bears to the total number of tons of cane processed by taxpayer for all of its members.

Marketing agreements between taxpayer and its members state, in effect, that the taxpayer buys and the member sells to the taxpayer, for a period of ten years, all sugar cane grown, produced, or acquired by or for the member as landlord or tenant, lessor or lessee, on the property described in the agreement which is owned, leased, or controlled by the member. These marketing agreements are with landowners, landlords or tenants, or lessors or lessees. The taxpayer had no marketing agreements with non-member lessors, lessees, landlords or tenants.

The Tax controversy here involves only the fact situation presented where taxpayer dealt with members who were landlords whose tenants were not members of taxpayer. In that fact situation, the patronage dividend was partially attributable to the member landlord's share of the crop and its proceeds, and was partially attributable to the nonmember tenant's share of the crop and its proceeds. Although that patronage dividend was partially attributable to the non-member tenant's share of the crop and its proceeds, that patronage dividend was distributed only to the member landlords.

The total patronage dividends distributed to members of taxpayer during the year ended March 31, 1963, amounted to \$143,483.74. The portion of those patronage dividends for that year attributable to the non-member tenants' shares of the cane harvested and delivered to taxpayer is \$44,944.99. The total patronage dividends distributed to members of taxpayer during the year ended March 31, 1964, was \$836,624.84, and the portion attributable to the non-member tenants' share of the cane harvested and delivered to taxpayer is \$294,728.71.

In the case of the patronage dividends that are attributable to the cane crop of member landlords and non-member tenants, the cane was in some instances grown, harvested, and delivered by the member landlord, and in some instances grown, harvested, and delivered to taxpayer by the non-member tenant. During the two years involved in this lawsuit, the taxpayer had no obligation whatsoever to distribute patronage dividends, refunds, or rebates to any nonmembers of taxpayer.

Taxpayer's only legal obligation to distribute patronage dividends was its legal obligation to distribute patronage dividends to members of taxpayer.

On its federal income tax returns for the years in issue, plaintiff deducted not only the portion of the patronage dividends attributable to the members' shares of the sugar cane crop, but also the portion of the patronage dividends attributable to the non-member tenants' shares of the sugar cane crop. The Internal Revenue Service disallowed as a deduction only the portion of the patronage dividends attributable to the nonmember tenants' shares of the crop, and assessed additional income taxes and interest as a result of such disallowance. The taxpayer has paid this assessment and here sues for a refund.

THE LAW

The taxpayer is allowed, by the Internal Revenue Code, to deduct various items from its income in order to arrive at its taxable income on its federal income tax return. One of taxpayer's allowable deductions for federal income tax purposes is the deduction for patronage dividends. Taxpayer's deduction for patronage dividends is provided by Section 1382(b) of the Internal Revenue Code of 1954, which, in effect, allows taxpayer to deduct its patronage dividends from its income to arrive at its net taxable income.

The term "patronage dividend" is defined by Section 1388(a), which says, in effect, that the term patronage dividend means an amount paid to a patron based on business done with or for such patron, and paid to that patron under an obligation which existed before taxpayer received the amount so paid. Section 1388(a) does, however, place the following highly significant restriction on patronage dividends:

(a) Patronage dividend.-- * * *

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. (Emphasis supplied.)

The taxpayer concedes that no part of the patronage dividends was paid by it directly to the non-member tenants, and further that taxpayer had no obligation to pay any portion of the patronage dividends to the non-member tenants. Since the Internal Revenue Code excludes from the patronage dividends deduction amounts paid to members to the extent that such amounts are attributable to business done with or for other patrons (in this instance, non-member tenants) to whom smaller or no patronage dividends are paid, the taxpayer is clearly precluded from including in its patronage dividend deduction the amounts paid to the members that were attributable to the non-member tenants' shares of the sugar cane crop.

The mandate of Section 1388(a) specifically excludes from deductible patronage dividends amounts paid out of earnings from business done with or for other patrons to whom smaller or no amounts are paid is discussed in Treasury Regulations on Income Tax, Section 1.1388-1(a)(2), as follows:

(a) Patronage dividend-- * * *

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend. (Emphasis supplied.)

Treasury Regulations on Income Tax, Section 1.1388-1(e), define "patron" as follows:

(e) Patron. The term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a

nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation or cooperative association.

In the United States Senate's explanation of Code Section 1388, S.Rep.No. 1881, 87th Cong., 2d Sess., p. 317, U.S. Code Cong. & Admin. News 1962, pp. 3297, 3620 (1962-3 Cum.Bull. 707, 1021), the legislative intention is expressed as follows:

It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

Subchapter T of the Internal Revenue Code, which contains Sections 1382(b) and 1388(a), was passed into law on October 16, 1962. It was, as specified in Section 17(c) of that Act, expressly made applicable to taxable years beginning after December 31, 1962. Thus, Sections 1382(b) and 1388(a) are applicable only to the latter of the two years involved in this case. However, prior to the passage of the Revenue Act of 1962, the courts had already held that, to the extent that a cooperative makes a distribution out of earnings from non-member business, the distribution is of profits, rather than a distribution to effectuate a corrective adjustment due the member for his patronage. Such distributions of profit were held to be nondeductible by the cooperative. United States v. Mississippi Chemical Co., 326 F.2d 569 (C.A.5, 1964); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (C.A.8, 1961).

A case almost identical with the instant case, was decided by the Fifth Circuit Court of Appeals--Smith & Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341 (1965). There the Fifth Circuit held that patronage dividends were not deductible to the extent that they were paid to member landlords out of earnings attributable to the non-member tenants' shares of the cotton crops which gave rise to the patronage dividends.

The taxpayer in Smith & Wiggins Gin, Inc., was a corporation organized for profit, which engaged in the business of ginning the cotton crops of its member landlords and their non-member tenants. The membership and patronage agreement which the member landlords were required to sign provided that the agreement covered all cotton produced on all lands owned, controlled, or operated by them. The taxpayer gin was legally obligated to distribute patronage dividends to the member landlords but not to the latter's non-member tenants. While the taxpayer gin was under no obligation to rebate anything to the non-member tenants, it did in practice make a flat rebate of three dollars per bale to the non-members to meet competition. When the rebate to which each member landlord was entitled was computed, the member was credited not only with his share of the cotton crop, but also with his non-member tenant's share of the crop. The full rebate or patronage dividend was made only to the member and not to the tenant. The Court held that to the extent that the gin's patronage dividends were attributable to the non-member tenants' shares of the cotton, the distributions were not true patronage dividends and were therefore not deductible. The court's reasoning and theory was that such distributions do not represent a rebate on the members' business, but instead represent profit made on non-member business, which will not qualify as a true patronage dividend.

The taxpayer contends that since its bylaws and the marketing agreements between taxpayer and its members required the latter to deliver to taxpayer all of the sugar cane crop, including the non-member tenants' shares of the crop, the business was transacted by only the members, and therefore the full patronage refund should be deductible. This contention is without merit, because it completely overlooks the fact that while the disputed portion of the patronage dividend was derived from the non-member tenants' shares of the crop, taxpayer was legally obligated to, and in fact did, pay it to the members. The

law clearly states that such a portion of a patronage dividend or refund is not a true patronage dividend, and consequently is not deductible for federal income tax purposes.

Judgment should be and is granted to defendant. Order attached.

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D. Dividends on Capital Stock

Amounts that can be distributed as patronage refunds came from defined calculation methods. The single definition of a patronage dividend relates not only to the allocation of net margins among patrons but to what, from all a cooperative's gross income, those net margins are.

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FCX, Inc. v. United States
531 F.2d 515 (Ct. Cl. 1976)

SKELTON, Judge:

This is a suit by plaintiff, FCX, Inc., of Raleigh, North Carolina, for refund of income taxes and interest thereon. Plaintiff is a nonexempt farmer's cooperative having retail, wholesale, and manufacturing operations and facilities in North and South Carolina and franchised dealers in both states. It has the accrual method of accounting with its fiscal year ending June 30.

During the fiscal years of 1967 and 1968, plaintiff paid dividends on its preferred stock of \$469,365 and \$477,202, respectively, out of earnings from non-member patronage and from non-patronage sources. During the same years plaintiff made patronage refunds to its patron members of \$981,433.02 and \$855,165.09, respectively. These refunds were paid from gross income attributable to member patronage. After audit of plaintiff's books by the Internal Revenue Service for these years, a portion of the amounts claimed as patronage refunds was disallowed. The plaintiff filed claims for refund, which were disallowed, and thereafter timely filed this suit to recover \$122,639 and \$126,579 for the taxable years 1967 and 1968, respectively.

The question to be decided is, whether, as the Government contends, dividends paid on capital stock of a non-exempt cooperative corporation must be deducted ratably from its earnings from all sources in computing the allowable patronage dividend deduction for federal income tax purposes, or whether for such purpose taxpayer was entitled to allocate capital stock dividends only to earnings from sources other than member patronage?

The facts in the case are stipulated and the issue before us is one of law. The case presents a question of first impression in this court, although other courts have considered and decided it in other cases, as will be shown below.

Plaintiff, as a nonexempt cooperative, is given special federal income tax treatment not afforded ordinary business corporations, in that under Sections 1381 through 1388 of the Internal Revenue Code of 1954 (Subchapter T), which was added to the Code by Section 17(a) of the Revenue Act of 1962, Pub.L. No. 87-834, 76 Stat. 960, it may deduct patronage dividends from gross income in computing its taxable income. Patronage dividends are defined in Section 1388(a) as follows:

s.1388. Definitions; special rules.

(a) Patronage dividend.--

For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies--

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and,

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. [26 U.S.C. s.1388(a) (1970).]

Prior to 1951, no statute recognized or sanctioned a deduction or exclusion of patronage dividends from the gross income of a cooperative. Nevertheless, the allowance of patronage dividends to nonexempt cooperatives had been an approved administrative practice for many years. *Farmers Cooperative Co. v. Birmingham*, 86 F.Supp. 201 (N.D.Iowa 1949); *Puget Sound Plywood, Inc.*, 44 T.C. 305 (1965); *Consumer Credit Rural Electric Cooperative Corp.*, 37 T.C. 136 (1961), *rev'd and remanded*, 319 F.2d 475 (6th Cir. 1963), *on remand*, 23 T.C.M. 149 (1964). See also T.C. 2737, 20 Treas.Dec.Int.Rev. 441 (1918) dealing with the exclusion of patronage dividends paid by cooperatives to the patrons. In 1951, the first statutory provision recognizing the prior administrative practice with reference to patronage dividends of cooperatives was contained in the Revenue Act of 1951, ch. 521, s.314(a), 65 Stat. 452. This Act added subparagraph (B) to Section 101(12) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.).

The first statute that permitted a non-exempt cooperative to deduct patronage dividends was the Revenue Act of 1962, Pub.L. No. 87-834, 76 Stat. 960. Section 17(a) of this Act added subchapter T to the Code of 1954, containing Sections 1381 through 1388, which controls the taxable years involved in this case. Section 1382(b) allows a nonexempt cooperative to reduce its taxable income by the payment of a qualifying patronage dividend, which is defined in Section 1388(a), quoted above.

A reading of Section 1388(a) shows that it defines patronage dividends as amounts paid to a patron of a cooperative (1) on the basis of quantity or value of business done with or for such patron, (2) where the cooperative is under a pre-existing obligation to pay such amount, and (3) the payment is determined by reference to the net earnings of the cooperative from business done with or for its patrons. The definition expressly excludes amounts paid from earnings other than from business done with or for patrons. Such exclusion was clearly intended by Congress as shown by H.R.Rep. No. 1447, 87th Cong., 2d Sess., A133 (1962-3 Cum. Bull. 405, 631) and S.Rep. No. 1881, 87th Cong., 2d Sess., 316-17 (1962-3 Cum. Bull. 707, 1020-21), U.S.Code Cong. & Admin. News 1962, pp. 3304, 3620, wherein it is stated:

It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

[Emphasis supplied.]

In this case, the plaintiff deducted dividends on its preferred stock solely from the earnings from business done with nonmember patrons and from earnings from other nonpatronage sources in computing its patronage refund. Plaintiff contends that Article VI, Section 4 of its By-Laws authorized it to follow this procedure in the following language:

Net earnings attributable to non-member patronage and to sources other than patronage * * * shall be applied first to payment of dividends on capital stock, * * * .

The Government contends that in computing its patronage dividend deduction, plaintiff must ratably reduce its earnings from all sources by the amount of dividends paid on its preferred stock, and that the provisions of its By-Laws are not controlling as to what constitutes a true patronage dividend under federal tax law. Magill and Merrill, The Taxable Income of Cooperatives, 49 Mich.L.Rev. 167 (1950).

It appears that the formula for computing the patronage dividend deduction under the facts of this case is indicated in long-standing administrative rulings as far back as 1924 (S.M. 1551), restated in A.R.R. 6967, III-1 Cum. Bull. 287, 289 (1924) as follows:

First compute the apparent net income of the cooperative association. From this amount deduct the fixed dividend paid or payable on any outstanding capital stock. The amount of such fixed dividends is the portion of net income properly attributable to the investment made in the association by the holders of any outstanding capital stock.

The balance consists of (1) the amount available for refund to the members of the association and (2) the profits made from nonmembers. In the absence of evidence to the contrary, it will be assumed that the dealings with members and nonmembers are equally profitable, and, accordingly, that the amount available for refund consists of that proportion of the apparent net profits, after deducting the fixed dividend on outstanding capital stock, which the amount of business transacted with members bears to the entire amount of business transacted. Up to the amount available for refund thus computed, a distribution by a cooperative association to its members, upon the basis of the business transacted with them, will be deemed to be a true patronage dividend, deductible by the association in computing its taxable net income for Federal income and profits tax purposes.

Prior to the enactment of subchapter T, A.R.R. 6967 was approved in Valparaiso Grain & Lumber Co., 44 B.T.A. 125 (1941); Farmers Union Cooperative Exchange, 42 B.T.A. 1200 (1940); and Trego County Cooperative Ass'n, 6 B.T.A. 1275 (1927). The formula set forth in A.R.R. 6967 quoted above has been republished in Rev. Rul. 68-228, 1968-1 Cu. Bull. 385. The plaintiff argues that Rev. Rul. 68-228, as well as Section 1.1388-1(a)(1) of Treasury Regulations on Income Tax promulgated under subchapter T are invalid. Section 1.1388-1(a) of the Regulations provides as follows:

s.1.1388-1 Definitions and special rules.

(a) Patronage dividend--(1) In general.

The term "patronage dividend" means an amount paid to a patron by a cooperative organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, which is paid--

(i) On the basis of quantity or value of business done with or for such patron.

(ii) Under a valid enforceable written obligation of such organization to the patron to pay such amount, which obligation existed before the cooperative organization received the amount so paid, and

(iii) Which is determined by reference to the net earnings of the cooperative organization from business done with or for patrons.

For the purpose of subdivision (ii) of this subparagraph, amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment. The term "net earnings," for purposes of subdivision (iii) of this subparagraph, includes the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items. For purposes of such subdivision (iii), net earnings shall not be reduced by any taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests.

(2) Exceptions. The term "patronage dividends" does not include the following:

(i) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings not derived from business done with or for patrons.

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(iii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents, even if such documents were originally paid as patronage dividends.

(iv) An amount paid to a patron by a cooperative organization to the extent that such amount is fixed without reference to the net earnings of the cooperative organization from business done with or for its patrons.

It is clear that A.R.R. 6967, and Rev. Rul. 68-228 and Section 1.1388-1(a)(1) require that a taxpayer, such as plaintiff here, in determining the amount of patronage dividend, must reduce the net earnings by dividends paid on capital stock, and that only net earnings so reduced are to be apportioned between the various relevant sources. We conclude that the revenue rulings and the regulations promulgated under subchapter T are consistent with the statute and are reasonable and valid.

The identical problem involved in this case was decided in favor of the Government by the Tax Court and the Eighth and Tenth Circuit Courts of Appeal in two cases that are, for all practical purposes, on "all fours" with the instant case, namely, Des Moines County Farm Service Co. v. United States, 448 F.2d 776 (8th Cir. 1971), affirming, 324 F.Supp. 1216 (S.D.Iowa); and Union Equity Cooperative Exchange v. Commissioner, 481 F.2d 812 (10th Cir. 1973), cert. denied, 414 U.S. 1028, 94 S.Ct. 457, 38 L.Ed.2d 321. We agree with the reasoning and decisions of the courts in those cases. In both cases the by-laws of the taxpayers provided that dividends on capital stock should first be paid out of earnings from sources other than member patronage, as in the instant case. The pertinent and controlling facts in those cases were, for all practical purposes, identical with the facts in the case before us. The decisions in those cases are strong precedents for our decision here. In the Des Moines case, the court, after reviewing the facts, held:

* * * The administrative practice of the Commissioner has always been to require corporations operating as non-exempt farmers' cooperatives to reduce "apparent" net income by the amounts paid as dividends on capital stock when making the patronage dividend exclusion computation. See Valparaiso Grain & Lumber Co. v. Commissioner of Internal Revenue, 44 B.T.A. 125, 127 (1941) and Rev. Rul. 68-228, 1968-1 Cum. Bull. 385. This administrative precedent has been judicially sanctioned. See Farmers Cooperative, *supra*. [86 F.Supp. 201 (N.D.Iowa 1949)]. Because Congress, in enacting Subchapter T, merely codified the prior administrative practice of the Commissioner, there is little basis on which to conclude that Congress intended to discard the long established method of computing the exclusion. Thus, under the spirit--if not the letter--of the reenactment doctrine, Congress must be taken to have approved the foregoing administrative and judicial constructions--not embodied in s.1.1388-1(a)(1)--and thereby to have given it the force of law. See United States v. Correll, 389 U.S. 299, 305-306, 88 S.Ct. 445, 19 L.Ed.2d 537 (1967); Fribourg, *supra*, [383 U.S. 272, 86 S.Ct. 862, 15 L.Ed.2d 751 (1966)] and the cases cited therein at 283 of 383 U.S., 86 S.Ct. 862. [15 L.Ed.2d 751.]

(5) The regulation is reasonable and consistent with the statute on which it is based. This without more is sufficient to validate it. See Bingler v. Johnson, 394 U.S. 741, 749-750, 89 S.Ct. 1439, 22 L.Ed.2d 695 (1969). [324 F.Supp. at 1219-20.]

The court further held:

After careful consideration of the pleadings and briefs and of the dearth of pertinent legislative history as affected and promoted by contemporaneously decided cases and administrative interpretations, the Court reaches the conclusion that s.1.1388-1(a)(1) must be sustained as a valid and reasonable construction of the statute which it was designed to implement. Thus, to the extent that payment of capital stock dividends is not charged ratably against all net earnings, the total amount paid or allocated member-patrons as patronage dividends by a nonexempt cooperative is not excludible from its taxable income. The Court so holds * * * .
[*Id.* at 1218-1219.]

In the Union Equity case, the court, after stating that "the Des Moines case is virtually on all fours with the instant case," and after approving the decision of the court in Des Moines quoted with approval the following holding of the Tax Court in Union Equity:

In attributing the entire dividend paid on capital stock to nonmember business, petitioner is saying, in effect, that its stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business. * * * We are unable to find any indication that the stockholders here invested in anything but the undivided totality of petitioner's operations and assets. By following a computational path that fails to reflect the reality underlying its mode of operation, petitioner has substituted accounting fiction for taxable fact.

"Consequently, in the absence of any evidence to the contrary, we uphold respondent's determination that the dividend paid on petitioner's capital stock was properly attributable to net earnings realized from member business and to net earnings realized from nonmember business in proportion to the business transacted with members and nonmembers respectively. Conversely, the amount of member earnings available for distribution as a true patronage dividend would not have to be reduced by that part of the dividend on capital stock which was attributable to member earnings." [481 F.2d at 815.]

Plaintiff relies heavily on United States v. Mississippi Chemical Co., 326 F.2d 569 (5th Cir. 1964). In that case the court upheld a corporate charter provision which required the payment of capital stock dividends out of earnings attributable to non-member business. The courts in Des Moines and Union Equity

considered the Mississippi Chemical case and refused to follow it. The court in Union Equity and the Tax Court in that case distinguished the Mississippi Chemical case on the ground:

* * * [T]here the trial court found as a fact that no part of the sum paid as a patronage dividend was paid, directly or indirectly, from the profits gained from business transacted with nonmembers * * * . [481 F.2d at 815-16.]

On appeal the Fifth Circuit Court of Appeals held that this finding was "particularly correct." In this connection, we find that the appellate court in that case stated:

* * * The record demonstrates, and the district judge concluded, that the cooperative actually paid the patronage refunds here from earnings on business done with the stockholder patrons. [326 F.2d at 573.]

The court further stated:

The District Court in the instant case was particularly correct in the following finding:

* * * That no part of said sum was paid from the profits on non-stockholder business. * * * [Id. at 574.] [Emphasis supplied.]

From these findings in the Mississippi Chemical case, we conclude, as did the courts in Des Moines and Union Equity, that it is clearly distinguishable from those cases and from the case before us. Another distinguishing fact is shown by the decision in Mississippi Chemical when the court stated:

* * * Treasury Regulations and Treasury Decisions, however, are not involved in the issue for decision here. * * * [326 F.2d at 571.]

In contrast, Treasury Regulations and Decisions and the statute of 1962 (subchapter T) are very much involved in the instant case.

We conclude, as did the courts in Des Moines and Union Equity, that Mississippi Chemical is distinguishable from the case at bar and we cannot and do not follow it, because, among other reasons, the amounts which the plaintiff seeks to deduct here from its gross income as patronage dividends were attributable at least in part to earnings from business none with nonmember patrons.

Plaintiff says that Section 1.1388-1(a) denies it equal protection of the law with respect to other corporations and in that respect, is discriminatory and unconstitutional. We do not agree. Plaintiff is not in the same class as ordinary corporations. As a nonexempt cooperative, the plaintiff receives benefits not given to ordinary corporations. As a cooperative, it enjoys the patronage dividend deduction in addition to deductions allowed to ordinary corporations. There is no discrimination between plaintiff and other cooperatives in the same class. We hold that the regulation does not deny plaintiff equal protection of the law, does not discriminate, is valid, and constitutional.

Finally, plaintiff contends that it is entitled to deduct a portion of the cash it paid to its member patrons because under Section 162 of the Code it was a deductible rebate. We do not agree. Plaintiff paid back to its member patrons all of the money it received from them. Any further distribution to members would have to be made out of earnings from sources other than from the members. Such a distribution is not a rebate and cannot be deducted under section 162 of the Code.

We hold that the plaintiff, as a non-exempt cooperative, was required to deduct dividends paid on its capital stock ratably from all of its net earnings in computing the allowable patronage dividend deduction for federal income tax purposes during its fiscal years 1967 and 1968, and that the determination by the Commissioner of Internal Revenue of the income tax owed by the plaintiff during those years was correct.

CONCLUSION OF LAW

Upon the foregoing opinion, which includes therein the necessary facts that were stipulated by the parties, the court concludes as a matter of law that judgment should be and is hereby entered in favor of the defendant; that plaintiff's claim is denied; and plaintiff's petition is dismissed.

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The "dividend allocation" rule has disadvantaged the few cooperatives that issue dividend-paying equity. Not only are cooperatives prevented from taking a deduction for the dividends paid, the amount that is properly available for distribution as a patronage refund loses the deduction it would normally have. Cooperatives and their trade associations attempted for many years to have this rule changed legislatively. The efforts paid off with the adoption of change in 2004.

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American Jobs Creation Act of 2004

P.L. 108-357

SEC. 312. PAYMENT OF DIVIDENDS ON STOCK OF COOPERATIVES WITHOUT REDUCING PATRONAGE DIVIDENDS.

(a) IN GENERAL- Subsection (a) of section 1388 (relating to patronage dividend defined) is amended by adding at the end the following: 'For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.'

(b) EFFECTIVE DATE- The amendment made by this section shall apply to distributions in taxable years beginning after the date of the enactment of this Act.

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V. Basic Tax Rules

Rules that determine what is taxed can be divided into three general parts for cooperatives. First, the most basic rules apply to patronage refunds paid to patrons. This includes circumstances under which a cooperative may take a deduction when the patronage refund is paid and the taxable nature of the refund when received by a patron. These three processes are noted following.

The second set of circumstances occurs when the patronage refund is paid in a form other than cash or property. This is a very common situation for cooperatives because of the nature of cooperative financing methods. When certain conditions are met, the cooperative and patron are treated as if the entire refund was paid in cash or property. Under other circumstances, only the cash portion of the refund is treated as a refund for tax purposes, with a possibility that it will be treated

as a cash refund at some time in the future. Under such circumstances, the final result regardless of timing is for most purposes the same.

The third and final transaction between cooperative and patron occurs when the cooperative redeems the patron's equity. If the patronage refund generating the equity under the cooperative financing system was treated as a refund deductible by the cooperative and taxable to the patron, no tax consequences occur upon redemption. If, on the other hand, the refund was not qualified for cooperative treatment at the time of the payment, the cooperative takes the deduction and the patron recognizes the income at the time of the redemption.

The detailed mechanics of the three processes are not described here. They are, however, critical for anyone advising cooperatives, patrons, or tax enforcement agencies. Further discussion is contained in Frederick, Donald A. *Income Tax Treatment of Cooperatives: Distribution, Retains, Redemptions, and Patrons' Taxation*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 3 (January 1995).

A. Patronage Refunds

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1382(a) Gross Income. - Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization or by reason of any amount paid to a patron as a per-unit retain allocation (as defined in section 1388(f)).

(b) Patronage Dividends and Per-Unit Retain Allocation. - In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year -

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year;

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred;

(3) as per-unit retain allocation (as defined in section 1388(f)), to the extent paid in money, qualified per-unit retain certificates (as defined in section 1388(h)), or other property (except nonqualified per-unit retain certificates, as defined in section 1388(i)) with respect to marketing occurring during such taxable year; or

(4) in money or other property (except per-unit retain certificates) in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income.

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B. Taxation of Section 521 Cooperatives

Section 521 cooperatives, the so-called "exempt" cooperatives, receive two deductions from taxes not afforded other cooperatives. The deductions are noted in subchapter T.

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Sec. 521. Exemption of Farmers' Cooperatives from Tax. -

(a) Exemption from Tax. - A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

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1382(c) Deduction for Nonpatronage Distributions, etc. - In determining the taxable income of an organization described in section 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter) -

(1) amounts paid during the taxable year as dividends on its capital stock; and

(2) amounts paid during the payment period for the taxable year -

(A) in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done for the United States or any of its agencies or from sources other than patronage, or -

(B) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid, during the payment period for the taxable year during which the earnings were derived, on a patronage basis to a patron with respect to earnings derived from business or sources described in subparagraph (A).

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C. Taxation of Patrons

The general rule is, not surprisingly, that patrons who receive patronage refunds from their cooperative receive taxable income. Complications develop when the cooperative pays patronage

refunds in a form other than money. As we will see, in most circumstances the patron will be required to take into account, for tax purposes, all patronage refunds or per unit retain allocations received in whatever form received. In general, patrons' tax liability will be coordinated with that of the cooperative. If it is deductible by the cooperative it is taxable to the patron, and vice versa.

Section 1385(a), following, summarizes the various kinds of payments and the significance of each for the patron.

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1385(a) General rule. - Except as otherwise provided in subsection (b), each person shall include in gross income -

(1) the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a non-qualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a),

(2) any amount, described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions by tax-exempt farmers' cooperatives), which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a)(1), and

(3) the amount of any per-unit retain allocation which is paid in qualified per-unit retain certificates and which is received by him during the taxable year from an organization described in section 1381(a).

(b) Exclusion from Gross Income. - Under regulations prescribed by the Secretary, the amount of any patronage dividend, and any amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was paid as a patronage dividend, shall not be included in gross income to the extent that such amount -

(1) is properly taken into account as an adjustment to basis of property, or

(2) is attributable to personal, living, or family items.

(c) Treatment of Certain Nonqualified Written Notices of Allocation and Certain Nonqualified Per-Unit Retain Certificates. -

(1) Application of subsection. - This subsection shall apply to -

(A) any nonqualified written notice of allocation which -

(i) was paid as a patronage dividend, or

(ii) was paid by an organization described in section 1381(a)(1) on a patronage basis with respect to earnings derived from business or sources described in section 1382(c)(2)(A), and

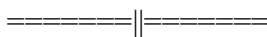
(B) any nonqualified per-unit retain certificate which was paid as a per-unit retain allocation.

(2) Basis; amount of gain. - In the case of any nonqualified written notice of allocation or nonqualified per-unit retain certificate to which this subsection applies, for purposes of this chapter -

(A) the basis of such written notice of allocation or per-unit retain certificate in the hands of the patron to whom such written notice of allocation or per-unit certificate was paid shall be zero,

(B) the basis of such written notice of allocation or per-unit retain certificate which was acquired from a decedent shall be its basis in the hands of the decedent, and

(C) gain on the redemption, sale or other disposition of such written notice of allocation or per-unit retain certificate by any person shall, to the extent that the stated dollar amount of such written notice of allocation or per-unit retain certificate exceeds its basis, be considered as ordinary income.



Revenue Ruling 70-407
1970-2 C.B. 52

Advice has been requested as to the existence and nature of a loss incurred by a taxpayer under the circumstances described below.

The taxpayer, who operates a cotton farm, is a patron of an agricultural cooperative described in section 1381(a) of the Internal Revenue Code of 1954.

The cooperative follows the practice of paying cash advances during its taxable year to all of its marketing patrons with respect to the cotton marketed. After the close of its taxable year the cooperative determines its net earnings, taking into account cash advances paid during its taxable year, from business done with or for its patrons and allocates and pays these net earnings to all its patrons as patronage dividends. The taxpayer includes the cash advances as well as any patronage dividends from the cooperative paid in money and qualified written notices of allocation in his gross income for his taxable year in which received. See section 1385 of the Code.

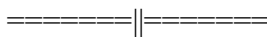
In 1968, the cooperative sustained a "net loss" in its cotton marketing function attributable to cash advances paid to the marketing patrons during 1968 that proved to be excessive because of an unanticipated decline in the price of cotton. The total cash advances received by the taxpayer in 1968 from the cooperative were included in his 1968 gross income. In 1969, consistent with its bylaws, the cooperative "collected back" the 1968 excessive cash advances from those marketing patrons who received the excessive cash advances in 1968. The amount determined to be due from the 1968 marketing patrons was offset against their outstanding marketing credits in the order issued until the full amount of the indebtedness due from each patron was offset. The cooperative accomplished the offset by notifying each patron in 1969, in writing, that specific marketing credits had been cancelled to the extent necessary to recoup the 1968 excessive cash advances received by that patron.

The marketing credits referred to above were evidenced by "notices of book credits" which had been sent by the cooperative to the patrons in taxable years prior to 1968. These "notices of book credits" were qualified written notices of allocation within the meaning of section 1388(c) of the Code. With respect to those patrons who did not have sufficient outstanding marketing credits from taxable years prior to 1968 to cover their part of the excessive cash advances received in 1968, the balance that was due was carried on the books of the cooperative to be offset against future marketing credits to be earned by such patrons in subsequent taxable years.

The specific questions presented are (1) whether the instant taxpayer (a patron) is entitled to a loss for Federal income tax purposes upon cancellation of his marketing credits and, if so, (2) whether the loss is an ordinary loss or a capital loss.

The transactions that gave rise to the receipt of the excessive cash advances in 1968 and the transactions that gave rise to the issuance of the qualified notices of allocation evidencing the taxpayer's marketing credits, arose in the ordinary course of his trade or business. The cancellation of his outstanding marketing credits (previously included in his gross income at dollar amount) resulted in a loss at that time since there was no possibility of such marketing credits being redeemed.

Accordingly, the instant taxpayer, who was notified in writing in 1969, that all or a portion of his outstanding marketing credits had been cancelled so that the cooperative could recoup the excess marketing advances paid to him in 1968, is entitled to an ordinary loss for 1969 under section 165(a) of the Code to the extent of the credits cancelled. Those patrons who did not have sufficient outstanding marketing credits from years prior to 1968 to cover their part of the excess marketing advances for 1968 will be entitled to an ordinary loss for the year of notification by the cooperative to the extent that their prior years' credits have been cancelled. Any subsequent offset against future patronage allocations will be deductible by those patrons as an ordinary loss in the year of offset, but will not affect the amount of patronage dividends otherwise includible in gross income for that future year under section 1385 of the Code.



VI. Patronage Based Financing

A. Principles

If cooperatives paid all patronage refunds in money, inquiry into some of the more interesting topics in cooperative taxation would be unnecessary. As we have seen, however, cooperatives, by principle and practice, relate use of the cooperative to its financing. The connection between patronage and financing is typically tied not just in the principle requiring certain variable levels of financial obligation based on business conducted with the cooperative, but the processes themselves are integrated. This may be referred to as "patronage based financing."

Tax laws recognize cooperatives' financing methods. (Financing methods unique to cooperatives preceded most, if not all, income tax laws.) The principles and practices have become an integral part of the taxing scheme for cooperatives. Unlike the generality of "operating on a cooperative basis," rules to be followed for patronage based financing are specific and detailed.

Two methods of patronage based financing are described in the Code. One is the retained patronage refund, the other per-unit capital retain certificates.

The term "retained patronage refund" is descriptive of the most commonly used cooperative patronage based financing. Rather than pay patronage refunds in money, the cooperative pays some or all of the patronage refund in equity interest in the cooperative. This process is the subject of the tax rules on retained patronage refunds.

These payments may be "qualified" or "nonqualified" (defined later). If "qualified," the process is taxed as if the entire amount was paid to the patron in money. That is, the cooperative deducts and the patron accounts for the face value of the instrument given to represent the patronage refund.

B. Written Notice of Allocation

All tax considerations of retained patronage refunds begin with written notices of allocation issued by the cooperative to each patronage refund recipient.

1388(b) Written Notice of Allocation. - For purposes of this subchapter, the term "written notice of allocation" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

The following case is included to demonstrate the need to adhere to requirements of written notices of allocation. The significance of much of the rest of the discussion, such as the 20 percent payment in cash, will become clear later.

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Seiners Ass'n v. Comm'r
58 T.C. 949 (1972)

FAY, Judge:

The issue for decision is whether petitioner is entitled to deduct as patronage dividends under section 1382(b)(1) or 1382(b)(2) amounts of money and scrip distributed to its members with respect to the years ended November 30, 1966, and November 30, 1967. * * *

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioner Seiners Association (hereinafter referred to as Seiners or petitioner) is a nonexempt cooperative organized under the laws of the State of Washington. At the time of filing the petition herein petitioner had its principal office in Seattle, Wash. Petitioner filed its Federal income tax returns (Form 1120) for the taxable years ended November 30, 1965, 1966, and 1967, with the district director of internal revenue, Tacoma, Wash.

The name "Seiners Association" was adopted effective December 1, 1965. Prior to that date petitioner was known as Purse Seine Vessel Owners Marketing Association. No capital stock in petitioner has been issued or authorized. A member of petitioner is issued a membership certificate which entitles each member to one vote.

The general policy of petitioner was to sell fishing gear, marine fuel, and insurance primarily to its members. At the end of each fiscal year petitioner determined the total amount of all "member rebates" on the basis of the purchases that the members had made during that fiscal year. Petitioner took the position that it could then declare, but not actually pay in cash, the full amount of this member rebate figure as a patronage dividend and deduct such amount from its taxable income as provided for in section 1382. Petitioner was intent on creating a capital fund and provided for this by retaining a portion of the declared patronage dividend and distributing to the member his "rebate" in the form of 20-percent cash and a revolving fund certificate representative of the retained 80 percent. Petitioner assumed that the members would then declare the entire distribution in their income tax as a patronage dividend.

To effectuate this general policy, the bylaws of Seiners provide in pertinent part:

ARTICLE VI

Association Revolving Capital

Section 1.--Revolving Capital Funds Created. There is hereby created a fund to be designated and carried on the books of the association as the "Revolving Capital Fund," by which term it is herein referred to. In the event that in addition to marketing the fishery products of its members this association shall render other services to its members, such as the supplying of gear, tackle, stores, equipment and supplies used on fishing boats or furnishing dock or berthing space or the financing of fishing boats and equipment or if this association shall engage in any other activities in pursuance of the other purposes of the association referred to in Article II, Section 1 of these By-Laws, then the Board of Directors, in its absolute discretion, may create more than one Revolving Capital Fund, provided that one such fund, and no more than one, shall be created and maintained with respect to all marketing of fishery products by the association and one or more such funds may be created and maintained with respect to other activities or operations of the association.

Section 2.--Deductions for Revolving Capital. From any money otherwise payable to each member, from time to time, there shall be deducted, withheld and retained by the association (in addition to other association charges and withholdings) such amounts as the Board of Directors, from time to time, shall fix and designate, and such amounts shall be placed in said Revolving Capital Fund or Funds.

Section 3.--Allocation and Notification. The amounts so retained and placed in said revolving capital fund or funds shall be allocated and credited on the books of the association on a proportionate or value basis to the credit of the respective members from whom retained, according to the respective amounts to which each member would have been entitled if current distribution had been made in lieu of retention by the association. As soon after the conclusion of each calendar or fiscal year of the association as conveniently may be done, the Board shall cause to be mailed or delivered to each member a statement showing the amount or proportionate part of the total amount retained from such member and placed in such revolving capital fund or funds to the credit of such member. Such notification shall be in the form and shall contain such information as the Board shall prescribe. The association may, but shall not be required to, issue certificates of revolving capital interest to the members showing their respective interests in the revolving capital fund or funds, and any such certificates, if and when issued, shall be in such form and shall contain such information and shall be issued and accepted under such terms and conditions as may be determined from time to time by the Board of Directors.

Section 6.--Revolution of Fund. At the end of each calendar or fiscal year, or at such other time as the Board of Directors may elect, the Board shall determine what part, if any, of the moneys in said revolving capital fund or funds (including those retained for the revolving capital fund or funds during such calendar or fiscal year) are not then needed and will not be required for use by the association. * * * No person in interest shall have or possess any vested right or interest in any revolving capital fund of the association, or any part thereof, unless and until payment or distribution thereof is ordered by action of the Board of Directors.

Section 9.--Dissolution. In the event of the dissolution or winding up of the affairs of the association, all the indebtedness represented by said revolving fund credits or certificates of revolving capital interest shall be deemed due, but shall not be paid in any part until all other indebtedness of the association has been paid, or its payment adequately provided for. Thereafter, said revolving fund credits or certificates of revolving capital interest shall be paid (to the extent of available funds) without regard to the time or year retained or to the classification of funds, or to the priorities applicable in the case of revolution of the fund or funds.

[Emphasis added.]

Article VI, section 11, of petitioner's bylaws was adopted on January 16, 1965. Notice of Adoption of By-Law Provision with respect thereto was mailed to each member of petitioner within a month or two after its adoption. Such notice was made available to both old and new members. Article VI, section 11, of the bylaws provides as follows:

Section 11.--Consent of Member to Include Amount of Revolving Fund Certificate as Gross Income. Each person who hereafter applies for and is accepted to membership in this association and each member of this association on the effective date of this By-Law who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after December 1, 1963 which are made in revolving fund certificates or other written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the association, will be taken into account and included in his gross income at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

During the 1966 and 1967 taxable years each member of the petitioner who was entitled to a patronage dividend by reason of his purchases received a receipt or invoice at the time of his purchases, reflecting the proper amount of each purchase. The measure of the amount of the potential patronage dividend attributable to each individual member could be determined by multiplying the member's total purchases for the year by a particular percentage factor which was set forth in the respective financial statements for the years 1966 and 1967. These percentage factors were 2.039 percent for fiscal 1966 and 3.355 percent for fiscal 1967.

Following the close of the 1966 and 1967 taxable years, petitioner, pursuant to notice, held annual membership meetings on January 21, 1967, and January 27, 1968. One of the first orders of business at these meetings was to have a representative of petitioner's accounting firm review the financial statements in detail.

The financial statement basically reflected petitioner's income for the year, total amount available for "members' rebates," and the percentage factor upon which individual rebates should be calculated.

A majority of the members attended these meetings at which the financial statements were distributed. The remaining members for the most part were given easy access to the information contained therein. At the time the annual meetings took place the dividends had actually been credited on the books of petitioner as a liability in toto.

The comparative statement of income and surplus distributed at the January 21, 1967, meeting showed the sum of \$8,502.23 as "Members' Rebates" with a footnote stating that such amount "represents 2.039% of sales to members for 1965-1966." The sum of \$8,502.23 comprised the total potential patronage dividends payable by petitioner for the year ended November 30, 1966.

The comparative statement of income and surplus distributed at the meeting of January 27, 1968, showed the sum of \$16,261 as "Members' Rebates" with a footnote stating that such amount "Represents 3.355% of sales to members for 1966-1967." The sum of \$16,261 comprised the total potential patronage dividends payable by petitioner for the year ended November 30, 1967.

Generally, each member kept his own record of purchases because most of the items purchased from petitioner were expense items. However, petitioner had its own records for purposes of determining the individual's allocable patronage dividend and the members were not required to have their receipts in order to qualify for the receipt of the proper patronage dividend.

If a member had kept all of his records he could have determined his allocable patronage dividend by multiplying the percentage figure given in the financial statements by the amount of his purchases for the

year. However, the financial statements which were distributed at the annual meetings did not by themselves contain sufficient information to compute each individual member's allocable share.

On August 18, 1967, each member of petitioner was sent a check for 20 percent of his allocated amount for the year ended November 30, 1966, plus a revolving fund certificate for the 80-percent balance.

On September 18, 1968, each member of petitioner was sent a check for 20 percent of his allocated amount for the year ended November 30, 1967, plus a revolving fund certificate for the 80-percent balance.

The revolving fund certificates dated August 18, 1967, and September 18, 1968, sent to the members read as follows:

This is your Revolving Fund Certificate advising you of the amount you have earned during the association's [1966 or 1967] fiscal year.

Your total computed rebate for the year [1966 or 1967] is \$ based on your gear, marine fuel, and insurance. A draft for 20% of this amount is enclosed. The balance will be paid at the discretion of the Board of Directors.

Remember, due to the Federal ruling governing cooperatives and/or associations, the law states that you are to report the full amount as indicated above for tax purposes.

The actual payment periods, as prescribed by statute, for the years ended November 30, 1966, and November 30, 1967, were August 15, 1967, and August 15, 1968, respectively.

At least 95 percent of the members of petitioner during the years 1966 through 1968 were individuals who reported their income for Federal income tax purposes each calendar year on the cash basis.

Petitioner for the taxable years 1966 and 1967 deducted \$8,502.23 and \$16,261, respectively, as a distribution of patronage dividends deductible under section 1382(b). Respondent in his notice of deficiency increased petitioner's taxable income to reflect the disallowance of these deductions in their entirety.

ULTIMATE FINDING OF FACT

Petitioner's financial statements, distributed at its annual meetings for taxable years 1966 and 1967, coupled with the receipts the members received upon purchasing goods from petitioner, did not constitute written notices of allocation.

OPINION

The question before this Court involves the deductibility of certain items under either section 1382(b)(1) of 1382(b)(2). 3/

[3/ SEC. 1382. TAXABLE INCOME OF COOPERATIVES.

(a) Gross Income.--Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization or by reason of any amount paid to a patron as a per-unit retain allocation (as defined in section 1388(f)).

(b) Patronage Dividends and Per-Unit Retain Allocations.--In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section

1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d))) with respect to patronage occurring during such taxable year;

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as patronage dividend during the payment period for the taxable year during which the patronage occurred;

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income.

[Emphasis added.]]

The effect of section 1382(b) is to allow a cooperative to reduce its taxable income when "patronage dividends" are properly distributed within the terms of the statute.

Petitioner claims that under section 1382(b)(1) all, or under section 1382(b)(2) at least part, of the scrip and monetary amounts distributed by it are deductible. To justify a deduction under either of these sections, it is imperative for purposes of the case at bar to initially find that "written notices of allocation," as defined by section 1388(b), had been distributed by petitioner within the proper time periods. Absent such a finding, all of petitioner's arguments for deductibility are to no avail.

Therefore, our finding that the financial statements in question did not constitute "written notices of allocation" is dispositive. However, for purposes of complete accuracy we will, in this opinion, answer all of petitioner's subsequent contentions.

Petitioner's complete argument is as follows:

(1) Certain financial statements distributed at petitioner's annual meetings, combined with receipts that each individual member received for purchases during the year, constituted written notices of allocation as defined in section 1388(b) which were distributed within the proper statutory time periods.

(2) These written notices of allocation were converted to "qualified written notices of allocation" as required by section 1382(b)(1) due to either of the following circumstances:

(a) There was constructive receipt within the required payment period of at least 20 percent of the dividends by virtue of each individual member's ability to collect his dividend at any time after it was declared.

(b) In order to qualify as a written notice of allocation, actual payment need not be made within the same payment period as the receipt of the written notice of allocation.

In an alternative argument, petitioner claims a deduction for a lesser amount under section 1382(b)(2).

Petitioner in its alternative argument contends that for the taxable year 1966 the financial statements received by the members qualify as "nonqualified written notices of allocation," and that these notices were partially redeemed by the checks distributed on August 18, 1967. Petitioner argues that it is therefore entitled to a deduction in its 1967 return under section 1382(b)(2), to the extent of this partial redemption. ^{4/}

[^{4/} Petitioner claims the argument applies equally to payments made in 1968 reflecting redemptions of fiscal 1967 nonqualified notices. However, petitioner on brief recognizes that 1968 is not at issue before this Court and it does not propose that we take any action for 1968.]

Essentially, the situation before us is that there are very definite rules which must be met in order for a cooperative to deduct patronage dividends from its taxable income. 5/

[5/ The background of the law in regard to patronage dividends and subch. T (dealing with the taxation of cooperatives and their patrons) is as follows:

Prior to legislation enacted in 1951 there were numerous cases and administrative rulings which recognized the rights of nonexempt cooperatives to exclude patronage dividends. See for example Puget Sound Plywood, Inc., 44 T.C. 305 (1965), and Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949).

It was generally thought that the 1951 legislation would insure that earnings of cooperatives would be currently taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons. See H. Rept. No. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 482; and S. Rept No. 1881, 87th Cong., 2d Sess. 1962-3 C.B. 817. However, following the enactment of the 1951 legislation certain court decisions turned the cooperative area into a revenue collector's nightmare. The notable cases in this area are: Commissioner v. Carpenter, 219 F.2d 635 (C.A. 5, 1955), affirming 20 T.C. 603 (1953), holding that a cash basis taxpayer and member of a cooperative need not include in his gross income the face amount of refund certificates issued by a farmer cooperative when those certificates had no fair market value at the time of issue; and Long Poultry Farms v. Commissioner, 249 F.2d 726 (C.A. 4, 1957), reversing 27 T.C. 985 (1957), holding that an accrual basis taxpayer and member of a cooperative did not properly accrue as an item of income a patronage refund credit for the year in which it was allocated to the taxpayer's account by the marketing cooperative if the right to receive payment was not definite and certain in that year. See also Caswell's Estate v. Commissioner, 211 F.2d 693 (C.A. 9, 1954), reversing 17 T.C. 1190 (1952); and Moe v. Earle, 226 F.2d 583 (C.A. 9, 1955). While the above cases permitted the cooperative's patrons to exclude certain distributions from income, the cooperatives continued to deduct these very same distributions as proper distributions of patronage dividends. See for example Farmers Cooperative Co. v. Commissioner, 288 F.2d 315 (C.A. 8, 1961), reversing 33 T.C. 266 (1959). When faced with this obvious inconsistency, the court in Long Poultry Farms v. Commissioner, *supra* at 731, responded as follows: "The answer is that Congress while granting the right to the deduction by the cooperative left the matter of taxing the dividends to the recipients to be dealt with by existing law, making no change whatever with regard thereto, with the result that cash basis taxpayers will report as income patronage dividends * * * when payment thereof is received and accrual basis taxpayers will report them as income for the year in which the right to receive payment becomes reasonably definite and certain."

Faced with the dilemma created by this case law, Congress, in the Revenue Act of 1962, adopted subch. T (secs. 1381-1388) of the 1954 Code so that what was essentially thought to be the law in 1951 would be specifically provided for by statute. See generally H. Rept. No. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 482-483.

It is the interpretation of this 1962 legislation which we are faced with in the present case. In light of subch. T's background it is imperative that we strictly construe the provisions of that subchapter, for it is clear from the legislative history and the state of events in existence prior to the enactment of subch. T that Congress intended the statute be exacting and specific so that cooperatives and their patrons might not be forced back into that unsure state which existed prior to 1962. Moreover, whether sec. 1382(b) was intended to provide for an exclusion or deduction, it is axiomatic that such provisions are a matter of legislative grace and must be strictly construed. See T.O. McCamant, 32 T.C. 824, 834 (1959); and Cooperative Oil Assn. v. Commissioner, 115 F.2d 666 (C.A. 9, 1940), affirming a Memorandum Opinion of the Board of Tax Appeals.]

The first of these requirements is that distributions which would otherwise meet the requirements of section 1382(b) must be made within the appropriate payment period, defined in section 1382(d) as follows:

(d) **Payment Period for Each Taxable Year.**--For purposes of subsections (b) and (c)(2), 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. * * *

According to this definition the appropriate payment periods for petitioner's 1966 and 1967 taxable years ended on August 15, 1967, and August 15, 1968, respectively. However, distributions by petitioner which would have unquestionably met the requirements of section 1382(b) were not made until August 18, 1967, and September 18, 1968. These distributions therefore cannot be recognized as meeting the requirements, and petitioner correctly does not propose that we stretch the payment period. 6/

[6/ See for example Mansuss Realty Co. v. Commissioner, 143 F.2d 286 (C.A. 2, 1944), affirming 1 T.C. 932 (1943), which strictly applied the payment period provisions of sec. 24(c) of the Revenue Act of 1938 (precursor to sec. 267, 1954 Code).]

What petitioner does contend is that certain other documents which were distributed well within the payment period met the definition of written notices of allocation, either qualified or unqualified, and therefore the requirements of section 1382 have been fulfilled. Petitioner claims that the patron's receipt of these documents is a sufficient basis upon which petitioner may claim a deduction.

Certain financial statements were distributed at petitioner's annual meetings. Furthermore, receipts were distributed to members upon their purchase of goods. Petitioner claims that together these documents were sufficient to constitute written notices of allocation, because any individual member in possession of the combined documents could easily determine his allocable share of patronage dividends by multiplying his total purchases for the year (as reflected by total receipts) by the specific percentage figures set out in the financial statements. We cannot agree that the combination of financial statements and receipts is sufficient to meet the statutory definition of a written notice of allocation. This definition as found in section 1388(b) defines such a notice as follows:

(b) For purposes of this subchapter, the term "written notice of allocation" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend. [Emphasis added.]

The specific words of the statute call for a proper written notice of allocation to disclose to the recipient the stated dollar amount allocated to him.

Webster's New International Dictionary (3d ed. 1961) defines the word "stated" in part as follows: "unmistakably known: AVOWED * * * set down explicitly." Can we say that the conglomerate of distributed papers meets the rather specific language of the Code? We think not.

It is a fact that petitioner's members were not even required to keep the cash receipts, which constituted one-half of the vital necessary papers, in order to assure themselves of a patronage dividend. Certainly no stated dollar amount could be determined in the absence of this key element. Even assuming that the members kept adequate records, they would still have been put to the task of making correct calculations to determine the allocable stated dollar amount. Therefore it is obvious that on their face these documents did not reveal a stated dollar amount. The available documents showed no individual dollar amounts whatsoever. Clearly the type of instrument intended by Congress as sufficient to meet the requirements of a written notice of allocation is that notice which petitioner sent out after the close of the payment periods. That petitioner understood as much is apparent by the form of the certificates distributed by it on August 18, 1967, and September 18, 1968. These certificates did specifically reveal to each individual member his allocable stated dollar amount.

Petitioner claims that Rev. Rul. 68-236, 1968-1 C.B. 382, 7/

[7/ That revenue ruling in pertinent part reads:

"In order to qualify as a deductible amount to the cooperative within the meaning of section 1.1382-1 of the Income Tax Regulations, a per-unit retain allocation must be paid in the form of a qualified per-unit retain certificate. Section 1388(g) of the Code defines a per-unit retain certificate as any written notice that discloses to the recipient the stated dollar amount of a per-unit retain allocation to him by the distributing cooperative organization. Some cooperatives issue preliminary statements indicating the amount of a per-unit retain allocation (for example, on the receipt issued at the time goods are delivered or on the voucher accompanying a check given as the initial payment for goods when delivered) and then issue a more formal statement after the end of a specified period (i.e., quarterly, semiannually, etc.) indicating the total amount of per-unit retain allocations for that period. Both sets of statements meet the technical definition of a per-unit retain certificate. * * *"]

is authority for the proposition that any notice (even if contained in more than one document) which discloses to the recipient the amount of his patronage dividend will suffice as a written notice of allocation. This revenue ruling interprets the Code definition of a "per-unit retain certificate" (another type of written notice of allocation). While this ruling does indicate some degree of informality, it still requires the written notice to disclose to each individual his amount of allocation. This is precisely what was not done in the initial documents sent out by petitioner in the present case.

Furthermore, Rev. Rul. 68-236, *supra* at 383, states that "the statement that is uniformly treated by the parties as the formal per-unit retain certificate shall be treated as the certificate for tax purposes." (Emphasis added.) It is clear from all the surrounding facts and circumstances that the informal array of statements which petitioner claims constituted written notices of allocation were not at the time of distribution treated for tax purposes by petitioner or its members as the formal written notices of allocation. To fall within the spirit of the revenue ruling petitioner must be consistent with all of its requirements.

Our holding that petitioner did not distribute written notices of allocation is sufficient to sustain respondent's determination. However, petitioner's further contentions merit discussion. Assuming a proper distribution of written notices of allocation, it is incumbent upon petitioner under section 1382(b)(1) to prove that these notices were "qualified written notices of allocation." Section 1382(b)(1) provides for a deduction to the extent patronage dividends are paid during the payment period in "qualified written notices of allocation." The definition of qualified notices is found in section 1388(c), and provides in pertinent part as follows:

(c) Qualified Written Notice of Allocation.--

(1) Defined.--For purposes of this subchapter, the term "qualified written notice of allocation" means--

* * *

(B) a written notice of allocation which the distributee has consented, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

Such term does not include any written notice of allocation which is paid as part of a patronage dividend or as part of a payment described in section 1382(c)(2)(A), unless 20 percent or more of the amount of such patronage dividend, or such payment, is paid in money or by qualified check. [Emphasis added.]

Since the necessary consent as required by section 1388(c)(1)(B) has been recorded by petitioner's members, the only point of contention is whether the 20-percent-payment requirement has been met. Petitioner's first argument on this point is that the members could withdraw their allocated 20 percent at any

time before the end of the payment period and this constituted constructive receipt which is sufficient to satisfy the 20-percent-payment requirement.

Petitioner has not advanced any sound reason for applying the "constructive receipt" doctrine to the distributions in question. Petitioner's bylaws are specific in stating that no person shall have any right to patronage dividends until payment or distribution is ordered by the board of directors. The evidence that such an action was taken by the board of directors is inconclusive. "In no case should the constructive receipt theory apply, we think, unless at some time the earnings of the cooperative were made available to or were subject to the control of the patron." William A. Joplin, Jr., 17 T.C. 1526, 1531-1532 (1952).

Even if we assume that constructive receipt may be present on the facts of this case, we believe that for the following reasons, the doctrine of constructive receipt is not appropriate to this particular area:

(1) It is clear from the legislative history that to incorporate the doctrine of constructive receipt into subchapter T would completely negate the purpose of the 20-percent-payment rule. The purpose of that rule was to assure actual payment rather than constructive payment so that the participating patrons would be able to at least pay the first bracket income tax on the entire qualified written notice of allocation which must be included in income. 8/

[8/ Senate Finance Committee, S. Rept. No. 1881, 87th Cong., 2d Sess., 1962-3 C.B. 818, states:

"Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons enough cash to pay at least the first bracket income tax. To give assurance that the cooperative provides the patron with at least enough money to pay the this first bracket tax, your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deductions for allocations (and the patrons are to be required to include any such amounts in their income.)"]

(2) The second point negating the application of the constructive-receipt doctrine is that the statute specifically calls for payment in the form of money or qualified check. Similar specific language is found in other areas of the Code and in one recent opinion of this Court we applied a strict interpretation to the term "money" as used in section 1375(f). See Randall N. Clark, 58 T.C. 94 (1972). That case leaves little room for doubt that when a statute requires a distribution of money its requirements cannot be met by the application of the constructive-receipt doctrine. We think a similarly strict interpretation of the words "qualified check" is also appropriate.

Petitioner's alternative argument in support of his claim that a "qualified written notice of allocation" was distributed is also totally without merit. In this argument petitioner submits that for purposes of qualification there is no provision in the last sentence of section 1388(c)(1) which requires that the 20-percent payment be made within the same payment period as the distribution of the written notice of allocation. Therefore, the fact that the check for the 20-percent payment was not mailed until days after the end of the payment period did not disqualify the written notice of allocation.

This argument is refuted by the logic and language of the statute and the relevant legislative history. Section 1382(b)(1) allows a deduction for amounts paid as patronage dividends during the payment period in qualified written notices of allocation. Written notices of allocation by definition are not qualified unless 20 percent or more of the amount of payment is paid by money or qualified check. It therefore follows that if the 20-percent payment is not made within the same payment period in which the written notice is distributed, that notice is not a qualified notice when it is distributed within that required payment period and it cannot be considered a distribution which meets the terms of section 1382(b)(1). In this context it is also noteworthy that Conference Report, H. Rept. No. 2508, 87th Cong., 2d Sess., 1962-3 C.B. 1169, in discussing qualification of written notices of allocation, states in pertinent part: "a written notice of

allocation is not a qualified one unless 20 percent or more of the distribution of which it is a part is paid in money or by qualified check. [Emphasis added.]"

Petitioner makes one final argument in its attempt to salvage at least part of the deduction. Under section 1382(b)(2) petitioner is allowed a deduction for payments in money or other property made in redemption of "nonqualified written notices of allocation" which had been paid as patronage dividends during the proper payment period. A "nonqualified written notice of allocation" is defined in pertinent part in section 1388(d) as follows:

(d) Nonqualified Written Notice of Allocation.--For purposes of this subchapter, the term "nonqualified written notice of allocation" means a written notice of allocation which is not described in subsection (c) [qualified written notice of allocation] * * *

Petitioner contends that if its written notices of allocation did not qualify under section 1388(c) they are nonqualified notices according to section 1388(d) and the 20-percent actual payment of August 18, 1967, was in redemption of 20 percent of these notices. It therefore claims a deduction for the year 1967 to the extent of the actual payments. Again, petitioner's argument is of no value for even nonqualified written notices of allocation are dependent on a finding that the papers distributed within the payment period constituted written notices of allocation. We cannot make this necessary finding.

=====||=====

C. Qualified Written Notice of Allocation

1. Options

A written notice of allocation becomes "qualified " when certain requirements of form and payment are met.

1388(c) Qualified Written Notice of Allocation. -

(1) Defined. - For purposes of this subchapter, the term "qualified written notice of allocation" means -

(A) a written notice of allocation which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation; and

(B) a written notice of allocation which the distributee has consented, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

The preceding Code language says qualified written notices are written notices that fall within either of two categories: the redeemable notice or the consent notice. Ways in which consent can be given are discussed below.

Such term does not include any written notice of allocation which is paid as part of a patronage dividend or as part of a payment described in section 1382(c)(2)(A), unless 20 percent or more of the amount of such patronage dividend, or such payment, is paid in money or by qualified check.

This is the basis for the 20 percent payment in money requirement.

(4) Qualified check. - For purposes of this subchapter, the term "qualified check" means only a check (or other instrument which is redeemable in money) which is paid as part of a patronage dividend, or as a part of a payment described in section 1382(c)(2)(A), to a distributee who has not given consent as provided in paragraph (2)(A) or (B) with respect to such patronage dividend or payment, and on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage dividend or payment of which such qualified check is also a part. Such term does not include any check (or other instrument) which is paid as part of a patronage dividend or payment which does not include a written notice of allocation (other than a written notice of allocation described in paragraph (1)(A)).

(d) Nonqualified Written Notice of Allocation. - For purposes of this subchapter, the term "nonqualified written notice of allocation" means a written notice of allocation which is not described in subsection (c) or a qualified check which is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is a part is paid.

(e) Determination of Amount Paid or Received. - For purposes of this subchapter, in determining amounts paid or received -

(1) property (other than a written notice of allocation or a per-unit retain certificate) shall be taken into account at its fair market value, and

(2) a qualified written notice of allocation or qualified per-unit retain certificate shall be taken into account at its stated dollar amount.

2. Consent

The following Code provision lists the three methods of giving consent.

=====||=====

(2) Manner of obtaining consent. - A distributee shall consent to take a written notice of allocation into account as provided in paragraph (1)(B) only by -

(A) making such consent in writing,

(B) obtaining or retaining membership in the organization after -

(i) such organization has adopted (after October 16, 1962) a bylaw providing that membership in the organization constitutes such consent, and

(ii) he has received a written notification and copy of such bylaw,

or

(C) if neither subparagraph (A) or (B) applies, endorsing and cashing a qualified check, paid as part of the patronage dividend or payment of which such written notice of allocation is also a part, on or before the 90th day after the close of the payment period for the taxable year of the organization for which such patronage dividend or payment is paid.

(3) Period for which consent is effective. -

(A) General Rule. - Except as provided in subparagraph (B) -

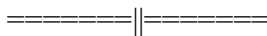
(i) consent described in paragraph (2)(A) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined with the application of section 1382(e)) during the taxable year of the organization during which such consent is made and all subsequent taxable years of the organization; and

(ii) a consent described in paragraph (2)(B) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined without the application of section 1382(e)) after he received the notification and copy described in paragraph (2)(B)(ii).

(B) Revocation, etc. -

(i) Any consent described in paragraph (2)(A) may be revoked (in writing) by the distributee at any time. Any such revocation shall be effective with respect to patronage occurring on or after the first day of the first taxable year of the organization beginning after the revocation is filed with such organization; except that in the case of a pooling arrangement described in section 1382(e), a revocation made by a distributee shall not be effective as to any pool with respect to which the distributee has been a patron before such revocation.

(ii) Any consent described in paragraph (2)(B) shall not be effective with respect to any patronage occurring (determined without the application of section 1382(e)) after the distributee ceases to be a member of the organization or after the bylaws of the organization cease to contain the provision described in paragraph (2)(B)(i).



Independent Cooperative Milk Producers Ass'n v. Comm'r
76 T.C. 1001 (1981)

HALL, Judge: The issue for decision is whether allocations of patronage dividends to certain of petitioner's members constituted "qualified written notices of allocation" as defined by section 1388(c).

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

At the time it filed its petition, petitioner had its principal place of business in Grand Rapids, Mich. Petitioner filed its tax returns on the calendar year basis.

Petitioner is a farmers' cooperative, incorporated in 1950 as a nonstock corporation under the laws of the State of Michigan. Petitioner's corporate purpose is to engage in collective sales of milk or milk products for its members and to act as bargaining agent for the membership in the sale and distribution of these products. During 1973 and 1974, petitioner qualified as an exempt farmers' cooperative under section 521. ^{2/}

[^{2/} During 1973 and 1974, petitioner marketed only milk of its member-farmers. In 1973, there were 488 members, and in 1974, there were 514 members.]

All of petitioner's members are dairy farmers. If a nonmember dairy farmer inquires about membership, petitioner dispatches a field representative to his farm. The field representative's visit serves a twofold purpose, to inspect the farm for quality control and to explain to the farmer how the cooperative works. After the field representative gives his approval, the prospective member signs a membership agreement in duplicate.

Both copies of the signed membership agreement are returned to petitioner's office pending approval by the board of directors. Upon approval, one copy of the membership agreement is retained by petitioner and the other copy is delivered to the new member. In addition to the membership agreement, each new member receives a welcome letter 3/

[3/ The welcome letter contains the following message:

"We urge you to cooperate as far as possible with YOUR fieldman and haulers in furnishing us with a clean, even flow of milk throughout the year.

"I am enclosing a copy of your contract for your records. Only by cooperation and fulfillment by all parties can the best milk market be maintained."]

and information relating to medical insurance.

In general, the membership agreement obligates each member to deliver all of his milk to petitioner for subsequent sale. In return, petitioner agrees to sell the milk and to distribute the sales proceeds (minus commissions, shipping costs, and other miscellaneous deductions) to each member on a monthly basis. The commission fees deducted by petitioner are used for salaries and other operating expenses of the cooperative. Furthermore, paragraph 6 of the membership agreement specifically provides:

6. THIS AGREEMENT is one of a series alike in terms, comprising with all such agreements signed by individual producers or otherwise, one single contract between the Association and the said producers mutually and individually obligated under all terms thereof and the signing of this contract shall be considered the signing of an application for membership in the Association and an agreement to abide by all rules and regulations thereof. The violation of this agreement by the producer shall be considered full and sufficient cause for the cancellation of the producers membership in the Association.

During 1973 and 1974, article 29 of petitioner's bylaws read, in pertinent part, as follows:

Section 1. In the marketing of agricultural and dairy products of its members and other producers, the corporation shall turn back to such members and other producers the proceeds of sales, less the necessary marketing expenses on the basis of the products marketed. In the purchasing and distribution of supplies and equipment, and in the rendition of services to its members and other patrons the corporation shall turn over such supplies and equipment, and render such services at cost, plus necessary expenses.

In order to operate on a non-profit and co-operative basis as aforesaid, and at the same time to insure the solvency and financial stability of the corporation, the charges, receipts and revenues of the corporation, and the expenditure, disbursements and distribution thereof, shall be handled and conducted in the manner set forth in the succeeding sections of this article.

* * *

Section 3. In Order to furnish funds to guarantee payment (to the extent such funds being available) for products sold to other purchasers, such funds being in addition to reinvestments by patrons of patronage funds, the board of Directors are authorized to retain from the proceeds due patrons from the sale of such products, made to or negotiated through the corporation, such amount per hundred weight of products marketed by such patrons as may

be authorized by the members at each annual meeting. Such amounts withheld from said proceeds, and not used to guarantee said payments within the same fiscal year to patrons making same, shall be allocated to patrons as retains, subject to redem[p]tion by the board of directors on such plan as it may adopt.

Section 4. The net annual margins, savings or earnings from the transaction of the business of the corporation shall be apportioned to and distributed among all the patrons as a cooperative dividend for the respective year in proportion to the patron's respective volume of milk marketed through the corporation, as the same appears upon the books and records of the corporation. Said cooperative dividend shall be paid or credited to the account of the patrons entitled thereto at least once each year.

Section 5. The board of directors is authorized to pay patronage dividends to the patrons in cash or by allocation on the books of the corporation with due notice to be given to the patron receiving such allocations; provided, however, that in the payment of patronage dividends, all patrons shall be treated alike, and there shall be no discriminatory treatment between member and nonmember patrons.

* * *

Section 7. Each person who hereafter applies for and is accepted to membership in this cooperative, and each member of this corporation on the effective date of this bylaw, who continues as a member after such date shall, by such act alone, consent that the amount of distribution with respect to his patronage occurring on or after October 1, 1963, which are made on written notices of allocation (as defined in 26 USC 1388), and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 USC 1385(a) in the taxable year in which such written notices of allocation were received by him.

Section 8. Each person who hereafter applies for and is accepted to membership on [sic] this cooperative on or after February 28, 1967 and each person who continues as a member after such date, shall by such act alone, consent to treat all certificates based on retains made by this cooperative from payments made for products sold by member through this cooperative, issued to member as qualified per unit retain certificates, as income at their stated dollar amount in the taxable year in which such certificates are received by members required by 26 [U.S.C.] 1385(a), as amended.

Sections 7 and 8 of article 29 reflect amendments adopted by petitioner's membership in March 1966 and March 1967. 4/

[4/ Petitioner did not distribute copies of sec. 7 of art. 29 to members who joined the cooperative after 1967.]

Petitioner's members were notified of the 1967 bylaw changes by means of a newsletter distributed in 1967.

In accordance with its bylaws, petitioner allocates its net annual earnings to its members based on the weight of milk sold for each member during the year. These allocations of net earnings will hereinafter be referred to as "patronage dividends." 5/

[5/ These allocations qualify as patronage dividends under sec. 1388(a). See note 11 infra.]

Pursuant to article 29, section 5, petitioner opted to pay 20 percent of the 1973 and 1974 patronage dividends by check. Petitioner retained the remaining 80 percent of the net earnings in each year and issued certificates of equity to each member for his allocable portion of the retained amounts. 6/

[6/ As used in sec. 7 of art. 29, the term "written notice of allocation" refers to these certificates of equity. Printed on the face of each certificate of equity is the following legend:

"This is to certify that the above named member has left on deposit with the Association the Allocated Credit of the Capital retains for the fiscal year ended * * * which was not distributed in the form of cash. The amount (as shown above) has been credited on the books to your account.

"This certificate is redeemable only in accordance with the by-laws of the Association."]

Members receive cash for their certificates of equity when petitioner redeems the certificates; the redemption date is determined by petitioner's board of directors. It has been petitioner's practice to redeem certificates of equity at face value in the ninth year after the year to which they relate.

* * *

Pursuant to the bylaws, petitioner's membership votes annually to withhold a certain amount of sales proceeds for the Producers Guarantee Payment Fund. The fund's purpose is to protect the members from defaults by milk purchasers. The amounts withheld are referred to as "retains." Each member is credited on the petitioner's books for the retains withheld from his sales proceeds. On an annual basis petitioner issues to each member a certificate of retains which reflects the members' contribution to the fund for that year. 7/

[7/ Printed on each certificate of retains is the following passage:

"This is to certify that the above named member has left on deposit with the Association the

[footnote as continued on p. 1006]

Allocated Credit of the Net Retained Producer Guarantee Payment Fund for the fiscal year ended * * *. The amount (as shown above) has been credited on the books to your account.

"This Certificate is redeemable only in accordance with the by-laws of the Association.

"The Internal Revenue Code implies that it is not necessary to pay any cash with respect to the written notice of allocation of Retained Producer Guarantee Payment Funds. However, the member will be obligated to include the entire amount of ALL Retained Funds and Cash Distributions in his gross income for income tax purposes."]

Members receive cash for their certificates of retains when petitioner redeems these certificates. The redemption date is determined by petitioner's board of directors. It has been petitioner's practice to redeem certificates of retains at their face value in the fifth year after the year to which they relate.

In 1973 and 1974, petitioner's membership voted to withhold as retains 1 1/2 cents per hundred weight of milk sold. Petitioner's total withholdings equaled \$37,024.05 for 1973 and \$42,009.43 for 1974.

On the first business day of September 1974, petitioner mailed to each member a packet of documents and forms relating to its 1973 taxable year. Each packet contained (1) a certificate of retains, (2) a check for 20 percent of the member's 1973 patronage dividend, (3) an invoice attached to the check, (4) a certificate of equity representing the remaining 80 percent of the member's 1973 patronage dividend, and (5)

a Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received from Cooperatives. 8/

[8/ The 1099-PATR forms received by the members contained the following statements:

(1) "Statement for Recipients (Patrons) of TAXABLE DISTRIBUTIONS RECEIVED FROM COOPERATIVES 1974; and

(2) "The amounts shown on this form are taxable payments only. Other payments that are not taxable need not be reported."

In filling out Form 1099-PATR for each member, petitioner aggregated the following amounts and placed the total in the box entitled "Patronage Dividend":

- (i) The amount on the member's certificate of retains.
- (ii) The amount on the member's certificate of equity; and
- (iii) The amount of the member's check from petitioner.]

The check issued to each member was an ordinary bank check, containing no information other than the drawer, drawee, payee, amount, date, and account to be charged. The invoice attached to this check contained the following printed information:

PLEASE HELP US TO HELP YOU, CASH THIS CHECK
IMMEDIATELY

INVOICE DATE	AMOUNT	DATE
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SUMMARY: 1973 OPERATING YEAR:

FORM 1099 IS THE TOTAL OF ALL BELOW DECLARED DOCUMENTS.

ALLOCATIONS: CERTIFICATE OF RETAINS (PGPF)
CERTIFICATE OF EQUITY (80%)

DISTRIBUTION: 20% OF EQUITY IS CASH

INDEPENDENT COOPERATIVE MILK PRODUCERS ASSOCIATION, INC.,
1221 McREYNOLDS, N.W., GRAND RAPIDS, MICHIGAN, 49504, PH. 459-9573.

In September 1975, petitioner mailed a packet of documents and forms to each member reflecting the cooperative's 1974 taxable year. The documents and forms were identical to those mailed to the members in 1974 except for the dates and amounts appearing on the various items. 9/

[9/ Petitioner also followed the same procedure for its 1972 and 1973 mailings.]

All checks issued by petitioner for 1973 and 1974 patronage dividends were endorsed by its members. The endorsements did not contain any written terms by which the endorser consented to include noncash patronage dividends in income.

Petitioner generally publishes a monthly newsletter which it distributes to its members with the monthly milk checks. The September 13, 1973, edition of the newsletter contained the following item:

1972 Distributing--You recently received your certificate on the reported income statement of 1972, which was the Guarantee of Pay Fund--\$35,597.72, and Producers Equity--\$54,218.06. Each year on September 1st, our office mails you your allocated amount in the form of certificates. Guarantee of Pay Fund (yellow paper) = 100%. Producers equity (white paper) = 80% and a check for 20%. (The Internal Revenue Service ruled several years ago that 20% of Producers equity had to be paid in cash to help you meet your income tax obligation). We urge you to use the forms 1099 PATR when declaring your 1973 Income Tax return. Then when these monies are paid you, the tax will have been paid.

Petitioner's taxable income, excluding adjustments for patronage dividends under section 1382, was \$109,624.80 in 1973 and \$136,163.26 in 1974. Petitioner claimed deductions for patronage dividends in each year equal to the above amounts thereby reporting no taxable income for either 1973 or 1974. In his statutory notice, respondent disallowed \$35,671.38 of the 1973 patronage dividend deductions and \$54,990.33 of the 1974 patronage dividend deductions. These amounts reflect the noncash patronage dividends allocated to members who joined petitioner after 1967.

OPINION

The issue for decision is whether petitioner's allocations of patronage dividends to certain of its members are "qualified written notices of allocation" as defined by section 1388(c).

Despite their status as exempt organizations, exempt farmers' cooperatives, like petitioner, are subject to tax. Secs. 521(a), 1381(a)(1), and 1381(b). 10/

[10/ Although "exempt" organizations, like petitioner, are subject to tax, they are otherwise treated the same as organizations exempt under sec. 501. See sec. 1.1381-2(a), Income Tax Regs.]

The extent to which these organizations are taxed is set forth in Subchapter T of the Internal Revenue Code. Secs. 1381 through 1388. In addition to the other deductions allowable under Chapter 1 of the Internal Revenue Code, exempt farmers' cooperatives are permitted those deductions specifically allowed under section 1382. * * *

As indicated in section 1382(b), patronage dividends * * * reduce a cooperative's taxable income only if they are paid in money, property or qualified written notices of allocation. The term "qualified written notice of allocation" is defined in section 1388(c), wherein it states: * * *

Thus the deductibility of patronage dividends * * * embodied in a written notice of allocation depends on whether the written notice is redeemable within the statutory period or whether the recipient consents to include such amount in his taxable income. Section 1388(c)(2) provides three alternative means by which a recipient of a written notice may consent to include the non-cash patronage dividend in income. The recipient may consent in writing (sec. 1388(c)(2)(A)), by retaining membership in the distributing organization provided that such organization has a by-law consent provision and the recipient has received a written notification and copy of the by-law (sec. 1388(c)(2)(B)), or by endorsing and cashing a qualified check (secs. 1388(c)(2)(C) and 1388(c)(4)).

Pursuant to its by-laws, petitioner allocated its 1973 and 1974 net earnings among its members based on their annual patronage. Petitioner paid 20 percent of these patronage dividends by check and issued Certificates of Equity for the remaining 80 percent. Petitioner deducted the entire amount of these patronage dividends in computing its 1973 and 1974 taxable income. Respondent does not dispute the deductibility of the amounts paid by check (sec. 1382(b)(1)), nor does he dispute the deductibility of the amounts

represented by Certificates of Equity issued to those members whose membership dates back to 1967 (sec. 1388(c)(2)(B)). 13/

[13/ The significance of the 1967 date relates to the amendments made to art. 29, sec. 7 of petitioner's bylaws. That section, as amended, contains a bylaw consent provision. Petitioner's membership was notified of these changes by a newsletter distributed in 1967. There is, however, no evidence in the record that post-1967 members ever received copies of this bylaw provision pursuant to sec. 1388(c)(2)(B)(ii).]

Rather, respondent disallowed only those patronage dividends reflected in the Certificates of Equity issued to petitioner's post-1967 members. Respondent contends that although the Certificates of Equity issued to post-1967 members constitute "written notices of allocation" under section 1388(b), they do not constitute "qualified" written notices of allocation because petitioner's members failed to properly consent under any of the methods provided in section 1388(c)(2). 14/

[14/ The parties agree that the certificates of equity were not redeemable within the statutory period provided under sec. 1388(c)(1).]

On the other hand, petitioner argues that its post-1967 members consented in writing in two different ways to include in their incomes the amounts stated on the certificates of Equity. 15/

[15/ Petitioner concedes that the requirements of secs. 1388(c)(2)(B) and 1388(c)(2)(C) have not been satisfied. See note 13 *supra*. Accordingly, petitioner must rely on the consent-in-writing requirement of sec. 1388(c)(2)(A).]

First, petitioner contends that the membership agreements signed by the post-1967 members constitute the requisite written consents. In support of this contention petitioner relies on the language of the membership agreement which states that "signing of this contract shall be considered the signing of any application for membership in the Association and an agreement to abide by all rules and regulations thereof." According to petitioner, the rules and regulations by which each member agreed to abide include its by-laws, and, more specifically, the consent provision contained in article 29, section 7 of those by-laws. 16/

[16/ On brief, petitioner argues that we should consider certain statements allegedly made to new members by its field representatives. No field representative testified at trial regarding such statements and, accordingly, they are inadmissible as hearsay. Fed.R.Evid. 802.]

The second mode of compliance asserted by petitioner relates to the endorsement and cashing of the 20 percent patronage dividend checks by the post-1967 members. On this point, petitioner attaches substantial significance to the fact that the dividend checks were always mailed in packets containing a Certificate of Equity, a Certificate of Retains and Form 1099-PATR. Petitioner asserts that the endorsing and cashing of the dividend check, in light of the directives printed in both the Certificate of Retains and the Form 1099-PATR to include the stated amounts in income, (see notes 7 & 8 *supra*) sufficiently satisfies the written consent requirement.

For the reasons stated below, we find that petitioner's members have not complied with the requirements of section 1388(c)(2).

To our knowledge this is the first case interpreting the consent provisions of section 1388(c)(2). In light of the issue's novelty, a retracing of the section's legislative history is warranted. 17/

[17/ For excellent discussions of the legislative history of subch. T and its predecessor, see Wile, "Taxation of Farmers' Cooperatives and Their Patrons," 1966 S. Calif. Tax Inst. 449 (1966); Logan, "Federal Income Taxation of Farmers' and Other Cooperatives," 44

Tex.L.Rev. 250, 1269 (1966). See also Farmers Cooperative Co. v. Birmingham, 86 F.Supp. 201 (N.D. Iowa 1949).]

Under section 101(12) of the 1939 Code the earnings of qualifying farm cooperatives were exempt from tax regardless of whether such earnings were distributed to its patrons. At the same time, the earnings of nonexempt cooperatives were subject to tax although numerous cases and administrative rulings recognized the rights of these cooperatives to exclude patronage dividends from their gross incomes. 18/

[18/ See note 12 supra.]

In 1951 Congress enacted legislation which, in part, attempted to eliminate the competitive advantage enjoyed by exempt cooperatives in accumulating capital with tax free dollars. See S. Rept. No. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 472, 473. As a consequence of new section 101(12)(B) of the 1939 Code, earnings of exempt cooperatives were subjected to tax. In addition, the newly enacted section provided that patronage dividends of exempt cooperatives "shall be taken into account in computing net income in the same manner as in the case of a [nonexempt] cooperative organization." Sec. 101(12)(B), I.R.C. 1939. 19/

[19/ The 1951 legislation did not eliminate all the differences between the taxation of exempt and nonexempt cooperatives. For instance, exempt cooperatives were permitted deductions for nonpatronage allocations. Sec. 101(12)(B)(ii), I.R.C. 1939. This same discrepancy has been carried forward to subch. T. See sec. 1382(c).]

Although the 1951 legislation did not address the taxability of patronage dividends to a cooperative's patrons, it was generally believed that the combined effect of that legislation and prior Treasury rulings insured that a cooperative's net earnings would be currently taxable to either the cooperative or its patrons. See, e.g., H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 402, 482; S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 703, 817; S. Rept. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 473. This presumed symmetry was shattered by subsequent judicial decisions. Most notable among these were Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957) and Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955). These cases in general permitted patrons to exclude noncash patronage dividends from current income while permitting current deductions to the cooperative for these very same allocations. The courts were not oblivious to this inconsistent treatment, yet they attributed the situation to the drafting of the 1951 legislation. As the court in Long Poultry Farms, supra, stated at page 731:

The Commissioner places great weight on the argument that by 26 U.S.C. Sec.101(12)(B) an exempt cooperative is permitted to deduct from gross income patronage dividends such as are here involved and that there was testimony before committees of Congress to the effect that these would be returned for taxation by recipients. The answer is that Congress while granting the right to the deduction by the cooperative left the matter of taxing the dividends to the recipients to be dealt with by existing law, making no change whatever with regard thereto * * * .

Faced with this "whipsaw" situation, Congress adopted Subchapter T of the 1954 Code in 1962 in order to insure the symmetrical treatment of patronage dividends. See, e.g., H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 402, 482. As stated in the legislative history of a subsequent amendment to subchapter T:

The patronage dividend provisions of the Revenue Act of 1962 were designed to assure that the amounts received by cooperatives in the course of their business activities with their patrons are included in computing the income tax of either the cooperative or the patron, thus subjecting these amounts to a single current tax. To accomplish this, the 1962 act provided detailed rules which specified the treatment which patronage dividends are to receive from the standpoint of both cooperatives and their patrons. It was hoped that these provisions would bring to an end the uncertainty that existed in the area of cooperative-

patron income taxation and consequently bring to a halt the litigation that the uncertainty engendered. * * * [S. Rept. No. 1707, 89th Cong., 2d Sess. (1966), 1966-2 C.B. 1055, 1108.]

Crucial to this entire statutory scheme, were the consent provisions presently in issue. Their import is reflected in the reports of both Houses of Congress: "Your committee believed that, since in the case of either the 90-day or consent allocation the patrons have constructively received the dividend and reinvested it, it is clear * * * that it constitutes income to the patron and is properly taxable to him. H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 402, 483. See also S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 703, 821.

Whether patronage dividends under section 1382(b) are categorized as exclusions or deductions (see note 12, *supra*), it is axiomatic that such provisions are a matter of legislative grace and must be strictly construed. See, e.g., *McCamant v. Commissioner*, 32 T.C. 824, 834 (1959); *Co-operative Oil Ass'n. v. Commissioner*, 115 F.2d 666, 668 (9th Cir. 1940), *affg.* a Memorandum Opinion of this Court. But even beyond this, the legislative history of subchapter T dictates that we strictly construe its provisions. See *Seiners Association v. Commissioner*, 58 T.C. 949, 955 n. 5 (1972) (strictly construing section 1388(b)). Congress has provided a detailed, well-integrated approach to the cooperative-patron relationship in order to minimize the uncertainties and inconsistencies that preceded the Subchapter's enactment. We decline to tinker with this legislative design and our analysis below reflects this reluctance.

Petitioner concedes that neither of the two writings relied upon, the membership agreement or the endorsed check, contains on its face specific language consenting to the inclusion of the noncash patronage dividends into income. Nonetheless, petitioner requests that we look beyond the actual writings for the requisite consent. In the case of the membership agreement, petitioner asks us to incorporate by reference the consent provision contained in its by-laws. With respect to the endorsed check, petitioner suggests that we consider the totality of the circumstances surrounding the check's issuance and endorsement. Unfortunately for petitioner, the statute may not be read so broadly as to encompass these situations.

Initially we note that petitioner's interpretation, in the context of this case, would transform the other two statutory modes of consent into mere surplusage. 20/

[20/ This is not meant to imply that a membership agreement or an endorsed check may never constitute a consent in writing. For example, if these documents contain express terms by which the signer agrees to treat all noncash allocations as constructively received and reinvested, then a different result may apply. See pp. 1017-1018 *infra*.]

If Congress had intended membership in a cooperative having a by-law consent provision to be a sufficient act of consent, it could have easily so provided. In section 1388(c)(2)(B), however, Congress went beyond this in requiring that the member receive a written notification and copy of the bylaw provision. Having failed to comply with that requirement, 21/

[21/ We presume this from petitioner's concession that sec. 1388(c)(2)(B) is inapplicable. See notes 13 & 15, *supra*.]

petitioner now seeks to avoid the consequences of that failure. The same is true with petitioners' endorsed-check argument. Congress could have provided that the mere endorsement of a check representing a portion of one's patronage dividend constitutes a consent to include in income the entire amount. Instead, Congress provided for consent by endorsement only if "there is clearly imprinted [on the check] a statement that the endorsement and cashing of the check * * * constitutes the consent of the payee to include in his gross income * * * the stated dollar amount of the written notice of allocation." Sec. 1388(c)(4). None of the checks issued by petitioner, however, contained the necessary imprint.

Furthermore, we believe the consent-in-writing provision and the accompanying regulations require that the writing contain, on its face, an explicit statement to the effect that the signing patron or member consents to include in income currently the amount stated on the written notice of allocation. 22/

[22/ We recognize that our approach herein is a narrow one. For example, although the signing of a membership agreement wherein it states the signer will abide by the organization's rules and regulations is not a sufficient consent in writing, a different result might be dictated where the signed agreement makes specific reference to a bylaw consent provision and summarizes its terms.]

A number of considerations lead to this conclusion.

First, explicit reference to the patron's consent on the face of the writing is best suited to achieve the certainty the statute was intended to produce. Once we go beyond the writing itself to ascertain whether consent has been given, we run the risk of recreating the confused and uncertain state that pre-dated the enactment of subchapter T. 23/

[23/ For instance, if we were to accept petitioner's position with respect to the signed membership agreements, we would be creating a potential repeat of the situation in Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957). In that case, the taxpayer successfully argued that noncash allocations of patronage dividends were not taxable currently to him despite the existence of a provision in the cooperative's bylaws that "all [noncash] amounts shall have the same status as though they had been paid to patrons in cash in pursuance of a legal obligation to do so and the patrons had then furnished corresponding amounts for capital for the association." 249 F.2d at 727.]

Second, support for this position is evidenced in the regulations accompanying section 1388(c)(2). Section 1.1388-1(c)(3)(i), Income Tax Regs., provides:

(i) Consent in writing. A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by signing and furnishing a written consent to the cooperative organization. No special form is required for the written consent so long as the document on which it is made clearly discloses the terms of the consent. Thus, the written consent may be made on a signed invoice, sales slip, delivery ticket, marketing agreement, or other document, on which appears the appropriate consent.
* * * [Emphasis supplied.]

In our view the above regulation clearly dictates that a valid written consent must expressly disclose, on its face, the terms of the consent. 24/

[24/ In his reply brief, petitioner makes a passing remark that sec. 1.1388-1(c)(3)(i), Income Tax Regs., is "not binding and is unduly restrictive as it goes far beyond the language and intent of Code section 1388(c)(2)(A), which sets forth a much broader requirement of a 'consent in writing.'" Due to the general nature of petitioner's complaint, we are hardpressed to provide any specific response. In general, however, we believe the regulation comports with the statute and its legislative history, as examined herein. In any event, petitioner has provided us with no "weighty reasons" for invalidating this regulation. Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).]

See also sec. 1.61-5(d)(2)(ii), Income Tax Regs. 25/

[25/ Sec. 1.61-5(d)(2), Income Tax Regs., deals with the cooperative-patron relationship in the taxation of per-unit retain certificates. See secs. 1382(b)(3), 1388(h). The tax treatment of these amounts parallels the treatment prescribed for patronage dividends. See S. Rept. 1707, 89th Cong., 2d Sess. (1966), 1966-2 C.B. 1055, 1108. For instance, a cooperative may deduct the amounts stated on a per-unit retain certificates if the distributees agree to take the stated amounts into income currently. Secs. 1382(b)(3), 1388(h)(1). As with patronage dividends, one method by which a distributee may agree to include retain

certificates into income is by written agreement. Sec. 1388(h)(2)(A). In discussing this mode of agreement, sec. 1.61-5(d)(2)(ii), Income Tax Regs., provides an example which would meet the requirements of sec. 1388(h)(2)(A):

"I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any per-unit retain certificates issued to me on or after ----- as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.

Signed"

Although the example relates to per-unit retain certificates and not patronage dividends, the two situations are sufficiently analogous to aid in our interpretation of sec. 1388(c)(2)(A). Moreover, the fact that the cited passage is but one form that a consent agreement may take does not detract from its utility as an interpretive tool. Accordingly, we believe the explicit language used in the above example supports our interpretation of sec. 1388(c)(2)(A).]

Third, the requirement of an explicit statement on the face of the consent comports with the other statutory alternatives under section 1388(c)(2). 26/

[26/ Petitioner contends that we should not view all three consent alternatives in the same light. According to petitioner, sec. 1388(c)(2)(A) should be interpreted as a broad, umbrella provision with sec. 1388(c)(2)(B) and (C) serving as very specific "safe harbor" provisions. In proposing this approach, petitioner hopes to avoid a strict interpretation of sec. 1388(c)(2)(A). Petitioner supports his argument by analogy to sec. 302(b). We do not agree with petitioner's analysis. Unlike the legislative history of sec. 302(b) (S. Rept. 1622, 83d Cong., 2d Sess. 44-45 (1954)), the legislative history of sec. 1388(c)(2) provides no basis for interpreting the consent-in-writing provision as a statutory catchall. In fact, the legislative history of sec. 1388(c)(2) treats all three consent alternatives equally. In the absence of any legislative directives to the contrary we will do likewise.]

The detail and specificity of the requirements set forth in the consent provisions are designed to insure that patrons are properly charged with constructive receipt of the noncash patronage dividends deducted currently by the cooperative. S. Rept. 1707, 89th Cong., 2d Sess. (1966), 1966-2 C.B. 1055, 1108; H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 402, 482; S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 821. In furtherance of this objective, the statute attempts to elicit unambiguous, affirmative acts of consent from the cooperative's patrons.

Under either the by-law consent approach (sec. 1388(c)(2)(B)) or the qualified check approach (sec. 1388(c)(2)(C)), compliance with the statutory requirements is sufficient in itself to guarantee that the patron's consensual act, i.e., retention of his membership or endorsement of the check, will be an informed and unambiguous one. The prior receipt of a copy of the by-law consent provision or the language imprinted on a qualified check adequately serves this purpose. In contrast, a writing under section 1388(c)(2)(A) will exhibit these same guarantees only if the statute is interpreted as requiring disclosure of the terms of the consent on the face of the writing. Without such an explicit requirement, we would be left to imply the quality of a patron's consent from surrounding circumstances. We do not believe Congress intended such a result especially in light of its artful drafting of the sister provisions to section 1388(c)(2)(A) and its aversion to expose this area to potential uncertainties. Rather, we believe a written consent under section 1388(c)(2)(A) must reveal, on its face, the informed nature of the patron's consent.

Finally, the statutory language itself supports our statutory construction. The provision, when read literally, requires a "consent in writing." Sec. 1388(c)(2)(A) (emphasis added).

In light of the above statutory construction, it is clear that petitioner may not prevail. Neither of the two writings relied upon by petitioner, i.e., the membership agreements or the endorsed checks, contain the requisite consent on their face. Consequently, petitioner has failed to satisfy the statute.

Perhaps realizing it may not prevail under the language of the statute, petitioner claims that the facts in this case indicate "good faith compliance with the spirit of the law." Central to this claim is petitioner's belief that the underlying purpose of the consent provisions is to insure that the patrons know their noncash distributions are taxable. According to petitioner, this purpose has been satisfied by the distribution of certain documents and forms, 27/

[27/ Petitioner also refers to the distribution of the Sept. 13, 1973, newsletter. See p. 1007 supra.]

especially Form 1099-PATR. See note 8 supra. We disagree with petitioner's focus. While Congress could have tied deductibility of noncash patronage dividends to the distribution of Form 1099-PATR, it did not do so. Rather, Congress evidently believed that merely informing a patron of the tax consequences of his noncash allocations would not adequately protect the public fisc against a repeat of the Long Poultry Farms and Carpenter cases, supra. As a result, Congress took great pains to insure that a patron's consent is in hand before it grants the cooperative a current deduction. In this case petitioner has come before us empty-handed and, accordingly, its deduction is denied. 28/

[28/ As alternative grounds for denying the claimed deductions, respondent asserts that petitioner has failed to demonstrate the timeliness of the consents (see sec. 1388(c)(3)(A)(i)), or their revocable nature (see sec. 1388(c)(3)(B)(i)). We will not address these alternatives in light of the result reached herein.]

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D. Per Unit Capital Retains

The following statutory definitions deal with per-unit capital retains.

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(f) Per-Unit Retain Allocation. - For purposes of this subchapter, the term "per-unit retain allocation" means any allocation, by an organization to which part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.

(g) Per-Unit Retain Certificate. - For purposes of this subchapter, the term "per-unit retain certificate" means any written notice which discloses to the recipient the stated dollar amount of a per-unit retain allocation to him by the organization.

(h) Qualified Per-Unit Retain Certificate. -

(1) Defined. - For purposes of this subchapter, the term "qualified per-unit retain certificate" means any per-unit retain certificate which the distributee has agreed, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

(2) Manner of obtaining agreement. - A distributee shall agree to take a per-unit retain certificate into account as provided in paragraph (1) only by -

(A) making such agreement in writing, or

(B) obtaining or retaining membership in the organization after -

(i) such organization has adopted (after November 13, 1966) a bylaw providing that membership in the organization constitutes such agreement, and

(ii) he has received a written notification and copy of such bylaw.

(3) Period for which agreement is effective. -

(A) General rule. - Except as provided in subparagraph (B) -

(i) an agreement described in paragraph (2)(A) shall be an agreement with respect to all products delivered by the distributee to the organization during the taxable year of the organization during which such agreement is made and all subsequent taxable years of the organization; and

(ii) an agreement described in paragraph (2)(B) shall be an agreement with respect to all products delivered by the distributee to the organization after he received the notification and copy described in paragraph (2)(B)(ii).

(B) Revocation, etc. -

(i) Any agreement described in paragraph (2)(A) may be revoked (in writing) by the distributee at any time. Any such revocation shall be effective with respect to products delivered by the distributee on or after the first day of the first taxable year of the organization beginning after the revocation is filed with the organization; except that in the case of a pooling arrangement described in section 1382(e) a revocation made by a distributee shall not be effective as to any products which were delivered to the organization by the distributee before such revocation.

(i) Nonqualified Per-Unit Retain Certificates. - For purposes of this subchapter, the term "nonqualified per-unit retain certificate" means a per-unit retain certificate which is not described in subsection (h).

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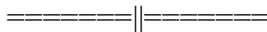
E. Equity Redemption

Code provisions we have already discussed describe tax implications of redemption in two distinct circumstances.

Redemption of equity that had originally been issued in qualified form yields no current tax consequences. Deductions were taken by the cooperative and the face value of the written notice of allocation or per unit capital retain certificate was accounted for by the patron for tax purposes. Redemption leads to no further deduction by the cooperative or income to the patron.

Redemption of equity that had originally been issued in nonqualified form has tax implications. The cooperative receives a deduction in the year of redemption and the patron receives

taxable income for the first time in the process. The Code describes an alternative method used by the cooperative to determine the amount of deduction received.



Revenue Ruling 81-103
1981-1 C.B. 447

ISSUE

Does the redemption of nonqualified written notices of allocation by payment of cash and by crediting accounts receivable qualify as a redemption by a cooperative within the meaning of Section 1382(b)(2) of the Internal Revenue Code?

FACTS

X is a cooperative within the meaning of Section 1381(a) of the Code. It employs an accrual method of accounting and reports its income on a calendar year basis. For taxable year 1976, X sustained a loss attributable to patronage transactions. X allocated this loss to its patrons for 1976 by written notice and the establishment on its books of accounts receivable due to it from these patrons. During the payment period for taxable year 1977, X properly allocated on a patronage basis the earnings from business done with or for its patrons. The allocation was in the form of nonqualified written notices of allocation. X recorded all of these transactions on its books of account.

In 1979, X redeemed, in total, the nonqualified written notices of allocation issued to patrons during the 1977 payment period. X informed those of its patrons obligated on accounts receivable due X that the redemption of the nonqualified written notices of allocation would first offset such accounts receivable. For example, X had a 1976 account receivable of \$4 from patron A. During the 1977 payment period, X issued a nonqualified written notice of allocation to A for \$15. In 1979, when X redeemed the \$15 nonqualified written notice of allocation, it paid A \$11 in cash and informed A that its account receivable from A of \$4 had been credited for \$4, thereby satisfying A's liability to X.

LAW AND ANALYSIS

Section 1382(b) of the Code provides that in determining the taxable income of an organization to which Section 1381 through 1388 apply, there shall not be taken into account amounts paid during the payment period for the taxable year (1) as patronage dividends, to the extent paid in money, qualified written notices of allocation, or certain other property with respect to patronage occurring during such taxable year; (2) in money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation that were paid as patronage dividends during the payment period for the taxable year during which the patronage occurred. Any amounts not taken into account under (1) or (2) above shall be treated in the same manner as items of gross income and as deductions therefrom.

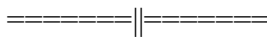
In this case, accounts receivable due X from its patrons are used to offset the payments required to redeem certain outstanding nonqualified written notices of allocation issued by X to its patrons. X accomplished this redemption of the nonqualified written notices of allocation by clearly identified book entries and notification to its patrons.

The transaction in 1979 redeemed the nonqualified written notices of allocation issued in 1977. The patrons received cash and a notice of satisfaction of their accounts payable to X. For Federal income tax purposes, X is treated as being paid \$15 in cash in redemption of the nonqualified written notice of allocation and as having recovered from A \$4 in cash to pay the account receivable due X. The satisfaction of the accounts receivable does not result in any additional income to X because, as an accrual basis taxpayer, X has already taken the accounts receivable into income. Under these facts, X is collecting from the patrons

the loss that X had allocated to them for taxable year 1976. Accordingly, a \$15 deduction is allowed to X under Section 1382(b)(2) of the Code.

HOLDING

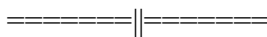
The redemption of the nonqualified written notices of allocation by X in 1979 by payment in cash and cancellation of accounts receivable due from patrons qualifies as a redemption within the meaning of Section 1382(b)(2) of the Code.



VII. Losses

As any business, a cooperative may be unfortunate enough to suffer a loss. Unlike other businesses, however, the cooperative's response depends upon the character of the organization. Two "big" issues raised in the federal income tax context, but of interest for other reasons, are: can a cooperative have a loss, and, if so, how may it be handled to preserve the cooperative character of the organization? These two questions are addressed in the following opinions.

A. Cooperative Alternatives



Associated Milk Producers, Inc., v. Comm'r
68 T.C. 729 (1978)

FAY, Judge: *** Petitioner having conceded certain of the adjustments contained in the notice of deficiency, the issues remaining for our decision are as follows:

(1) Whether petitioner, a dairy cooperative subject to the provisions of subchapter T (secs. 1381-1388), 1/

[1/ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended.]

is entitled to offset its net income for the years 1962 through 1966 by the carryforward of net operating losses incurred prior to 1962;

(2) Whether petitioner is entitled to deduct certain amounts which it paid to cover deficits of a patrons' trust which provided life insurance for patrons.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioner is an agricultural cooperative organized and existing under the laws of the State of Kansas, with its principal place of business in San Antonio, Tex. Petitioner is the successor of Rochester Dairy Cooperative, which merged into petitioner in 1969, and upon whose tax liabilities this case is based. For convenience Rochester is sometimes hereinafter referred to as petitioner.

During all of the taxable years at issue, Rochester was an agricultural cooperative, organized and operating under the laws of Minnesota, and dealing in dairy products. It operated a milk processing plant in Rochester, Minn., at which it received raw milk from its member-patrons and processed it into various products, including pasteurized fluid milk (both in bulk and packaged for retail sale), butter, and dried milk powder. For its fiscal years ended September 30, 1959, 1960, and 1961, Rochester filed income tax returns on Form 990-C as an exempt farmers' cooperative under section 521. Commencing with its 1962 fiscal year and for all subsequent years at issue, Rochester did not claim exempt status under section 521, but filed corporation income tax returns on Forms 1120. 2/

[2/ Despite the tax "exemption" provided to certain farmers' cooperatives under sec. 521, such cooperatives are subject to the corporation income tax and the alternative tax on capital gains (sec. 1201), but with special deductions allowed for patronage dividends, which normally result in no taxable income. The tax treatment of cooperatives is set forth in secs. 1381-1388 (subch. T), which sections were adopted in 1962 to replace comparable provisions in sec. 522, which was then repealed.]

During the years at issue, a milk producer could become a member-patron of Rochester by purchasing 1 share of \$1. voting stock. After becoming a member-patron, the producer was entitled to deliver milk to Rochester's processing facilities for which the producer was paid (on a semimonthly basis) at approximately the going market price for raw milk in the area. Rochester did not enter into contracts with its patrons, and its patrons were not obligated to deliver any particular volume of milk. A patron could discontinue doing business with Rochester at any time.

The following schedule represents the number of patrons at the beginning and end of Rochester's fiscal years 1959 through 1965, the number of patrons who joined or rejoined Rochester, and the number of patrons who canceled each year:

FYE Sept. 30--	Beginning patron count	Additions	Cancellations	Closing patron count
1959	1,995	319	393	1,921
1960	1,921	184	460	1,645
1961	1,645	131	355	1,421
1962	1,421	45	467	999
1963	999	306	202	1,103
1964	1,103	217	333	987
1965	987	128	142	973

Rochester utilized the basic cooperative principle of patronage refunds or credits. That is, the annual net income of the cooperative (i.e., the excess of proceeds from sale of processed dairy products over the costs of operation, including amounts paid to member-patrons for raw milk) was allocated to the member-patrons on the basis of the relative amount of patronage during the year. Such allocation could either be paid in cash or merely credited to the account of the patron on the cooperative's books, and the cash retained by the cooperative as additional working capital. 3/

[3/ The basic Federal income tax structure applicable to these cooperative principles is to eliminate any tax at the cooperative level by permitting a deduction for patronage allocations (sec. 1382), but to require such allocations to be included in the gross income of the patron (sec. 1385). In most instances this basic principle applies even though the patronage allocation is not paid in cash, provided the noncash allocation meets certain prescribed standards (sec. 1388).]

This latter method resulted in the creation of so-called "capital reserve accounts" allocated to the individual patrons on Rochester's books. At the end of its 1958 fiscal year Rochester had a total of \$1,447,038.92 in such capital reserve accounts.

Prior to amendment in 1962, Rochester's articles of incorporation contained the following provisions here pertinent:

ARTICLE IV

Section 1. This association shall be operated without profit. It shall be so operated that the current and active patrons of the association, members and non-members alike, will currently furnish money through their patronage for capitalizing the association and with the view of revolving the capital furnished in earlier years by the patrons and others.

* * *

In the event the association suffers a loss in any year, such loss shall first be charged against the capital-reserve accounts. Provided, however, to the extent that it shall be lawful, the board of directors shall prescribe the basis on which the capital contributions, including capital-reserve accounts, of the patrons shall be reduced on account of any such loss so that the loss will be borne by the patrons on a basis deemed equitable by the board of directors. All capital furnished by deductions or otherwise under specific contracts with patrons shall also be evidenced by preferred-stock, certificates of interest, certificates of indebtedness, or credited to patrons in the capital-reserve accounts of the association, and such preferred stock certificates, certificates of interest, certificates of indebtedness, and credits shall be subject in all respects to the provisions of these articles regarding such certificates and credits.

* * *

Section 4. Net income, if any, in excess of dividends and additions to reserves and surplus shall be distributed on the basis of patronage. Distribution in such event shall be made to member-patrons and non-member-patrons alike on a patronage basis in the forms of preferred stock, certificates of interest, certificates of indebtedness, or cash. Capital reserves and surplus shall be allocated and credited to the patrons on the basis of their patronage, and the records of the association shall show the interest of the patrons in the reserves and surplus. Stockholders, as such, shall have no property rights in any capital reserves or surplus, but all patrons, whether stockholders or nonstockholders, shall have such rights in proportion to their contribution to the aggregate capital reserves or surplus of the association. To the extent permitted by law it shall be the intention of this cooperative association to operate in such manner that it shall have no net income.

Substantially identical provisions were contained in Rochester's bylaws. At Rochester's annual meeting in December 1962 the articles of incorporation and bylaws were amended to eliminate the second paragraph quoted above, dealing with the treatment of losses.

As a result of poor management, Rochester suffered losses from its operations in the amounts of \$192,433.70 for the 1959 fiscal year and \$368,274.66 for its 1960 fiscal year. In the balance sheets contained in its income tax returns for those respective years, Rochester reflected its capital reserves in amounts which had been reduced by these respective losses. However, the board of directors of Rochester, in considering the proper handling of these losses, determined that it would be inequitable to charge the current losses against the capital reserve accounts, which accounts had been established based upon prior years' patronage. Because of the turnover of patrons from year to year, some patrons of prior years would have had their reserve accounts reduced even though they were not patrons during the loss years. The board also feared that the reduction of prior reserve accounts would anger the patrons, resulting in a serious loss of future business to competing dairies. Accordingly, the board determined that the 1959 and 1960 losses should be in effect carried forward to future profitable years, by reducing or eliminating what would otherwise be the patronage refund allocations of such future years. Accordingly, net income of the years 1962 through 1966 was offset and patronage refund allocations eliminated until the entire amount of the prior years' losses was absorbed.

In its tax returns for its fiscal years ended September 30, 1959 and 1960, Rochester reported deductions in excess of gross income in the amounts of \$192,433.70 and \$368,274.66, respectively. In its tax return for its fiscal year ended September 30, 1961, Rochester reported a net loss of \$11,749.25. Included in its 1961 return were the following pertinent items:

* * *

For the 5 years preceding its 1959 fiscal year Rochester had no taxable income to which it could carryback a net operating loss. On its income tax returns for the years commencing with the year ended September 30, 1962, Rochester claimed net operating loss carryforward deductions pursuant to section 172, and utilized the claimed net operating losses to offset net income in the following amounts:

* * *

Throughout the years at issue, Rochester faced stiff competition from commercial creameries and other cooperatives in attracting and retaining member-patrons who would provide a steady supply of raw milk. Rochester had a very large physical plant and required a substantial amount of raw milk daily in order to utilize the plant at optimum efficiency. Thus, it was vital to maintain membership and to maximize the supply of milk in order to avoid substantially higher unit costs which resulted from operation of the plant below capacity.

In an effort to make membership more attractive and thereby compete more effectively for milk suppliers, in 1965 Rochester established a program to provide life insurance and retirement benefits for its patrons. On April 1, 1965, a trust was established, denominated "Rochester Dairy Cooperative Patrons' Beneficial Trust" (hereinafter sometimes referred to as the Patrons' Trust). Under the program, Rochester withheld from its normal payments to members for milk a "retain" of 2 cents per hundredweight of milk delivered. These retained amounts were then paid over by Rochester to the Patrons' Trust, which utilized the funds to pay for insurance on the lives of the respective patrons. Each participant in the plan was entitled to a minimum level of insurance coverage, and the amount of coverage increased incrementally with the volume of patronage with Rochester.

This program was well received by Rochester's patrons. During the first years of operation of the plan and the Patrons' Trust, the amounts paid by the members through retains paid for most, but not all, of the costs of the Patrons' Trust. In these circumstances Rochester made payments to the Patrons' Trust out of its general funds sufficient to cover the trust's deficits in the amounts of \$5,845.92 in fiscal 1966, \$7,900 in fiscal 1967, and \$8,800 in fiscal 1968. After these initial years the trust did not run deficits, and Rochester made no further such contributions. Respondent has disallowed the amounts so paid in the 1966 through 1968 fiscal years as deductions in Rochester's returns for those years.

ULTIMATE FINDING OF FACT

The payments by Rochester from its general funds to make up the deficits of the Patrons' Trust were ordinary and necessary business expenses of Rochester.

OPINION

Respondent has disallowed petitioner's net operating loss carryforward deductions for the years 1962 through 1966. These deductions were claimed under section 172, based upon net operating losses reported by petitioner for the years 1959 through 1961. Respondent does not here dispute the amounts of the reported net losses from operations during 1959 and 1960; 4/

[4/ Respondent has challenged the \$11,749.25 net loss reported for 1961. This sub-issue is dealt with hereinafter.]

he does, however, contest petitioner's right to utilize the net operating loss carryover deduction of section 172.

Respondent's position in this case is not based upon any statutory exception to the loss carryover privilege, clearly stated in section 172, but upon respondent's theoretical perception of a cooperative as an exceptional entity which by its nature cannot ordinarily have a net operating loss for tax purposes. Respondent argues that the basic principle of a cooperative is that it operates at cost (after patronage dividend allocations) for its member-patrons. Pursuant to this "cost" principle, respondent contends, in any year in which expenses exceed gross income, this "loss" must be recouped from the members who were patrons for that period (i.e., the exact converse of a patronage dividend allocation when income exceeds expenses), so that the cooperative will then have operated at cost. The recovery of the operating deficit from the current patrons would thus eliminate any net operating loss for tax purposes. Respondent contends that Rochester was bound by its own articles of incorporation to recover losses in this fashion, and that case law supports its right to do so.

We consider respondent's position herein not only contrary to the express provisions of section 172, but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives. The deductions claimed are clearly authorized by section 172. There is nothing within that section or the regulations thereunder which indicates that the net operating loss deduction is not applicable in the case of a cooperative subject to subchapter T. In fact, quite to the contrary, the utilization of the net operating loss deduction by cooperatives is clearly implicit in certain subsections of the Code and the Income Tax Regulations, and in various of respondent's rulings dealing with cooperatives.

At the outset we note that section 172 itself contains a subparagraph applicable specifically to a certain type of cooperative. Section 172(b)(1), dealing with the years to which losses may be carried, refers specifically in subparagraph (G) to Banks for Cooperatives. 5/

[5/ Banks for Cooperatives are themselves cooperative organizations. See 12 U.S.C. sec. 1134 (1970).]

Section 172(b)(1)(G) reads as follows:

(G) In the case of a Bank for Cooperatives (organized and chartered pursuant to section 2 of the Farm Credit Act of 1933 (12 U.S.C. 1134)), a net operating loss for any taxable year beginning after December 31, 1969, shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss. [Emphasis added.]

Although this paragraph was adopted in 1969, subsequent to the years at issue herein, it was adopted for the purpose of lengthening the carry period for losses of this type of cooperative and its legislative history clearly indicates the previously existing availability of section 172. The Senate Finance Committee report contains the following pertinent language:

5. Banks for Cooperative (sec. 905 of the bill and sec. 172 of the code).

Present law.-- Under present law the thirteen existing banks for cooperatives are not allowed the same bad debt reserve deduction as commercial banks because they do not receive deposits, and, therefore, are not treated as banks under Internal Revenue Service rulings. Nor are these banks allowed any different net operating loss carrybacks than regular corporations. In other words, they are allowed a 3-year carryback and a 5-year carryforward of net operating losses.

* * *

Explanation of provision.--For the above reasons, the committee amendments provide that banks for cooperatives (as defined in section 2 of the Farm Credit Act of 1933) are to be allowed a 10-year net operating loss carryback, in addition to the 5-year carryforward now available.

[Emphasis added. S. Rept. 91-552 (1969), 1969-3 C.B. 423, 599.]

In addition, the regulations under subchapter T, governing the tax treatment of cooperatives, although not specifically authorizing the utilization of the net operating loss deduction, make several specific references to the deduction. See secs. 1.1383-1(a)(2) and 1.1383-1(b)(3), Income Tax Regs. An example contained in sec. 1.1383-1(d), Income Tax Regs., includes the following sentence:

In addition, under this alternative method the X Cooperative cannot use \$50,000 as a deduction for 1966 so as to increase its net operating loss for such year for purposes of computing a net operating loss carryback or carryover.

Respondent's position herein is also inconsistent with references to net operating loss deductions in several published rulings dealing with cooperatives. See, for example, Rev. Rul. 70-328, 1970-1 C.B. 5, reciting that the subject cooperative's operations "resulted in a net operating loss as defined in section 172(c) of the Code." In fact, Rev. Rul. 65-106, 1965-1 C.B. 126, specifically discusses the effect of net operating loss carryovers and carrybacks upon patronage dividend deductions. Moreover, respondent's own income tax Form 990-C Exempt Cooperative Association Income Tax Return, utilized by Rochester for each of its fiscal years 1959 through 1961, contains a separate line (35(a)) providing for the net operating loss deduction.

Finally, we note two recent cases in which the courts, in deciding whether a cooperative is entitled to a section 46 investment credit for property acquired in a year of a net operating loss, stated as an assumed premise that the section 172 carryback and carryforward would apply to the net operating loss. Farmers Grain Marketing Terminal v. United States, 434 F. Supp. 368 (N.D. Miss., June 20, 1977, 40 AFTR 2d 77-5182, 77-2 USTC par. 9533); Farmers Union Marketing & Processing Assn. v. United States, F. Supp. (D. Minn., Feb. 1, 1977, 39 AFTR 2d 77-963, 77-1 USTC par. 9213). In fact, in Farmers Union the presumed availability of the net operating loss carryback and carryover provisions was the very basis for the decision on the investment credit issue.

Respondent relies upon the fact that Rochester's articles of incorporation and bylaws which were in effect at the time that the losses occurred required that these losses be charged against the capital reserve accounts. He asserts that Rochester ignored this provision and improperly carried the losses forward to reduce future year's income which would otherwise have been available for patronage dividends. We disagree with respondent's interpretation of Rochester's articles and bylaws. The requirement that losses first be charged against the capital reserve accounts, in our view, merely stated a general principle that losses should be offset against accumulated income (i.e., capital reserve accounts) before being charged against the capital stock accounts. The principle is equivalent to that of an ordinary corporation charging a loss against its retained earnings account before charging its capital stock, paid-in surplus, or any other capital account. Interpreted in this general sense, the provision in question does not require that the loss in any given year be charged only against the then existing capital reserve accounts -- as opposed to charging it against net income (which would otherwise be allocated to patrons and become additional capital reserves) in later periods, as petitioner chose to do.

Thus, in one way or another, the losses will be charged against capital reserves. However, in a dogmatic effort to preserve the symmetry of the so-called annual "cost" principle of cooperative operations, respondent insists that the losses of any year must be charged against existing capital reserves, and cannot be carried over and charged against future income. The question naturally arising is: What difference does it make? The only difference which we can perceive is in the effective allocation of the losses among the cooperative's past and future member-patrons. Thus, if the losses are carried forward and reduce income and patronage dividend allocations of later years, the patrons of such later years, many of whom may not have been patrons during the loss years, will effectively bear those losses. On the other hand, if as respondent contends, the losses are charged to capital reserves existing at the end of the loss year, the burden of the loss might be allocable to the specific patrons of the loss year, but only to the extent that such patrons had capital reserve accounts from prior years' patronage.

Of course, some of the patrons of the loss year may not have been patrons prior to that year, and would thus not have existing capital reserve accounts to which their allocable share of the current year's loss could be charged. Respondent suggests that in these cases the cooperative should seek cash reimbursement from such patrons of the loss year. Although respondent cites cases holding that a cooperative has the legal right to assess patrons for reimbursement of losses, it is not at all clear whether Rochester possessed such legal authority under the law of Minnesota. 6/

[6/ See Elliott v. Adeckes, 59 N.W. 2d 894 (Minn. 1953), holding that patrons were not liable to a bankruptcy trustee for deficits of their cooperative; Minn. Stat. Ann. sec. 300.27 (West 1969), providing, inter alia, that no stockholder of a cooperative shall be liable for any debt of the cooperative.]

Moreover, regardless of what might have been Rochester's legal rights, we consider such a recoupment attempt highly impractical for a cooperative operating in a competitive environment, as was Rochester. The impracticality of such a step merely to preserve the "cost" principle of cooperative operation certainly calls into question the sanctity with which respondent views that principle.

The same articles of incorporation and bylaws upon which respondent relies as requiring that losses be charged to capital reserve accounts, go on to provide that the allocation of such charges among the various patrons' reserve accounts is to be determined on an equitable basis by the board of directors. Rochester's board of directors did in fact consider this question and determined that it would not be fair to allocate the losses to existing capital reserve accounts, and that charging them to future net income would be more equitable.

We fail to see any legitimate interest of respondent in the mechanics of petitioner's allocation of losses among its past, current, or future member-patrons. See Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326, 333 (8th Cir. 1961), affg. in part and revg. in part 31 T.C. 674 (1958). The so-called "cost" principle of cooperatives which respondent espouses with unaccountable zeal as the underlying basis for his position in this case appears to have emerged from no greater a source than certain incidental language in a 1969 ruling on an unrelated question of cooperative accounting. Rev. Rul. 69-67, 1969-1 C.B. 142, holding that a cooperative's yearend inventories should be valued at cost, contains the following paragraph:

One of the fundamental principles associated with a farmers' cooperative is that it is operated at cost for its patrons. This principle is usually evident when the net earnings (net savings) resulting from the operation of the cooperative from business done with or for its patrons are returned by the cooperative to its patrons in proportion to the amount of business done with or for each patron.

Certainly there is nothing in this language, nor in the substance of the ruling, which would warrant the exaltation of the quoted language into a full-blown principle of tax accounting, rendering the net operating loss carryover unavailable to cooperatives. Respondent has referred to no compelling policy considerations or dangers of tax avoidance which might even warrant an attempt to deny such carryover in the face of the clear language of section 172.

In addition to his basic position prohibiting the carryforward of losses incurred in 1959 and 1960, respondent has also questioned the correctness of the net loss reported by petitioner for fiscal 1961. In its 1961 return petitioner reported net income of \$15,831.75 (before its patronage dividend deduction). It claimed a patronage dividend deduction of \$27,581, and thus, reported a net loss of \$11,749.25. Respondent contends that under section 522 (the predecessor of present subchapter T), which was applicable in 1961, a patronage dividend deduction could not exceed the cooperative's net income for the year. The technical correctness of this assertion is not entirely clear, but it need not be decided here, since the record indicates that in fact Rochester's 1961 patronage dividend did not exceed its book net income.

The principal reason that a net loss was reported in its 1961 tax return was that the net loss reported for tax purposes on the sale of a building in that fiscal year was \$12,500 greater than the loss for book

purposes on such sale, due to a book write-down for obsolescence in fiscal 1960, which write-down had been charged against 1960 operations, but not deducted in the 1960 return. Thus, the 1961 net income for book purposes, upon which the patronage dividend was based, was higher than the net operating income for tax purposes. 7/

[7/ The exact difference was \$11,749.25, consisting of the \$12,500 additional loss in connection with the sale of the building, offset by \$750.75 in charitable contributions which were a book expense, but not deductible for tax purposes due to the limitations of sec. 170.]

In these circumstances it does not appear that the 1961 patronage dividend exceeded 1961 book income. The net operating loss reported for tax purposes, therefore, resulted from merely a timing difference in connection with the reporting of the loss on the building. Thus, respondent's disallowance of the net operating loss carryforward is no more justifiable with respect to the 1961 net operating loss than it is for the 1959 and 1960 losses. 8/

[8/ In Rev. Rul. 74-274, 1974-1 C.B. 247, it was held that a patronage dividend, as defined in sec. 1388, could not be deducted to the extent it exceeded net income from patronage business reported for Federal income tax purposes (in a case where book income was greater than taxable income due to variations in depreciation methods). Although this ruling is not applicable to the year 1961, when sec. 522 was the governing Code section, we have serious doubts as to its correctness even as an interpretation of sec. 1388.]

Accordingly, we hold that respondent erred in disallowing the net operating loss carryover deductions claimed by Rochester for each of the years in question.

The second issue herein involves certain payments by Rochester in its fiscal years 1966 through 1968 to the Patrons' Trust, to cover the deficits of the trust for those years. Petitioner contends that such payments are deductible as ordinary and necessary business expenses under section 162. Respondent, however, views the payments as nondeductible "dividends" to Rochester's member-patrons.

Petitioner basically argues that the establishment of the Patrons' Trust and the related patrons' life insurance plan was intended primarily to make patronage of Rochester more attractive and thereby help increase the essential supply of milk to its large plant. The maintenance of a satisfactory supply of milk from patron dairy farmers in the face of stiff competition was critical to Rochester's ability to operate its plant at economical unit costs. In essence, the plan was promotionally motivated. Respondent, in fact, does not dispute this. The plan was well received and helped Rochester significantly in attracting and retaining patron-suppliers. Thus, Rochester had a strong business interest in the continued successful operation of the plan. In these circumstances, the payment of the trust's relatively modest deficits for its first 3 years in order to assure its smooth continuance seems an eminently prudent, ordinary, and necessary expense of Rochester's business.

Section 162(a) provides for the deduction of ordinary and necessary business expenses as follows:

IN GENERAL.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

Cases interpreting the phrase "ordinary and necessary" are legion and need not be reexamined in detail here. There are, however, several cases quite similar to the instant case, and which, we believe, clearly establish that under the factual circumstances herein, the payments in question were ordinary and necessary business expenses of Rochester.

It is well established that expenses incurred to protect, maintain, or preserve a taxpayer's business, even though not in the normal course of such business, are deductible as ordinary and necessary business expenses. See, e.g., United States v. E.L. Bruce Co., 180 F.2d 846 (6th Cir. 1950); L. Heller & Son, Inc. v. Commissioner, 12 T.C. 1109 (1949); Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948).

In Crowder v. Commissioner, 19 T.C. 329 (1952), the taxpayer was engaged in the operation of a funeral home. In order to meet competition and preserve his business, he organized a mutual aid association to which members made contributions for burial insurance. The taxpayer, who had no ownership interest in the association, had organized it with the expectation that the insured members would utilize the services of his funeral home. The taxpayer made certain payments to the association to cover operating deficits in its early years. We held that such payments were ordinary and necessary expenses to protect and promote the taxpayer's business, and we consider the Crowder case directly analogous here. See also Hennepin Holding Co. v. Commissioner, 23 B.T.A. 119 (1931) (expense incurred by landlord to advertise business of important tenant); Dinardo v. Commissioner, 22 T.C. 430 (1954) (payments by medical partnership to cover deficits of hospital which was important source of partnership business); Snow v. Commissioner, 31 T.C. 585 (1958) (payments by law firm to cover operating deficits of savings and loan association organized as a source of legal business for the firm). In all of these cases (and a host of others not here cited) the concept of "ordinary and necessary" business expenses was held to include expenditures, even though seemingly made on another's behalf, motivated to protect or promote the taxpayer's business.

Respondent acknowledges Rochester's pressing need to maintain its milk supply in the face of stiff competition and also acknowledges that the insurance plan and Patrons' Trust were materially helpful in Rochester's retaining patrons. Nonetheless, respondent contends that the payments by Rochester to the trust were not ordinary and necessary business expenses, but were for the direct benefit of the patrons who obtained insurance through the trust, and as such, must be treated as dividends. Apparently based in part upon his theoretical view of a cooperative as an effective nonentity incapable of incurring its own business expenses not directly related to patronage activities, respondent's position appears sadly anemic in the face of section 162, as interpreted by the cases discussed above.

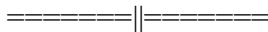
Respondent argues in effect that expenses incurred to protect or preserve its business cannot be considered ordinary and necessary business expenses in the case of a cooperative since a cooperative is a neutral entity which merely serves its members, cannot have business objectives of its own, and should not continue to operate if it must resort to "extraordinary" payments to patrons in order to induce patronage. Thus, he argues, the indirect payment (through the payments to the Patrons' Trust) of member-patrons' life insurance premiums as an inducement to maintain patronage must be viewed as a dividend to such patrons since if patronage cannot be maintained without such extraordinary payments, the cooperative is not a viable organization and should fail.

Unfortunately, in his preoccupation with the theoretical precepts of cooperative operation, respondent seems to have lost touch with the economic reality of Rochester's particular situation. Rochester operated a very large milk processing plant. Rochester's former chairman testified that this plant was considered the largest of its type in the world. This plant was owned by Rochester's member-patrons, through their retained equity interest in Rochester. Economical operation of a plant of this size required a substantial volume of raw milk deliveries, and thus, certain levels of patronage were essential. If patronage was inadequate, the plant would operate at a loss, which would have to be borne by the member-patrons. Thus, even if Rochester as an entity is ignored, it is clear that the member-patrons themselves, as beneficial owners of Rochester's plant, had a very real and material interest in the maintenance of patronage levels. In such circumstances, Rochester's expenditures in connection with the Patrons' Trust were no more extraordinary than if Rochester had expended the same amounts in direct mail solicitation costs, or other forms of promotion to potential patrons. The fact that the payments to the trust also incidentally benefited certain member-patrons who were participants in the insurance plan does not vitiate their deductibility. Cf. Rodgers Dairy Co. v. Commissioner, 14 T.C. 66 (1950). The two cases relied upon by respondent in support of his claim that the payments should be treated as dividends are clearly distinguishable in that both involved payments by closely held corporations which benefitted controlling stockholders, with no corporate business purpose.

Accordingly, we have found as an ultimate fact, and we hold, that the payments by Rochester to make up the deficits of the Patrons' Trust were ordinary and necessary business expenses, deductible under section 162.

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The following article, Baarda, James R., "Farmer Cooperative Loss Allocation: Survey of Federal Income Tax Considerations," 7 J. AG. TAXATION & LAW 40 (1985), surveys the combination of netting and losses issues.



Farmer Cooperative Loss Allocation: Survey of Federal Income Tax Considerations

Hard Times for the Farming Industry

Not unexpectedly, recent economic difficulties facing the farming sector of the U.S. economy are reflected in the economic and financial performance of businesses owned and controlled by farmers which are used to market their products and supply factors of production. The U.S. Department of Agriculture's (USDA's) Agricultural Cooperative Service estimates that 695 of the 6,211 farmer cooperatives operating during 1982 suffered losses.²⁸ In 1983, 702 of 5,989 cooperatives showed losses.²⁹ These figures represented 11 percent and 12 percent, respectively, of all farmer cooperatives.

The picture was similarly bleak for the larger cooperatives. The Agricultural Cooperative Service reported that for cooperatives with fiscal years ending in 1982, eighteen of the largest 100 farmer cooperatives in the United States suffered losses totaling \$248 million.³⁰ Though the number of cooperatives in the top 100 reporting losses in 1983 was lower than for 1982, the loss situation was still significant. In 1983, twelve of eighty-nine cooperatives not operating on a pool basis reported losses (about 14 percent).³¹ Losses in 1982 equaled two thirds of the amount of net margins, compared to 7.6 percent in 1983.³²

Margins and losses are not necessarily uniform among all services a cooperative provides to its patrons.³³ A cooperative with an overall net margin may have suffered losses in some of its operations, though total margins were more than enough to offset losses. A cooperative showing aggregate net operating losses may have had net margins in some of its operations. When both margin and loss situations occur as described within a cooperative performing multiple services for its farmer owner-users, the cooperative members must decide what to do. One of the critical decisions to be made is how losses and margins are to be allocated among groups of patrons whose business with the cooperative generated the margins or losses.

Federal income taxes are a major factor in nearly any business decision. Such is the case for allocation of net operating losses among operational units in a cooperative. Allocation of losses in a manner found unacceptable by the IRS may result in loss of Section 521 tax status or loss of deduction for patronage refunds given in Section 1382 of the Internal Revenue Code (the Code).

²⁸Agricultural Cooperative Service, unpublished findings. The 1982 data were estimated from a sample of cooperatives.

²⁹Agricultural Cooperative Service, unpublished findings. The 1983 data were generated from a survey of all farmer cooperatives, not a sample.

³⁰Davidson & Street, "Top 100 Boost Margins Despite Lower Volume," in Farmer Cooperatives 6 (U.S.D.A., Farmer Cooperative Service, Sept. 1984). Eight of the top 100 used pool accounting methods, reporting no net margin or loss. Thus, 20 percent of the largest 100 cooperatives whose operating methods could show a loss did so.

³¹Id.

³²Id.

³³See id. for examples of variation among commodity groups.

This article addresses tax issues raised when a cooperative has net operating losses in some of its operations and net margins in others.³⁴ Specifically, the article discusses current federal income tax considerations of decisions a cooperative may take concerning allocation of losses among patrons and groups of patrons. Its purpose is to survey the kinds of options open to a cooperative when net margins and net operating losses occur simultaneously in the same cooperative, and to identify the federal income taxation issues raised and the current status of unresolved issues. Discussion is limited to a survey of principles, and no attempt is made to address tax accounting, economic, or financial aspects of loss allocations.

Cooperative Principles

Disposition of net margins in a cooperative is a distinctive feature of the cooperative business enterprise. Allocation of net margins or losses among patrons or groups of patrons is in turn based on the return-of-margins principle. The IRS's positions with regard to loss allocation are based in part on specific provisions of Subchapter T of the Code and the Service's perception of what a cooperative is. The set of rules that specify characteristics of a cooperative enterprise making it a distinct kind of business are usually summarized as "cooperative principles." Statements of cooperative principles and expressions of cooperative principles in statutory descriptions of how farmers may conduct their affairs through cooperatives leave wide latitude in allocations within the cooperative enterprise among patrons and groups of patrons. A brief look at cooperative principles and their place in the law helps identify the extent to which tax enforcement policies may limit generally accepted allocation methods.

The first set of rules commonly considered cooperative principles was a combination of true principles and desirable business practices. Developed by a consumer cooperative of flannel weavers in England in 1844, these rules, though outdated in many respects, are still considered first expressions of modern cooperative principles.³⁵ In the United States, the Patrons of Husbandry (the Grange) developed a statement of cooperative principles in 1876 in response to widespread misunderstanding about what cooperatives were and what they could and could not do for farmers, and as a result of frequent failures of newly formed cooperatives.³⁶ The major Grange principles describe the way most cooperatives in the United States now operate, though most cooperatives have discarded some of the principles.³⁷

³⁴Discussion is limited to net operating losses. Capital losses or other extraordinary loss situations are not considered.

³⁵Scroggs, "Cooperative Principles--and How they Grew," in *Cooperatives-Keystone of Agriculture 1980-81*, at 153-159 (Washington, D.C.: American Institute of Cooperative, 1981). For other descriptions of cooperative principles and their growth, see M. Abrahamsen, *Cooperative Business Enterprise* (1976), and references cited therein at 69-70.

Rochdale principles were:

1. The store is open to all.
2. The store charges ordinary market prices.
3. The store receives only ready money and gives no credit.
4. The store gives dividends in proportion to purchases.
5. Every member must have a share or shares and receive good interest on them.
6. All are equal in voting power, whether they have few or many shares.
7. The store sells genuine articles that are what they profess to be.
8. The store has an honest manager and an active committee.
9. The Society insists on an efficient and intelligent audit and stock taking.

³⁶Note 12 infra.

³⁷Id. The 1876 Grange principles were:

1. One member, one vote.
2. Limitation of interest on invested capital.

The most recent statement of general cooperative principles was developed by the International Cooperative Alliance. The original statement of principles was developed in 1937 and restated in 1966.³⁸ The first four were considered essential, the last three desirable.

In 1965, the USDA studied the criteria commonly used to describe the characteristics of a business enterprise unique to cooperatives.³⁹ The Criteria listed in that publication provide a concise description of operation as cooperative business enterprise. The criteria include:

1. The basic purpose of a cooperative is to render economic benefits to its members.
2. Cooperatives are organized around the mutual interests of members.
3. Cooperatives are essentially nonprofit enterprises in the sense that they are not organized to make monetary gains for cooperatives as legal entities or for their members as investors, but primarily for all patrons as users of their services.
4. Cooperatives are democratically controlled.
5. Risks, costs, and benefits are shared equitably among members.
6. Members have an obligation to patronize their association.
7. Cooperatives do business primarily with members.⁴⁰

Contemporarily formulations of cooperative principles vary, but do not differ fundamentally from traditional principles. Combining the summary statements of principles with the descriptive formulation of the Farmer Cooperative Service permits a description of modern farmer cooperatives expressed in four principles:

1. Cooperatives are owned and democratically controlled by those who use their services.
2. Surplus is distributed to users in proportion to their use of the cooperative.
3. Returns on investment are limited.
4. Cooperatives are financed substantially by those who use their services.

Overview of Cooperative Tax Principles

Just as the cooperative business enterprise operates according to special rules with respect to its purposes and method of providing services, so the tax treatment of a cooperative recognizes its difference from the investor-owned, profit-seeking corporate business,⁴¹ and applies special principles of taxation to qualifying cooperatives. The general result of the applicable principles is that income flowing into the cooperative which must be passed through to patrons who use the cooperative is not taxed as corporate income to the cooperative entity. Instead, the patron receiving the surplus as a patronage refund takes the refund into account in determining his income tax calculation. Subchapter T⁴² of the Code contains requirements an organization must meet to qualify for deduction of patronage refunds.

-
3. Payment of dividends on patronage.
 4. Cash trading.
 5. "Neither fear nor court competition."

³⁸

³⁹Savage & Volkin, "Cooperative Criteria," Service Report 71, at 9 (U.S.D.A., Farmer Cooperative Service, 1965).

⁴⁰Id.

⁴¹Most cooperatives are corporations organized under state cooperative incorporation statutes. See Baarda, "State Incorporation Statutes for Farmer Cooperatives" (U.S.D.A., Agricultural Cooperative Service, 1982).

⁴²I.R.C. Sec. 1381-1388

When a cooperative has a net margin⁴³ and that net margins distributed to patrons on the basis of their use of the cooperative,⁴⁴ Section 1382 permits the cooperative a deduction for such patronage refunds.⁴⁵ Deduction is permitted only when the patronage refunds meet certain criteria.⁴⁶ In general, deduction will not be granted for a refund from net margins generated from business other than that with or for patrons. "Nonpatronage sourced" income is taxed as corporate income at the cooperative level as well as to the patron when received. Income, from whatever source, will not be deductible by the cooperative if returned to the patron on a basis other than patronage, such as in proportion to investments in the cooperative.

The member-patron⁴⁷ financing practices noted in the description of cooperative principles has led, over many years, to financing techniques unique to cooperatives. In the parlance of the code, a cooperative may issue a "written notice of allocation" in lieu of a cash patronage refund.⁴⁸ If the written notice of allocation is "qualified,"⁴⁹ the cooperative may deduct amounts paid in cash and by qualified written notice of allocation, and the patron takes the entire amount into account for his income tax purposes.⁵⁰ The process can be treated essentially as a payment of the refund to the patrons and an investment of part of the refund back into the patron's cooperative. When the equity is "redeemed" in following years as replaced by other equity or as no longer needed, there is no taxable event. If the allocation is not a qualified written notice, the cooperative may deduct only a cash portion and the patron accounts for only the cash portion received. At redemption, the cooperative receives a deduction while the patron receives taxable income.

A per-unit capital retain⁵¹ is based on units of patronage rather than net margins. For example, a cooperative may issue a per-unit capital retain for each cwt of milk delivered to the cooperative. Per-unit capital retains are contributions to capital and are generally taxed as such, and may be qualified or nonqualified.

⁴³The term "net margin" rather than "profit" is commonly used by cooperatives to describe excesses of income over expenses. This emphasizes the cooperative's obligation to account for such margins to its patrons in proportion to their use of the cooperative. See cooperative principles at notes 8, 10, 11 supra.

⁴⁴See cooperative principles at notes 8, 10, 11 supra.

⁴⁵The Code uses the term "patronage dividends." The term "dividends" is not used among cooperatives because it confuses patronage refunds with returns on investment, a distinctly different use of net margins. In this article "patronage refunds" will be used exclusively.

⁴⁶Definition of "patronage dividend" is given in Sec. 1388(a). Some specific provisions are noted below.

⁴⁷A cooperative may deal with patrons who are not members. Tax treatment of margins and refunds does not significantly differ, for member or nonmember patrons share net margins as patronage refunds. The term "patrons" is used throughout this article.

⁴⁸Defined in I.R.C. Sec. 1388(b).

⁴⁹Defined in I.R.C. Sec. 1388(c).

⁵⁰I.R.C. Sec. 1385 describes patrons' tax treatment. Two important requirements are that at least 20 percent of the refund be paid in cash, and the patron must consent, by defined methods, to take the entire amount into account for tax purposes.

⁵¹Defined in I.R.C. Sec. 1388(h).

Patronage refund deduction rules apply to "any corporation operating on a cooperative basis."⁵² A farmer cooperative meeting several fairly strict requirements is entitled to two additional deductions.⁵³ A Section 521 cooperative may deduct dividends paid on capital stock and incidental nonpatronage sourced income actually paid as patronage refund.⁵⁴ Other than the two additional deductions, a Section 521 cooperative is treated much the same as non-Section 521 cooperative.

Net Operating Losses

Though the Code addresses only net margins and their distribution as patronage refunds, a cooperative's expenses may exceed income. In many cases,⁵⁵ a cooperative may pay a "market price" for products received from a patron when delivered. This advance is added to operating expenses to determine total expenses for the accounting period. For a number of reasons, the combined advances and operating expenses may exceed income.

This net operating loss may be handled several ways (as discussed below). The use of retained patronage refunds and per-unit retains to pass the loss on to the patrons is noted here. A cooperative with a net operating loss may reduce the retained equity of patrons and former patrons. When this is done, the patron incurs a loss. For example, the cooperative may redeem the equity at less than face value. In that event, the patron suffers an ordinary loss in that year to the extent of the difference between the face value and the redemption payment.⁵⁶ Similarly, the cooperative may give written notice (analogous to the written notice of allocation) that the equity account has been reduced, the redemption being a loss for the patron.⁵⁷

Code Provisions

Service rulings and other statements about loss allocation are based, according to the IRS, on three provisions of the Code. The Code's language gives a starting point from which to trace service rules promulgated in the last twenty years about net operating loss allocation.

Subchapter T applies to "any corporation operating on a cooperative basis."⁵⁸ Because no further definition of a cooperative is given in the Code, the IRS has used principles of cooperative operation to describe how a cooperative operates and, thus, how a cooperative may allocate losses when they occur.

Cooperative principles definitions used as guidelines for Subchapter T qualification are found in the definition of a patronage refund (patronage dividend) given in the Code⁵⁹:

⁵²I.R.C. Sec. 1381(a)(2).

⁵³I.R.C. Sec. 521. These cooperatives are called "exempt" for Code purposes, but because they are not truly exempt organizations, the term "Section 521 cooperatives" is preferred.

⁵⁴I.R.C. Sec. 1382(c).

⁵⁵A "typical" situation does not exist, and the dangers of such fiction should be recognized.

⁵⁶For further descriptions of loss transfer to patrons, see Rev. Rul. 70-64, 1970-1 C.B. 36; Rev. Rul. 81-103, 1981-1 C.B. 447 (redemption of nonqualified written notices of allocation by payment in cash and cancellation of accounts receivable from prior loss year); Ltr. Rul. 7926068 (March 29, 1979); Ltr. Rul. 7950064 (Sept. 14, 1979); Ltr. Rul. 8031041 (May 8, 1980); Ltr. Rul. 8225100 (March 25, 1982) (effects on cooperative); Ltr. Rul. 8248048 (Aug. 30, 1982); Ltr. Rul. 8305051 (Nov. 2, 1982); Ltr. Rul. 8432010 (April 27, 1984).

⁵⁷See Rev. Rul. 70-407, 1970-2 C.B. 52.

⁵⁸I.R.C. Sec. 1381(a).

⁵⁹I.R.C. Sec. 1388(a).

Patronage dividend. For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part 1 of this subchapter applies--

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such an amount, which obligation existed before the organization received the amount so paid, and
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

A third provision of the Code, in addition to Section 1381(a) and 1388(a), relates only to Section 521 cooperatives.⁶⁰ The "exemption" applies to farmer cooperatives that are:

[O]rganized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

These three provisions of the code are applied in various situations by regulations, revenue rulings, and Service letter rulings. Because no mention is made in the Code of cooperative losses, the Code has been interpreted by rulings in particular circumstances. Changes in Code interpretation by the IRS, and in turn courts' analyses and acceptance or rejection of the IRS's position, have resulted in some uncertainty about proper tax treatment of net operating loss allocation over the last several years.

Examples of Loss Allocation Situations

The most direct way to consolidate and interpret the considerable number of revenue rulings and private letter rulings on loss allocation is to describe several kinds of circumstances facing cooperatives that have incurred a net operating loss. The examples demonstrate major categories of allocation possibilities, given different cooperative structures and methods of operation.

First, a cooperative with both patronage- and nonpatronage- sourced income or loss is described. Second, a cooperative with only patronage-sourced income or loss but with different departments or functions is discussed. Finally, cooperative allocation possibilities are outlined for a cooperative with no nonpatronage-sourced income or loss and only one department. In each case, the general situation is described, allocation options are noted, and the position of courts and the IRS are summarized.

Patronage/Nonpatronage Sources

In this patronage/nonpatronage-sourced income example, the cooperative is assumed to have income or loss from both patronage and nonpatronage sources.⁶¹ At issue are federal income tax considerations when

⁶⁰I.R.C. Sec. 521.

⁶¹Not addressed here is the difficult issue of determining whether income is patronage- or nonpatronage-sourced.

In addition to cases where the patronage/nonpatronage operations are distinct, or where the patronage/nonpatronage-sourced distinction is made by identifying the kind of transaction (e.g., interest or rental

either the patronage- or nonpatronage-sourced income or loss is netted against the other before determining taxable income or deductions available for amounts distributed to patrons as patronage refunds. Tax treatment will depend on allocation of losses between patronage and nonpatronage sources.

The patronage/nonpatronage-sourced income and loss allocation is primarily a problem for non-Section 521 cooperatives.⁶² Section 521 cooperatives will have limited nonpatronage-sourced income, and may distribute nonpatronage-sourced income to patrons and receive a deduction for the refund.⁶³ Thus, the distinction between patronage- and nonpatronage-sourced income is not as important for the Section 521 cooperative.

The present example describes the case of a non-Section 521 cooperative that can receive no deductions for nonpatronage-sourced income, even if distributed to patrons in proportion to business done with the cooperative.⁶⁴ Two situations are described for the example cooperative, and tax considerations for each allocation method are discussed.

In this example, the cooperative is assumed to have separate operations which can each independently generate either gains or losses, one generating patronage-sourced income or loss, the other generating nonpatronage-sourced income or loss. Two situations with allocation problems may occur in the given example--the cooperative may have losses from nonpatronage sources and earnings from patronage sources, or the cooperative may have nonpatronage-sourced income and patronage-sourced losses. The other two situations, where both operations have a net margin or both have an operating loss, present general netting problems if margins or losses within the operations.

payments and its relation to cooperative operation), a cooperative may be required to divide income from a single transaction into patronage- or nonpatronage-sourced income (see Rev. Rul. 74-84, 1974-1 C.B. 244, where gain on a single sale of property was divided into nonpatronage-sourced income from Section 1231 capital gain treatment while part of the gain was ordinary income by Section 1245 recapture rules and was patronage sourced), and allocate costs within a unified operation (see Rev. Rul. 74-160, 1974-1 C.B. 245, where a plywood-producing workers cooperative had to allocate operating losses in a veneer plant between member and nonmember workers), or among cooperative functions (see *Juniata Farmers' Coop. Ass'n v. Comm'r*, 43 T.C. 836 (1965); Rev. Rul. 67-128, 1967-1 C.B. 147).

⁶²Not exclusively, however. For example, if income from a sale is patronage sourced, it will be allocated to patrons who used the cooperative that year. If income is from a gain on capital investment, allocation may have to be made to all patrons active during years in which the property increased in value in proportion to their patronage during those years. See Reg. Sec. 1.1382-3(c); Rev. Rul. 68-332, 1968-1 C.B. 383.

⁶³I.R.C. Sec. 1382(c)(2).

In determining the taxable income of an organization described in section 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter)--

. . . (2) amounts paid during the payment period for the taxable year--

(A) in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done for the United States or any of its agencies or from sources other than patronage, or

(B) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation; which was paid, during the payment period for the taxable year during which the earnings were derived, on a patronage basis to a patron with respect to earnings derived from business or sources described in subparagraph (A).

⁶⁴No deduction is available because, by definition as nonpatronage-sourced income, Sec. 1388(a) requires that to be a patronage dividend the refund must be derived from business done with or for patrons on a patronage basis.

In a relatively typical situation, nonpatronage-sourced losses may occur when a cooperative deals with nonmembers on a noncooperative basis, with no obligation to return net margins to the nonmembers. At the same time, the cooperative may have net margins from business done with patrons, thus generating patronage-sourced income which, if distributed as patronage refunds, qualifies for deduction.⁶⁵ At one time the IRS held a cooperative was required to reduce net earnings from transactions with a nonmember in determining the amount of earnings available for payment as patronage refunds and the amount, if any, of a net operating loss.⁶⁶ With the revocation of Revenue Ruling 74-377, net margins from member businesses are available for distribution as patronage refunds in full without reduction by loss from nonmember business. Thus, the entire amount of patronage-sourced earnings may be distributed to patrons and may be deducted from the cooperative's taxable income under Subchapter T rules. The losses are treated as net operating losses as defined in Section 172.⁶⁷

A cooperative may have reasons to require members to make up a nonpatronage loss by reducing patronage refunds paid to patrons in the current year.⁶⁸ For example, as member-owned organizations, losses will be absorbed eventually by members, and members may wish to cover losses currently rather than treat losses as a residual decrease in member-patron equity interests. There appear to be no reasons to close this option to the membership. Revenue ruling 74-377⁶⁹ addressed only the question of whether a cooperative is required to reduce patronage-sourced income by nonpatronage-sourced losses. The ruling's statement that the entire patronage-sourced net margin is "available for distribution as patronage dividends" should not mean net margins cannot be reduced to cover nonpatronage losses.

Indeed, the Court of Appeals for the Eighth Circuit in dicta⁷⁰ noted that the practice of combining cooperative expenses and grower payments (deducted before arriving at gross income) may not be objectionable when patronage activities yield positive earnings because the deductibility of patronage refunds are limited to earnings on those activities. The court also noted fewer problems presented when a cooperative incurs a loss on its nonpatronage activities. Citing Revenue Ruling 74-377, the court said, "no avoidance of tax would result from either course of conduct: indeed, if the cooperative chose to offset the loss with current patronage income, it would have to forego the deduction for otherwise allowable patronage dividends."⁷¹

On the other hand, a cooperative with patronage-sourced losses and nonpatronage-sourced earnings may not allocate patronage losses to nonpatronage earnings, earnings which are taxed to non-Section 521 cooperatives whether distributed to patrons or retained by the cooperative. Nonpatronage-sourced income for a non-Section 521 cooperative is treated as corporate profit.

⁶⁵See notes 14-27 *supra* and accompanying text.

⁶⁶Rev. Rul. 70-420, 1970-2 C.B. 64, revoked by Rev. Rul. 74-377, 1974-2 C.B. 274.

⁶⁷Rev. Rul. 74-377, 1974-2 C.B. 274. "This net operating loss may be carried back and carried forward in accordance with section 172 to offset past or future income from business done with nonmembers to whom the cooperative has no obligation to return patronage dividends."

⁶⁸See *Plywood Mktg. Assocs. v. Astoria Plywood Corp.*, 16 Wash. App. 566, 558 P.2d 283 (1976), for a description of such a case. The Cooperative, under terms of its bylaws and applicable incorporation statutes, assessed a terminating member directly for losses sustained in prior years as a result of nonpatronage activities, improperly concealed in those years by an employee.

⁶⁹1974-2 C.B. 274.

⁷⁰*Farm Service Coop. v. Comm'r*, 619 F.2d 725, n.16 (8th Cir. 1980), rev'g 70 T.C. 145 (1978). *Farm Service* dealt with the opposite situation, where the cooperative had nonpatronage-sourced income and patronage-sourced losses. See *blow* for discussion of the case.

⁷¹*Id.*

The patronage loss/nonpatronage earnings situation was addressed in Farm Service Cooperative v. Comm'r.⁷² The cooperative in Farm Service divided its business activities into four categories: a broiler pool, a turkey pool, a regular pool (supply operation), and taxable activity. The cooperative maintained separate records for the four categories but combined the accounts for income tax purposes. Taxable income activity included gains from sale of property, dividends on a cooperative-owned stock, cancellation of outstanding dividend checks payable to former patrons who could not be located, and miscellaneous items. Some income from the regular pool was nonpatronage-sourced income. Losses in the broiler pool were offset by income from nonpatronage sources.⁷³

The Eight Circuit pointed out the distinction between Section 521 and non-Section 521 treatment of patronage- and nonpatronage-sourced income. It said that to permit a cooperative to reduce its nonpatronage-sourced income by patronage-sourced losses would be to obliterate the statutory distinction between the two kinds of cooperatives. The court stated:

We hold, then, that subchapter T requires a nonexempt cooperative to segregate its patronage and nonpatronage accounts in calculating its gross income, at least in those cases where the grower payments or per-unit retain allocations contribute to net operating losses in patronage activity. Likewise, subchapter T forbids a nonexempt cooperative to aggregate patronage losses with its income from taxable activities, if the two are separately calculated. A nonexempt cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage source income.

Interfunction, Interdepartment Netting

A second example demonstrates another class of allocation problems facing a cooperative with net operating losses. A cooperative with different functions (supply and marketing) or different departments within a function (corn marketing and soybean marketing)⁷⁴ may incur a loss with respect to one function or department but may generate net earnings with respect to another. The premise of the interfunction, interdepartment netting, then, describes a cooperative with no nonpatronage-sourced income or loss, but with a net operating loss in one department or function and a net margin in another. The problem is to determine the tax consequence of various ways margins and losses may be netted among patrons of functions or departments. Netting a loss in one department or function against the gain in another department or function before determining net margins available for patronage refunds to patrons of each department is an allocation of net margins and losses between patrons of the two functions. This relatively simple method of internal cooperative accounting has run afoul of tax principles in recent years.

While the revenue generation implications of the patronage/ nonpatronage-sourced income and loss netting methods of the previous example are quite clear, and consequent prohibitions on netting nonpatronage-sourced income against patronage-sourced losses not surprising, such is not the case for interfunction or interdepartment netting. Only net margins from patronage sources are involved and, if not offset by losses allocated from patronage-sourced losses, they would be fully deductible from the cooperative's taxable income under Subchapter T rules.⁷⁵ From a tax policy or revenue generation standpoint, therefore, netting patronage-sourced margins and losses within a cooperative are not so clearly objectionable. Under various circumstances addressed by IRS rulings and court decisions, four kinds of rationale by which

⁷²619 F.2d 725 (8th Cir. 1980), rev'g 70 T.C. 145 (1978).

⁷³The setoff was not quite so straightforward.

⁷⁴"Function" and "department" are not universal terminology but will be used consistently here.

⁷⁵See notes 14-27 *supra* and accompanying text.

to judge netting have been advanced, each of which will be discussed in the context of circumstances described below.⁷⁶

First, for Section 521 cooperatives, interfunctional netting restrictions are based on the description of qualifying cooperatives given in the Code. The second source of support for a no-netting rule, applicable to all cooperatives subject to Subchapter T rules, is an "equitability" requirement derived from the definition of patronage refunds in Section 1388 of the Code. Third, closely related to the equitable allocation requirement, is a "fairness" requirement derived from a general concept of how a cooperative must operate to be a true cooperative according to basic cooperative principles. The issue of member approval is included in this category. Finally, the statutory requirement that patronage refunds be paid pursuant to a preexisting legal obligation has suggested restrictions on a board of directors' discretion to allocate losses among functions and departments.

The present example assumes the operation of separate functions or departments, each with its own net margin or net operating loss. The separation of operations into functions or departments is addressed first. Then the case of a Section 521 cooperative is assumed, and specific rules applied are noted. Finally, a non-Section 521 cooperative with separate operations is used to demonstrate the above-described problems with interunit netting, IRS explanations, and judicial decisions on each.

Separate Operations

Limitations on interunit netting of margins and losses assume separate operations. Objections to netting are based primarily on separate groups of patrons using different services provided by the cooperative. At least some opportunity to allocate losses among groups of patrons in some disproportion to the net margins or losses attributable to each group's use of the cooperative must exist before the allocation problem exists.

Operating units may not be separately treated for loss allocation analysis for several reasons. The operations may be treated as "integrated" to the extent that they are treated as one natural allocation unit. In Pomeroy Cooperative Grain Co. v. Comm'r,⁷⁷ the court held that distribution of storage income to grain patrons was properly made to all grain patrons as part of the grain marketing function. The storage and marketing operations were part of one integrated operations. The Decision was based in part on the fact that the same facilities were used for storage and marketing operations, and that most members who stored grain subsequently used the cooperative's marketing services.⁷⁸ The IRS subsequently adopted this position by ruling.⁷⁹ Integration of separate operations into a single allocation unit may also occur when the financial and economic connections between two different operations is so pervasive that separation is not required.

A third reason permitting different operations to be combined into one is overlapping membership of the operations. This issue is discussed with respect to non-Section 521 cooperatives, below, where overlapping membership may justify netting losses and margins across truly separate departments or functions. Where a single allocation unit combines different operations as in the above examples, the interunit netting of losses and margins is not encountered. Where such integration is not sufficient, however,

⁷⁶Some principles apply in both the interunit netting of patronage-sourced income and losses example and in the case of single-department timing allocations discussed in the next section.

⁷⁷288 F.2d 326 (8th Cir. 1961). The Service had urged that storage income be distributed only to individual members who grain was stored with the cooperative. If the no-netting argument is extended to its limit, a cooperative would have to calculate net margins attributable to each patron's business. It is now uniformly held that this is unnecessary, and current netting issues begin at a "department" or "function" patron aggregation level.

⁷⁸"From a revenue standpoint, the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members." *Id.* at 333.

⁷⁹Rev. Rul. 63-58, 1963-1 C.B. 109.

interunit netting of margins and losses may be subject to challenge and may require justification for Section 521 and non-Section 521 cooperatives.

Section 521 Cooperatives

Though Section 521 and non-Section 521 cooperatives may face the same situation with respect to departments, functions, and allocations and some of the same principles may apply to both, the IRS has interpreted Section 521 so as to place a specific restriction on Section 521 cooperatives with respect to interfunction allocation practices.

Section 521⁸⁰ describes nonprofit marketing and supply functions separately. As a result of this Code description, the IRS has held that a Section 521 cooperative must meet cooperative operation requirements for each function separately. That is, if a Section 521 cooperative has both a marketing and supply function, the marketing function must be operated so that it turns back to members or other producers the proceeds of sales, less necessary marketing expenses, and the supply function must turn over supplies and equipment to members at actual cost, plus necessary expenses. As interpreted by the IRS, this requires separate accounting for each function and, as a result, if the marketing function incurs a loss while the supply function generates a net margin, losses from marketing cannot be netted against gains from the supply function.⁸¹

The Tax Court recently addressed the separation of functions for Section 521 cooperatives and held the separation need not be complete or rigid.⁸² The court held that neither operation at cost nor equitable allocation mandated particular forms of accounts. Citing Ford-Iroquois FS, Inc. v. Comm'r,⁸³ and Farm Service,⁸⁴ the court said that although it is easier to determine if the equitable allocation principle is satisfied with respect to both the purchasing and marketing functions if separate accounts are maintained, failure to account separately should not automatically cause the disallowance of patronage refunds. The two cited decisions were noted for their recognition of the board of directors' discretion and factors such as overlap of patronage and practicality of separating accounting for each function.

Concern with segregating a multiple-operation cooperative's patrons into groups, each to recognize costs and income of the separate operations seems, however, to have been based on "equality of treatment" principles in addition to the functional separation found in the Section 521 definition of an eligible cooperative. The issue was addressed in determining the exempt (Section 521) status of the cooperative. Examples included Juniata Farmers' Cooperative Association v. Comm'r⁸⁵ and Revenue Ruling 67-128,⁸⁶ permitting a Section 521 cooperative to allocate nonpatronage-sourced income or losses to the departments to which they related, "provided the allocation is not discriminatory among patrons similarly situated."⁸⁷

In a series of letter rulings, the IRS implemented the loss assignment principles by requiring as a condition for Section 521 qualification that applying cooperatives insert in their bylaws a provision to the

⁸⁰See notes 14-27 supra and accompanying text.

⁸¹Rev. Rul. 67-223, 1967-2 C.B. 214; Ltr. Rul. 7902004 (Sept. 27, 1978), in which Rev. Rul. 72-547 called exception to the rule.

⁸²Lamesa Coop. Gin v. Comm'r, 78 T.C. 894 (1982).

⁸³74 T.C. 1213 (1980).

⁸⁴619 F.2d at 728, rev'g 70 T.C. at 145.

⁸⁵43 T.C. 836 (1965), acq. 1966-1 C.B. 2.

⁸⁶1967-1 C.B. 147.

⁸⁷*Id.*

effect that losses will be assigned to those patrons whose business produced such losses.⁸⁸ This requirement, not restricted to interfunction netting, is apparently also based on interpretation of Section 1388(a).⁸⁹ No rulings have apparently addressed the issue since Lamesa Cooperative Gin v. Comm'r.⁹⁰

Non-Section 521 Cooperatives

Separation of functions for non-Section 521 cooperatives could not, of course, be based on the Section 521 definition. the equitability, fairness, and preexisting obligation bases for netting objections have surfaced at different times and are not always advanced consistently in netting issues. They have been applied to non-Section 521 functions and department practices as well as to department netting for Section 521 cooperatives where the marketing/supply function distinction in Section 521 is not applicable.⁹¹

In Revenue Ruling 72-547,⁹² a patron dealt with both the grain marketing and feed supply functions. Using a method approved by the ruling, the cooperative made separate allocations for the functions. The ruling applied an equitability test, nevertheless, to approve the cooperative's bushel in, bushel out method of allocating margins to a patron who both sold grain to the cooperative and repurchased the same grain in prepared livestock feed.⁹³ The test was whether the "method of sharing . . . earnings is equitable and nondiscriminatory," and included tests of the need to combine functions into one cooperative; the small number of patrons; and the economics of the purchasing, storage, and grain-manufacture process. The ruling specifically identified "equitable allocation" as a cooperative principle.

The equitable allocation principle was applied in Revenue Ruling 74-567⁹⁴ to test a cooperative's eligibility for Section 521. The ruling turned on the "equality of treatment principle reflected in Section 1388 of the Code."⁹⁵ Though the arrangements among departments made it possible for a patron's delivery of an identical amount of grain to the cooperative to receive different refunds depending on which of two departments received the grain, the ruling found "all patrons within each of the allocation units are treated equally" and the equality of treatment principle "reflected in" Section 1388 was not violated.

Note that in both Revenue Ruling 72-547⁹⁶ and Revenue Ruling 74-567,⁹⁷ permission to have separate allocation units was discussed and approved. In the former ruling, the small size of the patron groups and the impracticability of two separate cooperatives to perform two separate operations was noted

⁸⁸Typical was a requirement for a bylaw provision to the effect that "in the event the cooperative suffers a loss in any year the cooperative will trace the deficit or loss to patrons whose business gave rise to it and will take whatever steps are necessary to recover such losses or deficits from those patrons." Ltr. Rul. 7843060 (July 27, 1978). Ltr. Rul. 8019003 (Nov. 30, 1979); Ltr. Rul. 8021073 (Feb. 28, 1980); Ltr. Rul. 8025168 (March 27, 1980), Ltr. Rul. 8248048 (Aug. 30, 1982).

⁸⁹Similar rules apply for multiple-period gains on sale of property. See, e.g., Rev. Rul. 68-332, 1968-1 C.B. 383.

⁹⁰78 T.C. 894 (1982).

⁹¹See above for Sec. 521 treatment.

⁹²1972-2 C.B. 511.

⁹³This is because purchasing function patrons shared in the earnings of the grain function.

⁹⁴1974-2 C.B. 174.

⁹⁵Specifically I.R.C. Sec. 1388(a), definition of a patronage refund.

⁹⁶1972-2 C.B. 511.

⁹⁷1974-2 C.B. 174.

and, in the latter, the justification was economic and the fact that "members of the cooperative chose to establish a separate . . . branch."

The first of two Tax Court decisions in which restriction on netting losses of one department or function against margins in another were addressed was Ford-Iroquois.⁹⁸ The cooperative, a non- Section 521 cooperative, conducted both a marketing and a supply function for patrons. It sustained losses in both functions and proposed to carry the loss forward to offset the loss against the following years' margins generated only from supply operations.⁹⁹ The IRS raised objections to the netting of losses and margins of different functions. It argued that just as a cooperative must return earnings to the group of patrons whose business produced the earnings by equitable allocation principles, a cooperative should be required to return losses to the patrons whose business produced the losses.

The Tax Court held the cooperative's loss allocation method was permissible as it did not reject a general equitable allocation principle. It noted there was substantial overlap of member business between the two operations in the facts before the court. It also found the board of directors exercised its discretion and the members themselves found the allocation method acceptable. Finally, the court found no statutes, regulations, or prior decisions preventing such a carryforward to a specific function.

Similar factors were identified by the Tax Court in Lamesa, though no losses were involved in that case.¹⁰⁰ While the primary function of the cooperative, a Section 521 cooperative, was marketing, it also did a small amount of purchasing for patrons. Separate records were not kept. The Tax Court again rejected an interpretation of the equitable allocation principle that would have required separation of accounts of the two functions. The overlap of patrons, the discretion of the board of directors, the "practicalities of the allocations," and the apparent approval by patrons were all found to weigh in favor of the cooperative's allocation decision.

The "fairness" issue, including the member awareness and approval requirement, was noted in Revenue Ruling 72-547.¹⁰¹ In approving an allocation system permitting, albeit indirectly, a purchasing patron to receive some benefits of a closely related grain operation, the ruling said that the members agreed, through the cooperative's bylaws, with "full knowledge" of the allocation method. In addition, the end results "protect[ed] the interests of the marketing patrons" and they received an arm's-length price for interdepartment grain transfer.

The general "fairness" issue has not been discussed to any extent by the courts with respect to either interunit netting or single-department, time-period allocation situations. However, the discretion of the board of directors has been noted in all three major decisions on interunit netting--Farm Service,¹⁰² Ford-Iroquois,¹⁰³ and Lamesa¹⁰⁴--has been held to be a factor, along with others, by which to judge the options open to a cooperative. It would appear that fairness considerations are not separable from the equitable allocation considerations given Tax Court opinions identifying equitable allocation as the limiting factor in a cooperatives' options and granting boards of directors discretion to make decisions within the equitable allocation framework as interpreted by the courts.

⁹⁸74 T.C. at 1213.

⁹⁹The interperiod aspects of the loss carryforward are discussed, *infra*.

¹⁰⁰78 T.C. at 894.

¹⁰¹1972-1 C.B. 511.

¹⁰²619 F.2d at 723, *rev'g* 70 T.C. at 155.

¹⁰³74 T.C. at 1217.

¹⁰⁴I.R.C. Sec. 1388(a).

The IRS's concerns with interfunction and interdepartment netting were discussed by the then IRS Chief Counsel Kenneth Gideon, in a speech to the Legal Tax and Accounting Committee of the National Council of Farmer Cooperatives on January 25, 1982, in Washington, D.C. Gideon addressed the netting with certain restrictions. First, the preexisting legal obligation requirements for patronage refund deductions¹⁰⁵ would require a specific provision in the bylaws describing exactly how netting would take place, reducing the board of directors' discretion.

He also noted the special factors present in Ford-Iroquois and concluded a rule against interfunction netting was still justified, citing possible netting abuses.¹⁰⁶ Abuse was also mentioned as justification for objection to certain kinds of interdepartment netting, as where one operation's losses were perpetually subsidized by another profitable operation.

To date, the IRS has not proposed regulation on this subject, and there is no indication that the IRS's position has changed from that expressed by Gideon in 1982, though with Lamesa the Tax Court again refused to apply restrictive netting standards, even for a Section 521 cooperative. The wishes of the IRS are therefore somewhat at odds with limits imposed by the courts. Some uncertainty remains, but a cooperative facing the choices between the clearly permissible and clearly impermissible extremes may decide on allocation procedures fairest to members and most in accordance with the purposes of the cooperative enterprise.

Single-Function Timing Problem

Several fundamental loss allocation concepts are demonstrated in situations where a cooperative has no nonpatronage-sourced income and performs only one kind of operation for a single group of patrons. The examples given here to show various situations that can arise from such an operation assume a net operating loss isolated for a single tax year.

Applying the 'operating at cost' principle of cooperative operation, the IRS has suggested that operation at cost means that any loss in the current year should be recouped directly from patrons doing business with the cooperative during that year.¹⁰⁷ The argument is that because a cooperative operates at cost so as to have no net margin remaining undistributed at the end of the year either.¹⁰⁸

Situation 1

In this hypothetical situation a cooperative has members A through X. It has only one operation, and has no nonpatronage activities. Its costs at the end of the year exceed its income. To make up the difference, the cooperative assesses each patron the amount necessary to cover the loss in exact proportion to business done with the cooperative by that patron during the year. Thus, after the amounts are collected and the books are closed, the cooperative has no net operating loss. This method of handling net operating losses is, of course, acceptable to the IRS, and is the purest form of "operating at cost" each year.

Situation 2

¹⁰⁵I.R.C. Sec. 1388(a).

¹⁰⁶Lamesa had not yet been decided.

¹⁰⁷The position was taken in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1978). The facts in the case fit the examples given in situations 3 and 4, described and discussed below.

¹⁰⁸The argument is more fully described in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1978), and was disposed of by the Tax court in that case. See below for discussion.

In situation 2, the cooperative has the same membership and loss structure as described in situation 1. Instead of requiring a contribution of cash from each patron, however, the cooperative reduces each patron's retained equity by the proportional amount of the net operating loss attributable to each patron.¹⁰⁹

The loss recoupment method is recognized in revenue rulings and letter rulings.¹¹⁰ As far as allocation of losses among patrons is concerned, the effect is the same as in situation 1. The statement of income shows a net balance of zero at the end of the year, though, of course, the retained equity accounts have been reduced. The amounts have simply been recouped from the patrons whose business gave rise to the loss by reducing the amount of retained equity they have in the cooperative.

Note, however, that a cooperative may not be able to handle net operating losses as described in situation 1 and 2. It may not be practical or desirable for a cooperative to demand of its patrons return of previous advance payments at the end of the year.¹¹¹ Retained equities may also not be sufficient in the case of all patrons A through X to cover their proportionate share of the loss,¹¹² and the financial condition of the cooperative may not be such that reduction in equity accounts is feasible.¹¹³ A number of other reasons may also prohibit immediate, same-year recoupment of net operating losses, including basic fairness considerations applied by the cooperative given its operations and the nature of the membership.¹¹⁴

Situation 3

The cooperative above has a third means to recoup its losses from patrons whose business gave rise to the loss. The cooperative may seek reimbursement from those patrons to be taken from future patronage refunds as they are generated by business in future years. Thus, patrons A through X would return to the cooperative the amount of losses allocated to them individually in future years. Technically, this could be done either through the establishment of an account receivable or simply by a policy on the part of the cooperative to recoup losses in such a manner. Each patron's proportionate share of the current operating

¹⁰⁹Reduction of patron's equity to recoup net operating losses does not, of course, guarantee reduction of each patron's account in exact proportion to patronage for the loss year. For example, the articles of incorporation of the cooperative described in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1977), stated:

In the event the association suffers a loss in any year, such loss shall first be charged against the capital-reserve accounts. Provided, however, to the extent that is shall be lawful, the board of directors shall prescribe the basis on which the capital contributions, including capital-reserve accounts, of the patrons shall be reduced on account of any such loss so that the loss will be borne by the patrons on a basis deemed equitable by the board of directors.

Id. at 732.

¹¹⁰Rev. Rul. 70-407, 1970-2 C.B. 52; Ltr. Rul. 7937041 (June 15, 1979); Ltr. Rul. 7950064 (Sept. 14, 1979); Ltr. Rul. 8015048 (Dec. 31, 1979).

¹¹¹The board of directors in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1978), "feared that the reduction of prior reserves accounts would anger the patrons, resulting in a serious loss of future business to competing dairies." *Id.* at 733.

¹¹²Noted as a problem by the Tax Court in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1978).

¹¹³Reduction of retained equities to offset losses is conceptually the same as redemption of equity, with all attendant economic and financial consequences. Redemption of a cooperative's equity capital is not a process that can be safely subjected to rigid rules or rules dependent on vagaries of agricultural market behavior each year. See Cobia, et al., "Equity Redemption: Issues and Alternatives for Farmer Cooperatives," ACS Research Rep. 23, at 63ff. (U.S.D.A., Agricultural Cooperative Service, 1982).

¹¹⁴The reason given for the board of directors' decision in *Associated Milk Producers, Inc. v. Comm'r* 68 T.C. 729 (1978), to charge losses to future patronage was that it determined it would be "inequitable" to charge current losses against capital accounts based on prior years' patronage.

loss is charged to the patron by receipt from the patron of a liability to pay the cooperative. The cooperative's receivable is the current recoupment, and the "ideal" of operation at cost each year is met.¹¹⁵

Neither net margins nor allocations to each patron are reduced under the described circumstances. Rather than return the patronage refund in the years following the loss year, the cooperative treats the refund as a payment to meet a prior patron obligation to the cooperative. A 1977 revenue ruling¹¹⁶ describing the tax consequences in such a situation held that the offset against future patronage allocations does not reduce the amount of patronage refunds otherwise included in the patron's gross income for that future year under Section 1385.¹¹⁷ Because each patron pays to the cooperative, by reduced patronage refunds, the specific amount allocated to that patron, there is no interpatron allocation problem.

Situation 4

A problem may result if a cooperative attempts to recoup losses as described in situation 3. Patron A, whose business gave rise to a loss and who therefore owes the cooperative a determined amount of money, may decide to terminate membership in the cooperative or cease using its facilities. If the amount owing the cooperative is a simple debt, the cooperative may have recourse in addition to retention of future patronage refunds. Otherwise, patrons B through X have to make up the deficit.

A solution to the problem is to rely on future patronage refund generation to recoup losses from continuing patrons (situation 3) but to require direct assessments from terminating members. Ford-Iroquois¹¹⁸ and Associated Milk Producers, Inc. v. Comm'r¹¹⁹ describe the IRS's position, which was to require the cooperative to recoup currently from a terminating member. This recoupment method of handling losses should thus be permissible. Patrons are held responsible to the cooperative to make up for losses in proportion to their business done with the cooperative during the period in which the cooperative suffered a loss, and no reallocation of losses among past, present, or future patrons is made.

Situation 4 isolates the recoupment problem from terminating members where the general method of loss recoupment is from future patronage refund reduction. The cooperative first reduces retained patron equity previously generated from retained patronage refunds. These are found insufficient for some or all patrons of the loss year. Future patronage refund reduction is then identified as the second source of loss recoupment. However, distinguishing situation 4 from situation 3, the cooperative does not attempt to assess terminating members directly. Rather, losses attributable to terminating members are "absorbed" by the

¹¹⁵See Ltr. Rul. 7937041 (June 15, 1979). "Any other method of allocating losses will be permitted as long as it can be assured that the patron whose patronage gave rise to the losses properly assumes that burden of the losses attributable to his patronage."

¹¹⁶Rev. Rul. 407, 1970-2 C.B. 52. In the facts of the ruling, retained patronage refunds ("outstanding marketing credits") were reduced first, the future patronage refund reductions were used to recoup from patrons with insufficient market credits.

¹¹⁷I.R.C. Sec. 1385.

(a) General Rule. Except as otherwise provided in subsection (b), each person shall include in gross income--qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a), (2) any amount, described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions by tax-exempt farmers' cooperatives), which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a)(1), and (3) the amount of any per-unit retain allocation which is paid in qualified per-unit retain certificates and which is received by him during the taxable year from an organization described in section 1381(a).

¹¹⁸74 T.C. at 1218. See discussion of arguments and court decision following.

¹¹⁹68 T.C. 729 (1977).

cooperative.¹²⁰ With respect to losses generated from business with members who cease patronizing the cooperative (and who have no other way to compensate the cooperative, such as retained patronage-based equity), losses are allocated within the cooperative's membership.

Situation 5

Here, the cooperative carries the loss incurred in the current year to the next year to reduce net margins available for distribution as patronage refunds. It is assumed the cooperative does not mix methods of loss recoupment. Thus, patrons B through X who were patrons during the current loss year, and patrons Y and Z, new patrons in the next year, will receive proportionally less patronage distribution because of the current year's loss. The effect of such net margin reductions is to allocate losses in the current year to patrons in the following year whose business with the cooperative did not give rise to the losses, or gave rise to a proportion of losses differing from those in the loss year.

One mechanism used by cooperatives to achieve this result is that of the net operating loss carryforward described in Section 172.¹²¹ A net operating loss carryover, available as an interperiod tax distribution technique to all firms, occurs when a loss in the current year is applied to income in future years.¹²² While the method of loss recoupment described in situation 5 necessarily reduces patronage refunds in future years, a 1965 revenue ruling¹²³ held that the amount of loss carried forward or back from another year does not necessarily reduce a cooperative's earnings in the year of carryforward or carryback. The earnings of the cooperative available for payment of patronage refunds, eligible for deduction under Section 1381(b), are "not affected" by the net operating loss deduction. Thus, the amount of patronage refunds eligible for Subchapter T deductions is not recomputed. The ruling noted that while the loss in one year does not necessarily affect the earnings of another, the cooperative may have contracts with members or bylaw provisions that may affect the amount of patronage refunds the cooperative is obligated to pay in taxable years following the year a net operating loss is incurred.¹²⁴ Such is the case in situation 5.

A Section 172 carryforward, as used in situation 5, results in a reallocation of losses where patrons of the cooperative during the loss year terminate patronage, where new patrons use the cooperative, or where the proportion of business done with the cooperative by each patron changes from the loss year to the following year.

The courts, in response to the IRS's arguments against general loss carryforwards as under Section 172 rules, have addressed three principal issues raised by the loss allocation of situation 5. The first issue discussed is the availability of Section 172 loss carryforward for cooperatives. The second, and in some ways the most fundamental, issue is the role of the operation at cost principle on forward shifting of a current year's loss. The Operation at cost principle is the basic rationale put forward by the IRS to deny a Section 172 loss carryforward. Finally, the equitability of the reallocation and its possible role limiting carryforward of losses is discussed.

¹²⁰Discussed in situation 5, following.

¹²¹I.R.C. Sec. 172.

¹²²This is not, of course, the only means of loss carryforward a cooperative may choose. It is used in situation five because it demonstrates treatment of losses as a cooperative entity's own losses to be made up from future entity income, and because it was the Sec. 172 question that prompted the Service's specific objection to carryforward and the equity of allocation arguments, and led to court discussion and rejection of the Service's positions.

¹²³Rev. Rul. 65-106, 1965-1 C.B. 126.

¹²⁴Id. The ruling does not say what income sources may be applied to reduce the carryover loss amount if not from patronage-sourced income, nor if the net operating loss was patronage or nonpatronage sourced.

The Tax Court in Associated Milk Producers¹²⁵ concluded there is nothing inherent in the Code or its interpretation prohibiting a cooperative's use of a Section 172 carryforward. The court noted several specific references to net operating losses in the law, regulations and prior rulings that clearly indicate no blanket prohibition on net operating losses.

First, the court noted specific rules for net operating loss carryback and carryforward accorded a specific kind of cooperative, the Banks for Cooperatives.¹²⁶ Subchapter T regulations also make specific reference to net operating losses, though not explicitly authorizing their use. The court noted three examples.¹²⁷ The IRS's position was also held by the court to be inconsistent with published rulings dealing with cooperatives. Net operating losses were defined as Section 172 net operating losses in Revenue Ruling 70-328¹²⁸ and net operating loss carryback and carryforward effects on patronage refund deduction were discussed in Revenue Ruling 65-106.¹²⁹ Section 172 carryback and carryforward of cooperative net operating losses were assumed as premises for discussions of investment tax credits in two district court cases.¹³⁰

The Tax Court disagreed soundly with the position of the IRS, stating:

[W]e consider [the Service's] position herein not only contrary to the express provisions of section 172, but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives. The deductions claimed are clearly authorized by section 172. There is nothing in that section or the regulations thereunder which indicates that the net operating loss deduction is not applicable in the case of the cooperative subject to subchapter T. In fact, quite to the contrary, the utilization of the net operating loss deduction by cooperatives is clearly implicit in certain subsections of the Code and the Income Tax Regulations, and in various of [the Service's] rulings dealing with cooperatives.

If a principle of cooperatives were found which, as a matter of fundamental cooperative operations, prevented a cooperative from sustaining a net operating loss, a Section 172 carryforward would be a moot issue. The basis of the IRS's position in Associated Milk Producers was that the operation at cost principle of cooperative enterprises requires current recoupment from patrons of the operating deficit year. Thus, no net operating loss is ordinarily possible for a corporation "operating on a cooperative basis."¹³¹ As summarized by the court, "[The Service's] position in this case is not based upon any statutory exception to the loss carryover privilege, clearly stated in Section 172, but upon [the Service's] theoretical perception of a cooperative as an exceptional entity which by its nature cannot ordinarily have a net operating loss for tax purposes."

¹²⁵68 T.C. at 740.

¹²⁶I.R.C. Sec. 172(b)(1)(G).

(G) In the case of a Bank for cooperatives (organized and chartered pursuant to Sec. 2 of the Farm Credit Act of 1933 (12 U.S.C. Sec. 1134), a net operating loss for any taxable year beginning after December 31, 1969, shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the five taxable years following the taxable year of such loss.

¹²⁷Reg. Secs. 1.1383-1(a)(2), 1.383-1(b)(3), 1.1383-1(d).

¹²⁸1970-1 C.B. 5.

¹²⁹1965-1 C.B. 126.

¹³⁰Farmers Grain Mktg. Terminal (AAL) v. United States, 434 F. Supp. 368 (N.D. Miss. 1977); Farmers Mktg. & Processing Ass'n, 77-1 U.S.T.C. Para. 9103 (D. Minn. 1977).

¹³¹I.R.C. Sec. 138(a).

The Tax Court in both Associated Milk Producers¹³² and Ford-Iroquois¹³³ considered the issue and held that no principle of cooperative operations requires a cooperative to operate at cost each year and require all losses be borne only by patrons of the loss year. As described by the court in Associated Milk Producers¹³⁴:

[The Service] argues that the basic principle of a cooperative is that it operates at cost (after patronage dividend allocation) for its member-patrons. Pursuant to this "cost" principle, [the Service] contends, in any year in which expenses exceed gross income, this "loss" must be recouped from the members who were patrons for that period (i.e., the exact converse of a patronage dividend allocation when income exceeds expenses) so that the cooperative will then have operated at cost.

The recovery of the operating deficit from the current patrons would thus eliminate any net operating loss for tax purposes.¹³⁵ In both cases, existence of net operating losses at the end of the year was recognized. Following Associated Milk Producers, but preceding Ford-Iroquois, the IRS indicated its adherence to the operation at cost principle.¹³⁶

The current operation at cost implication that patrons of the loss year should be assessed directly for their share of losses was argued by the IRS in both Associated Milk Producers and Ford-Iroquois and, in both cases, the principle was rejected the Tax Court. The opinions were especially strong in refusing to require cooperatives to seek cash reimbursements from terminating members. In the words of the court in Associated Milk Producers:

[R]egardless of what might have been [the cooperative's] legal rights, we consider such a recoupment attempt highly impractical for a cooperative operating in a competitive environment, as was Rochester. The impracticability of such a step merely to preserve the "cost" principle of cooperative operation certainly calls into question the sanctity with which [the Service] views that principle.¹³⁷

The Tax Court in Ford-Iroquois¹³⁸ reached a similar conclusion. While in Associated Milk Producers the IRS sought to deny the net operating loss carryforward to all members, in Ford-Iroquois the focus was narrowed to the problem of terminating members.¹³⁹ The court again refused to apply a broad operation at cost principle to prohibit carryforward of losses attributable to terminating patrons. It reiterated the position in Associated Milk Producers that the IRS's position was "not only contrary to the express provisions of section 172, but conceptually strained and lacking in any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives."¹⁴⁰ Summarizing the Tax Court's

¹³²68 T.C. at 735.

¹³³74 T.C. at 1222.

¹³⁴68 T.C. at 735.

¹³⁵Id.

¹³⁶Ltr. Rul. 8030004 (March 20, 1980).

¹³⁷Associated Milk Producers, 68 T.C. at 739.

¹³⁸74 T.C. at 1213.

¹³⁹The narrower argument that losses attributable to terminating members could not be carried forward "appears to be a refinement" of the more general position in Associated Milk Producers.

¹⁴⁰Associated Milk Producers, 68 T.C. at 736.

position in Associated Milk Producers and Ford-Iroquois, the operation at cost principle 'describes a feature of a cooperative's relations with its members, not a codified requirement of tax accounting.'"¹⁴¹

The equitable allocation principle has played a role in carryforward questions, primarily as a companion to the operation at cost principle. It is very similar in substance to the equitable allocation principle applied in the interunit netting issues. Situations 4 and 5 note that losses attributable to some patrons will be recouped from other patrons where new patrons use the cooperative in the carryforward years. The equitable allocation issue focuses on the shifting of losses to new patrons and, as in Ford-Iroquois, patrons of other departments.

Allocation between past, present, and future patrons was noted by the Tax Court in Associated Milk Producers.¹⁴² The court did not find the problem a serious one,¹⁴³ and seemed to be quite satisfied that the expression of equitability goals in the cooperative's articles of incorporation were satisfied by the board's decision to carry losses forward. The court expressed concern that changing losses against existing capital reserves could itself bring about undesirable allocation contrary to the expressed desires of the cooperative as found in the articles of incorporation, and the directors' decision to carry losses forward was an unobjectionable alternative.

The court in Ford-Iroquois also addressed the equitable allocation concept. The carryover issue and interunit netting issues were combined because the cooperative not only carried forward losses attributable to terminating patrons but also to patrons of different functions as well.¹⁴⁴ The court in Ford-Iroquois, as in Associated Milk Producers, refused to apply an equitable allocation rule to prohibit allocation of losses among past, present, and future patrons and, as in Associated Milk Producers, gave weight to the cooperative's own allocation decisions. It said allocation of losses among a cooperative's past, present, and future patrons was properly the concern of the membership and its board of directors.¹⁴⁵ The cooperative "chose to carry forward the net operating losses rather than attempt to recover such amounts from terminated members. This was a business judgment."¹⁴⁶

The Tax Court once again addressed the operation at cost and equitable allocation issues in 1982,¹⁴⁷ though distribution of income attributable to ownership of property in prior years in a Section 521 cooperative was at issue rather than loss allocation across years. The Tax Court specifically adopted the holdings of Associated Milk Producers and Ford-Iroquois on the two issues. The court accepted the general premise that Section 1388(a) embodies an equitable allocation principle that embodies an equitable allocation

¹⁴¹Ford-Iroquois, 74 T.C. at 1219 (citing United Grocers, Ltd. v. United States, 186 F. Supp. 724 (N.D. Cal. 1960)). The court states that the "concept of operation at cost simply means that a cooperative was organized for the purpose of rendering economic services, without gain to itself, to shareholders or to members who own and control it."

¹⁴²68 T.C. at 729.

¹⁴³"The question naturally arising is: What difference does it make? The only difference which we can perceive is in the effective allocation of losses among the cooperative's past and future member-patrons." *Id.*

¹⁴⁴See the discussion of interunit netting equitable allocation concept, *supra*, for the tax court's interpretation of equitable allocation.

¹⁴⁵The articles and bylaws were silent on treatment of cooperative losses, and gave complete control in management to the board of directors. Ltr. Rul. 8043019 (July 24, 1980), issued prior to the Ford-Iroquois decision, said a short period loss could be taken into account subsequent to the year of change provided (1) that there was a substantial identity of patrons in both the short period and the year following and (2) there was an "equitable allocation" among all patrons in the year subsequent to the loss year.

¹⁴⁶Ford-Iroquois, 74 T.C. at 1222.

¹⁴⁷Lamesa, 78 T.C. 894.

principle that earnings must generally be allocated ratably to the patrons whose patronage created the earnings from which the allocation was made. This, however, did not require the precise allocation desired by the IRS. "Exact equity cannot be accomplished with sufficient Solomon-like attributes to be able to divine its parameters." The court held that like the operation at cost principle, the equitable allocation requirement is not a strict accounting requirement but a general principle. The practicalities of making allocations and the democratic nature of cooperatives is to be considered.

Neither did the operation at cost principle prohibit allocation to patrons in the year property was sold, though the property had been held for prior years. Noting the Tax Court's previous rejection of the operation at cost principle, the court repeated that the concept "simply means that a cooperative was organized for the purpose of rendering economic services, without gain to itself, to shareholders or the members who own or control it; it is not a codified requirement of tax accounting. . . . It does not require that net margins be allocated precisely in proportion to the patronage that generated them."

The clear statements of Associated Milk Producers, Ford-Iroquois, and Lamesa have led to a somewhat reluctant acceptance on the part of the IRS that the theoretical operation at cost principle as applied in its earlier arguments cannot be supported.¹⁴⁸ The current position of the IRS was describe in General Counsel's memorandum 39170.¹⁴⁹ The memorandum addressed a factual situation which permitted the IRS to agree with the holdings of Ford-Iroquois and Associated Milk Producers without, however, completely conceding to the conclusion of the courts in all cases. Three summary conclusions were state in the memorandum:

1. The taxpayer may utilize the net operating loss deduction provided by Section 172.
2. The taxpayer may carry forward the loss of one allocation unit to offset income of that same unit without tracing the loss to any particular patrons.
3. The taxpayer should not be required to recoup from its terminating members losses generated from those members.

Conclusion

State incorporation statutes provide little guidance on how a cooperative must allocate any incurred net operating losses. If a cooperative is to define its allocation practices prior to a year in which net operating loss occurs, the cooperative must carefully consider the interests of its members, its options, and desired results to be achieved by the allocation method.

Because the cooperative will operate according to its own rules, it is important that the allocation procedures be described, in whatever detail is considered necessary, in the bylaws or articles of incorporation. Establishment of bylaws and their later amendment is, of course, controlled by the membership of the cooperative. Therefore, any final decision of the cooperative on loss allocation will be that of the membership.

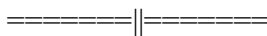
Income tax implications of various situations under which net operating losses can be incurred and allocated to patrons will provide one of the greater challenges to a cooperative when it considers its options. A number of clearly permissible practices have been described in this article. Likewise, a number of practices which are quite probably prohibited, especially for a Section 521 cooperative, have also been noted.

¹⁴⁸In Farm Service, the Service did not contest the proposition that a cooperative can have a net operating loss or that it can carry such losses forward and back under Sec. 172 rules.

¹⁴⁹G.C.M. 39170 (June 3, 1982), released in 1984. The memorandum was issued prior to Lamesa, and released subsequently. See also Ltr. Rul. 8316002 (Jan. 7, 1983).

There remains some confusion and disagreement concerning practices which have not clearly been approved either by the courts or by the Service. Cooperative directors, in consultation with legal counsel, make decisions about the risk of IRS challenge and benefits to be achieved for members and patrons by a desired method of net operating loss allocation.

Several topics have not been covered in this article that relate to cooperative losses. Nonoperating losses have not been discussed. Handling capital gains and losses by a cooperative, as for any other corporation, is a complicated procedure. In addition, the IRS's indications that Section 277 is applicable to non-Section 521 cooperatives has not been discussed but may in fact bear on a cooperative's decision on net operating loss allocation. Finally, loss treatment by patrons has not been discussed in any detail.



B. Section 277

IRS attempted to limit cooperative's flexibility to handle losses on a cooperative basis by applying the principles of membership organizations to cooperatives based on section 277.¹⁵⁰



Sec. 277. Deductions incurred by certain membership organizations in transactions with members

(a) **General Rules.** In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year. The deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year.

(b) **Exceptions.** - Subsection (a) shall not apply to any organization -

(1) which for the taxable year is subject to taxation under subchapter H or L.

(2) which has made an election before October 9, 1969, under section 456(c) or which is affiliated with such an organization, or

(3) which for each day of any taxable year is a national securities exchange subject to regulation under the Securities Exchange Act of 1934 or a contract market subject to regulation under the Commodity Exchange Act.



¹⁵⁰ Gen. Couns. Mem. 34,334 (Aug. 17, 1970); Gen. Couns. Mem. 34,935 (July 3, 1972).

Despite early doubts about the applicability of Section 277 to Subchapter T cooperatives expressed by judicial decisions,¹⁵¹ IRS continued to apply Section 277. Two later decisions addressed its application directly and rejected the IRS position.¹⁵² The IRS stated in 1997 that it would no longer apply Section 277 to Subchapter T cooperatives.

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VIII. Patronage and Nonpatronage Source Income

Because patronage source income qualifies for distribution as patronage refunds, thus for single tax treatment, and nonpatronage source income does not and is therefore taxable income to the cooperative, classification is crucial. This has led to constant disputation and the development of several principles.

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Certified Grocers of California, Ltd. v. Comm'r 88 T.C. 238 (1987)

KORNER, Judge

Respondent determined deficiencies in Federal income taxes for petitioner and certain consolidated subsidiaries for the 1979, 1980, and 1981 taxable years 3/

[3/ Petitioner's taxable years were fiscal years. Taxable years 1979, 1980, and 1981 ended on September 1, 1979, August 30, 1980, and August 29, 1981, respectively.]

as follows:

<u>Taxable Year</u>	<u>Deficiency</u>
1979	\$2,042,782
1980	1,005,038
1981	2,825,142

After concessions, the issues for decision are: (1) Whether interest income earned by petitioner from its surplus cash constituted "patronage-sourced" income within the meaning of Subchapter T, to any extent; 4/

¹⁵¹ *Farm Service Cooperative v. Comm'r*, 70 T.C. 145 (1978), *rev'd on other grounds*, 619 F.2d 718 (8th Cir. 1980); *Washington-Oregon Shippers Cooperative, Inc. v. Comm'r*, 52 T.C.M. (CCH) 1406 (1987).

¹⁵² *Landmark v. United States*, 25 Cl. Ct. 100 (1992); *Buckeye Countrymark v. Comm'r*, 103 T.C. 547 (1994). For an informative and interesting description of the Section 277 saga, see Frederick, Donald A. *Income Tax Treatment of Cooperatives: Handling of Losses*. U.S.D.A., Rural Business-Cooperative Service, Cooperative Information Report 44, Part 5 (January 1999).

[4/ All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

The terms "patronage-sourced" and "nonpatronage-sourced" do not appear in the Code. Instead, the terms are used by practitioners and in this opinion to distinguish between income that is and income that is not derived from business done with or for patrons of the cooperative. See sec. 1388(j)(4), as added by Pub. L. 99-272, 100 Stat. 82 (1986).]

(2) if not, whether petitioner can offset the nonpatronage-sourced interest income with a portion of its patronage-sourced interest expense, in the computation of its income from patronage and nonpatronage sources; and (3) for the year 1980, whether petitioner is entitled to offset the income of its noncooperative subsidiaries with its claimed net operating loss on its consolidated Federal Income Tax Return.

This case was submitted for decision on fully stipulated facts pursuant to Rule 122. 5/

[5/ A hearing was held before this Court on June 24, 1985, at which the parties agreed to submit the issue of whether petitioner's interest income was patronage-sourced for our decision based on stipulated facts. They stated that their stipulation of facts would raise the additional two issues presented here for our decision based on the stipulated facts. The parties indicated at the hearing that they were in the process of gaining final approval of a settlement that they had tentatively agreed to as to other issues in the case. This case was continued for possible trial of those issues until September 9, 1985. Prior thereto, respondent's counsel communicated to the Court, and confirmed on brief, that the remaining issues had been settled. Thus, no further trial was held.]

The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Certified Grocers of California, Ltd. (hereinafter petitioner), is a California corporation organized in 1925. 6/

[6/ Petitioner's subsidiaries are parties to this action for the years in which they joined petitioner in filing a consolidated return (see infra).]

Petitioner's principal office was located in Los Angeles, California, when it filed its petition herein.

Petitioner is a nonexempt cooperative within the meaning of section 1381(a)(2). Its patrons operate retail grocery stores and supermarkets, principally in southern California. Petitioner's function is to purchase food and related nonfood items in large volume to enable its patrons to receive the benefit of price discounts and favorable terms available to volume purchasers. 7/

[7/ During the years at issue less than five percent of petitioner's business was with nonpatrons.]

Petitioner warehouses the goods until it sells and delivers them to its patrons, who then sell them at their retail establishments. Petitioner also manufactures bakery and dairy products that it sells to its patrons. Petitioner, as a cooperative, operates at cost and renders services to its patrons at as low a cost as possible.

Petitioner is an accrual basis taxpayer. It filed consolidated Federal Income Tax Returns (Forms 1120) with some or all of the following subsidiaries for the taxable years at issue in which the following amounts of taxable income were reported:

* * *

Petitioner's reported \$172,759 loss for 1980 resulted from the issuance of patronage dividends based on book income that exceeded taxable income by that amount. 8/

[8/ Petitioner's book income for its taxable year 1980 was \$1,732,422. Petitioner's taxable income was lower because it did not include, inter alia, tax-exempt income, and because petitioner claimed larger deductions for tax purposes than for book purposes.]

None of petitioner's subsidiaries was a cooperative within the meaning of section 1381, and none was a patron of petitioner. The income earned by the subsidiaries was not income from patronage and could not have been the basis for the issuance or the deduction of patronage dividends pursuant to sections 1382(b) and 1388, either by petitioner or by any of the subsidiaries.

Petitioner needed cash to fund its operations and finance its inventory. 9/

[9/ The magnitude of petitioner's need for cash is indicated by the size of its inventory at the end of each of the taxable years at issue. Petitioner's inventory was \$67,261,250, \$80,115,068, and \$95,963,683 at the end of its taxable years 1979, 1980, and 1981 respectively. Petitioner did not bill its patrons until after it delivered goods to them, and payment was not due until one week after the bills were mailed.]

During the years at issue, petitioner obtained cash principally from deposits required from patrons, excess patron deposits, and borrowings from banks. 10/

[10/ Petitioner required its patrons to deposit with it a minimum amount of cash. New members were generally required to deposit an amount equal to twice their expected weekly purchases. Every six months the required deposit was reviewed and adjusted depending upon the amount of the patron's average weekly purchases. Each year, petitioner issued a patronage dividend to its patrons consisting of twenty percent cash and the remainder in the form of qualified written notices of allocation. Petitioner treated the qualified written notices of allocation as cash contributed by the patrons toward their required deposits.

If a required deposit account contained more than the patron was required to keep on deposit, the patron had the option of either withdrawing the excess in cash, or leaving it on deposit. Petitioner paid its patrons interest on excess deposits and on required deposits that exceeded one and one-quarter weeks average purchases. The excess deposits [provided petitioner with funds at a more favorable interest rate than available from commercial lenders and also reduced the amount petitioner needed to borrow from commercial banks.]

During the years at issue petitioner incurred and deducted the following interest expenses:

* * *

All of petitioner's interest expense for the years at issue was patronage-sourced, as it was directly related to its principal function as a cooperative: purchasing, warehousing, and distributing food and food-related products.

During the years at issue, petitioner occasionally had cash on hand it did not immediately need to use in its business. Petitioner used such excess cash to purchase short-term instruments such as bankers' acceptances, certificates of deposit, and repurchase agreements. 11/

[11/ The record does not reveal the exact terms of the instruments (e.g., just how short the "short-terms" were), nor the source of the excess cash.]

Petitioner obtained the instruments from commercial banks that were not its patrons, and earned the following amounts of interest on the various instruments:

	<u>Taxable Year</u>
<u>Instrument</u>	* * *
Bankers' Acceptances	
Certificates of Deposit	
Repurchase Agreements	

Petitioner reported the interest that it earned from its bank instruments as patronage income on its consolidated Federal Corporation Income Tax Returns for the years at issue, with one exception. The \$1,420,914 of interest from bank instruments earned during taxable year 1980 included \$186,454 allocable to funds borrowed to finance construction of a mechanized warehouse for use in petitioner's food and food-related purchasing and distribution business, and temporarily reinvested until needed. In reporting its gross income from interest for 1980, petitioner reduced the amount reported by \$186,454, but restored it to the full amount of \$1,420,914 in computing the allowable amount of patronage dividend for which it claimed a deduction.

Although petitioner chose to use its excess cash to purchase bank instruments in an effort to manage its money efficiently, it was not required to do so in order to obtain loans from banks.

Petitioner deducted patronage dividends of \$23,462,693, \$29,017,057, and \$27,637,572 for its taxable years 1979, 1980, and 1981, respectively, in arriving at its taxable income for those years. Respondent disallowed the portion of the deduction for patronage dividends representing petitioner's interest income from its short-term placement of excess cash with banks, as shown above, and determined deficiencies accordingly, based on his determination that petitioner had failed to establish that the interest income was patronage-sourced.

I. The Bank Interest as Patronage Income.

The first issue for decision is whether the interest income earned by petitioner from its purchase of short-term instruments with its cash surpluses was patronage-sourced income. 12/

[12/ The net income of nonexempt cooperatives such as petitioner is fully taxable. The significance of whether income is patronage-sourced is that only net patronage-sourced income is eligible to be distributed to a cooperative's patrons as patronage dividends, and deducted in arriving at taxable income. Secs. 1382, 1383.]

It is clear that interest income earned by cooperatives is, in some circumstances, patronage-sourced income. See Cotter & Co. v. United States, 765 F. 2d 1102, 1107 (Fed. Cir. 1985); Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459-460 (1986). The test used by this Court to determine if

income is patronage-sourced was set forth in Illinois Grain, where we indicated that income is patronage-sourced if it is:

so closely intertwined and inseparable from the main cooperative effort that it may be properly characterized as directly related to, and inseparable from, the cooperative's principal business activity, and thus can be found to "actually facilitate" the accomplishment of the cooperative's business purpose. * * * [87 T.C. at 459.]

We stated, conversely, that same is not patronage-sourced if it is derived from sources that:

have no integral and necessary linkage to the cooperative enterprise, so that it may fairly be said that the income from such activities does nothing more than add to the taxpayer's overall profitability. * * * [87 T.C. at 459.]

Our opinion in Illinois Grain indicates the analysis we apply in determining whether interest income is patronage-sourced. The petitioner in Illinois Grain was a cooperative that marketed its patrons' grain. It earned interest from cash that it placed temporarily in very short-term interest-bearing accounts (e.g., overnight, overweekend, or not-to-exceed ten-day deposits). We found that the specific nature of its business required it to have available on short notice large amounts of cash. We also found that the short-term placement of excess cash was simply prudent money management by the cooperative's managers, and we rejected the proposition that such placement constituted and "investment" of the cash as the term would generally be understood. 13/

[13/ Sec. 1.1382-3(c)(2), Income Tax Regs., defines nonpatronage-sourced income to include income derived from investment in securities.]

We instead found that the interest income was patronage-sourced as it was earned on funds that totaled no more than the cooperative needed to provide that liquidity necessary for it to operate.

As we recognized in Illinois Grain, our determination of whether interest income is patronage-sourced is necessarily fact-intensive. Petitioner bears the burden of establishing the facts necessary to prove that respondent's determination is incorrect. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a).

After carefully reviewing the entire record, we conclude that petitioner has established the facts necessary to prove that the \$186,454 of interest it earned in its 1980 taxable year on its temporary investment of borrowed funds was patronage-sourced. The facts establish that \$186,454 of the interest petitioner received in its 1980 taxable year was earned on the temporarily unspent portion of funds borrowed to finance construction of a mechanized warehouse for use in petitioner's food and food-related purchasing and distribution business. It is clear that the funds were needed for use in petitioner's main cooperative activity. The fact that the unspent borrowings were placed temporarily until needed in interest bearing accounts to help offset interest expense that was accruing on the borrowings was simply prudent money management. We hold that the \$186,454 of interest was so closely intertwined and inseparable from petitioner's principal business activity that it actually facilitated petitioner's business purpose and was therefore patronage-sourced income.

The story, however, does not end there. The stipulated facts further show that this \$186,454 of interest was not reported as gross income in petitioner's 1980 return, but was included in the amount which petitioner paid out as a patronage dividend and for which it claimed a patronage dividend deduction for 1980. It is obvious that petitioner may not claim a patronage dividend deduction, otherwise allowable, for an item of patronage income which has not been reported as

gross income in the first instance. Sec. 1382(a). On this ground alone, therefore, respondent's determination as to this amount must be sustained.

The facts establish only that the remainder of the interest at issue was earned from the "short-term" (not otherwise defined) placement of funds not immediately required for use in petitioner's business. They fail to establish that the cash was so closely intertwined with and inseparable from petitioner's main cooperative effort that the interest in question is patronage-sourced. 14/

[14/ Petitioner failed to make the extensive showing of specific foreseeable needs for cash that allowed us to determine in Illinois Grain Corporation v. Commissioner, 87 T.C. 435, 459-460 (1986), that the interest income at issue in that case was patronage-sourced. In Illinois Grain the cooperative involved established that it needed to maintain on hand large amounts of cash because it was required, on short notice, to meet margin calls, to repay members' notes, to satisfy patrons' demands under deferred payment contracts, and to pay expenses. The cooperative's management of funds was complicated by the fact that its business was seasonal and it was difficult for it to predict when it would receive income. Its volatile need for cash led us to recognize that it had to build into its financial structure a high degree of flexibility in the form of liquidity.]

Although we realize that cooperatives such as petitioner need cash to operate, the record in this case does not allow us to determine whether the funds that earned the interest income in issue were needed for use in petitioner's cooperative activity. The record does not disclose, for example, the amount of funds that earned the interest, the term for which the funds were placed, petitioner's needs for the funds, and when those needs were expected to occur. 15/

[15/ The record herein does not disclose the credit terms on which petitioner acquired from its suppliers the goods which it resold to its patrons. We do not know whether petitioner was required to pay for such goods C.O.D., within a week, a month, or some more generous payment period. Such facts are highly important in determining petitioner's needs for cash, and the relationship of its money-management practices to the requirements of the cooperative enterprise.]

Lacking such facts, we must hold that petitioner has failed to prove that respondent erred in determining that the remaining interest income was nonpatronage-sourced. Cf. Cotter & Co. v. United States, supra; Illinois Grain Corporation v. Commissioner, supra.

II. May Petitioner Allocate Patronage Interest Expense Against Nonpatronage Interest Income?

Having found that a portion of the interest income in question is nonpatronage-sourced, we must next determine whether petitioner is entitled to offset such interest income with an equal amount of its interest expense which was patronage-sourced, as the parties have stipulated. Petitioner argues that such an offset should be allowed, and that its allowable patronage dividends should therefore not be reduced. 16/

[16/ The net effect of the offset, if allowed by this Court, would be that petitioner's allowable patronage dividends would not be reduced by respondent's determination that the interest income in question was nonpatronage-sourced. Petitioner's net patronage-sourced income would remain at its original level, as patronage-sourced income and expense would both be reduced by identical amounts. The determination would similarly result in no net nonpatronage-sourced income with respect to the interest in question, as

nonpatronage-sourced interest income would be offset by patronage-sourced interest expense.]

Respondent disagrees. 17/

[17/ The parties stipulated that such issue, although not formally raised by the pleadings, was properly before the Court, but that petitioner had the burden of proof with respect thereto. See Rule 41(b).]

Subchapter T prohibits the payment of patronage dividends out of nonpatronage-sourced income, in the case of a cooperative such as this petitioner. Secs. 1382(b), 1388(a). Cooperatives must therefore determine their patronage-sourced income separately from their nonpatronage-sourced income, in order to compute the allowable amount of their patronage dividends. Expenses must be assigned to the type of income to which they apply and may not be arbitrarily assigned to reduce one type of income or the other. Farm Service Cooperative v. Commissioner, 619 F. 2d 718, 725 (8th Cir. 1980), revg. in part 70 T.C. 145 (1978). In the context of determining net income from patronage for purposes of establishing the amount available for deductible patronage dividends under sections 1382 and 1383, nonpatronage income may not be reduced by patronage expenses. Farm Service Cooperative v. Commissioner, supra.

Whether petitioner is entitled to offset its nonpatronage-sourced interest income with a portion of its interest expenses depends upon whether all or part of its interest expense is nonpatronage-sourced. Petitioner bears the burden of proving that a portion of its interest expenses is nonpatronage-sourced. Welch v. Helvering, supra; Rule 142(a).

The first step in determining whether an item of expense is nonpatronage-sourced is to establish how the expense arises. If the expense is incurred with respect to business done with or for patrons, it is patronage-sourced. Sec. 1388(a). The stipulated facts in this case establish that all of petitioner's interest expense was directly related to the business it does with or for its patrons: its food and food-related purchasing and distribution business which constitutes its principal cooperative function. 18/

[18/ The terms of stipulations are generally binding on the parties. Rule 91(e). Although this Court has authority to disregard a stipulation that is clearly contrary to the facts, Jasionowski v. Commissioner, 66 T.C. 312, 318 (1976), the facts here do not clearly demonstrate that a portion of petitioner's interest expense was nonpatronage-sourced.]

We accordingly reject petitioner's argument that it is entitled to offset its nonpatronage-sourced interest income with its patronage-sourced interest expense, for the purpose of determining its net income from patronage, and its allowable patronage dividend deduction. Petitioner's thesis - that the surplus funds which it used to earn interest from bank instruments could have been used to reduce its patronage-sourced debt; that the resulting interest expenses would thus have been less; that therefore petitioner should be allowed to offset its nonpatronage interest income (apparently to the point of extinction) by the interest expense which it actually incurred - is entirely speculative and unconvincing. There is nothing in this record to show to what extent, if any, petitioner could have used the excess cash which it temporarily had in its hands, from time to time, for the reduction of other indebtedness on which it was obligated, consistent with maintaining the liquidity necessary for the operation of its business. In any event, it was not done. Petitioner chose the manner in which it operated its business, and it must abide the tax results flowing from those choices. Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932). Such results cannot be changed by arguing that they would have been different if other choices had been made. See Television Industries, Inc. v. Commissioner, 284 F.2d 322, 324-325 (2d Cir. 1960).

III. The Use of Petitioner's Net Operating Loss In A Consolidated Return.

For the tax year 1980, petitioner reported a net loss of \$172,759. It was stipulated that this loss resulted from the payment by petitioner of patronage dividends based upon its book income, which exceeded its reported taxable income by this amount. Since petitioner apparently treated all its income as patronage-sourced, there was no attempt to make separate computations of income or loss from patronage and nonpatronage sources.

As shown in our findings of fact, petitioner filed consolidated returns in each year with certain of its subsidiaries, none of which were cooperatives. For the year 1980, this procedure resulted in a consolidated return in which petitioner's net loss, ostensibly from patronage, was combined with and offset against the net nonpatronage income of its consolidated subsidiaries. Respondent, challenging this treatment, contends that petitioner, a nonexempt cooperative, is not permitted to file a consolidated return with its noncooperative subsidiaries, at least so far as its cooperative activities are concerned. Petitioner claims it is entitled to do so, there being nothing in the Code or respondent's regulations to prevent it. 19/

[19/ As in the case of the preceding issue, the parties stipulated to the consideration of this issue by the Court, although not formally raised in the pleadings. Rule 41(b). The parties further stipulated, however, that on this issue it was respondent who had the burden of proof.]

So far as petitioner's rights to file a consolidated return with its subsidiaries is concerned, the case is one of first impression in this Court, but we have had occasion to consider the underlying fundamental problem in a slightly different context.

Addressing first the immediate question - whether a nonexempt cooperative such as this petitioner may file a consolidated return with noncooperative members of an affiliated group, under sections 1501 through 1504 - we have no difficulty in giving an affirmative answer to the general proposition. Petitioner and its subsidiaries appear to fulfill all the requirements of being includible members of an affiliated group, sec. 1504(a),(b), entitled to file a consolidated return under section 1501 and the legislative regulations promulgated by respondent under section 1502. Indeed, respondent's regulations clearly contemplate that a cooperative may file a consolidated return:

If * * * a cooperative organization described in section 1381(a) joins in the filing of the consolidated return, * * *. [Sec. 1.1502-3(a)(3)(ii), Income Tax Regs.]

Respondent relies on two premises to reason that petitioner is ineligible to file a consolidated return. First, pointing to section 1.1381-2(a), Income Tax Regs., respondent states that exempt cooperatives (under section 521) are to be treated as section 501 exempt organizations for purposes of any law that refers to tax exempt organizations. Respondent then points out that section 1504(b)(1) excludes section 501 exempt organizations from the definition of an "includible corporation" in an affiliated group entitled to file consolidated returns, except that section 501 organizations can file consolidated returns, if all other members of the group are also section 501 organizations. Sec. 1504(e).

Based on the above premises, respondent then constructs an argument based upon the following stair-step reasoning:

a. The only important difference between an exempt cooperative and a nonexempt cooperative, such as this petitioner, is that an exempt cooperative can deduct distributions (on a patronage basis) of both patronage and nonpatronage income.

b. Therefore, with respect to distributions of patronage income, a nonexempt cooperative functions the same as an exempt cooperative.

c. Therefore, so far as its cooperative activity is concerned, a nonexempt cooperative should be considered as an exempt organization, and should be subject to the same limitations with respect to the filing of consolidated returns.

d. Therefore, a nonexempt cooperative such as this petitioner should not be allowed to combine its net income/loss from patronage, even after the payment of allowable patronage dividends, with its net income/loss from nonpatronage sources, either in its own return or in the consolidated return which it files with its noncooperative subsidiaries.

e. Therefore, petitioner, for its fiscal year 1980, should not be permitted to include the \$172,759 of loss from cooperative operations in the computation of its own net income/loss, nor use it to offset the net income of its subsidiaries which was reported in its consolidated return.

We reject this line of argument out of hand. Whatever the situation may be with respect to cooperatives exempt under section 521 - whether respondent may decree that such cooperatives are to be treated as exempt under section 501, the statute being silent, and are therefore not permitted to file consolidated returns because of the prohibitions of section 1504(b)(1), except for the narrow exception of section 1504(e), see secs. 1.1381-2(a)(1), 1.1502-100, Income Tax Regs. - is a matter which we may leave to another day and another case. What is clear here is that this petitioner is not an exempt organization under section 521 or any other provision of the Code, and its cooperative activities are fully taxable. Secs. 1381, 1382. Subject to the limitation next discussed, we hold that it may file a consolidated return under section 1501 like any other qualifying corporation.

Even though a corporation may be entitled to file a consolidated return under section 1501, it is still subject to all the other relevant provisions of the Code. Sec. 1.1502-80, Income Tax Regs. In the instant case, this includes the law under Subchapter T, as it has developed with respect to the tax treatment of patronage and nonpatronage income and losses.

Respondent herein now appears to concede that a cooperative may have a net operating loss, which may be carried back and forward under the provisions of section 172, that such a net operating loss can occur with respect to patronage income, and that it can be caused by the payment of patronage dividends based upon book income which exceeds taxable income from patronage. Farm Service Cooperative v. Commissioner, supra; Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977); see and compare Rev. Rul. 74-377, 1974-2 C.B. 274. The problem of the netting of losses still remains, and it is the same problem whether considered in the context of the taxpayer's own return, the computation of net operating loss carryovers under section 172, or the filing of a consolidated return with noncooperative subsidiaries, as here. 20/

[20/ We are not here concerned with the problems of netting between functions or allocation units of the cooperative. Based upon the somewhat abbreviated record before us, including the consolidated returns filed herein, it appears that petitioner had only one department or allocation unit for patronage and nonpatronage income purposes. Cf. Farm Service Cooperative v. Commissioner, 619 F. 2d 718 (8th Cir. 1980), revg. in part 70 T.C. 145

(1978); Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213 (1980). See further sec. 1388(j), as added by Pub. L. 99-272, 100 Stat. 82 (1986).]

In Farm Service Cooperative, supra, the Court of Appeals held that it was improper for the taxpayer to net patronage losses against nonpatronage income through the use of carryovers under section 172. The reason was that where patronage losses result from the application of the special deductions allowed by section 1382 and section 1383, the use of such losses to offset nonpatronage income has the effect of allowing the deductions, reserved for patronage income only, to be taken against nonpatronage income in violation of Subchapter T. Thus, a cooperative must compute its income and loss from patronage and nonpatronage separately, and, at least where such computation results in a net loss on the patronage side, such loss may be carried over under the provisions of section 172 only to apply against net income from patronage in the carryover years. See Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213 (1980).

The reasoning of Farm Service Cooperative is equally valid in the consolidated return situation presented here. In the computation of its own net taxable income, petitioner must segregate patronage income and expense from nonpatronage income and expense, as we have held in the preceding section of this opinion. If the former produces a net loss it may not be offset against the nonpatronage income, either in its own return, Farm Service Cooperative, supra, or in a consolidated return which it files with its subsidiaries. Instead, such net loss from patronage will create a special net operating loss which may be carried over to other years under section 172 for application only against net income from patronage in such years. Farm Service Cooperative, supra; Ford-Iroquois FS, Inc. v. Commissioner, supra. 21/

[21/ As the Court of Appeals intimated in Farm Service Cooperative, supra at 725 n. 16, the same rule would not appear to apply where the facts are reversed. Thus, if a cooperative has net income from patronage sources, even after taking the special deductions provided by sections 1382 and 1383, there appears to be no reason why such income may not be combined and netted with the income or loss from nonpatronage sources, for tax purposes, at least. Such net income, after all, is as fully taxable as any other net income, secs. 1381, 1382(a), and the integrity of the special deductions of sections 1382 and 1383 is not jeopardized. Respondent appears to recognize this, and has raised no issue with respect to petitioner's right to file consolidated returns with its noncooperative subsidiaries for 1979 and 1981, years in which petitioner reported net taxable income.]

The net nonpatronage income or loss of petitioner, of course, may be freely combined with the net income or loss of petitioner's noncooperative subsidiaries in a consolidated return, just as any other qualified taxpayer may do.

As the result of our holding here, as well as in the two preceding portions of this opinion, a recomputation of petitioner's income from patronage and nonpatronage sources will be necessary. If such recomputation results in petitioner having a net loss for any year from patronage sources, such net loss may not be offset against nonpatronage income, either in petitioner's own return or in its consolidated return, but is to be available only as a carryover against its net patronage income in other years, as permitted by section 172. Farm Service Cooperative v. Commissioner, supra; Ford-Iroquois FS, Inc. v. Commissioner, supra; Associated Milk Producers Inc. v. Commissioner, supra.

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Cotter and Co. and Subsidiaries v. United States

765 F.2d 1102 (Fed. Cir. 1985), *rev'g*, 6 Ct. Cl. 219 (1984)

NICHOLS, Senior Circuit Judge.

The question presented on appeal is whether interest income from commercial paper and certificates of deposits (CDs) and income accruing from the rental of warehouse space are earnings from business done "with or for" patrons of a cooperative, under 26 USC s.1388, when the functions of the cooperative are the manufacture, distribution, and purchase of hardware and related goods in volume for its members. In this tax refund suit, the Claims Court held that the transactions were not business done for patrons, and the income generated could not be considered "patronage dividends" unrealized by the cooperative. On taxpayer's appeal, in which it receives support from the National Grocers Association as amicus curiae, we reverse as a matter of law on the grounds that the court improperly read St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041, 224 Ct. Cl. 289 (1980), and the intent of Congress.

I.

Appellant-taxpayer Cotter and Company and Subsidiaries (Cotter) is a nonexempt cooperative operating pursuant to Subchapter T (26 USC s.s.1381-1388) of the Internal Revenue Code (Code) of 1954, as amended. On its 1975 federal income tax return, Cotter reported gross interest income including income from commercial paper and CDs. This income and certain gross rental income were characterized by taxpayer as "patronage dividends" distributed to its members, and as such were deducted from Cotter's gross income. The Commissioner of Internal Revenue (Commissioner) reclassified this income as being nondeductible, nonpatronage sourced. After allowing certain related expenses against this recharacterized income and following other adjustments not relevant to this appeal, the Commissioner reduced Cotter's patronage dividend deduction by \$341,948. Subsequently, taxpayer filed claims for refund of taxes for the taxable years 1972, 1973, 1975, and 1976 in the aggregate amount of \$129,344.96. After the Commissioner denied these claims, taxpayer brought suit in the Claims Court, which held against it.

II.

The facts relevant to this appeal, the majority of which were stipulated and none of which are in dispute are set forth in detail in the opinion of the Claims Court, Cotter & Company and Subsidiaries v. United States, 6 Cl. Ct. 219 (1984), and are only briefly recounted here. Cotter was formed by small independent hardware retailers to gain the benefit of economical buying and merchandising through large volume transactions, comparable to those possible for chain retailers. Organized under Subchapter T, Cotter is obligated to distribute its net earnings from business done with or for its members as patronage dividends. Taxpayer acts for its patrons, in large part, by purchasing goods from independent manufacturers, warehousing their products, and distributing products using transportation owned or leased by Cotter. To a lesser extent Cotter itself manufactures products for its patrons. Cotter serves its members by purchasing goods at the lowest prices available through large volume purchasing, and warehousing and distributing the goods at the lowest possible cost.

Because members are located throughout the United States and need orders filled quickly and efficiently, Cotter must maintain adequate warehouse facilities in many locations for a broad range of products. Having had phenomenal membership growth from 1965 to 1975, Cotter continuously needed to increase its warehouse capacity by construction or acquisition. In forecasting its future needs, Cotter determined that it was economically necessary to factor in excess capacity, soon to be

absorbed by immediate and foreseeable growth, in planning new warehouse facilities. The rental income at issue here resulted from Cotter's leasing temporarily excess space to its tenants.

In June, 1975, Cotter established a finance department through which it sought to manage its financial affairs conservatively, so it would always have sufficient funds available to purchase goods on favorable terms. Similarly, the department attempted to maintain sufficient lines of credit. Cotter engages in a "seasonal" business in which it makes the bulk of its purchases in certain seasons, often many months before it resells its goods to its members. Because Cotter's payments to manufacturers often are due before it receives funds from its members, it was necessary at times to retain substantial sums of cash on hand. Generally, during part of the year Cotter has a working capital deficit which requires taxpayer to borrow on a short-term basis from banks; at other times Cotter has working capital which is temporarily not needed. While taxpayer could use this money to reduce its long-term debt, "the retention of liquidity during certain parts of the year was an important contributing factor to the successful operation as a cooperative * * * ." Cotter, 6 Cl. Ct. at 229.

When Cotter has capital temporarily excess to its needs, it tries to reduce the cost of capital used in the business by paying down any short-term loans, prepaying bills if advantageous, and finally reducing the overall cost of its funds, these costs being associated with its long-term debt, by buying short-term commercial paper. It would be inconsistent for Cotter to pay down long-term debt with these temporarily unneeded funds, although placing the funds in short-term instruments frequently does not produce as much interest as would be saved if Cotter's debt could be reduced directly, because of the seasonal nature of Cotter's business, its fluctuating capital needs, and the inflexibility of sources of capital to Cotter, a private company. The interest income considered in this appeal was generated by Cotter's purchase of commercial paper and CDs, with maturity dates of 43 days or less, using temporarily unneeded funds which, for the above-stated reasons, had to remain accessible to taxpayer. We may take judicial notice that anyone managing temporarily surplus funds for others is expected to realize on the fruits available in the form of interest, and not to do so would be a dereliction of duty, and as will appear, the record includes testimony to the same effect.

III.

Section 1382 of the Code exempts "patronage dividends," and s.1388 of the Code states in pertinent part that a patronage dividend "does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons * * * ." By s.1385 patrons report patronage dividends as income so Treasury needs are not ignored. The Claims Court considered a series of revenue rulings and cases in this and other courts construing s.1388, and concluded that the income produced was nonpatronage sourced, based upon a narrow analytical focus limiting the scope of the income-generating "transactions" and an inquiry regarding the need for the income itself. The court viewed its function as determining

only whether the "transaction(s)" which generated the * * * income facilitated the basic purchasing, marketing, or service activities of plaintiff. Simply put, such transactions involved the short-term investment of seasonal surplus cash, not the activities of plaintiff's Finance Department viewed as a whole. Although plaintiff persuasively establishes * * * that the retention of liquidity during certain parts of the year was an important contributing factor to its successful operation, it did not concomitantly demonstrate * * * that the income derived from the investment of surplus cash "actually facilitate(d)" its basic purchasing, marketing, or services activities.

Cotter, 6 Cl. Ct. at 229 [Emphasis supplied.]

The effect of this view is that a penalty is imposed upon Cotter and its patrons for doing what, under existing economic conditions, they have to do. Distributions to patrons are taxed only once except that, when the cooperative does what it must do, parts of the distributions are taxed twice. We cannot believe Congress intended such a result, despite the ambiguous legislative history the Claims Court cites, 6 Cl. Ct. at 227, and which we have considered. We conclude, however, that the Claims Court misapplied the analysis set forth in St. Louis Bank, and therefore the judgement must be reversed, although the opinion is well reasoned and, were the court writing on a clean slate, it might be difficult to refute.

This court looks, in the first instance, to our predecessor's opinion in St. Louis Bank. In that case the Court of Claims considered the nature of income produced by the investment of surplus funds, those funds being the product of borrowed money generated during the process of providing services to the cooperative's patrons. Plaintiff, a banking cooperative authorized to make loans to eligible farmers' cooperatives, occasionally found itself in an undesired surplus funds position; on an average, however, plaintiff was in a deficit position, borrowing substantially more funds on a short-term basis than it placed out. When in a surplus position, plaintiff would lend its excess funds to other related cooperatives; on occasion repurchase arrangements with brokerage houses were made. The income at issue was earned from these loans.

There, as in Cotter, the Commissioner argued that taxpayer's treatment of its surplus funds was functionally separate from its borrowing to correct a deficit position. Thus, while taxpayer's borrowing was service-related, according to the Commissioner, use of its surplus was a merely incidental attempt to make profits that did not directly facilitate taxpayer's services. The Court of Claims disagreed.

The Court of Claims had the benefit of the Service's revenue rulings and Treasury Regulation s.1.1382-3(c)(2), as we do, and distilled from these sources the standard to be applied in this case as in that. The inquiry concerns the direct relationship of the income-generating activities to the cooperative function. Rev. Rul. 69-576, 1969-2 C.B. 166, provides the basic distinction between patronage and nonpatronage activity:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the * * * activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction * * * merely enhances the overall profitability of the cooperative operation, the income is from nonpatronage sources.
[Emphasis supplied.]

This "directly related" test has been followed in subsequent revenue rulings. See Rev. Rul. 74-160, 1974-1 C.B. 246; Rev. Rul. 75-228, 1975-1 C.B. 278. See also St. Louis Bank, 624 F.2d at 1051 (discussing the defective nature of Rev. Rul. 73-497, 1973-2 C.B. 314, which did not apply the "directly related" test).

In St. Louis Bank the Court of Claims applied the "directly related" test by considering the immediate transaction at issue in light of its relationship to other activities undertaken. Considered controlling was the relationship of the surplus funds to the funds borrowed by the plaintiff. "In its management of the surplus funds, [taxpayer] secures interest income which results in lessening costs for the credit provided to its patrons. [Taxpayer's] demand loans * * * directly reduced the cost of the dollars which already had been borrowed * * * ." St. Louis Bank, 624 F.2d at 1052. The court determined that the "integrally intertwined" relationship of the use of surplus funds and the borrowed

money was determinative. "The transactions would not occur but for the process whereby plaintiff secures funds to lend to its members." Id. See also id. at 1053 (holding that income earned from ownership of bonds was patronage sourced as necessary to maintain the required liquidity for doing business at all). Any income generated in this way is considered the result of business done "for patrons."

While the nature of the income-generating transactions in St. Louis Bank and Cotter are remarkably similar, the Claims Court found St. Louis Bank distinguishable and therefore not controlling. The distinction held determinative was the nature of the cooperative: St. Louis Bank was a banking cooperative, while Cotter is a purchasing and distributing cooperative. Given this distinction, the Claims Court determined it should characterize Cotter's activity merely as the investment of capital in commercial paper and the rental of space, and thus narrowly focused only on one facet of intertwined transactions. Viewed in this way, the end product of the transaction is the accrual of only limited income, unnecessary to Cotter's purposes, and merely enhancing overall profitability.

We conclude, however, that our predecessor's method of analysis, focusing on the totality of the circumstances to determine relatedness, applies with equal vigor to Cotter's activities; St. Louis Bank cannot be so narrowly read as to limit its application only to banking cooperatives. Allowing the Claims Court's narrow focus, which considers the transaction without regard to the totality of the circumstances, would allow the surgical removal of one of a series of transactions from the economic realities that necessitated it. Consideration of the relatedness of a transaction to a cooperative's function must be undertaken by viewing the business environment to which it is arguably related. Accord Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827, 832 (5th Cir.), cert. denied, 395 U.S. 844, 89 S.Ct. 2015, 24 L.Ed.2d 462 (1969) (considering the economic realities of transactions in concluding them nonpatronage sourced). The activity producing the income may not be so narrowly defined as to limit it only to its income-generating characteristic when such a characterization is not consistent with the actual activity.

We are aided further by the Eighth Circuit's decision in Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982). There, taxpayer was required to purchase stock from its bank in order to borrow funds for cooperative purposes. The government argued that dividends from this stock, paid to patrons, were not patronage dividends because the cooperative could have borrowed elsewhere without earning income and the payment to the cooperative was not dependent on the amount of the loan. In rejecting the government's argument, which separated the income-generating transaction from the actual business activity as a whole, the court held the income was patronage sourced because it was tied to patronage business. The fact that less favorable loans not intertwined with income-generating components were available, did not skew the focus towards only the income-producing activity. See also Linnton Plywood Association v. United States, 410 F.Supp. 1100 (D.Or. 1976); Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983) (rejecting a "use" of income test).

IV.

Considering the case presented in light of the proper focus, we conclude that the income at issue was earned from business done for patrons. We address first the interest income.

The facts clearly establish that taxpayer must retain large amounts of capital, must retain liquidity, and must borrow money in order to function as a cooperative involved in a seasonal business. Since the St. Louis Bank decision in 1980, the roller coaster ride of interest rates has, if possible, taught added appreciation of the enormity of managing property for others (in this case, the patrons) and not realizing such interest as is possible, consistent with safety, on temporarily idle and

surplus funds. With such inflation as there may be, high or low, comes a constant shrinkage in the real worth of funds not managed in this way. The scheme established by the facts is as follows: taxpayer fulfills its primary function of providing goods at low cost by buying in volume, often before it resells to members. Taxpayer needs large amounts of capital to engage in this large volume merchandizing, and turns to funding by banks. At some point in its seasonal cycle, taxpayer has a temporary surplus of funds. To the extent possible, Cotter uses these funds to pay off debts in a manner consistent with its cooperative purpose; where it can prepay for goods and receive a discount, and thus lower the cost of goods to its customers, it does; where it can reduce its indebtedness without sacrificing its necessary retention of liquidity, it does. Finally, funds exist which must be held to allow Cotter to take advantage of any new purchasing arrangements that will arise in the oncoming months and to assure that it can seasonally retire its bank debt. (Cotter, as a seasonal business, is expected to pay up its bank borrowings within 30 to 90 days.) Cotter, acting as any reasonable business person, reduces the cost of this money while retaining its necessary availability by keeping short-term commercial paper. Its actions are akin to placing its funds in a bank account. Cotter's activity, viewed in the context of its business activity, cannot be considered an action enhancing overall profitability; merely to enhance profitability Cotter would pay off its debt or take other more profitable action. Rather, Cotter acts to retain its liquidity in a manner of any reasonable business person. Its actions are similar to those undertaken by taxpayer in St. Louis Bank.

The government ultimately argues that although retention of these funds is necessary, any activity which incidentally generates income is outside patronage business because such activity, even if the only conservative, reasonable business course available to Cotter, is not "necessary." At argument the government placed great emphasis on the testimony of Cotter's banker, in which he stated that he would not necessarily refuse to lend Cotter funds if it did nothing with the large amounts of capital it needed to retain. This testimony, according to the government, sets Cotter's case apart from Land O'Lakes.

The government's characterization of the testimony, while accurate, does not face up to the witness' plainly stated opinions. On direct examination, Mr. Nelson, the banker, made several points:

Q. How do you relate financial flexibility to the issue of liquidity?

A. * * * Liquidity has an enormous impact upon whether they can retire their debt on a seasonal basis * * * . Liquidity is a function that not only permits the annual pay off, but permits the company to finance that kind of growth without impacting [on] * * * membership confidence, bank confidence, and supplier confidence.

Q. Could a company like Cotter go along without a [financial] plan and just rely on its banks?

A. No.

Q. What would you do as a banker if you perceived that happening to one of your customers?

A. I would force a plan.

Q. How can you force a plan?

A. Not lend them money.

Q. What, if you were going to force a plan, what would some of the elements of this plan be?

A. Certainly I would want to have * * * an understanding as to how they intended historically as well as in the future to pay back their obligations.

I would want to be assured that they were taking those steps within the current structure to make my institution comfortable that we had sufficient protection.

I would want to be sure that they understood what was happening with them from a growth and volume standpoint so that they had thought out how they were going to finance that aspect of their business.

I would want to have an understanding of the unique capital structure that they had to make sure they didn't have a distribution action at a most inappropriate time.

* * * * *

Q. And does [the fact that] Cotter has the excess cash, does that enable you to sleep easier at night * * *

A. Absolutely. You know, it is hard to fully understand sleeping and not sleeping at night until you had a significantly bad credit for which you are responsible for. And it would be foolish of me to suggest that if you have bad credit, that they come from humongous traumatic events.

They come from very simple things like proper management of a company. And the reason why I would sleep well is that they recognized what they were, they were a seasonal company that significantly borrowed from their banks during this seasonal high and managed their affairs so that they could pay out their loans.

* * * * *

Q. [And if a company had no] excess cash, would that give you any discomfort from a seasonal concept?

A. Yes, it would tell me that the odds were very great, more than great, perhaps even absolute that there would come in the near term, a locked-in loan position for that company, so that I would be looking at a seasonal low when I should be paid out, and I'm still in the company's indebtedness. And if the company is growing, that locked-in position would grow over the year. And some time predictably, one or two things would happen: We would have to recognize that we were a stockholder with none of the benefits, or we would have to suggest that the company, that they find other means of financing or in the least possible extreme, would be to for the institution, to tell the person who handles the account to find other employment. But if it is not there, it would cause concern, very extreme concern.

Q. This case, the disallowance in this case is a result from interest income on the excess cash position. If Cotter and Company had not sought to earn any interest income on that excess cash position, what would that have told you as a banker?

A. I think we would feel delighted for a very, very brief period of time. And then I guess I would pick up the phone and call Dan or John and say that David had lost his mind and they should think about another treasurer, because nobody does that. We would like to think that people like us a lot, but nobody likes us that much.

That is a total--would have been a total error and inappropriate action in the financial responsibility of the individual that handles the current assets, current structure.

On cross examination, Nelson continued:

Q. Assuming that Cotter performed in 1975 as it did and as it had in the past, but that it refused to invest its excess cash in short term commercial paper, would Harris Trust have terminated its line of credit?

A. No. As I said earlier, if that was the case, I would be--feel very, very happy for a little while. I would call up Dan and suggest that he investigate the situation and look at [the manager's] personal habits or something.

I can, individual events, you know, a variety can add up to concern and add up to greater loss to the company. But to suggest that because I woke up one day and found out that Cotter and Company had unbelievably \$30 million in cash in a depository relationship that I would say, get your line and get the hell out of here. I would say, probably sit there and think about it so that I could then--I would call Dan, you know, and say, hey, what is going on, something is happening here. Somebody's got a wire that has gotten kind of twisted. * * *

Taken in context, Nelson's comments indicate that as a prudent banker he would not immediately act against a good customer for what was, one might hope, only temporary insanity, but would use his position to correct the financial mismanagement. Taken in context, Cotter's activity, if not "necessary" to retain its line of credit, was necessary to maintain its business credibility, and it does not require a hyperactive imagination to suppose what the patrons would think too if they learned of the cooperative's negligent management of their funds. The fact that other, somewhat incredible, alternatives were available, does not necessitate that Cotter act unreasonably to fall within the beneficial scope of Subchapter T.

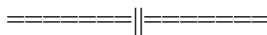
The rental income earned through the leasing out of temporarily excess space is also patronage sourced. The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space. Architects do not as yet provide warehouses with accordion pleated walls that may be expanded or contracted in strict conformity to the owner's needs. Indeed, the Claims Court concluded that "the purchase or construction of warehouse facilities larger than necessary for its present needs facilitated the operation of its growing business." *Cotter*, 6 Cl. Ct. at 231. The court then erred by considering the short-term rental of temporarily unneeded space apart from the facts that Cotter had to maintain excess space, the determination of required capacity is inexact, and the space was rented only as part of Cotter's plan to expand its space over its then-existing needs. It is clear from the undisputed facts that Cotter did not go into the warehouse rental business, seeking to enhance corporate profits while hiding behind its label as a cooperative. Indeed, Cotter occasionally must lease space from others as well. Rather, Cotter implemented a reasonable plan to secure the warehousing of its goods at the lowest cost to its patrons; the result is a primary function of Cotter's.

Conclusion

We agree with the Claims Court that Congress did not intend the term "with or for patrons" to be "of unlimited scope, [so that] all income produced by cooperatives that is passed through to patrons would be, in essence, income obtained for patrons, and would, therefore, be considered patronage sourced." *Cotter*, 6 Cl.Ct. at 227. A cooperative cannot merely "clothe its shareholders as patrons and its corporate dividends as patronage payments" and retain the benefits of Subchapter T. *Mississippi Valley*, 408 F.2d at 835. But Subchapter T was also not enacted to require that a cooperative acting for its patrons function in an economically unreasonable manner or penalize it for acting reasonably. Considering the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function will allow courts to distinguish from cooperative activity transactions which merely enhance overall profitability in a manner incidental to cooperative function. Such activity is not to receive the benefits of Subchapter T. but other activity, which does

directly relate to cooperative function when considered in its actual business environment, cannot properly be considered outside "business done with or for patrons." Cotter's transactions here were not merely to gain incidental profits; they resulted from activities integrally intertwined with the cooperative's functions. The earnings Cotter in this case produced and passed through to its members are patronage dividends.

Therefore, the judgment of the Claims Court is reversed. The cause is remanded to the Claims Court for determination of the quantum of recovery.



Illinois Grain Corp. v. Comm'r
87 T.C. 435 (1986)

KORNER, Judge: For the short fiscal period June 1, 1979 through February 29, 1980, respondent determined a deficiency of \$1,595,926 of corporate income tax against petitioner. After concessions by both sides, the issues which we must determine are (a) whether certain income earned by petitioner in the taxable period constituted income from patronage sources within the meaning of Subchapter T, 1/

[1/ All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.]

and (b) if not, whether such income is subject to reduction by any offsetting expenses attributable thereto in amounts in excess of those allowed by respondent.

FINDING OF FACT

Many of the facts herein were stipulated, and such stipulations are incorporated herein by this reference.

At the time of the filing of its petition herein, petitioner corporation (hereinafter "petitioner" or "IGC") had its principal office and place of business at Bloomington, Illinois. Petitioner's tax return for the period here involved was filed on the accrual basis with the Internal Revenue Service at Kansas City, Missouri.

During its taxable year beginning June 1, 1979 and ending February 29, 1980 ("FY 1980"), IGC was a corporation operating on a cooperative basis within the meaning of section 1381(a)(2), as amended. Prior to IGC's FY 1980, it operated with a fiscal year ending May 31. IGC's fiscal year 1980 was a nine-month taxable year, since, effective March 1, 1980, IGC combined with FS Services, Inc. (which on that date changed its name to Growmark, Inc.) and was then included in Growmark's consolidated Federal income tax return.

During FY 1980 and all of its prior taxable years, IGC was engaged, on behalf of its member and nonmember patrons, in the purchase, distribution and sale of grains, principally corn and soybeans, and the provision of certain ancillary services in connection therewith. With respect to its member patrons, IGC operated on the cooperative basis. With respect to its nonmember patrons, IGC operated on a noncooperative or commercial basis. During FY 1980, IGC had as member patrons approximately 187 local cooperatives located principally in Illinois and 8 regional grain

cooperatives located principally in the midwest. IGC's local cooperative members were farmers' cooperative associations which stored, purchased, conditioned and sold grains for their farmer members on a cooperative basis.

Membership in petitioner was limited to agricultural producers or associations of agricultural producers meeting the requirements and operating in accordance with the Agricultural Marketing Act of 1929 or the Capper-Volstead Act. Each member of petitioner entered into a uniform membership agreement with petitioner which provided that petitioner would, among other things: (1) Make its facilities and services available to a member company on the same equitable basis and manner as to other member companies signing similar agreements; (2) assist member companies in the selection of management personnel; and (3) furnish member companies with various advisory and consulting services. The member company, in turn, agreed that it would: (1) Operate within the provisions of the Capper-Volstead Act or the Agricultural Marketing Act of 1929; (2) use every reasonable effort to utilize the facilities and services of petitioner to the fullest possible extent; (3) offer petitioner the opportunity to purchase all of the grain marketed by the member company, except grain sold locally; and (4) comply with certain requirements pertaining to annual audits, management selection and use of trademarks. The membership agreement did not bind the member to sell its grain to petitioner, nor did it specify the amounts or timing of grain which would be offered for sale through petitioner.

Nonmember patrons, of course, had no such membership agreement with petitioner. Sales of grain offered by nonmember patrons were commingled and handled in the same manner by petitioner as sales for member patrons, except that no patronage refund or dividend was paid to nonmember patrons with respect to their business.

As part of its total grain marketing program, petitioner performed various services for its members. These services included furnishing members advisory and consulting services, information and data, specialized and technical business analysis, market information, hedging assistance, merchandising and storage-use programs and other assistance to help the members improve their operations. Petitioner's advisory services included reviewing members' financial positions and providing members with a comparative analysis of all the member companies as a basis to measure their own performance. The purpose of these member service functions was to assist members in improving their operations so that petitioner would be able to purchase more grain from them, which, in turn, would enhance petitioner's market position and its ability to service members.

With respect to its nonmember patron business, petitioner retained the earnings from such business and paid income tax thereon. During FY 1980, petitioner calculated that its business with members accounted for 65.62 percent of its total grain purchases, and its business with nonmembers accounted for the remaining 34.38 percent of its grain purchases. The division between member and nonmember patronage income was determined on this basis.

In order for petitioner to maximize the return it could get for marketing its patrons' grain, it was necessary that it be organized and operated in an efficient manner and that it find markets for the grain.

The grain which petitioner marketed for its patrons was sent to market either by rail or through a river barge system operating down the Illinois and Mississippi Rivers. Some of petitioner's patrons, located principally in central and eastern Illinois, were too far from the Illinois and Mississippi Rivers to be able to deliver grain economically to petitioner's "track and processor" merchandising operations. In its fiscal year 1979, petitioner opened a new grain terminal at Paxton, Illinois, to service these patrons. The terminal was located at the intersection of two railroads, and

patrons' grain could be shipped from there by rail either to the Gulf Coast or the East Coast for export. During FY 1980, petitioner leased approximately 400 covered railroad hopper cars to provide an assured supply of railroad cars for transportation to connect the Paxton terminal with export terminals on the Gulf and East Coasts. Having control of rail equipment is an important part of merchandising grain through rail terminals.

In the eight full fiscal years immediately preceding the short fiscal year in issue, the annual volume of petitioner's grain sales ranged from just under 160 million bushels to just under 318 million bushels. During this period, approximately 60 percent of the grain marketed by petitioner went through the river barge system. Ever since the late 1940's, the core of petitioner's grain marketing business was its river system. The river system was keyed to utilizing the advantages of economical river transportation to provide Illinois farmers an access to world markets. In addition to the numerous country grain elevators in Illinois owned by petitioner's members, petitioner owned six subterminal elevators on the Illinois River. Two terminal elevators on the Mississippi River in St. Louis, Missouri, were owned and operated by St. Louis Grain Corporation ("SLGC"), an interregional grain marketing cooperative of which petitioner was the principal member patron, and an export elevator in Ama, Louisiana, was owned by Farmers Export Company ("Farmers"), another interregional grain exporting cooperative in which petitioner was a member patron. Additionally, in FY 1980 petitioner was the second largest member patron of Agri-Trans Corporation ("ATC"), an interregional barging cooperative owned by five regional cooperatives. ATC barged grain south for its four grain member cooperatives, down the Illinois and Mississippi Rivers to New Orleans, and barged fertilizer back to the Midwest for the fifth member, a cooperative fertilizer manufacturer. ATC satisfied about 45 to 50 percent of petitioner's barging needs.

For a grain company such as petitioner, with river terminals, barging is an integral part of grain merchandising. Without direct or indirect control of barges, such a grain merchandiser is at the mercy of the market. Consequently, the ability to have an assured source of supply of barges was very important for petitioner. In prior years, petitioner and its predecessors had been adversely affected by barge shortages and had taken some steps to gain control over barges. This was done by leasing barges to barge companies who were then willing to commit a greater number of barges to move petitioner's grain. To assure a source of barges to move grain from its Illinois River terminals, in 1958 petitioner entered into an arrangement with its then principal supplier of barge transportation (The Mechling Company), a manufacturer of barges (Dravo Corporation), and an insurance company (Northwestern Mutual Life Insurance Co.), which called for the construction of four barges by Dravo, which were financed by the insurance company as owner, leased to petitioner pursuant to a long-term bareboat charter, and subchartered to Mechling, which then used those barges and others to move petitioner's grain. Petitioner originally entered into the bareboat charter arrangement with Northwestern Mutual Life Insurance Co. because petitioner was short of capital. The arrangement permitted petitioner to acquire the barges without incurring additional long-term debt.

Prior to 1967, petitioner had shipped a substantial amount of its grain through the Great Lakes and the St. Lawrence Seaway, using a terminal which it then owned in the area of Chicago. In 1967, petitioner disposed of its Chicago terminal and thereafter concentrated its efforts on shipping grain by barge south to New Orleans. Shipments down the Illinois and Mississippi Rivers increased dramatically, so that by its 1975 fiscal year, petitioner loaded approximately 1,300 barges of grain on the Illinois River.

After disposing of its Chicago terminal, petitioner caused its four barges to be subchartered to whichever firm was then the principal supplier of barge services to petitioner. In 1973, petitioner subchartered the barges (of which three remained in operation) to Rose Barge Line. At the time, Rose was the largest hauler of petitioner's grain to the Gulf. When ATC was formed in 1974, it purchased substantially all of the assets of Rose and also succeeded to the subcharter between

petitioner and Rose. The subcharter to ATC was subsequently renewed as to the barges (of which two remained in operation) and remained in effect in FY 1980.

Although petitioner could not control the specific use which ATC made of these barges under the subcharter, ATC used the subcharter barges plus its other barges to transport petitioner's grain from petitioner's river terminals to New Orleans. In FY 1980, petitioner relied on ATC to supply it with approximately half its barging needs. Petitioner regarded the barges it subchartered to Rose and later to ATC as an extension of its river system. In FY 1980, the two barges leased by petitioner to ATC comprised a small part of the ATC fleet of eight tow boats and 335 barges. In that year, ATC carried approximately 1,200 barge loads of grain for petitioner, at a cost to petitioner in the range of \$15 to \$25 million. With respect to the two barges subchartered to ATC, petitioner received gross barge rentals of \$13,109 in FY 1980. On its books, petitioner did not show the barge rentals as a separate item of income, but simply netted the barge rentals received against the overall transportation costs which it paid to ATC. On its FY 1980 tax return, however, petitioner reported gross income from various rents, among which was the \$13,019 from barge rent.

The grain business is extremely competitive, and competition for grain in the areas in which petitioner operated was intense. Petitioner competed with grain processors in Illinois and with the major worldwide grain companies. The principal form of competition was price competition. The major companies in the world grain trade are large private grain firms such as Cargill Inc., Continental Grain Company, Louis Dreyfus, and Bunge Corporation. These are very large companies with access to worldwide capital. For example, Cargill, Inc.'s fiscal 1985 sales were \$32 billion. By comparison, petitioner's annual sales in fiscal 1979 were approximately \$925 million.

The grain market is also highly volatile, which is the result of many things affecting supply, demand and price, including seasonal factors, cyclical factors, political factors and the weather. Seasonal factors affecting the grain business are a result of the fact that grain is harvested at one time of the year and then marketed over a 12-month period. The exact marketing pattern of each year's crop is not predictable.

There is no way for a company in the grain business to insulate itself from the supply, demand and resultant price volatility that exists in the grain business. The volatility of this business results in grain price fluctuations which have a major impact on grain companies. Grain price fluctuations can result in rapid changes in a grain company's capital requirements. A substantial increase in grain prices can result in significant cash demands upon a company, such as petitioner, as a result of such things as increases in margin requirements and inventory values. A substantial decline in grain prices would have the opposite effect; it would reduce capital needs and provide additional funds to a company such as petitioner. To deal with the volatility that exists in the grain business, a company must build into its financial structure a high degree of flexibility in the form of liquidity in order to fund the changes in its current assets and liabilities.

During the period June 1, 1978, through February 29, 1980, petitioner's assets (current and fixed) varied at month end from approximately \$60 million to more than \$100 million. The volatility in petitioner's capital needs arose principally from sharp fluctuations in its current assets (e.g., inventory, accounts receivable, margin deposits, grain sales advances, and cash and short-term instruments). For instance, petitioner's current assets went from approximately \$28 million on September 30, 1978, to approximately \$66 million on December 31, 1978, and back to approximately \$39 million on May 31, 1979. It was essential to the conduct of petitioner's grain marketing business that petitioner have the necessary financial flexibility to be able to finance the highs which it experienced in its capital needs. There were periods of time when petitioner was short of quick cash working capital, as well as other periods in the year when petitioner had temporary surpluses in its working capital. Petitioner was undercapitalized; it lacked an adequate amount of

capital to compete effectively with the large international grain companies. Undercapitalization made it potentially more difficult for petitioner to operate on a day-to-day basis.

Petitioner's long-term debt was financed with the St. Louis Bank for Cooperatives ("St. Louis Bank"). In its FY 1980, such long-term debt fluctuated narrowly in the range between \$13.7 million and \$14.9 million (using rounded figures). Aside from this long-term debt, petitioner had short-term or current liabilities, principally in the form of notes payable, sales advances and accounts payable, which fluctuated rapidly during the course of the year, and which generated both deficits and surpluses of working capital at various times. The causes of these fluctuations were both market conditions as well as specific financing programs which petitioner used in aid of its grain-marketing efforts. The principal causes may be identified and described as follows:

(A) Deferred Pricing Program.

Petitioner entered into contracts with members which allowed them to sell grain to petitioner, while at the same time allowing the member to defer the time when such grain would be priced for up to 270 days. Petitioner was able to take title to the grain, sell the grain and generate cash, while its obligation to pay for the grain was deferred. Later, when a member elected to price the grain, petitioner was required to make payment the next day, provided that in no event was payment due earlier than 60 days after the original transfer to petitioner.

In FY 1980, deferred pricing contracts generated temporary cash for petitioner, since many deferred pricing contracts were entered into in late summer and early fall 1979 and the member companies who entered into these contracts did not price the grain until after January 1, 1980. Although petitioner was initially reluctant to offer a deferred pricing program to its members, it did so to meet competition from other grain companies and to satisfy the demand for such arrangements from its members and from their farmer members. A deferred pricing program made it possible for petitioner to obtain grain at times its members might otherwise be reluctant to sell grain because of their evaluation of the market.

When petitioner sold grain which it had received under the deferred program, it immediately went into the futures market and bought a futures contract. Petitioner was then short in cash grain, because it had sold the grain, and it was long on the futures market. In this way, petitioner was able to hedge its position. Ordinarily, prices in the futures market are higher in March than in November. This increase reflects storage carrying charges for grain and the cost of money to hold the grain from November until March. To offset the storage carrying charge built into the cost of hedging, petitioner charged members a service charge for deferred pricing transactions. To offset the cost of money factor built into the cost of hedging, petitioner was able to use the cash generated by the transaction.

(B) Hedging Activities.

It was the policy of petitioner to sell grain on a hedged basis as much as was practical. Hedging is an integral and necessary part of the business of any grain marketing company. Petitioner entered into contracts to purchase grain and contracts to deliver grain and then hedged the open cash grain commitments in the futures market to minimize its vulnerability to losses from price fluctuations. For hedging purposes, petitioner used the services of Illinois Cooperative Futures Company ("ICFC"), a cooperative headquartered in Chicago, which executed futures contracts on the Chicago Board of Trade for its members. ICFC's membership included 104 regional and local cooperatives, including petitioner. It was necessary for petitioner to make an initial margin deposit on each futures contract it bought or sold when it hedged on the Chicago Board of Trade. As the market price of grain changes every day, petitioner was required either to make additional margin

deposits, or margin money was returned to petitioner. Petitioner normally was long on grain and short in the futures market. When the price of grain increased, petitioner was normally required to increase its margin deposits. When the price of grain decreased, margin deposits were returned to petitioner.

In FY 1980, petitioner's hedging activities generated cash as margin money was released. This was the result of petitioner's smaller inventory and of price movements in the market. In a 10-day period during June 1979, there was a \$10 million swing in amounts required to be put up by petitioner as margin for its hedging activities. Petitioner regarded the conditions leading to the reduction of its margin requirements as temporary in nature, and did not know how long they would last.

(C) The Member Note Program.

Petitioner believed that it was in its members' best interest to use their temporary surplus working capital in a way which would maximize the amount that they could return to their farmer members. In addition, petitioner was concerned that member company funds were not always safe when, as was often the case, they were left in small-town banks. In response to this situation, in the early seventies, petitioner developed a member note program. Offering the member note program to its members was one of the service programs which petitioner provided its members, similar to hedging and other service programs. It also provided petitioner with a source of short-term funds.

The member note agreements provided that petitioner would hold the members' funds for a minimum term of 15 days and a maximum of 270 days. Petitioner paid the member a fixed rate of interest which ordinarily was set at two percentage points below the prime rate of interest at the time the note was issued. A member could redeem its note upon demand for cash any time after the 15th day.

Petitioner's members increased the amount of member notes they placed with petitioner in the fall of 1979 over previous years. The same conditions that left petitioner with temporary surplus working capital during this period also left petitioner's members with temporary surplus working capital. The member company note program generated a significant amount of cash for petitioner in FY 1980, particularly during the period petitioner had temporary surplus working capital from other sources.

(D) Inventories.

Petitioner's inventories decreased in July and August 1979. Inventories moved upward in September and October, but not in as great an amount as was expected during a normal harvest period. Inventories dropped further in November and December and then increased in January and February 1980. When inventory quantities or values decreased, funds were freed up in petitioner's business. Declines in the quantities and value of petitioner's inventory contributed to its temporary surplus working capital during the last part of FY 1980.

(E) Earnings.

Petitioner generated small earnings during the early portion of its FY 1980. As petitioner got into the harvest period, however, it generated substantial earnings from August through December. There was a reduction in earnings in January of about \$1 million as a result of the Russian grain embargo and a slight recovery in February. Earnings were one source for petitioner's temporary surplus working capital position during the last part of FY 1980.

* * *

In the management of its capital requirements, petitioner maintained banking relationships with the St. Louis Bank and also with the First National Bank of Chicago ("First National Bank"). In addition to its long-term debt which it had financed with the St. Louis Bank, petitioner also had a \$40 million short-term line of credit from the St. Louis Bank, and a \$20 million short-term line of credit with the First National Bank. The rate of interest the St. Louis Bank charged petitioner on short-term and long-term borrowing during the fall of 1979 was 10 percent. On January 1, 1980, the short-term rate moved up to 13 percent while the long-term borrowing rate stayed at 10 percent.

During FY 1980, before the end of the grain market on each day (approximately 1:15 to 1:30 p.m.), petitioner assessed its cash needs for the day. If it required additional cash, it would borrow short-term from one of the two above mentioned banks. If it made this decision before noon, it borrowed funds from the St. Louis Bank. If the need for funds arose later in the day, the funds were borrowed from the First National Bank. Since the Chicago Board of Trade required any additional required margin to be posted within 45 minutes of the closing of the market, it was necessary that petitioner have a banking relationship with a bank located in Chicago. In addition to its needs for funds to meet these requirements, petitioner also felt that it was important to its financial flexibility not to restrict itself to a banking relationship with a single bank.

As a result of all the forces described above, if petitioner found itself in a net positive cash position on a particular day, it would first pay back any short-term borrowings that it had outstanding (e.g., member notes, short-term bank loans). If no short-term borrowings were outstanding, then petitioner would use any temporary surplus working capital to purchase short-term instruments. Occasionally, by miscalculation or mistake, petitioner would use such cash to purchase short-term instruments before all short-term borrowings were paid back. This occurred on only two occasions in FY 1980. Petitioner rarely found itself in a position where it neither required additional cash nor had temporary surplus working capital.

Beginning on September 7, 1979, and continuing through the end of FY 1980, petitioner was in a position where it had temporary surplus working capital, in varying amounts. Petitioner used these temporary surpluses to purchase short-term instruments from the First National Bank. It purchased commercial paper of the holding company of the First National Bank, and certificates of deposit of the First National Bank. On a few occasions during FY 1980, petitioner entered into repurchase agreements or purchased Treasury Bills through the First National Bank. During FY 1980, petitioner made 136 separate purchases of interest-bearing instruments. Ninety-eight of these transactions, or 72 percent, were overnight or overweekend transactions. Twenty-eight of such purchases, or 21 percent, were for a week or less, mostly overweekend with an extra day tacked on at one end of the weekend. The remaining 10 transactions were for more than a week. Of these 10, 4 took place in December when petitioner was confident that its member companies would not want their funds until January.

The reason for the high level of overnight transactions was that petitioner did not know when it would need the temporary surplus working capital in its business. Petitioner was making daily judgments that, for the most part, it would need its surplus working capital on its next business day. If petitioner had been willing to purchase short-term instruments with longer maturities, it would have been able to earn a higher rate of interest. The rates of interest for commercial paper were going up during this period of time.

Petitioner never considered using its temporary surplus working capital to pay off any long-term debt. Since its long-term debt agreements with the St. Louis Bank required that any prepayment of principal be applied to the last principal payment due under the note, any such

prepayment by the petitioner would not have reduced its current level of payments on the long-term debt.

Petitioner likewise never considered leaving its temporary surplus working capital in a noninterest-bearing account, or distributing such excess working capital to its members. Given petitioner's state of under capitalization, and its chronic need for short-term funds, either such practice would have been viewed with extreme disfavor by the First National Bank of Chicago as evidencing poor financial management on the part of petitioner. Since the First National Bank was an important source of credit and funds, petitioner considered it important to maintain and strengthen its relationship with the bank.

On its books, petitioner netted its interest income against interest expense. The actual figures on its financial statements for FY 1980 were interest expense of \$1,592,000, interest income of \$744,000, or net interest expense of \$847,000. In its tax return for FY 1980, however, petitioner listed gross income from interest from a number of sources, one of which was \$585,490.22 from "commercial paper, certificates of deposit, repurchase agreements, treasury notes."

Petitioner's return for FY 1980 treated all its net income as derived from its cooperative grain marketing activity, that is to say, as patronage-sourced income. Petitioner then allocated such income between member business and nonmember business on the basis of the quantity of grain sold for members and the quantity of grain sold for nonmembers. Petitioner then paid patronage refunds to its members in the amount of \$3,304,253.04. Of this amount, \$663,078.04 was paid in cash and \$2,641,175 was paid in petitioner's stock. The patronage refunds paid by petitioner to its members with respect to its fiscal year 1980 were: (a) Paid on the basis of the quantity or value of business done with or for patrons; (b) paid under an obligation of petitioner to pay such patronage refunds, which obligation existed before it received the amount so paid; (c) actually paid on or before the fifteenth day of the ninth month following the close of FY 1980; and (d) paid entirely in cash and "qualified written notices of allocation," as that term is defined in section 1388(c).

Upon audit of petitioner's return, respondent determined, inter alia, that \$213,795 of petitioner's patronage dividends exclusion under section 1382(b) was not allowable because such amount was "attributable to income not derived from patronage sources and therefore is not deductible." Respondent has now agreed that the correct amount of such disallowance should be \$143,359. Included in this figure is respondent's determination that the interest which petitioner earned on the short-term debt instruments which it purchase, in the net amount of \$324,435, as well as the barge lease income, in the net amount of \$7,179, was not derived from patronage sources and accordingly was not eligible for distribution as a patronage refund.

Ultimate Finding of Fact

The interest income which petitioner received from the purchase of short-term debt instruments, as well as the rentals from its two barges, were derived from business done with or for petitioner's patrons.

OPINION

The principal question which we must decide in this case is whether certain income earned by petitioner was derived from patronage sources within the meaning of subchapter T of the Internal Revenue Code. More specifically, was the income in question derived by petitioner from "business done with or for [its] patrons," within the meaning of section 1388(a)(1)?

The question is of unique importance in the taxation of cooperatives, and of nonexempt or taxable cooperatives in particular. In general, all cooperatives, whether so-called "exempt" cooperatives under section 521, or so-called "nonexempt" or "taxable" cooperatives, are taxed in the same fashion as any other corporation. Secs. 1381(b), 1382(a). 2/

[2/ Certain special types of cooperatives are not included within the ambit of subchapter T. Thus, certain mutual savings banks and building and loan associations are taxed under the special provisions of Part II of subchapter H and certain insurance companies are specially taxed under the provisions of subchapter L. Such companies, together with cooperatives furnishing electrical energy or providing telephone service to persons in rural areas, are excluded from the provisions of subchapter T. Sec. 1381(a)(2).]

Such cooperatives, however, are entitled to certain additional deductions, not available to other taxpayers, in the computation of their net taxable income. 3/

[3/ "Profits" and "income" are considered somewhat dirty words in the cooperative fraternity. Consistent with the broad philosophy that cooperatives are intended to operate at cost, eliminating entrepreneur profit and returning their net earnings to their patrons on an equitable basis, see secs. 1382(b), 1388(a); see also Packel, *The Organization and Operation of Cooperatives*, (4th ed. 1970), sec. 2, cooperatives tend to eschew the words "profits" and "income," preferring instead the more delicate terms "margins" and "savings." Under the iron rod of the Internal Revenue Code, however, and subchapter T in particular, cooperatives do have taxable income, particularly where, as here, the cooperative elects to distribute patronage dividends only to its member patrons. The balance of a cooperative's income, not so distributed to patrons on a patronage basis, sec. 1388(a), is fully taxable, whether patronage-sourced or not.

In *Farm Service Cooperative v. Commissioner*, 619 F.2d 718, 723 (8th Cir. 1980), revg. 70 T.C. 145 (1978), the Court of Appeals said:

A nonexempt cooperative is a hybrid business organization, taxed like an ordinary corporation with respect to nonpatronage-sourced income (see subchapter C, IRC 301 et seq.), but like a partnership with respect to patronage-sourced income. * * * That is to say, nonpatronage-sourced income is fully taxable to the cooperative and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxed only once, usually to the patron.]

Among these additional allowable deductions, available to both exempt and nonexempt cooperatives, is that provided by section 1382(b)(1), which states:

(b) Patronage Dividends and Per-Unit Retain Allocation.--In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year; * *

* 4/

[4/ Certain other additional deductions are provided for all cooperatives in sec. 1382(b), and further additional deductions are provided for exempt cooperatives under sec. 1382(c). We are not concerned with those special deductions here.]

Section 1388(a) defines patronage dividend as follows:

(a) Patronage Dividend.--For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies--

- (1) on the basis of quantity or value of business done with or for such patron,
- (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
- (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

What, then, is the meaning of the phrase "business done with or for such patron," or, as the synonymous phrase has evolved, "income from patronage sources"? The Code provides no definition, and the legislative history of the subchapter T provisions is not helpful. The sole guidance to be found in respondent's regulations is one which undertakes to define the concept in negative terms, that is to say, by attempting to give a definition of that which is not patronage income. Thus, in attempting to define income "from sources other than patronage" under section 1382(c)(2), respondent's regulations provide:

(2) Definition. As used in this paragraph, the term "income derived from sources other than patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage. [Sec. 1.1382-3(c)(2), Income Tax Regs.]

Although the above-quoted language appears in respondent's regulations with respect to a Code provision of exclusive application to exempt cooperatives -- section 1382(c) -- it appears to be generally accepted that this definitional attempt is of equal application to both exempt and nonexempt cooperatives.

In spite of the apparently clear language of the regulation, however, the law, as it has developed, shows that the language does not always mean what it literally says. Both respondent and the courts have played a hand in this evolution of the law, as we shall see.

Thus, in the case of interest, both the courts and respondent have acknowledged that interest income may have the quality of income from patronage sources, depending upon the circumstances. Cotter and Company v. United States, 765 F. 2d 1102 (Fed. Cir. 1985); St. Louis Bank for Cooperatives v. United States, 624 F. 2d 1041 (Ct. Cl. 1980); Rev. Rul. 74-160, 1974-1 C.B. 245. Dividend income has sometimes likewise been held to be patronage sourced. Land O'Lakes, Inc. v.

United States, 675 F. 2d 988 (8th Cir. 1982); Linnton Plywood Association v. United States, 410 F. Supp. 1100 (D. Ore. 1976); Rev. Rul. 75-228, 1975-1 C.B. 278. Rental income has also been held to be patronage sourced, on occasion. Cotter and Company v. United States, *supra*; Rev. Rul. 63-58, 1963-1 C.B. 109 (semble); and some capital gains income has been held to be income from patronage sources, under the circumstances presented in the particular case. Astoria Plywood Corp. v. United States, an unreported case (D. Ore. 1979), 43 AFTR2d 79-1114, 79-1 USTC par. 9197; contra Rev. Rul. 74-160, 1974-1 C.B. 245.

Is there any touchstone or common thread running through these various cases and rulings which enables them to be reconciled with their facial inconsistency with the language of respondent's regulation, quoted above? We think it can be found in one of respondent's own pronouncements.

In Rev. Rul. 69-576, 1969-2 C.B. 166, the taxpayer, a nonexempt farmers cooperative, borrowed money from a bank for cooperatives, itself a cooperative. The money was borrowed to finance the acquisition of agricultural supplies for resale by the taxpayer to its members. The taxpayer cooperative paid interest to the bank on this loan. After the close of the year, the cooperative bank determined its net margins or savings from business done with borrowers, and paid to the taxpayer, as a patronage dividend, its ratable and patronage share of the interest income thus earned. The taxpayer cooperative, in turn, included the amount of such patronage dividend in the patronage distribution which it made to its member patrons. In holding that this patronage dividend from the cooperative bank should be considered as patronage-sourced income in the hands of the taxpayer cooperative, respondent ruled:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

Accordingly, inasmuch as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its member, thereby directly facilitating the accomplishment of the cooperative's purchasing activities, it is held that the allocation and payment of this same amount by the nonexempt farmers' cooperative to its own patrons (farmers) qualifies as a patronage dividend. * * * [Rev. Rul. 69-576, 1969-2 C.B. 167.]

Analysis of the relevant cases under the above standard shows that they can be reconciled. What is revealed is that the courts (if not respondent) have consistently resolved the cases before them, based upon an application of the principles of Rev. Rul. 69-576 to the facts at hand.

In Astoria Plywood Corp. v. United States, *supra*, the taxpayer cooperative leased a plant facility in which it conducted its activity of manufacturing plywood. When the landlord canceled the lease, it made a lease cancellation payment of \$50,000 to the taxpayer. Holding that the use of the plant facilities to manufacture plywood was directly related to the taxpayer's cooperative activities, the court held that the income from the cancellation of the lease (arguably to be classified as capital gain income) was nevertheless income from patronage sources and was eligible for distribution as a patronage dividend. In so holding, the court clearly disapproved, without mentioning it by name, the provisions of Rev. Rul. 74-160, *supra*, which held to the contrary.

In Linnton Plywood Association v. United States, *supra*, the taxpayer cooperative, together with another cooperative, organized a third corporation, in which the taxpayer owned a 50 percent interest, for the purpose of making glue which the two cooperatives used in their business of making plywood. The court held that the dividends received by taxpayer from the 50 percent-owned subsidiary were patronage-sourced income, since such income was directly related to the cooperative's business, in which glue was an essential element. In this case, it is noteworthy that there was no suggestion that the glue could not have been obtained from any other source.

In Land O'Lakes, Inc. v. United States, *supra*, the taxpayer, a dairy marketing cooperative, borrowed money from the St. Paul Bank for Cooperatives in order to finance its cooperative business. In order to be eligible to borrow from the bank, the taxpayer had to buy a certain amount of stock in the bank. Dividends received on such stock by the taxpayer were distributed to its member patrons on a patronage basis, an action which the Commissioner disallowed on the basis that the dividend income was not patronage-sourced pursuant to section 1.1382-3(c)(2), Income Tax Regs. The court held, however, that the purchase of the bank's stock actually facilitated the cooperative business by making favorable financing available to it, and thus the dividends received were patronage-sourced. In so holding, the court cited with approval and appears to have clearly adopted the rationale of Rev. Rul. 69-576 and Rev. Rul. 74-160.

In Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983), the taxpayer was a nonexempt cooperative, serving as a purchasing, warehousing and distribution facility for the goods sold by its member patrons. On occasion, when it had temporary surpluses in its cash, above immediate needs, the taxpayer invested such funds in short-term certificates of deposit and earned interest thereon, which it distributed to its member patrons as part of its patronage dividends.

In upholding the government's disallowance of these distributions on the grounds that the interest income was not patronage sourced, the Claims Court emphasized what it considered to be the lack of a sufficiently direct relationship between the lending of surplus funds and the principal business of the cooperative. Thus, the court found that there was little if any connection between the cooperative's money management and the services which the cooperative provided to its patrons, and that there was no direct connection between the short-term loans and the cooperative activity of buying, storing and distributing merchandise. The court rejected a test which would have qualified the income as patronage sourced simply because it was used to enhance the profitability of the business as a whole. In so holding, it seems clear that the court was accepting and following the rationale of Rev. Rul. 69-576, and, in its own wisdom, was applying it to the facts of the case before it.

In St. Louis Bank for Cooperatives v. United States, *supra*, the taxpayer was a nonexempt cooperative bank, whose business was to make loans to other cooperatives. The taxpayer's source of funds, with which it made loans to other cooperatives, in addition to a certain amount of equity capital, was derived from long-term debt which it issued itself and short-term borrowings from the Central Bank for Cooperatives, as well as from commercial banks and from other farm credit banks. During the period in question, its primary source of funds was its long-term debt, and the Central Bank for Cooperatives was relied upon as the primary supplier of short-term borrowings.

The St. Louis Bank was constantly engaged in managing its funds so that it would have sufficient funds on hand to lend to eligible cooperatives. Such needs fluctuated widely on a very short-term basis. The taxpayer attempted to make provision for its necessary funds on a daily basis, but it sometimes resulted that it had a deficit in its necessary available cash, while at other times it found it was in a surplus position with respect to available cash. These surplus or deficit positions resulted from overestimating the needs of its borrowers, or underestimating those needs. Its cash

position was rarely in balance, although it was more often in a deficit position than otherwise, and frequently had to borrow funds on a short-term basis.

During the years before the court, when the taxpayer found it had funds available that were temporarily surplus to its needs, it normally loaned the funds on a demand basis to the Central Bank for Cooperatives or, on several occasions, to other farm credit banks in its district, in compliance with established policy to encourage intersystem use of surplus funds. In a few cases it loaned funds on a short-term basis to commercial houses under repurchase agreements. Such loans were always on a demand or short-term basis, in order to assure availability to the taxpayer in the event it was determined that such funds were needed to cover advances to eligible borrowers.

The taxpayer treated the interest which it made on its short-term loans of the surplus funds as patronage-sourced income, and included it in the amounts which it distributed to its patrons on a patronage basis. The government took the position that such interest income was not patronage sourced, in that the loans were not made to taxpayer's patrons, nor made for them. On the contrary, the government contended that the placement of the taxpayer's temporary surpluses in short-term and demand instruments was not integrally related to the conduct of the cooperative business and was therefore to be classified as nonpatronage-sourced income not eligible for distribution as patronage dividends.

The Court of Claims rejected the government's position in this case, and in so doing, clearly embraced the directly-related standard of Rev. Rul. 69-576. It held that the taxpayer's placement of temporary surpluses in short-term loans was "integrally intertwined" with the taxpayer's cooperative business of managing its money supply. It held that such short-term placements were not "investments" but simply constituted the prudent and correct management of the taxpayer's money which was directly related to the conduct of its cooperative business. As the court said:

Interest income from bonds plaintiff held for liquidity purposes is patronage sourced because the transactions involved are directly related to plaintiff's services to its patrons. They were a prerequisite to plaintiff's functions. Unless the bonds were held, plaintiff could not issued consolidated bonds, the primary source of loan funds for its patrons. [St. Louis Bank for Cooperatives v. United States, 624 F. 2d at 1053.]

Finally, we consider the case of Cotter and Company v. United States, *supra*. In that case, as in the instant case, the taxpayer had two sources of funds which were challenged as not being patronage sourced. The taxpayer was a nonexempt cooperative engaged in the business of purchasing, manufacturing and distributing to its patron members hardware and related goods in large volume. In the conduct of the enterprise, it was essential that taxpayer have cash available, either through short-term borrowings or cash on hand, in order to finance the volume purchase of goods which it later resold to its patron members. The taxpayer's business was seasonal, in that it made many of its purchases throughout the year, frequently some time before it resold the goods to its members. Because its payments to its suppliers were frequently due before it received funds from its members, it was required to maintain substantial liquidity either from short-term borrowings or from cash on hand. It happened that at many times during the year the taxpayer had a working capital deficit, whereas at other times it had surpluses of cash in excess of its immediate needs. At all times, however, the retention of sufficient liquidity was essential to the proper conduct of its business.

When the taxpayer had temporary surpluses of cash, it followed the practice of paying down short-term loans or prepaying bills. When these measures had been exhausted, it followed the practice of placing its temporary cash surpluses in short-term commercial paper. The Claims Court found that the taxpayer's money management practices in this respect were directly related to its

cooperative activity and were an inseparable part thereof. The government, however, disallowed the interest income earned by the taxpayer from the short-term placement of its funds, on the grounds that such actions were merely a passive investment of surplus funds, which had no purpose except to enhance the overall profitability of the cooperative. Accordingly, the government urged (and the Claims Court below found) that the interest income earned by the taxpayer was not patronage sourced nor eligible for distribution as patronage dividend.

The Federal Circuit reversed the Claims Court in this matter, and in so doing, it clearly adopted the directly related test of Rev. Rul. 69-576, as well as the rationale of the Court of Claims in *St. Louis Bank for Cooperatives v. United States*, *supra*, and that of the Court of Appeals of the Eighth Circuit in *Land O'Lakes v. United States*, *supra*. In following the lead of the Court of Claims in *St. Louis Bank*, the Federal Circuit held that the directly-related principle employed was not to be applied only to money-management activities of cooperatives engaging in the banking business. As the Court said, to allow such a

narrow focus, which considers the transaction without regard to the totality of the circumstances, would allow the surgical removal of one of a series of transactions from the economic realities that necessitated it. Consideration of the relatedness of a transaction to a cooperative's function must be undertaken by viewing the business environment to which it is arguably related. * * * The activity producing the income may not be so narrowly defined as to limit it only to its income-generating characteristic when such a characterization is not consistent with the actual activity. [*Cotter & Co. v. United States*, 765 F. 2d at 1106-1107. Emphasis in original.]

The Federal Circuit went on to say:

Cotter, acting as any reasonable business person, reduces the cost of this money while retaining its necessary availability by keeping the short-term commercial paper. Its actions are akin to placing its funds in a bank account. Cotter's activity, viewed in the context of its business activity, cannot be considered an action enhancing overall profitability; merely to enhance profitability Cotter would pay off its debt or take other more profitable action. Rather, Cotter acts to retain its liquidity in a manner of any reasonable business person. Its actions are similar to those undertaken by taxpayer in *St. Louis Bank*. [765 F. 2d at 1107.]

The Court of Appeals accordingly held that the incidental interest income earned by the taxpayer cooperative from the short-term placement of its temporary surpluses was directly related to and actually facilitated the cooperative enterprise within the meaning of Rev. Rul. 69-576. As a result, such income was considered as patronage sourced and eligible for distribution as a patronage dividend.

The second issue involved in the *Cotter* case involved rental income. The taxpayer required substantial amounts of warehouse space in the conduct of its cooperative business, to store merchandise which it had acquired or manufactured and which it had not yet shipped out to its patron members. The business was experiencing rapid growth, and the cooperative realized that it had a need for additional warehouse space, which would increase even further in the future. It accordingly designed and had built, or leased, additional warehouse space, including some excess space which it anticipated it would need in the future. In the meantime, it leased out its temporarily excess warehouse space, and derived some minor rental income therefrom.

Here, as in the case of the interest income, the government contended that the taxpayer's rental income from leases of excess warehouse space was not directly related to its cooperative enterprise and should be considered as nonpatronage-sourced income, apparently relying on the

quoted regulation. The Claims Court upheld the government's position, but once again the Court of Appeals reversed, saying:

The rental income earned through the leasing out of temporarily excess space is also patronage sourced. The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space. Architects do not as yet provide warehouses with accordion pleated walls that may be expanded or contracted in strict conformity to the owner's needs. * * * It is clear from the undisputed facts that Cotter did not go into the warehouse rental business, seeking to enhance corporate profits while hiding behind its label as a cooperative. Indeed, Cotter occasionally must lease space from others as well. Rather, Cotter implemented a reasonable plan to secure the warehousing of its goods at the lowest cost to its patrons; the result is a primary function of Cotter's. [765 F. 2d at 1109-1110.]

* * *

A review of the statutory provisions, the decided cases in the area and, indeed, respondent's announced position on the subject, as embodied in Rev. Rul. 69-576, leads us to the conclusion that in this case, the petitioner must prevail as to both types of income here in issue. As the cases make clear, such a determination is necessarily fact-intensive. Income derived by a cooperative from its various business activities may indeed be so closely intertwined and inseparable from the main cooperative effort that it may be properly characterized as directly related to, and inseparable from the cooperative's principal business activity, and thus can be found to "actually facilitate" the accomplishment of the cooperative's business purpose. On the other hand, it is equally possible that a cooperative may undertake business activities which, while profitable, have no integral and necessary linkage to the cooperative enterprise, so that it may fairly be said that the income from such activities does nothing more than add to the taxpayer's overall profitability. It all depends on the facts of each case. In the instant case, we consider the facts with respect to each type of income separately.

1. The Interest Income.

The facts in this case show that petitioner's principal cooperative enterprise was the marketing of its patrons' grain. The financing of this enterprise was complex, and called for petitioner's constant attention and management of its money, so as to have available on short notice large amounts of cash to meet margin calls, to repay members' notes, to satisfy patrons' demands under the deferred pricing arrangements which petitioner had with its patrons, and to pay its current bills. On the other hand, petitioner received funds, not entirely on a predictable basis, from sales (reducing its inventories), and from lessening margin requirements (which fluctuated on a daily basis), as well as from its long-term and short-term borrowings. Although petitioner analyzed its cash needs on a daily basis, it could not always be precise. On some days, petitioner had to exercise its short-term line of credit to borrow from the First National Bank or the St. Louis Bank. On other days, petitioner would find itself in a surplus cash position. When the latter event occurred, petitioner, in the exercise of ordinary prudent business management, placed its temporary surplus funds in extremely short-term debt instruments -- for the most part, overnight or overweekend loans to the First National Bank, or its wholly-owned subsidiary. The primary purpose here was not to "invest," but to find a temporary parking place for its surplus funds, consistent with safety and prudent money management. We do not agree with respondent's contention that such placement of temporary surplus funds in short-term debt instruments constituted an "investment" of such funds, as that term would generally be understood. Petitioner's actions here were entirely comparable to placing the funds in a bank account. One does not make an "investment" in a bank account. The rate of interest which petitioner earned on these extremely short-term placements was less, as we have

found, than the interest which petitioner could have earned elsewhere on longer-term debt instruments.

In short, we are convinced that petitioner's money management activities in this case were inseparably intertwined with the overall conduct of its cooperative enterprise, and the interest income which it earned was therefore patronage sourced, to the same extent as in the Cotter and St. Louis Bank cases.

2. The Barge Rental Income.

The facts here show that petitioner relied heavily upon river barges to transport its patrons' grain to market. In fact, in the period before us, over half of petitioner's grain went to market in this fashion. Petitioner operated no barges itself to transport its members' grain, but over the years had relied on various barge companies to perform this service. In order to secure an adequate supply of barges for the transport of its grain, petitioner some years prior to the year in issue, had caused four barges to be constructed, which it then leased from the Northwestern Mutual Life Insurance Co. as owner, and subleased to whichever barge company was performing the transportation function for it. We assume that it paid the normal transportation costs for the barging of its grain, and that the barge company to whom it subleased its barges likewise paid a fair and arms-length rental; respondent herein does not contend otherwise.

By the time of the year here in issue, petitioner's four barges had dwindled to two, which were subleased by petitioner to a barge transportation cooperative of which it was a member-patron. Although, as we have found, petitioner did not exercise direct control over the use to which the barges were put, it was clearly in petitioner's interest to see to it that the barge company had an adequate supply of bottoms in which to transport petitioner's grain. We can find no distinction here between petitioner's actions in providing barges to ATC, and its actions in leasing 400 covered railroad hopper cars to provide a supply of such cars for the shipment of its grain by rail, handled by various railroads, a situation as to which respondent has raised no question.

Here again, as in the case of petitioner's interest income, we are satisfied that petitioner's leasing and subleasing of barges to its transportation cooperative was not an "investment" in such barges, intended to produce merely passive rental income, but was an integral part of its overall cooperative activity in moving its patrons' grain to market. The provision of such barges by petitioner to ATC may not have been a significant factor in the ability of ATC to move petitioner's grain, given the fact that there were only two barges left by the year in issue, but we think it was clearly linked to petitioner's principal cooperative enterprise, and was not entered into as an independent and unrelated profit-making activity. We accordingly hold that the barge rentals which petitioner derived in the year in issue were patronage sourced income, within the rationale of Rev. Rul. 69-576, and consistent with the philosophy expressed in the Cotter case.

In opposition to petitioner's position herein, respondent argues strenuously that the Federal Circuit went too far in Cotter, and that the standard enunciated in that case opens the door to a cooperative claiming that any income it earns, from whatever activity, can be qualified as patronage sourced income simply because it improves a cooperative's overall profitability. Thus, according to respondent, if we follow Cotter, every "car wash" or "bake sale" sponsored by a cooperative will produce income from patronage sources, simply because the net proceeds are used in the cooperative's business.

We think that respondent's concerns are considerably overblown. In our view, the Federal Circuit in Cotter clearly was aware of the danger of an indiscriminate application of its interpretation of subchapter T. It addressed this concern in these words:

We agree with the Claims Court that Congress did not intend the term "with or for patrons" to be "of unlimited scope, [so that] all income produced by cooperatives that is passed through to patrons would be, in essence, income obtained for patrons, and would, therefore, be considered patronage sources." Cotter, 6 Cl. Ct. at 227. A cooperative cannot merely "clothe its shareholders as patrons and its corporate dividends as patronage payments" and retain the benefits of Subchapter T. Mississippi Valley, 408 F. 2d at 835. But Subchapter T was also not enacted to require that a cooperative acting for its patrons function in an economically unreasonable manner or penalize it for acting reasonably. Considering the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function will allow courts to distinguish from cooperative activity transactions which merely enhance overall profitability in a manner incidental to cooperative function. Such activity is not to receive the benefits of Subchapter T, but other activity, which does directly relate to cooperative function when considered in its actual business environment, cannot properly be considered outside "business done with or for patrons." * * * [765 F. 2d at 1110.]

We repeat that every case of this nature must necessarily turn upon its own facts. The same activities which may be directly related to the cooperative enterprise in one case may not be so directly related in another case. It all depends upon the nature of the cooperative effort, and the way the cooperative conducts its business. In the instant case, we do not think petitioner did anything different with respect to managing its short-term funds than any other business enterprise would have done, consistent with skilled professional money management. Respondent would appear to require that petitioner do something less than this in order to secure the benefits of subchapter T. We do not think the law requires this, and common sense indeed dictates otherwise. As we said in Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, 736 (1977):

We consider respondent's position herein not only contrary to the [law], but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives. * * *

Holding in favor of petitioner on the primary issue presented, it therefore becomes unnecessary for us to consider the second issue.

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St. Louis Bank for Cooperatives v. United States
624 F.2d 1041 (Ct. Cl. 1979)

PER CURIAM:

This federal income tax refund case comes before the court on both parties' exceptions to the recommended decision of Trial Judge Harkins filed on August 8, 1979.

The plaintiff is a nonexempt cooperative corporation. The questions are whether three items of the plaintiff's income for 1972 and 1973 were patronage sourced income under section 1382(b) of the Internal Revenue Code of 1954 and therefore deductible from the plaintiff's gross income. These items are: (1) interest received on demand deposits in Farm Credit Banks or on loans to brokerage firms; (2) interest received on federal bonds the plaintiff purchased to maintain liquidity; and (3) a gain of \$386 upon the sale of an automobile used in the plaintiff's business. The trial judge held that items (1) and (2) were patronage sourced and deductible but that item (3) was not patronage sourced and therefore was not deductible.

Upon consideration of the briefs and after oral argument, we agree with the trial judge's conclusion with respect to the first two items and adopt, with modifications, his recommended opinion and findings as the basis for our decision on those issues. We disagree, however, with the trial judge on issue (3), and we conclude that the gain on the sale of the automobile also is patronage sourced. We therefore have substituted our own discussion for that of the trial judge in the portion of his opinion following the caption, "Sale of Automobile."*

[* With the one exception noted below, we have adopted the trial judge's findings of fact. We have not printed them, however, because, to the extent necessary to the decision, they are incorporated in the opinion. Finding 89, however, is changed to read as follows:

The gain realized by plaintiff from the sale in fiscal year 1972 of an automobile used in its business constitutes earnings from "business done with or for patrons" as used in 26 U.S.C. s.1388(a).]

OPINION OF THE TRIAL JUDGE

HARKINS, Trial Judge: Plaintiff, the St. Louis Bank for Cooperatives, a non-exempt corporation operated on a cooperative basis, claims a refund of income taxes and assessed interest in the amount of \$18,021.62 for the taxable year ended June 30, 1972, and \$17,120.08 for the year ended June 30, 1973. Defendant has filed a counterclaim for additional income taxes and interest in the amount of \$7,744.58 for the 1972 tax year and \$13,247.36 for 1973.

At issue is whether the following items of income qualify for distribution as patronage dividends pursuant to section 1382(b) of the Internal Revenue Code of 1954, as amended:

(a) interest income from demand deposits in nonpatron farm credit system banks, or from short-term loans to several brokerage houses through repurchase agreements, received by plaintiff through its management of funds surplus to the daily needs of its patrons;

(b) interest income obtained from certain Federal bonds required to be held for liquidity purposes in support of its banking business; and

(c) a gain of \$386 realized upon the sale of an automobile used as a pool car by plaintiff's officers and staff.

The following analysis shows that these three items qualify as section 1382(b) patronage sourced income. 1/

[1/ In addition, the parties identified and briefed two other issues: whether any interest expense is allocable to the interest income obtained by plaintiff in issue (b), and whether plaintiff is entitled to offset nonpatronage sourced losses against undistributed patronage sourced income to determine plaintiff's taxable income. The disposition of issues (a) and (b) makes decision on these additional issues unnecessary, and no decision is made on those issues.]

As a corporation that operates on a cooperative basis, plaintiff is subject to the provisions of Subchapter T of the Internal Revenue Code of 1954, as amended. 2/

[2/ Pub.L.No. 87-834, s.17(a), 76 Stat. 1045 (codified at 26 U.S.C. s.s.1381-88 (1976)). Unless otherwise specified all code references are to the Internal Revenue Code of 1954, as amended.]

Subchapter T was added to the Internal Revenue Code in 1962 to clarify the tax status of patronage dividends paid by various types of organizations that operate on a cooperative basis. Prior to the 1962 amendments, farmers' marketing and purchasing cooperative organizations had enjoyed long-standing exemptions from Federal income taxation. Until 1951, these exempt farmers' cooperatives (about one-half the total cooperatives in the United States) were not required to file income tax returns; non-exempt organizations that operated on a cooperative basis, however, historically had been required to file. Commencing 1951, exempt farmers' cooperatives were required to file ordinary corporate income tax returns. Both exempt and nonexempt cooperatives, when computing taxable income, continued to be allowed to deduct the dollar value of patronage dividends from gross income. This deduction had been permitted for both exempt and nonexempt cooperatives as an administrative practice by the Internal Revenue Service as early as 1918. 3/

[3/ T.D. 2737, 20 TREAS.DEC.INT.REV. (1918).

The exclusion of patronage dividends for federal income tax purposes was justified upon the theory they were either (1) rebates on purchases that represented a reduction in cost for goods purchased on the patrons' behalf, or (2) deferred payments on sales in the nature of additional consideration for goods the cooperative sold for the patrons. See generally, Farmers' Coop. Co. v. Birmingham, 86 F.Supp. 201, 205-14 (D.C. Iowa, 1949).]

Exempt farmers' cooperatives, in 1951, were granted additional special deductions from gross income for amounts paid as dividends on capital stock and amounts allocated to patrons which were paid from funds derived from nonpatronage business.

The Internal Revenue Codes of 1939 (as amended) and 1954 addressed only a defined group of exempt farmers' cooperatives, which were permitted all of the above deductions from gross income. 4/

[4/ Int. Rev. Code of 1939, ch. 1, s.101(12) (as amended, ch. 521, title III, s.s.314(a) and (b), 65 Stat. 490 (1951)); and Int. Rev. Code of 1954, s.s.521-22 (as amended and partially repealed, 76 Stat. 1045 (1962)).]

Subchapter T permits all cooperatives covered to deduct from gross income amounts paid currently as patronage dividends; and retains the above special deductions as to exempt farmers' cooperatives.

As a nonexempt cooperative, plaintiff is authorized to deduct from its gross income amounts that were paid "as patronage dividends," which amounts are treated as items of gross income and as deductions therefrom. 5/

[5/ 26 U.S.C. s.1382(b) (1976), in part, provides:

"(b) Patronage dividends and per-unit retain allocations

"In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

"(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year;

* * *

"For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income."]

A "patronage dividend" is defined as an amount "paid to a patron" on the basis of quantity or value "of business done with or for such patron." Subchapter T specifically excludes (a) any amount paid to a patron that is out of earnings other than from "business done with or for patrons" or (b) any amount that is from earnings from business done "with or for other patrons" to whom different amounts were paid on transactions substantially the same. 6/

[6/ 26 U.S.C. s.1388(a) (1976) provides:

"(a) Patronage dividend

"For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies--

"(1) on the basis of quantity or value of business done with or for such patron,

"(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

"(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

"Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."]

To determine plaintiff's income subject to tax, accordingly, its net earnings must be divided into two categories: net earnings from business done "with or for patrons" and earnings which are derived from sources other than patronage. Only earnings from business done with or for patrons may be excluded as patronage dividends.

Before the 1962 amendments to the Internal Revenue Code, patronage dividends were not specifically confined to amounts derived from business done "with or for" patrons. Nor was such a definition embodied in the Treasury regulations. The code, however, authorized exempt farmers'

cooperatives specifically to deduct "amounts allocated to patrons with respect to income not derived from patronage." 7/

[7/ Int. Rev. Code of 1939, supra note 4, and Int. Rev. Code of 1954, s.522 (repealed 1962).]

Subchapter T continues this special deduction for farmers' cooperatives in 26 U.S.C. s.1382(c).

Regulations pursuant to Subchapter T were promulgated April 2, 1963. 8/

[8/ T.D. 6643, 1963-1 C.B. 148.]

With respect to the phrase "business done with or for" patrons, the regulations in essence restate the statute and do not elaborate on its content. 9/

[9/ Treas.Reg. s.1.1388-1(a). The regulation does give content to "patron" as follows:

"(e) Patron. The term 'patron' includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association."

(Treas.Reg. s.1.1388-1(e)).]

They, however, do amplify the statutory phrase "sources other than patronage" applicable to exempt farmers' cooperatives.

Patronage sourced income and nonpatronage sourced income are mutually exclusive classifications. Definition of the content of the phrase "patronage sourced income," accordingly, can be inferred from interpretations that have been given the phrase "sources other than patronage." Whether the challenged items were properly classified by plaintiff as income from business done with or for its member patrons depends upon their exclusion from the factual content of the phrase "sources other than patronage."

A particular item of income is patronage sourced when the transactions involved are "directly related to the marketing, purchasing, or service activities of the cooperative association." The description of nonpatronage sourced income in the IRS regulations has remained identical since first introduced in 1951. 10/

[10/ Regulations promulgated in 1951 under the Internal Revenue Code of 1939, as amended, defined income not derived from patronage as follows:

"s.39.101(12)-3(d):

"There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of s.101(12)(A) and s.39.101(12)-1 amounts allocated to patrons with respect to income not derived from patronage . . . As used in this paragraph 'income not derived from patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of

premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage."]

The Subchapter T regulation, consistent with the provisions of section 1382(c), continues this description for income derived from sources other than patronage. 11/

[11/ Treas.Reg. s.1.1382-3(c)(2) provides:

"(2) Definition. As used in this paragraph, the term 'income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage."]

The IRS description of nonpatronage sourced income is a longstanding interpretation and the statutory provisions to which the regulations pertain twice have been reenacted by Congress without material change. 12/

[12/ Int. Rev. Code of 1954, and Subchapter T in 1962.]

The Treasury regulation in these circumstances is deemed to have Congressional approval. A court may accord great weight to a longstanding interpretation placed on a statute by the agency charged with its administration. 13/

[13/ NLRB v. Bell Aerospace Co., 416 U.S. 267, 274-75, 94 S.Ct. 1757, 1761-1762, 40 L.Ed.2d 134 (1973); Crane v. Commissioner, 331 U.S. 1, 7-8, 67 S.Ct. 1047, 1051, 91 L.Ed. 1301 (1946).]

Plaintiff's Business

Plaintiff is part of the Federal farm credit system, which is under the supervision of the Farm Credit Administration (FCA), an independent agency of the Executive Branch. The United States is divided into 12 farm credit districts, with 37 banks in the system: 12 Federal land banks, 12 federal intermediate credit banks, 12 district banks for cooperatives, and the Central Bank for Cooperatives. Plaintiff is chartered by the Federal Government pursuant to the Farm Credit Act of 1933, and now operates pursuant to authority in the Farm Credit Act of 1971. 14/

[14/ Farm Credit Act of 1971, 85 Stat. 602; 12 U.S.C. s.s.2121-34 (1976).]

From 1933 to 1968, banks for cooperatives were funded by Government capital and were tax exempt. Legislation in 1955 authorized retirement of Government capital to facilitate borrower participation in the management, control and ultimate ownership in the banks for cooperatives. 15/

[15/ Farm Credit Act of 1955, 69 Stat. 655.]

In June 1967, plaintiff retired all United States capital and, beginning with fiscal year 1968, plaintiff became subject to Federal income tax. Plaintiff continues to be regulated and supervised by the FCA; FCA examiners audit and examine plaintiff's operations at least once a year. 16/

[16/ Farm Credit Act of 1971, supra not 14.]

Plaintiff is authorized to make loans to eligible farmers' cooperatives located in the St. Louis farm credit district, which consists of Illinois, Missouri and Arkansas. Plaintiff's members and owners are eligible farmers' cooperative borrowers, which contribute to the equity of plaintiff in proportion to business done with plaintiff. As a cooperative, plaintiff is obligated to distribute its annual net earnings to its member patrons as patronage dividends on a cooperative basis based upon the volume of business done by each member with plaintiff.

The Central Bank for Cooperatives is organized on a cooperative basis to serve as the central bank for banks for cooperatives. It does not lend money directly to farmers' cooperatives. Plaintiff and the other 11 district banks provide the equity for, and constitute all of the members and owners of, the Central Bank for Cooperatives.

The Central Bank for Cooperatives had two primary functions: (1) it purchases participations in the loans of district banks for cooperatives when such loans exceed FCA legal lending limits; and (2) its money desk serves as a clearing house for short-term loans within the farm credit system. When the Central Bank purchases a participation in one of plaintiff's loans, plaintiff is a borrower from the Central Bank and is required to pay interest to it. The 12 district banks for cooperatives receive patronage dividends from the Central Bank for Cooperatives, distributed on a cooperative basis based upon the volume of participation done by each district bank with the Central Bank for Cooperatives.

Plaintiff's sources of funds for loans to its borrowers include: equity capital raised by required purchases of override stock in connection with each loan made to an eligible cooperative borrower and by distributions of annual patronage dividends in class C stock or allocated surplus; sales of consolidated bonds; and, after 1975, sales of consolidated systemwide discount notes. Plaintiff also obtains additional loanable funds through short-term borrowings from the Central Bank for Cooperatives, from lines of credit with several commercial banks and from the other farm credit banks in its district.

Authority for the banks for cooperatives to issue consolidated debentures (changed to "consolidated bonds" in 1971) as a method of raising loanable funds was not conferred until 1954, and the first sale occurred in 1955. Consolidated bonds are secured joint and several obligations of the 13 banks for cooperatives, have a 6-month maturity, are issued on a monthly basis, and are sold on the open market through a Fiscal Agent in New York City. During fiscal years 1972 and 1973, consolidated bonds were authorized to be issued ten times a year, once each month except in March and September. Consolidated systemwide discount notes are secured joint and several obligations of the 37 farm credit system banks, have a maturity ranging from 5 to 150 days, and are marketed on a weekly basis.

During fiscal years 1972 and 1973, plaintiff's primary source of funds for loans to its member borrowers was the issuance of consolidated bonds, and the Central Bank for Cooperatives was relied upon as the primary supplier of short-term borrowings.

Plaintiff's borrowing of funds from the Central Bank for Cooperatives on a demand basis, and its lending of surplus funds on a demand basis, and its lending of surplus funds on a demand basis to the Central Bank, had no effect on plaintiff's equity position in the Central Bank. The Central Bank for Cooperatives, the Federal Intermediate Credit Bank of St. Louis, and the Federal Land Bank of St. Louis, are not members or owners of plaintiff and they do not receive patronage dividends from plaintiff.

For fiscal year 1972, plaintiff reported it had 272 borrowers, and total loans outstanding of \$220,638,606. For fiscal year 1973, plaintiff reported it had 284 borrowers, and total loans outstanding of \$325,541,342. Plaintiff's total capital, surplus and reserves, was \$33,175,956 on June 30, 1972, and \$35,355,237 on June 30, 1973. During fiscal year 1972, plaintiff sold \$292 million in consolidated bonds and retired \$271 million in matured bonds. In 1973, sales of consolidated bonds were \$333 million and retirements were \$306 million.

Surplus Funds

In the normal course of its operations to provide banking services to its borrowers, plaintiff would determine on a daily basis whether it was in a deficit funds position or in a surplus funds position, after 12 o'clock noon, when it closed transactions with its borrowing cooperatives. Plaintiff was in a long position, and had surplus funds, when it had overestimated the needs of its borrowers and had available cash on hand not loaned out to cooperatives; it was in a short or deficit position when it had underestimated their needs.

Plaintiff's position varied considerably from day to day, and rarely was in balance. Variances frequently were in the millions of dollars. During fiscal years 1972 and 1973, plaintiff on the average was in a deficit position and had to borrow substantially more funds on a short-term basis than it placed out. Plaintiff's net daily deficit position averaged approximately \$5 million in 1972 and \$15 million in 1973.

The source of any surplus funds was plaintiff's most recent sale of consolidated bonds. Surplus funds were borrowed money that had been generated during the process of providing banking services to borrowing cooperatives.

Participation in a consolidated bond issue involved procedures that frustrated accurate planning or precise adjustment of available funds to borrowers' loan demands. Arrangements for each consolidated bonds issue involved coordination of the individual bank for cooperatives, the FCA, and the Fiscal Agent. Approximately 45 days in advance of the market date, each district bank for cooperatives began preparing its information and supporting data for the amount of its participation. Each bank was required to submit to the FCA a firm commitment for its desired participation along with relevant supporting data, from 3 to 4 weeks before each issue date. The FCA worked with the Fiscal Agent to coordinate the requests and to arrange the details of each issue. During fiscal years 1972 and 1973, an issue usually was priced a week after the date the banks were required to submit data to the FCA. The bonds then were offered to the public at that price for delivery several weeks later. On the date of delivery (the "issue date"), the proceeds of that issue were made available to the individual participating banks.

Supporting data submitted to the FCA on a participation in a bond issue set forth plaintiff's actual position as to loans outstanding and source of funds at the prior bond entry date, and plaintiff's projected position as of the forthcoming, and five succeeding bond entry dates. Beginning with the June 1973 issue, plaintiff was required to project its position for 12 succeeding months.

Participation in an issue required plaintiff to predict its loan demand for almost a 2-month period--the period until the next succeeding bond issue date when its position could be adjusted. During the two periods in fiscal years 1972 and 1973 when there was no market date in a month (March and September), plaintiff was required to make firm commitments for a period that extended over 75 days.

Planning a participation in a consolidated bond issue was complicated further by the volatility of loan demand and repayments. Loan demand from plaintiff's borrowers fluctuated by millions of

dollars day to day. Unpredictable external factors that affect farm operations, size of harvests, and marketing of farm products had an influence on loan demand. Weather, commodity prices, transportation developments, marketing developments, and foreign demand had affected plaintiff's borrowers' loan requirements. Alternate sources of credit, such as the loan programs of the Commodity Credit Corporation, had a direct impact on plaintiff's loans to member cooperatives.

During fiscal years 1972 and 1973, to avoid having surplus funds, plaintiff attempted to set the level of its participation in each consolidated bond issue at a level that would permit it to meet or be slightly short of the needs of its borrowers. The limited number of bond entry dates and the volatility and unpredictability of loan demand, however, prevented realization of this objective, and it was not always possible for plaintiff to avoid having surplus funds on hand on any particular business day. Plaintiff never set its level of participation in a bond issue with the intention of obtaining funds that were surplus to the needs of its borrowers.

During fiscal years 1972 and 1973, when plaintiff found itself in a deficit position, the Central Bank for Cooperatives generally had available sufficient funds that plaintiff could borrow on a demand basis to cover advances to its borrowers. If funds were not available at the Central Bank, plaintiff would utilize lines of credit maintained with several commercial banks. If necessary, plaintiff borrowed funds on a demand basis from other farm credit banks in the district, the Federal Land Bank of St. Louis, and the Federal Intermediate Credit Bank of St. Louis.

During fiscal years 1972 and 1973, when plaintiff found it had funds available that were surplus to the needs of its borrowers, it normally loaned the funds on a demand basis to the Central Bank for Cooperatives, or, on several occasions, to other farm credit banks in its district, in compliance with FCA policy to encourage intersystem usage of surplus funds. On four occasions in fiscal year 1972, when it became apparent that neither eligible cooperative borrowers nor other farm credit system banks would have an immediate need for surplus funds, plaintiff used repurchase arrangements to loan the funds to brokerage houses that sold consolidated bonds. The repurchase agreements were designed to mature in conjunction with the next consolidated bond maturity date.

In fiscal years 1972 and 1973, there were six periods when plaintiff had surplus funds for longer than 1 day: (1) August 18 to October 20, 1971; (2) November 1, 1971, to January 3, 1972; (3) August 31 to October 2, 1972; (4) October 12 to October 16, 1972; (5) November 1 to December 11, 1972; and (6) May 16 to May 30, 1973. At trial plaintiff's treasurer explained the events that produced these periods. They were due variously to underestimates on the volume of pay downs by borrowers, major borrowers' use of CCC funds to repay loans made by plaintiff, erroneous projections that loan demand would not increase between a February bond issue and the next issue in April 1972, fluctuations in commodity prices caused by Russian wheat purchases, and changes in CCC commodity loan programs. This testimony was a cogent explanation of the direct relationship of plaintiff's money management operations to the provision of banking services.

Plaintiff's surplus funds were derived from sales of consolidated bonds; accordingly, the interest cost was the effective interest rate of the most recent bond offering. The interest rate obtained by plaintiff on loans of surplus funds on a demand basis generally was lower than the effective interest rate for consolidated bonds with a 6-month maturity. Plaintiff's surplus funds cost it \$18,615.74 during fiscal year 1972 and \$4,270.20 during 1973.

Surplus funds on hand after the noon cutoff point could not be used to retire outstanding consolidated bonds, which were not subject to call, before the next bond maturity date. Surplus funds could not be used to make interim patronage dividends or retire capital stock in the hands of plaintiff's member patrons because the Act, FCA regulations, and plaintiff's charter and by-laws prohibited the use of borrowed funds for distribution to patrons or to redeem stock.

Surplus funds were loaned on terms that were materially different from the loans plaintiff made to member patrons. Surplus funds were loaned on a demand or short-term basis to assure availability in the event it was determined they were needed to cover advances to eligible borrowers. Variable interest rates did not apply to loans of surplus funds. Term loans, seasonal loans, and loans with variable interest provisions were made only to eligible farmers' cooperatives.

Defendant argues that plaintiff's treatment of surplus funds functionally is a separate activity from its borrowing to correct a deficit position. Borrowing of funds to correct a deficit position is admitted to be directly related to plaintiff's banking service for its member cooperatives; lending surplus funds to other farm credit system banks and to the brokerage houses, however, is seen as a separate operation only incidental to plaintiff's authorized banking service to its patrons. Defendant contends the term "money management" can be applied only to plaintiff's activities to correct a long position; activities to correct a short position are part of plaintiff's banking services and are not an aspect of "money management" according to defendant.

In defendant's analysis, plaintiff's loans to the Central Bank for Cooperatives, the Federal Land Bank of St. Louis, the Federal Intermediate Credit Bank of St. Louis, and to the brokerage houses were not business done "with" its patrons because they are not members or owners, they were not paid dividends, and business was not done with them on a cooperative basis. The loans of surplus funds were not business transactions "for" patrons, according to defendant, because they were incidental attempts to make profits that did not directly facilitate plaintiff's banking services. Defendant relies upon the line of cases that hold, where a cooperative's income is derived from business done with both members and nonmembers to whom dividends are not paid on a cooperative basis, income from the nonmembers is nonpatronage sourced. 17/

[17/ Pomeroy Coop. Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961); Smith & Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341 (5th Cir. 1965); and Iberia Sugar Coop. v. Commissioner, 360 F.Supp. 967 (W.D.La. 1972), aff'd per curiam, 480 F.2d 548 (5th Cir. 1973).]

Defendant's analysis is too narrow. Plaintiff's loans of surplus funds cannot be viewed in isolation from plaintiff's overall business functions. Plaintiff found itself with surplus funds or in a deficit position on particular days as a result of a procedure that required it to make forward commitments for participations in bond issues based upon anticipated needs subject to wide variations. Management of both surplus funds and funds to cover a deficit position was an integral part of plaintiff's activities as a banking service cooperative. Plaintiff's business as a service cooperative was not to make loans to nonmembers; loans to the other farm credit system banks and to the brokerage houses differed fundamentally from the kind of service plaintiff gave to its patrons. Plaintiff's banking service was the provision of a ready source of funds for long-term or seasonal loans to its members. Nonmembers did not get this service; nonmembers were a source of funds temporarily surplus. Loans made with surplus funds differed materially from the term or seasonal loans made to member patrons. Loans to member patrons were to provide financing for agricultural activities necessary to a farmers' cooperative. Nonmembers were not eligible for, and did not receive, term or seasonal loans from surplus funds. Nor did variable interest rates apply to loans of surplus funds.

The Pomeroy line of cases defendant cites does not fit the facts of this case. In each of those cases, the transactions between the cooperative and its patrons were the same as the transactions between the cooperative and the outsider that did not receive dividends. 18/

[18/ Id. In Pomeroy, the grain elevator cooperative stored grain for its members and for the Government, Commodity Credit Corporation; in Smith & Wiggins Gin, the

cooperative ginned and wrapped cotton, and processed marketed cotton seed from cotton, for both members and their nonmember tenants; in Iberia Sugar, the cooperative refined and sold sugar owned by its patrons and by outsiders who were tenants of patrons.]

Plaintiff provides a service to its member cooperatives that is dissimilar in character from the activities undertaken with nonmember borrowers.

There are three revenue rulings which provide guidance as to the types of transactions that satisfy the "directly related" test in Treasury Regulation s.1.1382-3(c)(2) as applied to patronage sourced income. Two of the factual situations involved in the revenue rulings were concerned with income from nonmembers which nonetheless qualified as patronage sourced. A fourth ruling, relied upon by defendant, also addresses the standard defined in Treasury Regulation s.1.1382-3(c)(2). It is inherently defective.

Revenue Rulings are not binding precedent, but they can provide some guidance as to the types of transactions which are directly related to the business of the cooperative. 19/

[19/ Helvering v. New York Trust Co., 292 U.S. 455, 468, 54 S.Ct. 806, 810, 78 L.Ed. 1361 (1933).]

They "reflect the trend of official opinion" and the position of administrators experienced with the application of the act. 20/

[20/ Brennan v. Great Am. Discount & Credit Co., 477 F.2d 292, 297 (5th Cir.), cert. denied, 414 U.S. 856, 94 S.Ct. 160, 38 L.Ed.2d 106 (1973).]

A 1969 ruling 21/

[21/ Rev. Rul. 69-576, 1969-2 C.B. 166.]

addressed the question where the taxpayer-cooperative borrowed money from a bank for cooperatives to finance acquisition of agricultural supplies for resale to members. Interest dividends from the bank were patronage sourced because the loan actually facilitated the cooperative's purchasing activities. The ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperatives' marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

A 1974 ruling 22/

[22/ Rev. Rul. 74-160, 1974-1 C.B. 245.]

involved a nonexempt cooperative for the manufacture and sale of plywood which loaned money to its chief supplier, a nonpatron, to finance equipment to be used in the supplier's business. Without

the loan, the supplier would not have been able to supply the cooperative. The ruling expressly reaffirms the 1969 principles and holds that although interest from the loan did not arise directly from a transaction with patrons, it was patronage sourced income because the transaction directly facilitated accomplishment of the cooperative's purchasing activities. A 1975 ruling 23/

[23/ Rev. Rul. 75-228, 1975-1 C.B. 278.]

involved a Domestic International Sales Corporation (DISC), created by an exempt farmers' cooperative to sell in overseas markets fruits produced by its members. The DISC paid dividends to its parent based upon its selling commissions, which were held to be patronage sourced. The ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent upon the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. Thus, if the income is produced by a transaction directly connected with marketing patrons' products, the income is from patronage sources.

Persuasiveness of an administrative interpretation of a statute or rule depends "upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements" 24/

[24/ *Skidmore v. Swift & Co.*, 323 U.S. 134, 140, 65 S.Ct. 161, 164, 89 L.Ed. 124 (1944); *Brennan v. Great Am. Discount & Credit Co.*, *supra* note 20, at 297.]

Revenue Rulings 69-576, 74-160, and 75-228 are persuasive to indicate the scope of activities that are encompassed in the "directly related" test. A reasonable application of Treasury Regulation s.1.1382-3(c)(2) encompasses activities "facilitating" the accomplishment of the business activities of the cooperative, activities not "merely enhancing the overall profitability," and activities not "merely incidental to the cooperative association's overall operation."

Defendant relies upon a 1973 ruling 25/

[25/ Rev. Rul. 73-497, 1973-2 C.B. 18.]

as authority that plaintiff's interest income from loans of surplus funds was nonpatronage sourced because the income was attributable to business with nonmembers who were not dealt with on a cooperative basis. This revenue ruling does not apply the "directly related" test. It specifically is concerned with two of the three issues involved in this case, was issued after the controversy herein arose, and it lacks a reasoned analysis. The ruling reiterates the language of the regulation, is conclusory in content, and of little persuasive value. There is no discussion of facts which delimit the role of surplus funds in the services provided by a bank for cooperatives. Its promulgation after the controversy at bar arose detracts from its persuasive force. 26/

[26/ *Case & Co. v. Board of Trade*, 523 F.2d 355, 361 (7th Cir. 1975).]

The IRS in the 1973 ruling adopted a view antagonistic to its previous construction of the statute and regulation, and out of step with the subsequent 1974 and 1975 rulings that applied the "directly related" test. In these circumstances, the 1973 ruling is entitled to no weight as an administrative determination. 27/

[27/ Atchison, Topeka & Santa Fe Ry. v. United States, 209 F.Supp. 35, 42 (N.D. Ill. 1962).]

The "directly related" test can be satisfied when the transactions with non-members are different in nature from the cooperative's transactions with patrons. In Linnton Plywood 28/

[28/ Linnton Plywood Ass'n v. United States, 410 F.Supp. 1100, 1108 (D.Or. 1976).]

two nonprofit workers' cooperatives for the manufacture of plywood organized a glue manufacturer in which each owned 50 percent. Dividends paid by the glue manufacturer on a patronage basis to the organizers were patronage sourced because procurement of glue is essential for the manufacture of plywood, and the glue business was "reasonably related to the business done with or for its patrons."

Transactions with third parties that are reasonably related to the business which a cooperative conducts with its patrons, and which benefits the patrons other than incidentally through the generation of extra income, is business "with or for" patrons. Defendant does not dispute the Linnton Plywood decision on its facts, and defendant accepts the propriety of the "directly related" test where the facts accord. Defendant asserts, however, that plaintiff's money management activities with surplus funds were not directly related to its banking service for patrons. Defendant draws an analogy to a manufacturing corporation or a marketing or purchasing cooperative managing funds temporarily surplus by placing them in Treasury bills, commercial paper or certificates of deposit. The analogy is not apt. Plaintiff's money management activities are more than the mere investment of extra funds generated in functionally unrelated business activities. Plaintiff is a service cooperative, not a marketing or purchasing cooperative, and its function is to serve as a financial intermediary that transfers capital from buyers of consolidated bonds to its member patrons in the form of credit.

In its management of surplus funds, plaintiff secures interest income which results in lessening costs for the credit provided to its patrons. Plaintiff's demand loans of surplus funds to the other farm credit system banks and the brokerage houses directly reduced the cost of the dollars which already had been borrowed through the sale of consolidated bonds.

The transactions which generated interest income from the use of surplus funds are integrally intertwined with the process of borrowing money to supply capital to the cooperatives. The transactions would not occur but for the process whereby plaintiff secures funds to lend to its members. In these circumstances, income derived from management of surplus funds is directly related to plaintiff's services to its members and is patronage sourced.

Liquidity

During fiscal years 1972 and 1973, prior to January 2, 1973, the FCA required plaintiff, as far as practicable, to keep invested in cash or eligible investments an amount equal to between 20 and 25 percent of its capital stock. During this period, plaintiff met the FCA requirements by holding United States Treasury bonds in the amount of \$1,545,000 and FNMA bonds or consolidated Federal land bank bonds in the amount of \$500,000. The purpose of the FCA regulations was to assure banks for cooperatives maintained adequate liquidity to be able to provide a ready source of credit to farmers' cooperatives. Effective January 2, 1973, FCA regulations were changed to make it the responsibility of each bank to establish its liquidity needs, subject to FCA review. Plaintiff continued to follow, during the balance of fiscal year 1973, the minimum investment requirements previously set by the FCA.

Defendant contends that plaintiff's ownership of United States Treasury bonds, Federal National Mortgage Association bonds, and consolidated Federal land bank bonds are investments. Defendant relies upon Treasury Regulation s.1.1382-3(c)(2), which cites income from investments in securities as one specific example of incidental income not directly related to marketing, purchasing or service activities of a cooperative, and the determination in Revenue Ruling 73-497 that banks for cooperatives owned the Government securities as investments. To buttress this contention, defendant points to FCA regulations, plaintiff's articles of incorporation, income tax returns, and reports to its directors and stockholders, which refer repeatedly to the ownership of bonds held for liquidity purposes as "investments." Defendant also challenges plaintiff's contention that ownership of the bonds for liquidity purposes involved a net cost. In support, defendant cites the Federal tax maxim that a transaction is to be given its tax effect in accord with what actually occurred, not with what might have occurred. 29/

[29/ Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148-49, 94 S.Ct. 2129, 2136-2137, 40 L.Ed.2d 717 (1974); Higgins v. Smith, 308 U.S. 473, 477, 60 S.Ct. 355, 357, 84 L.Ed. 406 (1940).]

Defendant points out that the coupon interest rate on FNMA bonds was always substantially above the effective rate of plaintiff's outstanding consolidated bonds.

Plaintiff responds that the bonds were not held for investment purposes, and complains defendant confuses common usage of the word "investment" with its definition for tax purposes. How plaintiff referred to the bonds in its FCA reports, and its internal documents may indicate lack of artistry in record keeping, but it has little probative value as to whether the bonds were held as "investments" for purposes of Federal income tax. It is necessary to ascertain the purpose for which the bonds were held to determine whether they were in fact "investments" that produced income incidental to plaintiff's banking services for its patrons.

Plaintiff must maintain a level of liquidity that permits consolidated bonds to be marketed at a reasonable cost. Liquidity also assists plaintiff to borrow from secondary sources when a need for funds develops between consolidated bond issues, and provides plaintiff with some cushion in the event adverse economic conditions limit regular sources of loan funds.

Holding bonds for liquidity was not incidental to the provision of banking services, it was a prerequisite of plaintiff's doing business at all. The bonds were not held as investments, they were necessary to fulfill plaintiff's purpose as a bank for cooperatives.

The interest yield of the bonds held for liquidity was substantially below the rate of interest charged members and the cost of money to plaintiff. To carry the bonds, plaintiff incurred additional interest and general administration expenses. In order to carry the bonds, plaintiff had to pay interest on borrowed funds at a rate which exceeded the yield of the bonds. Although defendant is correct that the yield on FNMA bonds sometimes exceeded the effective rate of outstanding consolidated bonds, on net plaintiff incurred a cost that was substantial.

Interest income from bonds plaintiff held for liquidity purposes is patronage sourced because the transactions involved are directly related to plaintiff's services to its patrons. They were a prerequisite to plaintiff's functions. Unless the bonds were held, plaintiff could not issue consolidated bonds, the primary source of loan funds for its patrons.

.....

Sale of Automobile

[The discussion of this issue is by the court,
in place of the trial judge's discussion.]

During fiscal year 1972, plaintiff realized a gain of \$386 from the sale of an automobile that had been used solely in its business as a pool car by plaintiff's officers and staff. During the years the plaintiff owned the automobile, it took depreciation on the car and treated that depreciation as a patronage expense that offset its patronage sourced income and thus reduced the patronage dividends paid to its members. The gain plaintiff had upon the sale of the automobile reflected the recapture, pursuant to section 1245 of the Code, of depreciation previously taken on the car.

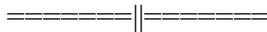
The plaintiff reported this gain as ordinary income and as patronage sourced. The Commissioner classified the gain as nonpatronage sourced on the ground that it was income from the sale of a capital asset, which Treasury Regulation s.1.1382-3(c)(2) includes as an example of income derived from sources other than patronage. The treatment was erroneous, however, since the car was not a capital asset under section 1221 of the Code, which excludes from the definition of capital assets "(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167." The car was used in the plaintiff's business, and depreciation properly was taken on it.

The gain on the sale of the automobile was patronage sourced because, like the income from the plaintiff's surplus funds and from its liquidity assets, it was "directly related" to the plaintiff's normal activities. The automobile was one of three used in the plaintiff's business, and the cost of operating it, including depreciation, was treated as an expense of serving plaintiff's patrons. The sale of the car when it was no longer needed for plaintiff's business, was closely related to and stemmed from the prior use of the car. Depreciable assets used in a business wear out and become obsolete, and when that happens, frequently they are sold or traded in for a replacement. Indeed, plaintiff's normal practice upon selling its automobiles was to subtract any gain upon the sale of the used vehicle from the list price of the new vehicle and to carry the new vehicle at the net price; the sale of the automobile for cash in 1972 was inadvertent. It would be anomalous to treat the gain upon the sale of the automobile resulting from the recapture of excess depreciation as nonpatronage sourced when the depreciation itself was treated as patronage sourced.

The Commissioner has recognized that in such circumstances the gain on the sale of the equipment is patronage sourced. In Rev. Rul. 74-84, 1974-1 C.B. 244, the taxpayer, a nonexempt cooperative, sold at a gain machinery used in its manufacturing operations on which it had taken depreciation. The Commissioner ruled that the "portion of the gain from the sale of machinery treated as ordinary income under section 1245 of the Code is considered patronage sourced income because, in effect, the taxpayer is merely recapturing income that otherwise would have been available for distribution as a patronage dividend." Indeed, in its brief to the trial judge the defendant itself stated that "taxpayer properly reported this gain [on the sale of the automobile] as patronage sourced income." We agree with that view.

CONCLUSION

The plaintiff is entitled to recover on its three claims. The case is remanded to the Trial Division to determine the amount of recovery pursuant to Rule 131(c).



The preceding decisions along with regulations and IRS rulings have led to suggestions for terms that summarize the character of patron-source income as opposed to non-patronage-source income. One of these tests is the "directly related" test suggested in Treas. Reg. § 1.1382-3(c)(2). To determine if the income is directly related to the business of the cooperative, an assessment is

made of what the cooperative does and determines the relationship between that and the source of the income generation.

The “actually facilitates” test determines to what extent the income-producing activity facilitates the business done with or for patrons.

A third standard is based on the manner in which the income was generated rather than its relation to the cooperative’s business. For example, income that is derived from the lease of a cooperative’s premises, from investment in securities, or from the sale or exchange of capital assets may be classified as non-patronage-source income regardless of how directly related it is to the cooperative’s business or if it actually facilitates that business, according to Treas. Reg. 1.1382-3(c)(2). Courts have not generally applied such a rigid rule and prefer to look to the substantive relationship of income and patronage.¹⁵³

¹⁵³ See discussion and references in Frederick, Donald A. *Income Tax Treatment of Cooperatives: Patronage Refunds*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 2 (December 1993)