United States Department of Agriculture

Rural Business/ Cooperative Service

Cooperative Information Report 44 Part 1

Income Tax Treatment of Cooperatives:

Background

Abstract

Income Tax Treatment of Cooperatives: Background

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Cooperative tax rules are a logical combination of the unique attributes of a cooperative and the income tax scheme in the Internal Revenue Code. The single tax principle is applied to earnings from business conducted on a cooperative basis in recognition of the unique relationship between the members and their cooperative associations. Cooperatives have been granted a certain degree of flexibility in their financial and tax planning and should exercise their options effectively to maximize benefits for members.

Key words: Cooperative, equity, income, patronage, per-unit retain, tax

Cooperative Information Report 44, Part I
November 1993
Reprinted May 1996

Preface'

Cooperative taxation does not occur in a vacuum. As business corporations, cooperatives are subject to many of the tax rules applicable to other business forms. But cooperatives also have special features that justify unique approaches to certain aspects of income taxation.

This report provides important background to understanding present day income tax treatment of cooperatives. Chapter 1 begins with an explanation of key terminology used in the context of cooperative taxation. The role cooperatives play in the agricultural economy is presented. A description of the forms of doing business and an overview of the general tax treatment of each organization, including cooperatives, is provided. The role played by legislation, administrative rulings, and judicial decisions in establishing cooperative tax policy also is described.

Chapter 2 focuses on cooperative organization and operation, and their relationship with taxation. The meaning of "operating on a cooperative basis" as the term is used in the Internal Revenue Code is explored. Nontax statutes that guide cooperative businesses and organizational documents used by cooperatives are described. Examples illustrate how cooperatives operate. Sources of equity capital and financial planning options are reviewed.

Chapter 3 examines the historical development of cooperative income taxation. A synopsis of the constitutional underpinnings of the power of the Federal Government to levy an income tax and a discussion of tax logic and cooperatives precede a review of the two early paths followed in cooperative taxation. One covers administrative and judicial rulings establishing the single-tax treatment of cooperatives incorpo-

[1] This report does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. This publication is presented only to provide information to persons interested in the tax treatment of cooperatives.

rated in Subchapter T of the Internal Revenue Code. The other is a legislative trail leading to present section-521 tax treatment.

This report contains the first chapters of a larger project on income taxation of cooperatives. Dr. James R. Baarda, while employed at USDA's former Agricultural Cooperative Service (now USDA's Rural Business-Cooperative Service, conducted the initial research for the entire project. Don Frederick and John Reilly provided additional research for the project and edited and expanded Dr. Baarda's draft.

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Highlights

Familiarity with the special terms associated with any technical subject is a prerequisite to mastering that subject. Certain terms take on a precise meaning when used in the context of cooperative taxation. The technical differences between words sometimes treated as synonyms in general conversation are explained to promote understanding of the nuances of cooperative income taxation.

Cooperatives are a vibrant business form in the agricultural sector of the economy. With business volume approaching $100 billion on an annual basis, and more than 4 million farm memberships, cooperatives are big business when measuring their importance to rural America. Yet with 85 percent of farmer cooperatives reporting sales volumes of less than $15 million, they are primarily small businesses serving a local community and the surrounding area.

Cooperatives are one of several forms of doing business recognized by the Internal Revenue Code. Like sole proprietorships, partnerships, and Subchapter S corporations, single tax treatment is available to cooperatives and their member-owners, on business conducted on a cooperative basis. Earnings on noncooperative operations, like those of investor-general corporations, are subject to taxation at both the firm and ownership levels.

Several sources contribute to cooperative tax law. The Internal Revenue Code (Code) provides the legislative foundation. The Code contains provisions applicable to all businesses, and other language specifically referring to cooperatives. The Internal Revenue Service (IRS or the Service), through a variety of administrative determinations, interprets the Code and applies it to the situation of each taxpayer. Courts of law act as final arbiter for any unsettled disputes between the Service and taxpayers over the meaning of the Code.

Cooperative tax treatment is available to any organization that comes within the scope of “operating on a coopera-

tive basis" under the Code. Other, nontax statutes establish cooperative characteristics that must also be considered in a business plan where tax law is only one external factor. Likewise, a cooperative's organizational documents and contracts with its members set forth how the organization will function.

One major challenge created by the user orientation of a cooperative is raising equity capital. The single tax treatment accorded cooperatives facilitates equity accumulation through business operations. Retained patronage refunds and per-unit retains are financing tools eligible for single tax treatment.

Cooperative tax rules reflect the unique nature of a cooperative venture. Whether patronage financing is viewed as a price adjustment, or the cooperative is considered an agent or conduit for the members, single tax treatment of margins and per-unit retains is analogous to taxation of certain other business forms, including investor-oriented firms.

Shortly after ratification of the 16th Amendment answered questions about the constitutionality of an income tax, a comprehensive income tax was enacted. Early on, a statutory exemption was created for farmer cooperatives that met certain operational tests. Nonfarm cooperatives and farmer cooperatives that chose not to operate according to these standards had no special statutory status. Treasury rulings and court decisions, however, permitted these cooperatives to exclude patronage refunds from taxable income.

In 1951 the tax law was changed through a repeal of the farmer cooperative exemption and the addition of deductions for previously exempt farmer cooperatives for stock dividends and patronage-based distributions on nonpatronage income. When the courts began allowing both cooperatives and patrons to exclude patronage refunds from taxable income, the tax law was rewritten in 1962 to ensure that a single current tax was paid on these margins.

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CHAPTER 1. TAX PRINCIPLES, TERMINOLOGY, AND SOURCES

This publication is the first in a series of reports about Federal income taxation of farmer cooperatives.* The reports are designed as research tools, intended to help those making tax decisions with respect to farmer cooperatives in the U.S. agricultural sector.[3]

Persons likely to benefit from these papers include accountants and bookkeepers employed by cooperatives, managers, financial officers, corporate planners, directors, lenders, accountants advising cooperatives, attorneys, scholars studying cooperatives, and public policymakers. The reports' ultimate beneficiaries will be the farmer-owners of cooperative enterprises.

[2] Rural Business-Cooperative Service "shall render service to associations of producers of agricultural products, and federations and subsidiaries thereof, engaged in the cooperative marketing of agricultural products..." and is authorized to "conduct studies of the economic, legal, financial, social, and other phases of cooperation, and publish the results thereof." Cooperative Marketing Act of 1926, 7 U.S.C. §§ 453(a) and 453(b)(2).

[3] The material in this report, and in all subsequent reports in this series, does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. These publications are presented only to provide information to persons interested in the tax treatment of cooperatives.

SCOPE

Effective tax planning requires a knowledge of all pertinent tax law. Tax law distinctive to cooperatives comprises a small portion of the tax spectrum, but is, of course, critical to cooperatives.

The reports in this series focus on tax rules unique to cooperatives or of special application to cooperatives. The reports are not intended to provide information on all aspects of taxation with which cooperative advisors and decisionmakers should be acquainted. General rules are discussed, however, to the extent necessary to place cooperative taxation in perspective and highlight cooperative-noncooperative differences.

Three guidelines are used to determine subject matter covered, depth of analysis, and relative length of discussion on each topic. First, most attention is given to situations that affect a large number of cooperatives. Sophisticated or highly unusual situations generally are not addressed.

Second, the extent of legal authority addressing particular issues varies greatly. As a result, some topics of relatively less importance may occupy more space than important topics simply because of the amount of authority to be discussed.

Third, some material is included, even if not detailed or even specifically addressed by authority now available, to make the end product a more logical and coherent work.

Explanations of tax law are based on interpretation of legal authority. The choice of authority and style of interpretation both determine final written results. To the extent possible, these reports include all available primary authority.[4] The reports' usefulness to researchers, attorneys, and accountants mandates full citation of this authority. As a result, footnotes

[4] Relevant provisions of the Internal Revenue Code and associated regulations, judicial decisions and revenue rulings are analyzed. In addition to these primary authorities, private letter rulings and technical advice memoranda are discussed. While pursuant to Code §6110(j)(3) letter rulings may not be cited as precedent, they give some insight into the IRS's views on subject matter addressed. Sources of legal authority are described in the subsequent section of this chapter, "Sources of Tax Law."

are used extensively throughout to identify sources upon which the accompanying exposition is based.

Interpretation of authorities is as "neutral" as possible, and no advocacy positions are taken. Where disagreement exists on correct application of tax laws to cooperatives, the rationale underlying positions taken by various parties is explained to the extent articulated by the parties.

TERMINOLOGY

Neither popular nor technical terminology is uniform for many important aspects of cooperative operation, accounting, and taxation. The way cooperatives use various terms differs, often to reflect the method the cooperative uses to compute and allocate patronage refunds. For example, the precise meaning of a term for an individual cooperative may depend on whether the association employs book or tax accounting rules to compute its patronage refunds.

For the sake of clarity, these reports will use certain terms as defined in the mini-glossary that follows. Other terms with limited application are defined when introduced in the text.

Margins, Income, and Earnings

Margins. "Net margins" or "margins" are used in place of terms such as "profit," "net profit," "income," "net savings," and "net income" when referring to money a cooperative earns on business conducted on a cooperative basis. Margins generally correspond to the phrase "net earnings of the organization from business done with or for its patrons" used in the Code.[5] As explained by the U.S. Tax Court:

> "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); cooperatives tend to eschew the words "profits" and "income," prefer-

[5] I.R.C. § **1388(a)(3).**

ring instead the more delicate terms “margins” and "savings."[6]

Income. As the quote above points out, “income” is sometimes used as a synonym for “profit.”

In this paper “income” will mean “gross income” as defined in the Code.[7] “Income” is all wealth that flows into the cooperative from business operations. “Income” is defined broadly to include cash and checks received to pay for services rendered and products provided. Income also includes interest, rents, and dividends received.

Funds obtained as loans or equity investments are not considered income for tax purposes.

Earnings. “Earnings” describes what is commonly referred to as “profit,” or total income less expenses. This must constantly be distinguished from the more limited term “margins,” which are earnings from business operated on a cooperative basis. Cooperatives can, and frequently do, conduct some of their operations on a nonconoperative basis. This is one of several business options available to cooperatives, and highlights one of the more complex areas in terms of Code interpretation by the Internal Revenue Service[8] and cooperatives alike.

In summary, “income” refers to all funds that flow into the cooperative because of its business operations. “Earnings” are income less expenses, while “margins” are earnings on business conducted on a cooperative basis.

Patron Distinguished From Member

The definition of “margin” above is based on a Code provision that discusses "earnings...from business done with or for its patrons."[9]

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[6] Illinois Grain Corp. v. Commissioner, 87 T.C. 435,450 note 3 (1986).

[7] I.R.C. § 61(a).

[8] Internal Revenue Service, a part of the Department of the Treasury, is frequently referred to in this series of publications as “IRS” or “the Service” in keeping with common terminology.

[9] I.R.C. § 1388(a)(3).

While the Code does not define patron, a Treasury Department regulation describes a patron as "any person with or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association...."[10] In other words, a patron is a person who shares in the earnings of the cooperative on the basis of the amount of business conducted with the cooperative.

The regulation highlights the important distinction between a member and a patron. A member is generally regarded as a person who has the right to vote on issues decided by the membership. A patron is a person who does business with the cooperative and has a right to share in the cooperative's earnings on a pro rata, patronage basis.

There is usually substantial overlap between the "members" and the "patrons" of a cooperative. A cooperative, however, may do business with members on a nonpatronage basis, and it may conduct business on a patronage basis with nonmembers.

The options concerning whom a cooperative does business with on a cooperative basis contribute to the complexity of the tax treatment of cooperatives.

Patronage Refund Distinguished From a Dividend

A "patronage refund" consists of net margins from business done with or for patrons that are allocated or distributed to patrons on a patronage basis. For example, if a cooperative has a net margin for the year of $5,000, and Ms. Jones accounted for 5 percent of the business conducted on a cooperative basis that year, then Ms. Jones receives a patronage refund of $250 ($5,000 x .05).

A primary difference between cooperatives and other forms of business is the way earnings are distributed. In a cooperative, the margins are returned to users as patronage refunds, based on the amount of business each user does with the cooperative. In a noncooperative, the earnings are returned to investors as dividends, based on the amount of investment in the company. Thus a patronage refund is a return based on use, a dividend is a return based on investment.

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[10] **Treas. Reg.** §1.1388-1(e).

This distinction is complicated by the Code's use of the term "patronage dividend" in referring to what is generally called a "patronage refund."[11] "Patronage refund" is used rather than "patronage dividend" in these reports in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

A major portion of this series of reports is devoted to the tax treatment of patronage refunds.

FACTS ABOUT FARMER COOPERATIVES

Farmer-owned cooperatives have traditionally played a vital role in the production and distribution of agricultural products. Cooperatives' important position in agriculture continues undiminished, although many changes have taken place in farm commodity production, processing, marketing, and distribution over the years.

In 1991, 4,494 farmer cooperatives provided marketing, farm supplies, and services to farmers.[12] This represents a steadily declining number of farmer cooperatives, down from about 10,000 in 1950, and 6,211 in 1981. This decrease in the number of cooperatives reflects the trend of consolidation and merger occurring in many segments of the food industry.

Of cooperatives operating in 1991, 2,384 primarily marketed farm products, 1,689 primarily provided farm supplies to farmers, and 421 primarily provided other services. Many cooperatives engage in two or three types of activities, although they are classified under only one primary function.

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[11] See, e.g., I.R.C. §§ 1382(b) and 1388(a). In a technical sense, a "patronage dividend" (within the meaning of the Code) is a "patronage refund" that meets certain Code requirements, such as being paid pursuant to a preexisting legal obligation on the cooperative to make the refund. In most instances, "patronage refunds" that do not qualify as "patronage dividends" (for tax purposes) are treated as "dividends" for tax purposes. See, e.g., People's Gin Co. v. Commissioner, 41 B.T.A. 343 (1940), *aff'd*, 118 F.2d 72 (5th Cir. 1941); Juneau Dairies, Inc. v. Commissioner, 44 B.T.A. 759 (1941).

[12] The data in this section is taken from R. Richardson, et al., Farmer *Cooperative* Statistics, *1991,*

Cooperatives can also be classified according to organization structure. Centralized cooperatives have only farmer members. Federated cooperatives have only other farmer cooperatives as members. The membership of mixed cooperatives consists of both farmers and farmer cooperatives. In 1991, 4,358 cooperatives were centralized, 84 were federated, and 52 were mixed.

About 4.1 million producer memberships in farmer cooperatives were reported in 1991. This number includes duplications for farmers who hold membership in more than one cooperative, a common situation. The tax treatment of patronage refunds paid to patrons and other tax implications of farmer membership affect a great number of farmer taxpayers.

The gross business volume of all cooperatives in 1991 was $90.8 billion. Marketing represented 67.7 percent of the total, farm supplies 29.6 percent, and selected services 2.7 percent. If intercooperative business transactions are eliminated, net business volume was $76.6 billion, up from $71.5 billion in 1981.

Most farmer cooperatives are relatively small businesses. In 1991, 84.9 percent of all farmer cooperatives reported business volume of less than $15 million.

Looking at some balance sheet numbers, combined assets of all farmer cooperatives in 1991 totalled $31.3 billion. Total liabilities were $17.2 billion, leaving net worth, or member and patron equity, at $14.1 billion.

The 100 largest cooperatives (the so-called Top 100 in Rural Business-Cooperative Service publications), usually operate over sizable geographic areas, and make up an important segment of the farmer cooperative industry. In 1991, the Top 100 accounted for nearly $52.8 billion in business volume, 58.1 percent of the business volume for all farmer cooperatives.[13] They likewise dominated the balance sheet items with $18.6 billion in total assets (60% of the total) and $7.0 billion in member and patron equity (50% of the total).

How a cooperative uses its earnings affects tax calculations of both the cooperative and its farmer patrons. Total

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[13] All 1991 Top 100 data are from J. Staiert, "Top 100 Cooperatives 1991 Financial Profile," which reprinted articles from the 1992 September, October, November, and December issues of *Farmer Cooperatives magazine* (USDA, January 1993).

earnings of the Top 100, from both patronage and nonpatronage business, were $790.5 million in 1991.

These earnings were accounted for in five ways. Cash patronage refunds totaled $251.5 million (31.8 percent). Retained patronage refunds were $382.2 million (48.3 percent). Thus over $4 out of every $5 in margins realized by the Top 100 (80.1 percent) were distributed or allocated as patronage refunds.

The Top 100 paid $93.2 million in corporate income taxes in 1991 (11.8 percent). Dividends on stock amounted to $14.0 million (1.8 percent), and $49.6 million (6.3 percent) of net margins were placed in unallocated reserves.14

TAX TREATMENT OF NONCOOPERATIVE BUSINESSES

Farmer cooperatives are business organizations and are taxed as business organizations. All businesses, however, are not taxed alike. Tax laws divide businesses into several categories, each with its own special tax provisions. An understanding of the tax treatment accorded other types of businesses is beneficial to understanding the tax treatment of cooperatives, and to accessing the strengths and challenges of operating a business on a cooperative basis.15

Sole Proprietorships

An individual's business activities are all taxed as part of the individual's income, not as a separate taxable unit. Income

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14 Historical and current statistics on farmer cooperatives are found in ACS publications. Data is collected by the agency and reported for all cooperatives combined. Separate data collection and analysis provide more detailed information about the financial profile of the largest 100 farmer cooperatives. Updated information on all farmer cooperatives, and on the Top 100, can be obtained from the agency.

15 A new form of business, the limited liability company (LLC) has been authorized in a number of States. An LLC is a hybrid entity designed to provide partnership tax treatment combined with limited liability for the members. Under certain circumstances, an LLC can be taxed as a corporation. While still more talked about than used, LLC's will likely become more common in the future.

from a sole proprietorship is combined with nonbusiness income and adjusted for deductions, exemptions, and all other appropriate factors to determine the individual's taxable income. The resulting taxable income figure is taxed to the individual carrying on the business at the individual's applicable tax rate.

Thus, earnings of a sole proprietorship are not taxed as earnings of a separate business and again as personal income to the sole proprietor. Rather, a single tax is applied to sole proprietorship income at the individual's level.

Partnerships

Partnerships are a second way of conducting business. While considered a business form, partnerships are not taxable entities for income tax purposes.[16] Partnerships have income and expenses related to their operation. Rather than determine taxable income at the partnership level, however, partnership income and deductions are passed through to the partners. Individual partners receive "distributive shares" of the partnership's income, deductions, and credits based upon the agreement among partners.

Items of income or deduction received from the partnership are taken into account by individual partners as income or deductions and combined with partners' other reported items.[17] The passthrough occurs whether the partnership actually distributes any money or property or not. Each partner incurs whatever tax liability the resulting taxable income occasions when the reported items are included in the partners' individual income tax return.

Corporations

Unlike sole proprietorships and partnerships, corporations are taxable business entities.[18]

Corporations incur tax liabilities based on their taxable income whether distributed to shareholders or not.

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[16] I.R.C. § 701.

[17] I.R.C. § 702.

[18] "A tax is hereby imposed for each taxable year on the taxable income of every corporation." I.R.C. § 11.

A corporation's taxable income is determined by subtracting from its gross income certain items permitted in the Internal Revenue Code.[19] The resulting income is taxable. Corporate tax rates are applied to this taxable income to find the corporation's tax liability. The corporation itself pays the tax.

When earnings and profits are distributed to shareholders, shareholders take the distribution into account as dividends received, with certain exceptions, and incur tax liability on that income.

Specific items of income and deduction used by the corporation to determine its taxable income are not passed through to shareholders. Shareholders receive dividend income only when declared by the corporation. If no dividend is paid, shareholders receive no income from the corporation, even though the corporation has net income for the year. Excessive accumulation of undistributed earnings by the corporation is limited by law.

When the corporation pays dividends on capital stock, it receives no deduction against its taxable income.

Shareholders, who are themselves corporations, receive some relief from the general rule that shareholders must recognize dividends as taxable income. In general, if a corporate shareholder owns less than 20 percent of the distributing corporation's stock, it may deduct 70 percent of the dividends received.[20] If a corporate shareholder owns 20 percent or more of the distributing corporation's stock, it may deduct 80 percent of the dividends received.[21] The special dividends received deduction does not apply to dividends received from a farmers' cooperative that utilizes Code section 521.[22]

Payments to shareholders may be of two types-dividend on stock or a redemption or return of capital. Dividends on capital stock are taxable income. A redemption of capital, however, is not a distribution of corporate profit or earnings,

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[19] Federal income tax law is contained in the Internal Revenue Code of 1986, codified as Title 26 of the United States Code. In the text, it is frequently referred to as the "Code." Convention dictates that in footnotes it be represented by the initials I.R.C.

[20] I.R.C. § 243(a).

[21] I.R.C. § 243(c).

[22] I.R.C. § 246(a)(1).

but a return of the shareholders' capital contribution to the corporation. Numerous tax law rules distinguish dividends on stock from stock redemption, earnings or profits from return of capital, and taxable from nontaxable transactions with respect to corporate stock.

While there are important exceptions, as a general rule the corporate and individual tax structures lead to double taxation of income flowing into a corporation and eventually to stockholders as dividends on capital stock. The corporation pays tax on its income. Any income then distributed to stockholders as dividends is taken into account as taxable income by those stockholders, whether they be individuals or taxable business entities.

S Corporations

Some business corporations may elect to have most or all of their income taxed only at the shareholder level. This eliminates the double tax burden placed on the corporate form of doing business. Electing corporations are called "S corporations," from subchapter S of the Code in which they are described and their special tax treatment rules given.

To qualify for subchapter S tax status, a corporation must be a domestic corporation[23] and also meet the following requirements:

(A) It may not have more than 35 shareholders (husband and wife are counted as one shareholder).

(B) All shareholders must be individuals, estates, or certain described trusts. Shareholders can not be corporations or partnerships.

(C) All shareholders must be U.S. citizens or resident aliens.

(D) An S corporation must have only one class of stock.[24]

Subchapter S is designed to give the owners of qualifying businesses the option to adopt partnership-like tax status

[23] A "domestic" corporation must be created or organized in the United States or under the law of the United States or one of the individual States. I.R.C. § 7701(a)(4).

[24] I.R.C. § 1361(b)(l).

while enjoying certain nontax benefits of incorporation, such as limited liability.

In most regards, S corporation taxation is similar to partnership taxation. Items of income, loss, deductions, and tax credits are calculated separately and passed through to shareholders. Any remaining income or loss is calculated and passed on to shareholders.[25] Individual items of S corporation income or loss are passed to shareholders proportionately, based on the amount of stock owned each day during the tax year.[26] For the most part, income flowing through the S corporation to shareholders is taxed but once, at the shareholder level.

COOPERATIVE TAX PRINCIPLES

As one form of business corporation, cooperatives calculate taxable income and use tax rates like other corporations, but with one principal difference. This difference is based on cooperatives' distinct way of distributing net margins to its patrons based on use rather than to investors based on investment. This report gives the general taxation rules applicable to cooperatives. The concepts are quite simple, just as are those applied to sole proprietorships, partnerships, corporations, and S corporations. Actual application of the rules, however, can be complex.

The general principle of cooperative income taxation is that money flows through the cooperative and on to patrons, leaving no margins to be retained as profit by the cooperative. Thus margins are taxed only **once. The tax is ultimately paid by the final recipient (the cooperative patron), although under some circumstances the cooperative pays tax on a temporary basis, then receives a deduction when the money is finally passed on to the patron.**

This **single tax principle only applies if business income sources and distribution methods are "cooperative" in nature. Earnings from sources other than patronage and margins not distributed in the manner specified by the Code are generally not eligible for single tax treatment.** The critical issue **in distinguishing patronage- and nonpatronage-sourced income is dis-**

[25] I.R.C. § 1366.

[26] I.R.C. § 1377.

cussed in chapter 5 of this series of reports. General corporate income tax rules apply to earnings from nonpatronage sources and double taxation results.

When statutory conditions are met, cooperatives treat retained patronage refunds and per-unit retains as if the funds retained had been paid to the patron, deducted by the cooperative, taken into the patron's income as ordinary income, then invested in the cooperative. Conditions for this tax treatment include agreement by the patron to recognize the full patronage refund for tax purposes even though not received in cash or negotiable form.

Farmer cooperatives that meet several organizational and operational rules set out in Code section 521 are allowed to deduct two additional items: (1) dividends paid on capital stock and (2) distributions of nonpatronage earnings to patrons on the basis of their patronage.[27] The special tax treatment of section 521 cooperatives will be discussed in a later report.

SOURCES OF TAX LAW

At every stage of tax planning and decisionmaking, cooperative advisors, directors, management, and other employees must make judgments about tax implications of cooperative actions. Tax law is derived from several sources, including the Internal Revenue Code, its interpretation by IRS, and the courts. The resolution of specific tax questions can require looking at a number of sources.

This section describes the principal sources that give and clarify tax laws applied to cooperatives.

Internal Revenue Code

Income tax law is contained in the Internal Revenue Code of 1986,[28] commonly referred to as the "Code."

Prior to 1939, the statutory provisions relating to taxes were contained in numerous individual revenue acts. Because of the inconvenience and confusion that resulted from dealing with many separate acts, Congress codified all of the Federal

[27] I.R.C. §§ 521(b), 1381(a)(1), and 1382(c).

[28] Title 26 of the United States Code.

tax laws in 1939. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes. A further rearrangement took place in 1954 and resulted in the Internal Revenue Code of 1954.

With some exceptions, neither the 1939 nor the 1954 Codes substantially changed the existing tax law. Much of the 1939 Code, for example, was incorporated into the 1954 Code. The major change was the reorganization and renumbering of the tax provisions. This point is important in accessing rulings and court decisions interpreting earlier versions of the Code. If the same provision was included in the subsequent Code(s), the rulings and decisions relating to that provision remain valid.

The Code was given its present name by the Tax Reform Act of 1986.[29]

The periodic statutory amendments to the tax law are integrated into the Code. The Revenue Reconciliation Act of 1990,[30] for example, became part of the Internal Revenue Code of 1986.

The Code is divided into chapters, subchapters, parts, sections, etc. The Code includes all income tax rules applicable to individuals, partnerships, corporations, cooperatives, estates, trusts, exempt organizations, specially treated organizations, and all laws related to tax law administration.

Most parts of the Code apply to cooperatives and patrons by virtue of the fact that cooperatives and patrons conduct business and have income. A few provisions, however, relate specifically to cooperatives and their patrons. This publication focuses on these parts of the Code.

Subchapter T

Subchapter T of the Code, "Cooperatives and Their Patrons,"[31] is the basis for cooperative taxation and the taxation of patrons.

Part I of subchapter T consists of three sections. Section 1381 describes cooperative organizations to which subchapter

[29] Pub. L. No. 99-272, 100 Stat. 82 (1986).

[30] Pub. L. No. 101-508, 107 Stat. 1388 (1990).

[31] I.R.C. §§ 1381-1388.

T applies. Subchapter T applies to all farmer cooperatives, including farmer cooperatives qualifying under section 521 .[32]

A business need not be a farmer cooperative to qualify for subchapter T tax status. Any business "operating on a cooperative basis" uses subchapter T when computing its tax liability.3

Section 1382 describes how cooperatives calculate their taxable income. This provision explains how cooperatives may reduce their gross income by the amount they pay in noncash patronage refunds and per-unit retains. Section 1382 also covers the time period within which patronage refunds and per-unit retains must be paid, special accounting rules for pooling arrangements, and the problem of earnings received after patronage has occurred.

Section 1383 describes how a cooperative is to compute taxes in the year it redeems nonqualified written notices of allocation and nonqualified per-unit capital retains. The cooperative makes two alternative calculations described in the section and uses the more favorable of the two.

Part II of subchapter T consists only of section 1385. This section addresses patron taxation. It describes how patrons are to account for patronage refunds and per-unit retains received from a cooperative. Section 1385 authorizes patrons to exclude from gross income patronage refunds properly taken into account as an adjustment in the basis of property, or attributable to personal, living, or family items.

Part III of subchapter T also contains but one section, section 1388. This section contains an important set of definitions including such key cooperative tax terms as "patronage dividend (refund)," "written notice of allocation," "qualified written notice of allocation," "per-unit retain allocation," and "qualified per-unit retain certificate." Section 1388 also provides rules for obtaining consent from patrons to include noncash allocations in taxable income and for the netting of patronage gains and losses.

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[32] I.R.C. § 1381(a)(l).

[33] I.R.C. § 1381(a)(2). Language in section 1381(a)(2) specifically excludes mutual savings banks, insurance companies, and utility cooperatives from the scope of subchapter T.

Section 521

Section 521[34] defines the kind of organization frequently called an "exempt" farmer cooperative. The term "exempt" is misleading as these cooperatives are not truly exempt from all taxation, but only entitled to additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income. They will be referred to as "section 521 cooperatives" in this report.

Section 521 (b) establishes the basic requirements to qualify for the additional deductions:

(1) Qualifying organizations must be farmer cooperatives operated for the purpose of marketing farm products and returning margins back to patrons, or for purchasing supplies and equipment for farmers at cost plus expenses.

(2) Section 521 cooperatives may have capital stock, but substantially all voting stock must be in the hands of farmers who use the cooperative. Dividends on capital stock are limited.

(3) Section 521 cooperatives may maintain certain reserves.

(4) Such cooperatives may conduct up to half their business with nonmembers and make up to 15 percent of their supply sales to persons who are neither members nor producers.

Other Code Provisions

The bulk of all special cooperative tax principles and applications is contained in subchapter T and section 521. Other Code provisions also apply specifically to cooperatives.

Tax returns. A cooperative described in section 6072(d)[35] has 8 1/2 months after the close of the taxable year to file its tax return. This extended filing period is available for section 521 cooperatives and other subchapter T cooperatives with an obligation to pay patronage refunds on at least 50 percent of their net earnings from business done with or for patrons.[36]

Farmer cooperatives file on form 990-C. Other cooperatives file form 1120.

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[34] Found in subchapter F, Exempt Organizations, of the Code.

[35] I.R.C. § 6072(d).

[36] Most business corporations only have 2 1/2 months after the close of the taxable year to file their tax returns. I.R.C. § 6072(b).

Reporting of patronage-based allocations. Reporting requirements for cooperatives paying patronage refunds and per-unit retains are described in section 6044.[37] Cooperatives must report such distributions to IRS (form 1096) and to the patron receiving the distribution (form 1099-PATR). Section 6044(c) provides an exemption from reporting for certain consumer cooperatives.[38]

Dividends Received Deduction. Section 246 provides that the deduction for dividends received by a corporation from another corporation is not allowed when the dividends are received from a section 521 cooperative.[39]

Judicial Decisions

Courts decide disputes between IRS and taxpayers through analysis and interpretation of the Code, regulations, and the IRS's application of the tax laws. Courts give the final judgment on Code interpretation and, unless changed by legislation, court opinions stand as the source of highest authority. In addition to their precedent value, judicial decisions also provide guidance on applying Code provisions to specific circumstances. The reasoning used to reach conclusions can also be quite helpful.

Tax disputes usually reach the courts after a taxpayer has exhausted some or all of the administrative remedies within the IRS. The case is first considered by a court of original jurisdiction (frequently referred to as a trial court), with any appeal by either the taxpayer or IRS taken to the appropriate U.S. Court of Appeals. Only a small number of tax cases are accepted for review by the U.S. Supreme Court.

In most situations, the taxpayer has a choice of three courts of original jurisdiction: a Federal District Court, the U.S. Court of Federal Claims, or the U.S. Tax Court (formerly the Board of Tax Appeals). While the first two courts decide a wide spectrum of cases, the Tax Court hears only tax cases. Choosing the best forum for a particular tax case is a matter of strategy to be determined by taxpayers and their counsel.

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[37] I.R.C. § 6044.

[38] I.R.C. § 6044(c).

[39] I.R.C. § 246(a)(l).

Decisions of all of the trial and appellate courts mentioned have precedential value for future cases with the same or similar facts. Unless an issue has been settled by a decision of the U.S. Supreme Court, the IRS, as a part of the executive branch, can disregard the court's reasoning when handling the same issue with other taxpayers in the future.

If IRS loses a case before the Tax Court, it frequently announces its acquiescence (agreement) or nonacquiescence (disagreement) with the decision. IRS can retroactively revoke its acquiescence. IRS also will occasionally announce whether or not it will follow a decision of another Federal court on similar issues.

A nonacquiescence puts taxpayers on notice that reliance on the court's decision may be risky and that IRS may litigate the issue again.

IRS Administrative Determinations

In many specific situations, the Code does not provide a precise answer to the issue raised. Code provisions therefore must be interpreted. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, prescribes all necessary rules and regulations for the interpretation and enforcement of the Code.[40]

Regulations

The Treasury Department, through IRS, issues regulations in connection with most provisions of the Code. Regulations are interpretations of the Code and provide taxpayers with guidance on the meaning and application of the Code. Although not law as such, regulations carry considerable weight and are an important factor to consider in complying with the tax law.

Some regulations carry more weight than others. Sometimes when passing a tax law, Congress will specifically instruct the Treasury Department to develop regulations to implement parts of the new law. These "legislative" regulations have virtually the force and effect of law.

A regulation's validity is also enhanced if it accurately reflects the intent of Congress. Thus, a regulation that draws

[40] I.R.C. § 7805; Treas. Reg. § 301.7805-l.

on legislative language or language in a Congressional committee report explaining the underlying legislation is often given special credence by a court.

In any challenge to the validity of a regulation, the burden of proof is on the taxpayer to show the regulation is wrong.

New regulations and changes in existing regulations usually are issued in proposed form so that taxpayers and other interested parties can comment on the propriety of the proposal. Proposed and final regulations are published in the Federal Register and reproduced in the major commercial tax reporting services.

Revenue Rulings and Revenue Procedures

Revenue rulings are official pronouncements of the National Office of the IRS. Like regulations, revenue rulings provide interpretation of Federal tax law from the IRS perspective.

Revenue rulings typically describe a set of facts, then analyze how tax law should be applied. Taxpayers generally may rely on published revenue rulings, and published revenue rulings generally are not revoked retroactively. These rulings do not have the force and effect of the Code, regulations, or court decisions. They can be used and cited as precedent in situations where the facts or issues are similar and the logic of the ruling can be applied; but in litigation the courts usually do not give any special deference to revenue rulings.

A revenue procedure is an official statement of procedure from the IRS National Office. They guide IRS personnel and taxpayers in handling routine tax matters.

Both revenue rulings and revenue procedures are published weekly in the Internal Revenue Bulletin. Every 6 months the recent rulings and procedures are organized by Code sections and republished in the Cumulative Bulletin.

Private Letter Rulings and Technical Advice Memoranda

Both private letter rulings (PLR's) and technical advice memoranda (TAM's) are written interpretations from the IRS National Office of how the tax law applies to a specific set of circumstances. PLR's are issued in response to requests for advice from taxpayers. TAM's arise from audit controversies

and are issued as responses to requests for guidance from IRS District Directors and Appeals Officers.

Prior to 1976, IRS treated these rulings as confidential information to be made available only to the requesting party. That position was successfully challenged as being in violation of the Freedom of Information Act.[41]

The Tax Reform Act of 1976 included a provision stating that written determinations by IRS shall be open to public inspection.[42] Information disclosing the identity of the taxpayer is deleted before the documents are made available to the public.

PLR's and TAM's respond only to the facts presented. According to the Code, they may not be cited as precedent,[43] but some uncertainty exists about how and when they can be used by other taxpayers.[44] PLR's and TAM's are used in this publication to help describe the IRS position on a variety of situations requiring tax implication analysis.[45]

General Counsel Memoranda and Actions on Decisions

General Counsel Memoranda (GCM's) are legal analysis prepared by the IRS Office of the General Counsel, usually drafted in connection with proposed PLR's, TAM's, or revenue rulings. Actions on Decisions (AOD's) are legal memoranda that are prepared when the IRS loses an issue in a litigated tax case. AOD's offer a suggested IRS course of action in response

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[41] Tax Analysts and Advocates v. Commissioner, 505 F.2d 352 (D.C. 1974).

[42] I.R.C. § 6110.

[43] Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent. I.R.C. § 6110(j)(3).

[44] See H. Massler, "How to Get and Use IRS Private Letter Rulings," 33 *Pract. Lawyer* 11 (1987); G. Portney, "Letter Rulings: An Endangered Species?" 36 *Tax Lawyer* 751 (1983); and J. Holden and M. Novey, "Legitimate Uses of Letter Rulings Issued to Other Taxpayers - A Reply to Gerald Portney," 37 *Tax Lawyer* 337 (1984).

[45] An interesting discussion of what IRS regards as authority is found in the regulations interpreting the accuracy-related penalty provision of the Code, Treas. Reg. §1.6662-4(d)(3)(iii).

to the decision and legal analysis to support the recommendation.

Historically, the IRS resisted disclosure of GCM's and AOD's as internal memoranda not prepared for public use. In 1981, however, litigation under the Freedom of Information Act forced IRS to begin releasing GCM's and final AOD's.[46]

Unlike PLR's and TAM's, no specific statutory language prohibits GCM's and AOD's from being used as precedents. Although such documents are now publicly available, IRS contends GCM's and AOD's remain nothing more than internal memoranda and are not elevated to the status of official agency documents that can be cited as precedent.

[46] Taxation with Representation Fund v. Internal Revenue Service, 646 F.2d 666 (D.C. Cir. 1981).

CHAPTER 2. COOPERATIVE STRUCTURE, OPERATION, AND TAXATION

No simple and all-encompassing definition exists to distinguish an organization called a "cooperative" from other forms of business enterprise. As Justice Louis Brandeis once noted, "[N]o one plan of organization is to be labeled as truly cooperative to the exclusion of others."[47]

A wide range of business operations are eligible for the tax benefits provided in subchapter T. This chapter discusses eligibility for subchapter T, other laws that govern cooperative conduct, various structures and methods of operation used by cooperatives, and the relationship between cooperative equity accumulation and tax treatment.

OPERATING ON A COOPERATIVE BASIS

According to the Code, "any corporation operating on a cooperative basis" may receive the tax benefits of subchapter T. Specifically excluded from the application of subchapter T are mutual savings banks, insurance companies, and organizations furnishing rural electric energy or providing telephone service to persons in rural areas.[48]

The Code does not include any specific definition of "operating on a cooperative basis." The regulations only repeat the Code language and add the phrase "and allocating amounts to patrons on the basis of the business done with or for such patrons."[49]

Any Organization Eligible

Although this report focuses on cooperatives whose members are farmers, subchapter T tax treatment is also available for cooperatives whose members are not farmers. The House and Senate Reports accompanying passage of subchapter T noted, "the tax treatment outlined here applies to the so-

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[47] Dissenting opinion in Frost v. Corporation Comm'n, 278 U.S. 515,546 (1929), quoted in Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213, 1217, note 3 (1980).

[48] I.R.C. § 1381(a)(2).

[49] Treas. Reg. § 1.1381-l(a).

called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis."[50]

The tax law is replete with examples of nonfarm businesses operated as subchapter T cooperatives. Retail stores, particularly grocery stores, have used cooperatives to purchase, manufacture, warehouse, and transport groceries and related items.51 Savings in volume discounts and favorable terms of purchase, as well as inventory supply and control make cooperative purchasing attractive in these situations. Similar arrangements are beneficial for hardware stores, particularly where uniform or specially designed or formulated product is desirable;[52] builders who need supplies and transportation services;53 and other retailers.54

Cooperatives are not limited to marketing and purchasing, they may also perform services as their primary activity. An example of a service cooperative is an association formed by a variety of members to consolidate and distribute freight.[55] The firm combined small, less-than-truckload sized shipments for coordinated shipments in a more efficient manner. A group of banks formed a cooperative to provide on-line computer services and management consulting services.56

Revenue Ruling 66-98[57] describes a financing corporation formed by department stores to purchase their accounts receivable, thus supplying member-patrons with working capital. The corporation charged a discount and made refunds at

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[50] H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1961), 1962-3 C.B. 405, 483, and S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 819, 1962 U.S. Code Cong. & Admin. Serv. 3304, 3416.

[51] Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987); Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983); and United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962), *aff'g*, 186 F. Supp. 724 (N.D. Cal. 1960).

[52] Cotter and Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985), *rev'g*, 6 Ct. Cl. 219 (1984); and Priv. Ltr. Rul. 8006112 (Nov. 20, 1979).

[53] Tech. Adv. Mem. 8118012 (Jan. 28, 1981).

[54] Tech. Adv. Mem. 8130001 (Mar. 24, 1981).

[55] Washington-Oregon Shippers Cooperative, Inc. v. Commissioner, 52 T.C.M. (CCH) 1406 (1987).

[56] Priv. Ltr. Rul. 7731017 (May 4, 1977).

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

year's end based on the total discounts charged each patron as a proportion of total discounts charged for the year. Payments based on discounts satisfied the requirement that distributions must be paid to patrons on the quantity or value of business done with the cooperative, and the finance corporation was operating on a cooperative basis for purposes of subchapter T.

Nonfarmer corporations operating a clearinghouse to facilitate settlement orders among members may qualify for subchapter T.[58] So may a cooperative in which workers own a manufacturing facility and pay themselves from margins derived from their labor;[59] fishermen provide themselves ice, tackle, gear, fuel and other needs;@ taxi services provide dispatching, repair, auto supplies, taxi car rentals and other services to drivers and mechanics;[61] and restaurants purchase products and supplies in volume.[62]

Code Meaning

The fact that the Code provides that "any corporation" can be a cooperative indicates an intent by Congress to accommodate within the scope of subchapter T the special nuances, regulatory requirements, financial arrangements, and other factors unique to a wide variety of industries.

The only statutory limits to the benefit of qualifying as a cooperative, access to single tax treatment of patronage refunds and per-unit retains, are found in the definitions of a patronage refund (dividend)[63] and per-unit retain allocation.[64]

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

[59] 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, 236 F. Supp. 227 (D. Ore. 1964); Puget Sound Plywood, Inc. v. Comm'r, 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 3; 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); and Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. P.9197 (D. Ore. 1979); Rev. Rul. 74-160, 1974-l C.B. 245; Rev. Rul. 74-84, 1974-l C.B. 244; Rev. Rul. 71-439, 1971-2 C.B. 321; Tech. Adv. Mem. 7746003 (Aug. 2, 1977).

[60] Seiners Ass'n v. Commissioner, 58 T.C. 949 (1972).

[61] Priv. Ltr. Rul. 8129050 (Apr. 22, 1981).

[62] Priv. Ltr. Rul. 9313016 (Dec. 23, 1992).

[63] I.R.C. § 1388(a).

[64] .R.C. § 1388(f).

To be excluded from taxable income, a patronage refund must be paid (1) on the basis of the business each patron conducted with the cooperative, (2) under a pre-existing legal obligation to make the payment, and (3) out of earnings of the cooperative from business with patrons. In addition, refunds must be computed on the same basis for patrons who engaged in substantially identical transactions with the cooperative. The Code requires a per-unit retain also be made pursuant to an agreement between the cooperative and the patron.

IRS Reliance on Puget Sound Plywood

In the late 1950's and early 1960's, the Service took the position that workers cooperative associations were not among the classes of cooperatives eligible to exclude patronage refunds from taxable income. In 1961, a brief revenue ruling was issued that expressed the Service's position.[65]

During floor debate on the legislation that became subchapter T, a colloquy between Senator Kerr (floor manager of the bill) and other Senators attempted to establish legislative history that worker cooperatives were entitled to exclude patronage refunds.[66] The Service, however, continued to press its position in litigation.

In late 1964, the Chief Judge of the Federal District Court in Oregon held in *Linnton* Plywood *Ass'n v. United States* that a workers cooperative was entitled to exclude retained patronage refunds from gross income to the same extent as purchasing or marketing cooperatives.[67] In Puget Sound Plywood *v.* Commissioner, the Tax Court also decided against the Service and held that a workers cooperative was a "cooperative association" for Federal income tax purposes.[68]

In concluding that worker cooperative associations were cooperatives for tax purposes, the court in Puget Sound

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[65] Rev. Rul. 61-47, 1961-1 C.B. 193, revoked by Rev. Rul. 71-439, 1971-2 C.B. 321.

[66] 108 Cong. Rec. 18,322 (1962), *quoted in* Puget Sound Plywood v. Commissioner, 44 T.C. at 321.

[67] Linnton Plywood Ass'n v. United States, 236 F. Supp. 227 (D.C. Ore. 1964), 1964-2 U.S.T.C. (CCH) ¶ 9819.

[68] Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

Plywood listed "three guiding principles as the core of cooperative economic theory:" (1) subordination of capital, (2) democratic control by the members, and (3) proportional allocation of margins on the basis of patronage.[69]

Beginning in 1982, IRS issued a number of private rulings that decided whether a cooperative association was "operating on a cooperative basis" by measuring compliance with the list of cooperative principles referred to in Puget Sound *Plywood*.[70] In 1993, the Service issued its first public ruling relying on Puget Sound *Plywood*, stating, "The cooperative principles stated in *Puget Sound Plywood* . . . provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of subchapter T of the code."[71]

In the 1990's, the Service has added four "additional factors" it considers important in considering whether a taxpayer qualifies as a cooperative: (i) existence of some joint effort on behalf of the members; (ii) a minimum number of patrons; (iii) member business should exceed nonmember business; and (iv) upon liquidation, present and former patrons must share in the distribution of any remaining assets in proportion to the business each did with the cooperative over some reasonable period of years.[72]

In *Puget Sound Plywood*, the Tax Court was clearly saying a cooperative association with certain attributes comes within the scope of "operating on a cooperative basis" under sub-

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@ Id. at 308.

[70] Tech. Adv. Mem. 8219821 (Mar. 18, 1982); Tech. Adv. Mem. 8225013 (Mar. 18, 1982); Priv. Ltr. Rul. 8324108 (Mar. 17, 1983); Priv. Ltr. Rul. 8505001 (May 15, 1984) and Tech. Adv. Mem. 8707005, (Nov. 7, 1986), both substituting "operation at cost" for (3); Priv. Ltr. Rul. 8744007 (July 21, 1987); Priv. Ltr. Rul. 8748015 (Aug. 27, 1987); Priv. Ltr. Rul. 8823032 (Mar. 8, 1988); Priv. Ltr. Rul. 8842034 (July 26, 1988); and Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).

[71] Rev. Rul. 93-21, 1993-13 I.R.B. 5.

[72] Priv. Ltr. Rul. 9117037 (Jan. 28, 1991); Tech. Adv. Mem. 9303004 (Oct. 7, 1992). Only additional factors (ii) and (iii) were considered in Priv. Ltr. Rul. 9141028 (July 11, 1991), Priv. Ltr. Rul. 9235011 (May 21, 1992), Priv. Ltr. Rul. 9237013 (June 10, 1992). Additional factors (ii), (iii), and (iv) were mentioned in Priv. Ltr. Rul. 9313016 (Dec. 23, 1992). While several of the rulings state these additional factors are considered important by the courts, no citations are provided.

chapter T. The Service appears to be reading that decision to say only cooperatives with those specific traits can be considered as "operating on a cooperative basis." And even a cooperative that meets the Puget Sound *Plyzuood* tests still may not be "operating on a cooperative basis" if it does not conform to various additional procedures.

However, the only Code requirement to single tax treatment of patronage refunds and per-unit retains is that they be returned or allocated to patrons on the basis of patronage, pursuant to a pre-existing legal obligation. In CF Industries *v.* Commissioner, the U.S. Court of Appeal for the 7th Circuit bolstered the view that the obligation to pay patronage refunds is the predominant characteristic of a cooperative when it stated:

> The principal difference between the cooperative form of doing business and the ordinary corporate form is that the shareholders of a cooperative share in the cooperative's income in proportion to their purchases from the cooperative rather than to the number of shares they own.[73]

The argument then suggests that the various expressions of cooperative principles and practices in the literature should not be read into the Code as additional mandatory restraints on organizations wishing to qualify for subchapter T tax treatment.

This approach is supported by the Tax Court opinion in *Ford-Iroquois* FS, Inc. *v. Commissioner.*[74] After quoting a textbook definition of a cooperative, the court said, "The definition is of value as a matter of clarification but should not be used for substantive exclusion or for limitation or analysis." [75] Similarly, the court said "The 'operation at cost' principle

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[73] CF Industries, Inc. v. Commissioner, Nos. 92-1579, 92-2046, slip op. at 1 (7th Cir. May 26, 1993).

[74] Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213 (1980).

[75] ***Id.*** at 1217, note 3. The court then quoted the language from Frost v. Corporation Commission, 278 U.S. 515,546 (1929), found in the first paragraph of this chapter.

describes a feature of a cooperative's relation with its members, not a codified requirement of tax accounting."[76]

A previous attempt by the Service to establish a quantitative requirement into "operating on a cooperative basis" was rejected by the courts. In 1972, the Service held an organization was not "operating on a cooperative basis" if the value of business with nonmembers exceeded that of member business.77 In subsequent years, three different courts rejected IRS's attempt to add the "50 percent" rule as a requirement for "operating on a cooperative basis."[78]

Finally, in Revenue Ruling 93-21,[79] the Service agreed that a cooperative that operates on a nonpatronage basis with nonmembers will not be precluded from being considered as "operating on a cooperative basis" simply because it does less than 50 percent in value of its business with members on a patronage basis. As Revenue Ruling 93-21 indicates, however, IRS still considers the 50 percent rule to be a factor in determining whether a cooperative is entitled to subchapter T tax treatment.

Whether these precedents will lead to an eventual determination that the only consideration needed in an "operating on a cooperative basis" inquiry'is whether the patronage refunds or per-unit retains meet the definitional requirements of the Code is an issue whose final resolution is unlikely for some time to come.

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[76] Id. at 1222. In this case IRS alleged that a cooperative principle stating cooperatives "operate at cost" barred a cooperative from carrying a loss forward for tax purposes. The court rejected the IRS position and permitted the cooperative to carry the losses forward under I.R.C. § 172. See also, Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, 740 (1978).

[77] Rev. Rul. 72-602, 1972-2 C.B. 511.

[78] Conway County Farmers Ass'n v. United States, 588 F.2d 595 (8th Cir. 1978), *rev'g* 1978-1 U.S.T.C. (CCH) ¶ 9334 (E.D. Ark. 1978); Columbus Fruit & Vegetable Coop. Assn. v. United States, 7 Cl. Ct. 561 (1985); Geauga Landmark, Inc. v. United States, No. 81-942 (N.D. Ohio 1985). The Claims Court found the IRS's position in the Columbus ***Fruit*** case so unreasonable that legal fees were awarded to the taxpayer. 8 Cl. Ct. 525 (1985).

[79] Rev. Rul. 93-21 1993-13, 5, *Modifying* Rev. Rul. 72-602, 1972-2 C.B. 510.

NONTAX STATUTES THAT CHARACTERIZE COOPERATIVES

Tax law does not operate in a vacuum. Many other laws provide privileges and place responsibilities on cooperatives that impact on the way cooperatives conduct their business operations. This section summarizes laws outside the tax area that influence cooperative structure and operations. An understanding of these laws is critical to overall business planning for a cooperative, a process where taxation is only one of several key elements.

State Incorporation Laws

Virtually all cooperative businesses are incorporated. Incorporation offers advantages over other forms of doing business where a large number of persons may become involved in the venture.

Incorporation facilitates the orderly succession of ownership. The entity has a perpetual life. As some members resign and new people join, redemption and issuance of a share of common stock or a membership certificate is a relatively simple means of clarifying each person's status and rights in the association.

Incorporation will also generally limit the personal liability of each member, for losses suffered by the cooperative, to the members' equity in the cooperative.

All States have recognized cooperatives' unique characteristics by enacting statutes specifically designed for incorporating cooperatives. The 50 States have approximately 85 such statutes[80]. Some are broad, permitting the incorporation of virtually any business as a cooperative. Others are limited in scope. Many States have an Agricultural Cooperative

[80] State cooperative laws are analyzed in detail in J. Baarda, State *Cooperative Incorporation Statutes for Farmer Cooperatives,* ACS Cooperative Information Report. No. 30 (USDA 1982). A brief history of their development is given in J. Baarda, *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises,* ACS Research Report. No. 54 (USDA 1986) at 5-9.

Associations Act specifically written to authorize incorporation of associations of agricultural producers.

An organization need not be formed pursuant to a cooperative incorporation statute to qualify as a cooperative under subchapter T of the Code or the other Federal acts mentioned in the next subsection of this report. Every State also has a general business corporation statute. A cooperative may be incorporated under this law and have its cooperative character established through proper drafting of the articles of incorporation and bylaws.

While most cooperatives are organized under a law of the State where the principle office is located, this is not a legal requirement. A number of cooperatives are organized under a cooperative law or general business act of a different State.

The different laws have various rules on such key issues as who can be a member, voting rights of members, the extent of permissible nonmember business, and who can be a director or an officer. The primary consideration in selecting an incorporation statute is that the act permits a structure that meets the needs and desires of the members.

Federal Statutes

Three nontax Federal laws that effect cooperatives have more detailed eligibility requirements than does the Internal Revenue Code (Code). These statutes are the Capper-Volstead Act, the Agricultural Marketing Act of 1929, and the Farm Credit Act of 1971. The descriptions found in these Federal laws are adopted by reference in other statutes and regulations. Cooperatives that wish to utilize legal rights conferred under these laws must meet their qualification standards, regardless of whether the organization is operating on a cooperative basis for tax purposes.

Capper- Volstead Act

The Capper-Volstead Act,[81] enacted in 1922, provides a limited antitrust exemption for agricultural producers to market their products on a cooperative basis. To qualify for

[81] 42 Stat. 388 (1922), *codified at 7* U.S.C. §§ 291-292 (1988).

Capper-Volstead protection, the producers must adhere to these organizational and operational standards:

1. Membership must be limited to agricultural producers.
2. The association must be operated for the mutual benefit of the members as producers.
3. Either no member may have more than one vote because of the amount of equity owned or dividends on equity cannot exceed 8 percent per year.
4. The value of products handled for members must exceed that handled for nonmembers.

Agricultural Marketing Act of 7929

The Agricultural Marketing Act of 1929[82] created the Federal Farm Board, with the joint missions of stabilizing farm prices and financing cooperatives. A forerunner of the Farm Credit Acts, this law includes a definition of "cooperative association" virtually identical to the one in the Capper-Volstead Act. The Agricultural Marketing Act of 1929, however, has broader application, covering farm supply as well as marketing cooperatives.[83]

Farm Credit Act of 1971

The Farm Credit Act of 1971[84] includes a definition of a cooperative eligible to borrow from Banks for Cooperatives.[85] This definition is similar to, though somewhat more flexible than, the definition in the other two statutes:

1. The borrower must be an association of farm or aquatic producers. At least 80 percent (60 percent in some specific instances) of the voting control of the association must be held by farm or aquatic producers, or associations of such producers.
2. No member may have more than one vote because of the amount of equity owned or dividends on equity can not exceed a rate established in regulations of the Farm Credit Administration.

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[82] 46 Stat. 11 (1929), *codified at* 12 U.S.C. § 1141 (1988).

[83] 12 U.S.C. §1141j.

[84] 85 Stat. 583 (1971), *amended 89* Stat. 1060 (1975), 94 Stat. 3437 (1980), 100 Stat. 1877 (1986), *codified at* 12 U.S.C. § 2001 et seq. (1988).

[85] 12 U.S.C. § 2129.

3. The value of products handled for members and supplies provided members must exceed that handled and provided for nonmembers.

STRUCTURE AND OPERATIONS

Statutes provide the general framework within which cooperatives must operate. The primary sources of information about the structure and operation of **a** particular cooperative are its organizational documents. Like other corporations, the basic legal documents of a cooperative will be its articles of incorporation and bylaws. Many cooperatives also have special membership, marketing, and/or purchasing agreements with their members that set out rules for how the cooperative venture will conduct itself.[86]

Articles of Incorporation

The articles of incorporation, when accepted by the State government, establish the cooperative as a legal entity. Each incorporation statute, whether written specifically for cooperatives or for corporations in general, lists subjects the articles of incorporation must address. Articles of incorporation usually contain the following kinds of information about the cooperative:

1. The cooperative's purposes. These are usually stated quite broadly. Any service the cooperative may someday provide its members is frequently authorized, at least in a general way.
2. The cooperative's powers. The State statute authorizing formation of a cooperative usually sets out in detail the activities the cooperative may engage in. This provision is often a virtual verbatim copy of the statutory language.
3. The cooperative's term of existence, which is usually perpetual.
4. The number of directors and the names and addresses of the initial directors.

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[86] For an explanation of the key provisions in each of these documents, and sample drafting language, see D. Frederick, Sample Legal Documents **for** *Cooperatives,* ACS Cooperative Information Report No. 40 (USDA 1990).

5. The amount of capital stock, number of shares, par value, and descriptions of preferred stock, if any.

6. Special stock provisions such as limitations on transfer, common in cooperatives.

7. For cooperatives without capital stock, articles of incorporation will describe the relative rights of members.

Bylaws

A cooperative's bylaws are the most important source of information about how the cooperative operates. Most methods of distributing net margins as patronage refunds (and otherwise) are found in cooperatives' bylaws. Bylaws are tailored to each cooperative's particular situation, and no single provision is universally useful.

Bylaw provisions are more detailed than articles of incorporation. A typical set of bylaws might contain information about the following:

1. A description of who can be a member.

2. Entrance, organization, service, and membership fees.

3. Cessation or suspension of membership; reasons and procedures.

4. Members' interest when membership is terminated, including an appraisal if needed or required by State law.

5. Member meetings, annual and special.

6. Voting procedures, including the number making up a quorum of members and provisions on proxy or mail voting.

7. Qualification, election, and duties of directors.

8. Directors' terms of office.

9. Director quorum, board of director committees, and other board conduct items.

10. Marketing contracts, requirements, and liquidated damages clauses.

11. Descriptions of the distribution of net margins as patronage refunds, form of distribution as cash or other forms.

12. Reserves and their investment.

13. Stock and membership transfer restrictions.

14. Payment of dividends on capital stock, conditions and rates.

Key provisions of the business relationship between the members and the cooperative are often contained in the

bylaws, a practice unique to cooperatives as compared to most for-profit corporations.

Contractual Agreement with Members

Cooperatives often find it useful to have a contract with each member specifying in more detail the relationship between that member and the association. These agreements are usually executed at the time of application for membership. They deal with special provisions concerning membership, marketing, purchasing, or other services provided through the cooperative. For example, a marketing agreement might describe the member's obligation to deliver product to the cooperative and the cooperative's responsibilities concerning the marketing of that product.

These contracts sometimes duplicate and thereby reinforce provisions of the bylaws. It is usually preferable not to use a contractual provision in lieu of an appropriate bylaw.

As the material covered in these contracts varies greatly, the importance of such agreements for tax purposes depends on their individual provisions.87

General Operational Characteristics

Farmer cooperatives are owned and controlled by farmers. Control is typically evidenced by the ownership of a share of common stock in the case of stock cooperatives or a membership certificate in the case of membership or nonstock cooperatives. Owners of common stock in a stock cooperative are often simply called members. Evidence of membership is generally issued only to farmers. Restrictions on transfer, directly or indirectly, are common.

Members elect a board of directors almost always made up of fellow farmer members. This is true not only for small cooperatives but for the largest cooperative corporations in the country. Unlike noncooperative business corporations, cooperative directors are users of the services of the coopera-

87 For an explanation of the types and formats of marketing agreements, common provisions, and sample drafting language, see J. Reilly, *Cooperative Marketing Agreements: Legal Considerations,* ACS Research Report No. 106 (USDA 1992).

tive and recipients of net margins as users. Thus their interests are the same as other owner-user-farmers for whose benefit cooperatives exist.

The number of directors serving on a cooperative's board ranges from three to many. Directors may be chosen at large or elected by geographical districts. A delegate system sometimes is used to help choose representative directors.

In the annual membership meeting, which is open to all members, directors are elected and other business is conducted. Annual financial reports may be presented at the membership meeting or distributed to members by some other means if permitted.

The most noteworthy characteristic of a cooperative, distinguishing it from other forms of business enterprise, is how it distributes its net margins or earnings. Margins generally are distributed to patrons in proportion to their use of the cooperative rather than on the basis of capital investment in the cooperative.

Examples of Cooperative Operations

No definitive set of examples can convey the variety of ways cooperatives do business with and for their patrons. The following examples, however, demonstrate the general principles of operation commonly found in simple circumstances.

Example 1

A marketing cooperative engages in the sale of member-patrons' products only. The operation is a simple buy-sell arrangement in which patrons bring the product to the cooperative and the cooperative purchases it. This is a typical practice for many marketing cooperatives.

The price paid upon purchase by the cooperative may be the current market price for that commodity, may be established at a certain percentage of the current market price, or may simply be an advance based on financial considerations. The price may vary depending on the time of delivery and the quality of the product delivered. The commodity is commingled with all other deliveries of like goods. The cooperative sells the product. Under expected circumstances, the sale price will exceed the price that was paid to members at delivery.

The cooperative determines its net margins at the end of the fiscal year by normal accounting procedures. Total revenue received is reduced by the expenses of doing business, including the payments to patrons made when the cooperative purchased their production.[88]

Assume the cooperative's key financial results are reflected in the following simplified income statement:

Gross income from sale of commodities	$100,000
Cost of goods sold (payments/advances to member-patrons)	80,000
Other expenses	10,000
Net margins	$10,000

Net margins of $10,000 are available for payment as patronage refunds. Each patron's share of total net margins is calculated by determining each patron's share of total patronage during the year. In this example the cooperative deals with five patrons. The patrons delivered and the cooperative sold 2,000 units of product during the year. A percentage of total patronage is established for each patron:

Patron	Sales to Cooperative	Percentage of Total Sales
A	500 units	25.00
B	250 units	12.50
C	625 units	31.25
D	300 units	15.00
E	325 units	16.25

[88] Some cooperatives do not purchase member product, but rather serve as an agent to sell that product for member-patrons. The cooperative may make advance payments to patrons, as in example 1. The patronage refund allocations are the same as example 1.

Net margins are distributed by allocating the amount available for distribution ($10,000) by the proportion of total business attributed to each patron.

Patron	Percentage of Total	Patronage Refund
A	25.00	$2,500
B	12.50	1,250
C	31.25	3,125
D	**15.00**	**1,500**
E	**16.25**	**1,625**

Example 2

In this example the cooperative adds value to the farm product delivered to it by such means as processing or manufacturing. Gross income is derived from the sale of the finished product. Expenses include costs of other ingredients, labor, costs of fixed assets, any other expenses incurred in processing, marketing, etc.

Any increase in margins from value-added activities are returned to patrons on the same basis as their deliveries. Thus, the percentage of total sales will remain the same.

The assumed income statement is modified to reflect this expanded cooperative effort and the hoped-for higher margin:

Gross income from sale of processed products	$200,000
Cost of goods sold (payments/advances to member-patrons)	80,000
Processing expenses	80,000
Other expenses	25,000
Net margins	$15,000

The amount available for distribution is $15,000 instead of $10,000 in example 1, and the proportion of margins allocated to each patron remains the same. Based on proportion of the product delivered to the cooperative, each patron's patronage refund would be:

Patron	Percentage of Total	Patronage Refund
A	25.00	$3,750
B	12.50	1,875
C	31.25	4,687
D	15.00	2,250
E	16.25	2,438

Example 3

In this example, the cooperative described in example 2 has the same $15,000 income from business done with its patrons but, in addition, generates $1,000 of net income not related to business done with or for its patrons.

Net **margins from patronage business**	$15,000
Nonpatronage-sourced income	1,000

Assume the cooperative does not qualify for section 521 tax status, and therefore cannot deduct patronage-based distributions of nonpatronage income.[89] Also assume the corporate income tax rate is 15 percent on the first $50,000 of taxable income.

The patrons each receive patronage refunds in the same amount as in example 2.

The cooperative pays tax of $150 on $1,000 and will likely retain the $850 as earned surplus (an unallocated reserve>.

Example 4

This example reverts to the situation described in example 1 (the cooperative has a $10,000 margin), but with one exception. Patrons A, B, and C are members of the cooperative. D and E do business with the cooperative, but are not members. The cooperative's member and nonmember business are equally profitable.

The cooperative does not pay patronage refunds to nonmembers, but keeps the earnings on nonmember business as a

[89] The qualification requirements and special tax treatment of farmer cooperatives qualifying for section 521 tax status will be discussed in detail in a subsequent report.

tax-paid reserve. Individual producer sales to the cooperative are the same as in example 1.

Patrons A, B, and C provide 1,375 of the 2,000 units of product sold to the cooperative (68.75 percent). Therefore 68.75 percent of the $10,000 total earnings, or $6,875, is available for distribution as patronage refunds. The proportion of total member patronage conducted by each patron is calculated and applied to the $6,875 to determine individual patronage refunds.

Patron	Percentage	Patronage Refund
A	36.36	$2,500
B	18.18	1,250
C	45.46	3,125

The cooperative pays tax of 15 percent on the $3,125 in earnings from nonpatronage business ($469) and retains the remaining $2,656 as surplus.

Example 5

The cooperative in this example is in the same situation as in example 4. The cooperative, however, decides to return margins earned on nonmember business to its member patrons on a patronage basis. It pays tax of $469 on the amount earned on nonpatronage business and allocates the remaining $2,656 to its members in proportion to business done with the cooperative.

Patron	Percentage	Patronage Refunds	Other Payments	Total
A	36.36	$2,500	$966	$3,466
B	18.18	1,250	483	1,733
C	45.45	3,125	1,207	4,332

The three members collectively receive $9,531, the $10,000 in earnings less the $469 tax paid on the nonpatronage portion of the earnings.

Example 6

A cooperative may perform different services for different patrons. This example shows one way a cooperative may handle the income from two units and how it may distribute net margins.

The cooperative markets product X for patrons A, B, C, and D. It markets product Y for patrons C, D, and E. As the cooperative is marketing different products with different values and characteristics, it computes patronage on the basis of value rather than volume.

The cooperative calculates the percentage of total combined deliveries of X and Y. The total value of X and Y delivered to the cooperative is $100,000.

Patron	Product X	Product Y	Total Delivered
A	$20,000		$20,000
B	10,000		10,000
C	25,000	$10,000	35,000
D	12,000	13,000	25,000
E		10,000	10,000

The percentage of total product delivered to the cooperative attributed to each patron is calculated.

Patron	Percentage of Total
A	20.00
B	10.00
C	35.00
D	25.00
E	10.00

The cooperative in this example calculates a single net margin for its entire business. The total net margin, $15,000, is allocated to patrons without regard to division between units. Each patron's percentage of business is applied to the margin available for distribution.

Patron	Percentage	Patronage Refund
A	**20.00**	$3,000
B	**10.00**	**1,500**
C	**35.00**	**5,250**
D	**25.00**	**3,750**
E	**10.00**	1,500

Example 7

In this example, the cooperative engages in the same activities as the cooperative described in example 6. The cooperative, however, pays net margins derived from product X activities only to patrons delivering product X to the cooperative ($67,000 in product). Margins from product Y activities are distributed only to those patrons delivering product Y ($33,000 in product). Percentages for net margins are calculated for product deliveries separately.

Patron	Percentage, Product X	Percentage, Product Y
A	29.85	
B	14.93	
C	37.31	30.30
D	17.91	39.40
E		30.30

Assume the cooperative generated a margin of $8,000 from marketing product X and a $7,000 margin from marketing product Y. Applying the allocation percentages to net margins available for refund from each activity ($8,000 for product X, $7,000 for product Y), the patrons' patronage refund allocation from each activity is determined.

Patron	Refund, Product X	Refund, Product Y	Total Refund
A	$2,388		$2,388
B	1,194		1,194
C	2,985	$2,121	5,106
D	1,433	2,758	4,191
E		2,121	2,121

EQUITY ACCUMULATION

One of the greatest challenges facing cooperatives is raising equity capital. As businesses operated primarily to flow through earnings on a patronage basis to the users of their services, cooperatives cannot attract equity from outside sources to the same extent as investor-owned businesses.

Cooperatives are not alone. Sole proprietorships, partnerships, and closely-held corporations all face similar problems acquiring equity. For these entities, equity capital usually is raised from a limited number of owners or from retained earnings.

The single tax treatment accorded these entities tends to help alleviate the capital accumulation problem. Earnings of investor-owned corporations are subject to taxation twice, once at the corporate level when earned and a second time at the ownership level if an when distributed as dividends. Owner(s) of a sole proprietorship, partnership, closely-held corporation, or cooperative can generally reduce tax liability at the firm level if they meet specific Code requirements. A greater portion of income is therefore available for reinvestment in the business.

The fact that user-owners of a cooperative receive the margins in proportion to their use of its services, not according to the level of their investment, is a significant difference between cooperatives and other forms of business. Less incentive exists for the owners and other potential investors to make equity available to cooperatives compared to other business forms.

In addition to single tax treatment, subchapter T responds to the unique features of a cooperative with certain flexibility, such as the option to have the single tax on internally generated equity assumed at the corporate level until such time as that equity is paid out to the owners.[90]

[90] This is accomplished through the use of nonqualified retained patronage refunds and per-unit retains. The mechanics on nonqualified retains will be explained in a subsequent report in this series.

Sources of Equity Capital for Cooperatives[91]

The three primary ways members provide equity to their cooperative are direct investment, retained earnings, and per-unit retains. Cooperatives may also acquire equity through direct investment by persons outside the membership and retained earnings on nonmember, nonpatronage business. This section explains the nature of each source of equity.

Direct Investment

Direct investment refers to cash purchases of membership certificates, common and preferred stock, or other evidences of equity.

Most cooperatives require a member to make a direct payment when joining the cooperative. This generally is evidenced by the cooperative issuing the member a membership certificate in a nonstock cooperative or a share of common stock in a stock cooperative. The membership certificate or common stock usually conveys to the owner the right to vote on matters submitted for decision to the cooperative membership, and the owner is generally referred to as a member of the cooperative.

Direct investment by members is often a minor source of equity to a cooperative. Most cooperatives are trying to retain current members and attract more members and member business. And members generally prefer the cooperative to generate its own equity, rather than solicit checks from them. Thus the cost of a membership certificate or share of common stock is usually modest, $100 or less. Equity that evidences membership usually does not pay a dividend, if for no other reason than the administrative expense of issuing a large number of small checks would be substantial.

Direct investment can be a major source of equity in two instances. Direct investment is often the primary means for a new cooperative to acquire equity capital. Once the cooperative is functioning, it then can accumulate additional equity from operating funds in the form of retained earnings or per-unit retains.

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[91] This section is based on material **in D. Cobia et al.,** *Equity Redemption: Issues and Alternatives for Farmer Cooperatives,* **ACS Research Report No. 23, (USDA 1982) at 12-15 and M. Matthews,** *Financial Instruments Issued by Agricultural Cooperatives,* **ACS Research Report No. 68, (USDA 1988) at 7-33.**

A number of cooperatives also acquire equity by selling nonvoting stock or equity certificates to members and nonmembers. This nonvoting equity usually pays a limited dividend as an inducement for persons to make capital available to the cooperative.

Generally, the tax treatment of direct investments in a cooperative follows the same rules as a direct investment in an investor-owned corporation. The payment to the cooperative is a nontaxable event. While the value of cooperative equity is usually constant, any gain or loss realized by the equity holder is generally a capital gain or loss. And cooperative earnings used to pay dividends on equity are subject to taxation at both the cooperative and the recipient levels.[92]

Margins

While cooperatives are sometimes characterized as businesses that operate "at cost," few if any can do so on a day-to-day basis. Rather, cooperatives seek to generate income that exceeds expenses on an ongoing basis. Then, usually after the close of the fiscal year, they return earnings from business conducted on a cooperative basis, called margins, to the persons responsible for the business generating those earnings, who are called patrons. These returns, based on the amount of business each patron does with the cooperative during the year, are called patronage refunds. The net result is "at cost" operations.

Business conducted on a cooperative basis is called patronage sourced. Earnings realized on patronage-sourced business may be returned to the patrons as cash patronage refunds. Or the members may decide to let the cooperative retain some or all of their patronage refunds as an equity investment in the cooperative. Single tax treatment is available only for patronage-sourced earnings that are returned to the patrons as cash or "other property," or retained under procedures set out in the Code.

Determining what portion of a cooperative's earnings qualify for distribution as tax-deductible patronage refunds

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[92] An exception is dividends paid on capital stock by a cooperative that qualifies for I.R.C. § 521 tax status. Such dividends are deductible by the cooperative under I.R.C. § 1382(c)(l). This special deduction will be discussed more fully in the report covering section 521 tax status.

has evolved into an exercise in distinguishing patronage- from nonpatronage- sourced income.[93]

Patronage-sourced earnings are not eligible for single tax treatment when the cooperative chooses not to meet the applicable Code requirements. An example of this situation would be a cooperative placing patronage-sourced income into an unallocated reserve. In this case the earnings are treated just as earnings of an investor-owned firm. They are taxable income to the cooperative when earned and taxed a second time to the recipients when distributed by the cooperative.

Per-Unit Retains

Cooperatives that market products produced by their members have a third means of acquiring equity capital, per-unit retains. Per-unit retains are capital investments based on either the number of physical units handled by the cooperative or on a percentage of sales revenue. Per-unit retains are deducted from sales proceeds due the members from the cooperative.

The patronage/nonpatronage source issue, so important in determining the tax status of retained earnings, has little significance to per-unit retains. As per-unit retains can only be collected from the proceeds of marketing products for patrons, the patronage nature of the underlying business transaction has not been subject to challenge. Thus the material in these reports on per-unit retains is relatively short. But this reflects the lack of controversy concerning their tax status. It does not diminish their value as a source of cooperative equity.

As with retained patronage refunds, single tax treatment is discretionary. A cooperative may place some or all per-unit retains into an unallocated reserve, thereby forfeiting access to single tax treatment under subchapter T.

People sometimes blur the distinction between patronage refunds and per-unit retains. Patronage refunds are based on the earnings of the cooperative, per-unit retains on the volume or value of business done with the cooperative. Thus, a cooperative can acquire capital, even in a year of limited margins or a loss, through the use of per-unit retains.

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[93] Differentiating patronage and nonpatronage income will be thoroughly discussed in chapter 5.

Nonmember/Nonpatronage Earnings

Non-tax laws, such as the Capper-Volstead Act and State cooperative incorporation statutes, frequently require affected cooperatives to do a majority of their business with members. This still leaves those associations free to do up to 49 percent of their business with nonmembers on a noncooperative basis.[94] Earnings on this business are not eligible for single tax treatment. But the after-tax earnings can be used to build the equity base of the cooperative to improve its balance sheet and finance services it provides to members.

Cooperatives that market products on a noncooperative basis, usually for nonmembers, sometimes collect the equivalent of a per-unit retain on this nonpatronage-sourced business. They usually call the moneys retained by another name, such as service fees. These funds are subject to double taxation.

Financial Planning Options

As the flow chart on the following page illustrates, cooperatives have flexibility in designing an equity accumulation program to meet their individual needs. An understanding of the alternatives is especially important when allocating the patronage-based sources of equity, retained margins and per-unit retains.

Direct investments usually are made to purchase membership equity, the membership certificate, or a share of common voting stock.

Nonpatronage income is likewise usually placed into a single type of account, an unallocated reserve.

Patronage-based sources of equity can be used for at least four purposes: cash refunds, qualified retained patronage allocations, nonqualified retained patronage allocations, and unallocated reserves.

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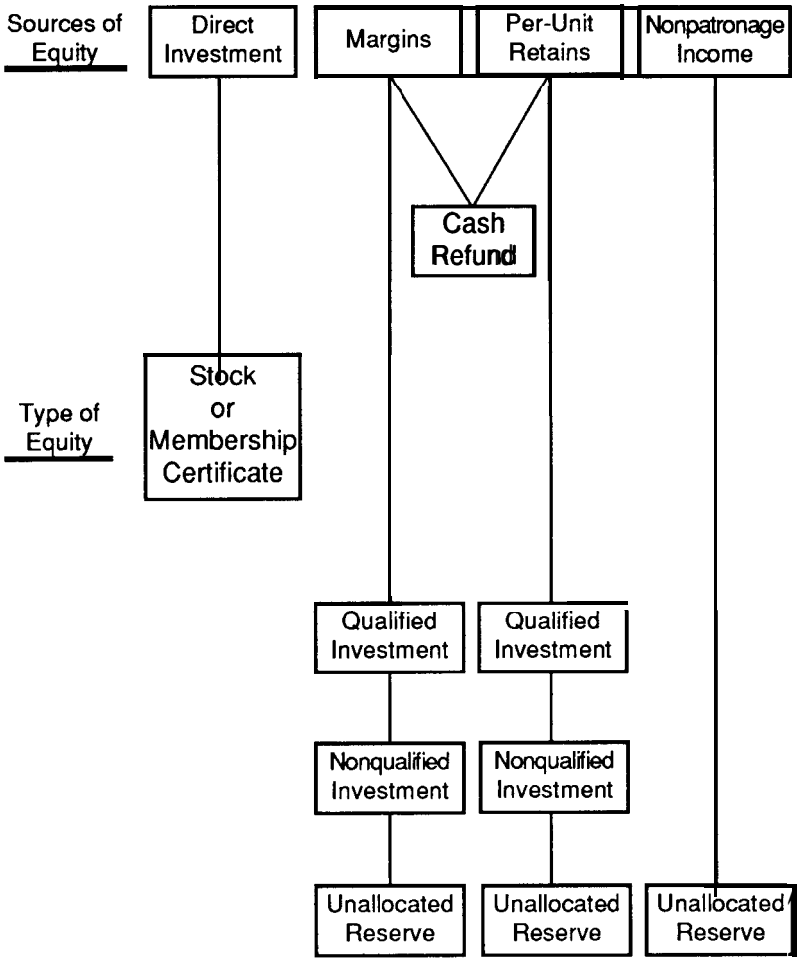
[94] IRS has conceded that subchapter T does not require an association to do a majority of its business on a cooperative basis to qualify for cooperative tax treatment on the patronage refunds it does distribute. Rev. Rul. 93-21, 1993-13 I.R.B. 5. Thus, if free of other legal impediments, a "cooperative" may do more than 50 percent of its business on a noncooperative basis without forfeiting access to single tax treatment of its margins.

SOURCES AND TYPES OF EQUITY



Cash Refunds

Cooperatives can distribute their margins and per-unit retains as cash refunds to the patrons. Cash distributions are generally tax deductible by the cooperative in the year of distribution and taxable income to the recipient in the year of receipt. Cash refunds do not add to the equity of the cooperative, but rather provide an immediate additional return to the patron on his or her use of the cooperative.

Qualified Investments

Cooperatives can retain margins and per-unit retains and allocate the retained funds to equity accounts of the patrons, based on the amount of business each patron did with the cooperative during the year. If the equity is qualified as defined in the Code, the cooperative can deduct the amount of the allocations from its taxable income in the year the margins and retains were realized. Patrons include the amount allocated in their taxable income in the year they receive a required written notice of the allocation. The retained funds become an equity investment by the patron in the cooperative.

The Code requires at least 20 percent of a qualified patronage refund be paid in cash. But the cooperative can still retain up to 80 percent of its margins on a tax-free basis. There is no 20-percent cash distribution requirement for qualified per-unit retains, so a cooperative can keep the entire amount free of tax liability.

The redemption of qualified equity is a tax-free event for both the cooperative and the patron.[95]

The tax treatment of qualified retained equity is similar to the passthrough procedures that provide single tax treatment for partnerships and subchapter S corporations. But, cooperatives have additional flexibility not generally available to other pass-through entities.

Nonqualified Investments

Cooperatives have the option to delay the pass-through. Cooperatives can hold margins and per-unit retains at the firm

[95] Assuming redemption is for full face value. Redemptions at less than face value will be discussed in the equity redemptions section of these reports.

level without forfeiting access to single tax treatment of those moneys.

With retained equity that is nonqualified, cooperatives allocate margins and per-unit retains to the equity accounts of the patrons, but pay corporate income taxes on the funds retained. The patron has no tax obligation in the year of allocation.

When nonqualified investments are redeemed, the cooperative then recaptures the tax paid at the time of allocation. At this time, the patron is obligated to pay income tax on the funds received.

Nonqualified allocations have particular appeal to cooperatives with member-patrons in high marginal tax brackets. If the cooperative uses qualified allocations, it must make substantial cash payouts or high income patrons may suffer a negative cash flow on the margins they generate. This occurs when the total tax owed on the allocation (Federal and State) exceeds the amount of cash paid out as part of the distribution.

By using nonqualified allocations, no tax is due from patrons until the allocation is redeemed. Also, there is no 20 percent cash payout rule for nonqualified allocations.[96]

Cooperatives are free to use a combination of cash payouts, unallocated reserves, and qualified and nonqualified allocations.[97] This makes it possible for the leadership to develop a program that reflects the best interests of the membership.

Unallocated Reserves

Cooperatives can treat margins just as a noncooperative firm would treat earnings, put them into an unallocated reserve and pay corporate income tax. Under this approach, single tax treatment is forfeited. If the funds are later dis-

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[96] The temporary Federal and State tax obligations to the cooperative on its nonqualified allocations, depending on its marginal tax rate, may be greater than 20 percent. This limits the amount of equity a cooperative can accumulate using nonqualified allocations.

[97] The applicable Treasury Department regulations include an example of a cooperative that makes a patronage refund partly in cash, partly as a qualified allocation, and partly as a nonqualified allocation. Treas. Reg. §1.1388-1(c)(1).

tributed, the recipients must pay a second income tax at the recipient level.

Equity Redemption[98]

Capital contributions will continue to build as time passes and patronage occurs. Membership will also change over time.

Three methods of redeeming member equity have achieved general acceptance: the "revolving fund plan," the "base capital plan," and "special plans." Although the systems are often viewed as unrelated, they may, in fact, operate together.[99]

Revolving Fund Plan

"Revolving fund financing" is a term used for systems in which patrons make capital contributions on an annual basis, typically through retained patronage refunds or per-unit retain allocations. The cooperative, in turn, redeems earlier capital contributions on a regular basis. Redemption is usually on a first-in, first-out basis. The cooperative determines what its total capital requirements are, and the excess is redeemed each year, the earliest or "oldest" equity being revolved out first.

A revolving fund plan is frequently described as "systematic" if older equities are retired on a regular basis, usually a given number of years after they were issued. In a systematic plan, member investment is related to recent and current use. Newer members usually add equity to their account during their early years in the cooperative. The accounts of established members are adjusted each year to better reflect current

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[98] For a thorough discussion of cooperative equity redemption programs, see D. Cobia, et al., ***Equity Redemption: Issues and Alternatives for Farmer Cooperatives,*** ACS Research Report No. 23 (USDA 1982).

[99] The structure of a cooperative's equity redemption program is usually set out in its bylaws. For sample bylaw language pertaining to each method discussed herein, see D. Frederick, ***Sample Legal Documents for*** Cooperatives, ACS Cooperative Information Report No. 40 (USDA 1990).

patronage. They make new investments based on current year's patronage and have their earliest year's equity redeemed. The accounts of former members are paid off during the life of the revolving cycle beginning the year after they cease patronizing the cooperative.

Balance sheet classification as equity rather than debt makes it important to condition payment on the board of directors determining that funds for revolvement are available. Director discretion also insures that there is room for flexibility if the situation warrants it. For instance, if there is a shortfall in new equity or a need exists to increase the cooperative's total equity, current equity can be protected by lengthening the revolving cycle (the cooperative keeps equity for a longer period of time).

This tactic should be used sparingly, as it deviates from the objective of having current users finance the cooperative. Also, it can create member relations problems if the members have the expectation that their oldest equities will be redeemed on a fixed schedule, sometimes without regard for the cooperative's financial condition.

Base Capital Plan

"Base capital plan" is a general term given to a financing system that focuses more directly on the current proportion of capital a patron should have in the cooperative at a particular time, based on the degree of use.

Development of the base capital plan involves several accounting steps.

1. The cooperative determines what its total equity capital needs are.

2. The equity capital needs are allocated among patrons based on the proportion of the cooperative's business each patron did with the cooperative during a base period, usually the past 3 to 7 years.

3. Each year the cooperative's equity requirements are reviewed and adjusted as the board of directors finds appropriate. Each patron's share of the equity requirement is also adjusted to reflect (a) any change in the total requirement of the cooperative and (b) any change in the patron's proportional share in the new base period.

4. Underinvested patrons must add to their equity account, usually through the current year's retained patronage refunds or per-unit retains, or by direct contribution.

5. Fully invested and overinvested patrons generally are paid a cash rebate of current year's patronage refunds and per-unit retain allocations. Overinvested patrons may receive an additional payment in redemption of their excess share of the equity.

The association will also have a plan to redeem equity investments of former patrons whose proportional share will fall each year until reaching zero at the end of the base period beginning the first year after they cease patronizing the cooperative.

Special Plans

A special plan is one in which a specific event or condition, such as a member's death, triggers equity redemption. The most common events covered are death, retiring from farming, or reaching a specified age. Once the condition is verified, the member's equity may be returned at once or over a prescribed number of years.

Special plans are often popular with members, who see redemption of their equity investments supplementing retirement income or their estates. But special plans can complicate financial planning for the cooperative. One complication is forecasting how much equity will be callable in a given year.

Another difficulty is dealing fairly with members who are partnerships or corporations and whose farming activity or life may continue well beyond that of individual partners or shareholders. One approach is for the association to redeem that portion of the member firm's equity equal to the ownership interest in the firm of the person meeting the special redemption condition. Then the firm would be expected to make up the difference just as if it had been underinvested by the amount of the redemption.

Special plans are sometimes combined with revolving fund or base capital plans.

Pooling

Many marketing cooperatives do business under a unique arrangement called pooling. Cotton, fruits and vegeta-

bles, grain, milk, rice, and sugar are among the commodities pooled for marketing purposes.

The textbook "Cooperatives in Agriculture" contains a cogent description of pooling:

> Pooling is a distinctive cooperative practice.... Products of many producers are commingled and, after deducting expenses, the average net price received is paid to producers. Key elements of a pool are the sharing of risks, expenses, and revenues and the payment of an average price, with possible adjustments for product quality and for time and location of delivery.
>
> Each cooperative pool has its own operating procedures. However, most have the following characteristics. Farmers sign marketing contracts... with the cooperative that guarantees delivery of all or part of their production to the pool. The contract transfers all authority over marketing decisions (including timing, pricing, and further processing) to the cooperative and its professional management. An initial advance is paid to members upon delivery of the product. The advance is generally a percentage of the government support price or an estimated market price if no support price is available. One or more progress payments may be made as the product is sold out of inventory.
>
> When all or most of the product has been sold, generally within 12 months of delivery, the pool is closed. A total value, including an estimated value of any remaining inventory, is determined for the pool. Operating and administrative expenses are allocated and subtracted. Any excess over previous payments is then distributed to patrons. This final payment results in zero net income for the cooperative or business at cost.[100]

[100] D. Cobia (ed.) Cooperatives *in Agriculture*, (Prentice Hall 1989) at 198.

Pooling cooperatives, to some, truly embody the concept of operating at cost. By intentionally accounting for their funds to avoid generating earnings, cooperatives that pool achieve a nonprofit result on an annual basis.

Advances paid during the year, and the final payment when the pool is closed, are deducted by the cooperative as cost of goods sold and recognized as income by patron recipients. For tax purposes, a final pool payment is hard to distinguish from a patronage refund payment made entirely in cash. Both are deductible by the cooperative and taxable to the recipient.

CHAPTER 3. HISTORICAL DEVELOPMENT OF COOPERATIVE TAXATION

This chapter traces the evolution of tax law specifically applicable to cooperatives. Two important paths developed from enactment of the first modern income tax law in 1909 until 1951. In one, the basic single tax treatment for cooperative patronage refunds, paid pursuant to a prior legal obligation, is established. This path leads to provisions on cooperatives found in subchapter T of the current Internal Revenue Code (Code). A statutory exemption for qualifying farmer cooperatives existed until 1951. This path leads to the present section 521.

In 1951, the complete exemption for eligible farmer cooperatives was eliminated and a legislative scheme for taxing all margins and previously exempt farmer cooperatives put in place. The 1951 law's purposes, however, were defeated by subsequent judicial interpretation. In 1962, enactment of the present subchapter T preserved the basic single tax concept but added a mechanism for inclusion of cooperative net margins in the current income of either the patrons or the cooperative.

THE POWER TO TAX

The foundation for cooperative tax treatment was built early in the development of the Federal income tax system. A brief history of the tax system is presented as background for the material that follows on taxation of cooperatives.

The power to tax is essential for the maintenance of any governmental system. A serious weakness of the Articles of Confederation was that Congress could not levy and collect taxes.[101] Not surprisingly, the power to tax is the first authority of Congress to be enumerated in article I, section 8 of the Constitution. This provision grants Congress the power: "To lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States."[102]

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[101] R. Tresolini, *American Constitutional Law* (2d ed.), The Macmillan Company (New York 1965), at 288.

[102] U.S. CONST. art. I, § 8, cl. 1.

The Constitution imposes two limits on Congressional taxing power. First, *duties, imposts, and excises* must be levied uniformly throughout the United States.[103] Second, *direct taxes* must be apportioned among the States according to population.'@

The rule of uniformity found in article I, section 8, does not prohibit different taxes on different goods or activities. Nor does it bar a progressive tax system. All that is required is that "whatever plan or method Congress adopts for laying the tax in question, the same plan and the same method must be made operative throughout the United States."[105]

Applying the rule of proportionality for direct taxes proved troublesome. The term "direct tax" did not have an established meaning when the Constitution was drafted, and none evolved in the years thereafter.[106] This uncertainty played a key role in the development of the power of Congress to implement an income tax.

The first income tax was an emergency measure enacted to finance the Civil War.[107] A taxpayer challenged the constitutionality of the tax on the grounds that it was a direct tax, not apportioned among the States. The U.S. Supreme Court, in a unanimous decision, found only capitation taxes and taxes on real estate were direct taxes. The validity of the Civil War income tax was upheld.[108]

The Civil War income tax was allowed to expire in 1872, but in 1894 another income tax was passed.109 The 1894 tax

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[103] *Id.*

[104] U.S. CONST. art. I, § 2, cl. 3; art. I, § 9, cl. 4.

[105] Knowlton v. Moore, 178 U.S. 41, 84 (1900) (inheritance tax); Brushaber v. Union Pacific R. R. Co., 240 U.S. 1 (1916) (income tax).

[106] A. Gunn, Cases and *Other Materials on Federal Income Taxation*, West Publishing Company (St. Paul 1981) at 2.

[107] Act of August 5, 1861, ch. 45, § 49, 12 Stat. 292,309 (1861); Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473 (1862); Act of June 30, 1864, ch. 183, § 116, 13 Stat. 223,281 (1864); Act of March 3, 1865, ch. 78, 13 Stat. 469,479 (1865).

[108] Springer v. United States, 102 U.S. 586,602 (1881). Lengthy tax litigation is hardly a modern phenomenon. Note that this case, which involved a dispute over taxes owed for 1865, took over 15 years to resolve.

[109] Act of August 27, 1894, ch. 349, §§ 27-37, 28 Stat. 509, 553-560 (1894).

was strongly opposed by business interests, which sought a prompt judicial determination of its legality. In *Pollack v. Farmers' Loan and Trust Co.*, the U.S. Supreme Court declared an income tax on rental income from real estate and interest income from State and municipal bonds was a direct tax, unapportioned among the States, and therefore invalid.[110] With one Justice absent because of illness, the Court was divided on the broader issue of the overall propriety of the income tax. [111]

After a rehearing, the Supreme Court voted 5-4 that a tax on income generated from personal property was also an improper direct tax. The Court concluded that since the entire scheme of income taxation was tainted by the various invalid sections, the income tax as a whole was unconstitutional.[112]

Chief Justice Fuller's opinion in *Pollock* on rehearing observed that the direct tax provisions of the Constitution were subject to amendment so that if, on the "sober second thought of every part of the country," an income tax was thought desirable, it could be obtained.[113]

On June 16, 1909, President Taft recommended to Congress the adoption of an amendment to the Constitution authorizing an income tax.[114] The Senate,[115] and then the House,[116] debated and approved a resolution authorizing the amendment in early July 1909. The requisite three-fourths of the 48 States ratified the 16th Amendment, which became part of the Constitution February 25, 1913. The amendment reads: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[117]

The amendment removed income taxes from both limits on the taxing power of Congress. The 63rd Congress immedi-

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[110] Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429 (1895).

[111] Tresolini, at 295.

[112] Pollock v. Farmers' Loan and Trust Co., 158 U.S. 601 (1895).

[113] Id. at 635 (1895).

[114] Reprinted as S. Doc. No. 98, 44 Cong. Rec. 3344-45 (June 16, 1909).

[115] 44 Cong. Rec. 4105-4121 (July 5, 1909).

[116] 44 Cong. Rec. 4389-4441 (July 12, 1909).

[117] U.S. CONST. amend. XVI.

ately made income taxation a part of American life as the Revenue Act of 1913 portion of the Tariff Act of 1913.[118]

TAX LOGIC AND COOPERATIVES

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 of their distinctive form of operation, not because they are thought to deserve special privileges, with the exception of additional deductions given farmer cooperatives qualifying under section 521. A simple analysis is given here to provide some perspective to the considerable complexity of cooperative taxation.

Price Adjustment Characterization

Patronage refunds are often viewed as adjustments to prices that cooperatives pay patrons for the product delivered for marketing or prices received for supplies provided patrons. For example, a cooperative may receive the product and make an advance payment. Then, following sale of the product, the cooperative pays an additional amount to the patron as a patronage refund.

Under general tax law, a business usually can deduct expenses incurred. This includes costs of goods purchased. The price adjustment concept simply says the total cost to the cooperative for goods received, for purposes of determining deductible business expenses, includes both the advance paid immediately and the patronage refund paid later. So the deductibility of patronage refunds by cooperatives is merely an extension of general tax law allowing all businesses to deduct the cost of goods purchased.

The IRS has long recognized the price adjustment concept.

[118] Act of October 3, 1913, ch. 16, section II, 38 Stat. 114, 166-187 (1913).

As IRS stated in an early ruling:

> Under long established Bureau practice, 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.[119]

Agent or Conduit Characterization

A second characterization of the justification for patronage refund deduction (or, more accurately, exclusion) is based on the idea that the cooperative functions as an agent of the patrons. In general, an agent who receives money for sale of someone else's property does not earn income. The income belongs to the seller, not the seller's agent. If the cooperative is an agent of its patrons, then the patrons are entitled to any income received by the cooperative. As the funds never belonged to the cooperative, the patrons, not the cooperative, recognize the income for tax purposes.

The United States Tax Court has embraced this line of reasoning-that the income should be taxable only at the patron level since the money never belonged to the cooperative-for some time:

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[119] I.T. 3208, 1938-2 C.B. 127. See also, Rev. Rul. 83-135, 1983-2 C.B. 149,150, wherein the Service's justification was based on the theory that "these 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."

> 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.[120]

This concept is sometimes referred to as the conduit approach:

> 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...[121]

The price adjustment characterization and the agency or conduit characterization both depend upon the underlying obligation of the cooperative to distribute net margins to patrons on a patronage basis. The following sections explain how this obligation has become codified in existing tax law.

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[120] Harbor Plywood Corp. v. Commissioner, 14 T.C. 158, 161 (1950), *affirmed without opinion*, 187 F. 2d 734 (9th Cir. 1951).

[121] Dr. P. Phillips Cooperative v. Commissioner, 15 T.C. 1002 (1951).

PRE-1951 RULINGS FOR NONEXEMPT COOPERATIVES: THE ROAD TO SUBCHAPTER T

Only a limited class of cooperatives qualified for tax exempt status as it existed before 1951—farmer cooperatives that conformed to all the conditions prescribed in the applicable statutes. Other farmer cooperatives and nonfarmer cooperatives, even though they paid patronage refunds "to members or to prospective members or to patrons generally," did not come "within any of the exceptions or exemptions" of the revenue acts in effect at that time.[122]

These nonexempt associations had no statutory authority to exclude or deduct patronage refunds from taxable income. No "partial exemption" existed for an organization operating on a cooperative basis but for some other reason was not eligible for exemption.[123] Nevertheless, patronage refunds were generally exempted from taxation by early administrative rulings. Courts approved the practice and discussed reasons why the administrative holdings were justified.

Early rationales for the treatment of patronage refunds absent statutory authority relied on tax theory and practice. This logic is useful when thinking about the treatment of patronage refunds under the current Code.

Three aspects of this early treatment of patronage refunds are important:

1. The practice as developed in administrative rulings and judicial decisions,

2. The characteristics required of a patronage refund before it could qualify for exclusion, and

3. Variations in payment form, particularly where noncash patronage refunds were paid as part of a cooperative's equity financing plan.

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[122] T.D. 2737, 20 Treas. Dec. Int. Rev. 441-442 (June 19, 1918) (cooperative merchandising organization); See also, Off. Dec. 65, 1 C.B. 208 (1919) (cooperative university book store).

[123] Farmers Union Cooperative Oil Co. v. Commissioner, 38 B.T.A. 64 (1938).

Patronage Refund Tax Status

The unique nature of the patronage refund, and the resultant application of the single tax principle, were acknowledged early in the process of developing rules to implement the income tax.

A Treasury Department pronouncement in **1918** provided:

> Cooperative societies, associations, or corporations which make a periodic refund-sometimes called a dividend-to members or to prospective members or to patrons generally, in proportion to the purchases made by the recipient, are not (totally tax exempt).
>
> Where such refund payments are made in accordance with by-laws or published rules regularly adhered to, they are to be regarded as discounts or rebates, tending to reduce the taxable net income of the organization. Like discounts generally, they should appear as an added item of cost in the detailed schedule of cost items submitted with the organization's return of income.

This ruling is in accordance with settled practice in the administration of the income-tax laws, adopted because the real purpose of such organizations is to furnish goods at cost.[124]

This ruling sets out important tenets that have remained consistently valid and are currently reflected in Subchapter T of the Code.

First, cooperatives as a class are not "tax exempt."

Second, if patronage refunds are to be excused from tax, they must be paid pursuant to a legal obligation to make the payment.

Third, the patronage refund system permits cooperatives to generate earnings from ongoing operations and still operate "at cost."[125]

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[124] T.D. 2737, 20 Treas. Dec. Int. Rev. 441-442 (1918).

[125] These points are reiterated in I.T. 1499, I-2 C.B. 189 (1922).

The 1918 ruling makes an interesting observation in noting the deduction of patronage refunds as a "settled practice in the administration of the income-tax laws."[126] This practice was subsequently described as "consistent" in 1922,[127] and "long established" in 1 938.[128]

The courts also consistently permitted nonexempt cooperatives to deduct or exclude patronage refunds from taxable income, if certain conditions were met, even though no statutory provision specifically excepted such refunds from taxation.[129]

This administrative practice remained in effect until the deductibility of patronage refunds by all cooperatives was codified in the Revenue Act of 1962. In 1959, the U.S. Tax Court adroitly summarized the rationale and requirements for exclusion of patronage refunds:

> The basis for the Commissioner's policy in allowing the exclusion of patronage dividends by nonexempt cooperatives is that such dividends in reality represent either rebates to patrons of a part of the price initially paid by them on purchases made through a cooperative purchasing organization, or an additional cost paid by a cooperative marketing organization to its patron for products sold to it. The propriety of the respondent's practice in permitting such exclusions by non-exempt cooperative associations has been recognized and sustained by this and other courts (cites omitted).

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[126] T.D. 2737, 20 Treas. Dec. Int. Rev. 441,442 (1918).

[127] I.T. 1499, I-2 C.B. 189, 191 (1922).

[128] I.T. 3208, 1938-2 C.B. 127.

[129] Homebuilders Shipping Ass'n v. Commissioner, 8 B.T.A. 903 (1927); Anamosa Farmers Creamery Co, v. Commissioner, 13 B.T.A. 907 (1928); Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941); San Joaquin Valley Poultry Producers Ass'n v. Commissioner, 136 F.2d 382 (9th Cir. 1943); United Cooperative v. Commissioner, 4 T.C. 93 (1944); Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949); Colony Farms Cooperative Dairy v. Commissioner, 17 T.C. 688 (1951); Southwest Hardware Co. v. Commissioner, 24 T.C. 75 (1955).

> The foregoing decisions indicate that an allocation of earnings by a cooperative to its patrons cannot qualify as a true patronage dividend unless (1) the allocation was made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative, (2) the allocation was made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made, and (3) the allocation of earnings was made ratably to the particular patrons whose patronage created the income from which the allocated refund was made (cites omitted).[130]

The *Farmers* Cooperative Co. decisions refer to the nontax status of patronage refunds as an exclusion, not a deduction. An early Treasury Decision suggested patronage refunds should be deducted as a cost of goods.[131] For some time, neither Treasury nor the courts seemed concerned about whether patronage refunds were excused from taxation as a "deduction" or an "exclusion." The terms were used virtually interchangeably. As the distinction had no impact on the tax due from the cooperative of the recipient, this indifference is understandable.

As an exercise in understanding taxation and cooperatives, the proper classification of the patronage refund would be as an exclusion from income of the cooperative. A deduction is an amount includable in the income of a taxpayer and

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[130] Farmers Cooperative Co. v. Commissioner, 33 T.C. 266 (1959). The Tax Court denied the cooperative's patronage refund deduction because the cooperative did not provide a timely written notice to patrons explaining the allocation. The Eighth Circuit, quoting the above language with approval, reversed the Tax Court on the grounds the neither a statute nor a valid regulation required a written notice. Farmers Cooperative Co. v. Commissioner, 288 F.2d 315,317 (1961). Congress clarified the issue when it wrote the written notice of allocation requirement into subchapter T as part of the Revenue Act of 1962.

[131] T.D. 2737, 20 Treas. Dec. Int. Rev. 441, 442 (1918). See also, A.R.R. 6967, holding a patronage refund "should be allowed as a deduction...." III-I C.B. 287, 290 (1924).

then excused from taxation under a specific provision of tax law. An amount is excluded from taxable income of a taxpayer if it was never really income to the taxpayer in the first place. As no statutory provision provided for the deduction of patronage refunds by nonexempt cooperatives, their nontax status would rest on their never having been income to the cooperative.

Treasury recognized this distinction in a 1938 ruling, when it stated:

> Under long established Bureau practice, 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 amounts are not includable 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.[132]

The courts were somewhat slow in recognizing this distinction.[133] By the early 1950's, the status of the patronage refund as an exclusion was generally accepted.[134]

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[132] I.T. 3208, 1938-2 C.B. 127-128. See also Gen. Couns. Mem. 17,895,1937-l C.B. 56.

[133] See, e.g., Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941) Patronage refunds were referred to as a "deduction" throughout the opinion.

[134] Colony Farms Cooperative Dairy, Inc. v. Commissioner, 17 T.C. 688 (1951); Dr. P. Phillips Cooperative v. Commissioner, 17 T.C. 1002 (1951); Southwest Hardware Co. v. Commissioner, 24 T.C. 75 (1955); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (1961), *rev'g, on other grounds,* 31 T.C. 674 (1958).

Patronage Refund Requirements

The most important information to be learned from administrative rulings and judicial decisions permitting exclusion of patronage refund payments for cooperatives prior to statutory definition is the set of requirements or elements a patronage refund had to have before it was afforded that treatment. These same requirements have found their way into subchapter T of the Code, under which cooperatives are presently taxed.

Preexisting Legal Obligation

The preexisting legal obligation was recognized as a basic patronage refund requirement early in the development of patronage refund exclusion practices.135 The preexisting legal obligation could be created by a state statute,[136] the articles and bylaws of the cooperative,[137] or a contract between the producers and the cooperative.[138] The preexisting legal obligation was found when cooperatives were obligated to make patronage refunds without additional corporation action.[139]

Cooperatives were denied exclusion for amounts paid as patronage if the required preexisting legal obligation did not exist. A provision in a cooperative's articles of incorporation requiring that bylaws provide, in whole or in part, for distribution of net margins on the basis of business done with the

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135 Patronage refunds were excepted from taxation where made "in accordance with by-laws or published rules regularly adhered to...." T.D. 2737, 20 Treas. Dec. Int. Rev. 441,442 (1918). See also I.T. 1499, I-2 C.B. 189,191 (1922).

136 Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941).

137 San Joaquin Valley Poultry Producers Ass'n v. Commissioner, 136 F.2d 382 (9th Cir. 1943); Colony Farms Cooperative Dairy, Inc. v. Commissioner, 17 T.C. 688 (1951); Albany Creamery Ass'n v. United States, 1951-l U.S.T.C. ¶ 9526 (D. Ore. 1950). 24 T.C. 75 (1955) (binding oral agreement implied).

138 Dr. P. Phillips Cooperative v. Commissioner, 17 T.C. 1002 (1951) (written contract); Southwest Hardware Company v. Commissioner 24 T.C. 75 (1955) (binding oral agreement implied).

139 United Cooperatives, Inc. v. Commissioner, 4 T.C. 93 (1944), *acq.*, 1945 C.B. 6.

cooperative failed to provide the necessary obligation where the bylaws were silent and there was no other action.[140]

Adoption of a resolution declaring payment after the underlying margins were earned was held to be an insufficient obligation because no preexisting obligation existed.[141] Obligations not legally binding upon the cooperative were insufficient, even though members and the cooperative had an "understanding" that surplus would be returned at year's end.[142]

In one case, the court held that where a cooperative could pay dividends on capital stock up to 8 percent, but paid all net margins as patronage refunds, only the refunds in excess of the potential stock dividend payment qualified as being paid under a preexisting legal obligation.[143]

If the obligation is too vague, it may be held to be nonexistent.[144] Likewise, a poorly drafted article of incorporation can defeat a legitimate attempt to create the preexisting condition.[145]

In one instance the court questioned whether the failure to have a preexisting legal obligation to return net margins as patronage refunds called into question the status of the orga-

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[140] Farmers Union State Exchange v. Commissioner, 30 B.T.A. 1051, 1066 (1934) ("...there should have been some declaration or act on the part of the directors with respect to payment of patronage dividends."). See also Fruit Growers' Supply Co. v. Commissioner, 21 B.T.A. 315 (1930), *aff'd* 56 F.2d 90 (9th Cir. 1932) (The bylaws required the board to declare patronage refunds and the board did not do so).

[141] Peoples Gin Co. v. Commissioner, 118 F.2d 72 (5th Cir. 1941), aff'g, 41 B.T.A. 343 (1940).

[142] American Box Shook Export Ass'n v. Commissioner, 4 T.C. 758 (1945), *aff'd*, 156 F.2d 629 (9th Cir. 1946).

[143] United Cooperatives, Inc. v. Commissioner, 4 T.C. 93 (1944), *acq.*, 1945 C.B. 6.

[144] See, e.g., Farmers Union Co-op Co. of Guide Rock, Neb. v. Commissioner, 90 F.2d 488 (8th Cir. 1937). State law and the cooperative's organizational papers required only some undefined "part" of net margins be distributed as patronage refunds.

[145] Associated Grocers of Ala. v. Willingham, 77 F. Supp. 990 (N.D. Ala. 1948). The cooperative's charter provided only that it had the "right in the discretion of the board of directors" to pay patronage refunds, not a straightforward obligation.

nization as being a cooperative.[146] because the status of "cooperative" conveyed no exclusion in and of itself, the failure to be a cooperative had the same consequence as a simple disqualification of the patronage refund exclusion for failure to establish the pre-existing obligation.

Patronage Business Requirement

Patronage refund exclusion was historically, as now, extended only to refunds based upon business done with or for patrons on a cooperative basis. Numerous early rulings recognized that a cooperative could have income not eligible for exclusion as a patronage refund. These amounts, even if distributed to members on a patronage basis, could not qualify as an excludable patronage refund.147 Thus, the distinction between income from patronage and nonpatronage sources was a part of early cooperative tax considerations.[148]

Administrative and judicial refusal to extend patronage refund exclusion to nonpatronage earnings rested oh the fact that the character of nonpatronage income was such that it actually belonged to the cooperative entity Suppose a cooperative dealt with nonmembers at a profit and attempted to exclude from its income all amounts refunded to member-patrons, including the margins from nonmember business. Nonmember business net income could receive no special treatment no matter how it was distributed. As the court in *Fruit Growers Supply Co. v. Commissioner* said:

> The simple fact is that, to the extent to which the [cooperative] engaged in the business of purchasing supplies and furnishing such supplies to nonmembers, it was not doing the type of business exempted by law, and its profit thus derived was taxable as income under the general provi-

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[146] American Box Shook Export Ass'n v. Commissioner, 4 T.C. 758 (1945), *aff'd,* 156 F.2d 629 (9th Cir. 1946).

[147] I.T. 1499, I-2 C.B. 189 (1922); I.T. 3208, 1938-2 C.B. 127; Rev. Rul. 57-59,1957-l C.B. 24; Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), ***rev'g in part, aff'g in part,*** 31 T.C. 674 (1958).

[148] Distinguishing patronage and nonpatronage income is the subject of chapter 5 of this report.

> sion of the revenue law, regardless of the disposition made of these profits by the corporation. We cannot believe that the method by which this income is distributed to the members detracts in anywise from the fact that the profit is essentially an income to the corporation....[149]

Distributed on a Patronage Basis

The early rulings permitting exclusion of patronage refunds recognized cooperatives made some payments that were not based on business done with the cooperative. An example frequently cited was dividends paid on capital stock. Dividends were usually distributed in proportion to stock ownership rather than on the basis of business done with the cooperative.

Net margins available for distribution as excludable patronage refunds were reduced by dividends on capital stock. As stated in A.A.R. 6967, "From [gross income] deduct the fixed dividend paid or payable on any outstanding capital stock. The amount of such fixed dividend is the portion of net income properly attributable to the investment made in the association by the holders of any outstanding capital stock."[150]

Dividends on capital stock were not deductible for a nonexempt cooperative any more than for a noncooperative corporation.[151]

Under some circumstances, cooperatives that paid dividends on stock lost their exclusion for a portion of their patronage refunds. A preexisting legal obligation was held not to extend to any net margins that could have been, by cooper-

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[149] Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90, 93 (9th Cir. 1932), *aff'g*, 21 B.T.A. 315 (1930).

[150] A.R.R. 6967, III-1 C.B. 287,289 (1924).

[151] Gallatin Farmers Co. v. Commissioner, 132 F.2d 706 (9th Cir. 1942); Appeal of the Trego County Cooperative Ass'n, 6 B.T.A. 1275 (1927); Juneau Dairies, Inc. v. Commissioner, 44 B.T.A. 759 (1941).

ative decision, paid out as dividends on capital stock rather than as patronage based refunds.152

The courts have addressed whether a payment to member shareholders was a dividend on capital stock, thus nondeductible, or a cost of goods sold. Juneau *Dairies, Inc, v. Commissioner* held that contracts between a cooperative and its four members to pay a bonus of the cooperative's entire net profits "as and when declared by the directors" were contracts to pay dividends. The distribution was "made to shareholders because they were shareholders," not because they patronized the cooperative. The court rejected an argument that because payments were not made in proportion to shares of stock held, payments could not be dividends.[153] A similar result was reached when distributions failed to meet the preexisting obligation test when made as a result of board resolution at the end of the year.154

The courts were sometimes reluctant to support patronage refund status when the cooperative failed to clearly establish a distribution from the cooperative to its patrons had taken place. Exclusion was not permitted where some net margins were not allocated or distributed to patrons but were placed instead in a working capital reserve.155 Patronage refund status was also denied when the court was not convinced the patrons had sufficient interest in funds placed in an allegedly allocated reserve to establish the funds belonged to the patrons and not to the cooperative.156

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152 United Cooperatives, Inc. v. Commissioner, 4 T.C. 93 (1944), acq., 1945 C.B. 6. Under subchapter T, the amount remaining after the actual dividend is paid, even though bylaws permit a larger dividend payout, qualifies for distribution as a patronage refund from tax purposes. Rev. Rul. 69-621, 1969-2, C.B. 167.

153 Juneau Dairies, Inc. v. Commissioner, 44 B.T.A. 759, 763 (1941).

154 Peoples Gin Co. v. Commissioner, 118 F.2d 72 (5th Cir. 1941), *aff'g*, 41 B.T.A. 343 (1940).

155 Cooperative Oil Ass'n v. Commissioner, 115 F.2d 666 (9th Cir. 1941).

156 Fountain City Co-op Creamery Ass'n v. Commissioner, 172 F.2d 666 (7th Cir. 1949), *aff'g*, 9 T.C. 1077 (1947).

In another case, however, amounts allocated and credited to patrons' accounts were excluded from the cooperative's income where patrons' rights in the reserve were established and no further action by the cooperative was required to bind the cooperative to payment.[157]

Computing the Patronage Refund

Early administrative instructions (1924) outlined computation of patronage refunds 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 dividend 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.[158]

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[157] Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941).

[158] A.R.R. 6967, III-1 C.B. 287,289 (1924).

This ruling was an early recognition that a cooperative could have income not eligible for exclusion as a patronage refund where it did business with nonmembers and did not pay patronage refunds to nonmembers.

This approach was applied in Farmers *Union Cooperative Exchange v. Commissioner.*[159] The cooperative paid no stock dividends. The association divided its net income between patronage and nonpatronage categories on the basis of the percentage of business it conducted on each basis.

The Commissioner assessed the association with a deficiency, arguing a cooperative had to reduce net book earnings by the amount of Federal income taxes due before applying the percentage rates to determine deductible patronage-sourced income. This argument was summarily dismissed by the board of Tax Appeals, which found:

> The purpose of the computation provided by the regulation (A.R.R. 6967) is clear. What is sought is the segregation of the earnings from business done with members. These are available for return in rebates to them and, as such, constitute a proper deduction by petitioner, leaving subject to tax only the profit accruing from nonmember business.
>
> . ..If Federal taxes and penalties, which are a burden borne by the profits accruing from nonmember business, are deducted from the total net income before application of the percentage of the member business to total business, in determining the amount of the profit from the total business returnable in rebates to members, it may be readily seen that the result of the computation is to include with the taxable profit accruing from nonmember business a portion of that derived from sales to members.[160]

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[159] Farmers Union Cooperative Exchange v. Commissioner, 42 B.T.A. 1200 (1940).

[60] *Id*. at 1202.

Noncash Refund Payments

The unique role of patrons as the principal source of capital for cooperatives led to the development of special financing techniques, most notably the issuance of an equity interest instead of cash as a form of patronage refund payment. While the Treasury Department was at times reluctant to recognize noncash allocations as excludable patronage refunds,*61 the courts were generally supportive.

In *Anamosa Farmers Creamery Co. v. Commissioner,* [162] the cooperative, pursuant to a bylaw provision, retained its entire margin and credited it to patrons' accounts in proportion to the amount of cream delivered during the year. The cooperative was assessed a deficiency for taxes allegedly due on the entire allocation. The Board of Tax Appeals held the allocation should not be included in the taxable income of the cooperative, even though no cash was paid to patrons.

The exclusion of noncash patronage refunds was attacked again in *Midland Cooperative Wholesale v. Commissioner.*[163] Treasury asserted the cooperative knew earnings placed in an unallocated, permanent reserve would be included in taxable income. Therefore placing them into a patronage-based, allocated reserve should be treated as an unauthorized tax avoidance scheme. In contrast, the Board of Tax Appeals found that so long as the underlying patronage refund met the requirements for exclusion, whether the refund was in cash or noncash form was not material. The noncash patronage refund was excludable from the taxable income of the cooperative.

In another case, the U.S. Court of Appeals for the Ninth Circuit reached the same conclusion, stating: "The fact that the sums were not payable to the members on demand, or at any

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[161] The Service did acknowledge patronage refund status of funds retained pursuant to a State law in the so-called "Iowa ruling," I.T. 3208, 1938-2 C.B. 177.

[162] Anamosa Farmers Creamery Co. v. Commissioner, 13 B.T.A. 907 (1928). See also Growers Cold Storage Co. v. Commissioner, 17 B.T.A. 1279 (1929).

[163] Midland Cooperative Wholesale, 44 B.T.A. 824 (1941). See also United Cooperative, Inc. v. Commissioner, 4 T.C. 93, 108 (1944), *acq.,* 1945 C.B. 6.

fixed time, does not alter the fact that they were their property and not [the cooperative's]. [The cooperative] held them, not as owner, but as agent or trustee for the members."[164]

In Colony *Farms Cooperative Dairy, Inc. v. Commissioner,* the Service again challenged the exclusion of noncash patronage refunds from a cooperative's taxable income. The court, in rejecting the Service's position, discussed the nature of a noncash patronage refund:

> It must be kept in mind that the funds represented by these certificates of interest are retained by the corporation with the consent of its members and represent an investment by each of them in the business to the same extent as if the distribution had been made in cash and the amount in each instance had been repaid by the member to the association for its use as working capital.
>
> That the distributions in the form of certificates of interest effected a distribution of the earnings just as effectively as though made in the form of cash, it is thought, cannot be disputed.[165]

In *Farmers Cooperative Co. v. Commissioner,*[166] the Service made one more challenge to the exclusion of noncash patronage refunds shortly before the enactment of Subchapter T in 1962. Certain court decisions had held that noncash patronage refunds were not taxable income to the patron recipients.[167] The Service argued that cooperative earnings are income to

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[164] San Joaquin Valley Poultry Producers Ass'n v. Commissioner, 136 F.2d 382,385 (9th Cir. 1943).

[165] Colony Farms Cooperative Dairy v. Commissioner, 17 T.C. 688, 693-694 (1951). See also Dr. I'. Phillips Cooperative v. Commissioner, 17 T.C. 1002, 1011 (1951); Southwest Hardware Company v. Commissioner, 24 T.C. 75, 84-86 (1955).

[166] Farmers Cooperative Co. v. Commissioner, 288 F.2d 315 (8th Cir. 1961, *rev'g* 33 T.C. 266 (1959).

[167] Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955), *aff'g,* 20 T.C. 603 (1953) (cash basis taxpayer); Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957), *rev'g,* 27 T.C. 985 (1957) (accrual basis taxpayer).

someone, and if the noncash patronage refunds are not taxable income to the patrons, they must remain taxable income to the cooperative. The U.S. Court of Appeals for the 8th Circuit acknowledged the logic of the Service's position. Nonetheless, it noted noncash refunds had been excluded from taxable income of cooperatives for decades and Congress had taken no action to alter this fact. Therefore they would remain a proper exclusion.[168]

Noncash patronage refunds could be issued in the form of debt instruments rather than equity instruments. When promissory notes were credited to patrons in specific amounts to represent patronage refund amounts and were carried at that value as cooperative liabilities, the face amount was accrued income to patrons.[169]

In summary, prior to enactment of subchapter T in 1962, the law was firmly established that cooperatives could exclude patronage refunds from income for tax purposes. The exclusion was not based on statutory authority, but rather a recognition that such refunds belonged to the patrons and not to the cooperative. To qualify for exclusion, the refund allocation had to be made (1) pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative, (2) out of earnings from transactions with the particular patrons to whom the refunds are paid, and (3) on the basis of the amount of business each patron conducted with the cooperative.170

PRE-1951 TAX LEGISLATION: THE ROAD TO SECTION 521

The first Federal tax statute to refer to farmer cooperatives was the Revenue Act of 1898. That law had a section pro-

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[168] Farmers Cooperative Co. v. Commissioner, 288 F.2d 315 (8th Cir. 1961), rev'g 33 T.C. 266 (1959). See also Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), rev'g 31 T.C. 674 (1958).

[169] Bradshaw v. Commissioner, 14 T.C. 162 (1950); Southwest Hardware Co. v. Commissioner, 24 T.C. 75 (1955).

[170] Farmers Cooperative Co. v. Commissioner, 288 F.2d 315,317 (8th Cir. 1961), rev'g 33 T.C. 266 (1959).

viding for stamp taxes, which contained the following exception:

> ... the provisions of this section shall not apply to any fraternal, beneficiary society, or order, or farmers' purely local cooperative company or association, or employees' relief associations operated on the lodge system, or local cooperation plan, organized and conducted solely by the members thereof for the exclusive benefit of its members and not for profit.[171]

This exemption was the first step in creating true tax-exempt status for certain farmers' cooperatives that lasted until 1951, and continues in modified form today as section 521 tax status.

Agricultural and Horticultural Organizations Exemption: 1909-I 916

Section 38 of the 1909 Tariff Act provided a tax on the net income of every corporation, organized for profit and having capital stock. That law contained a specific exemption for "agricultural and horticultural organizations...no part of the net income of which inures to the benefit of any private stockholder or individual."[172]

In *Flint v. Stone Tracy Co.*,[173] the U.S. Supreme Court distinguished *Pollack*[174] and upheld the constitutionality of the corporate tax. The Court noted:

> As to the objections that certain organizations, labor, agricultural, or horticultural are excepted from the operation of the law, we find nothing in them to invalidate the tax. As we have had frequent occasion to say, the decisions of this court from an early date to the present time have emphasized the right of Congress to select the

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171 30 Stat. 448,461 (1989).

172 Act of August 5, 1909, ch. 6, §38, 36 Stat. 11, 113.

173 Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

174 Pollack v. Farmers' Loan and Trust Co., 158 U.S. 601 (1985).

> objects of excise taxation, and within this power to tax some and leave others untaxed, must be included the right to make exemptions such as are found in this act.175

The Revenue Act of 1913, enacted shortly after ratification of the 16th amendment, established a comprehensive personal and corporate income tax scheme. The 1913 act did not specifically mention cooperatives. It did, however, contain a general exemption for all farm organizations, based on section 38 of the 1909 act. The 1913 act stated, "[N]othing in this section shall apply to labor, agricultural or horticultural organizations...."[176]

In discussing these exemptions, the Supreme Court said:

> The statute provides that the tax should not apply to enumerated organizations or corporations, such as labor, agricultural or horticultural organizations and the argument is that as the Amendment authorized a tax on incomes 'from whatever source derived,' by implication it excluded the power to make these exemptions. But this is only a form of expressing the erroneous contention as to the meaning of the Amendment, which we have already disposed of. And so far as this alleged illegality is based on other provisions of the Constitution, the contention is also not open, since it was expressly considered and disposed of in Flint *v.* Stone *Tracy Co.*[177]

In 1914, the Treasury Department, in its first interpretation of this language in a cooperative context, issued a regulation finding cooperative dairies, not issuing stock and paying

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[175] Flint v. Stone Tracy Co., 220 U.S. at 173.

[176] Subsection G, section 2, Act of October 13, 1913, 38 Stat. 172 (1913).

[177] Brushaber v. Union Pacific Railroad Co., 240 U.S. 1, 21 (1916). Art. 92 of Income Tax Regulations No. 33 (Jan. 5, 1914), published at 16 Treas. Dec. Int. Rev. 29, 62 (1914).

patronage refunds based on the percentage of butter fat in milk furnished, were tax exempt under this provision.178

This regulation was supplanted within a few months by Treasury Decision 1996, holding cooperative dairies, "no matter how organized, do not appear to fall within any of these exempted classes" under the act. Insofar as applicable, this ruling was extended to mutual or cooperative telephone companies, farmers' insurance companies, and like organizations.179

In late 1914, the Treasury Department published a synopsis of rulings on the income tax act of 1913. In describing the exemption for agricultural and horticultural associations, Treasury found it was limited to "associations as county fairs, or like organizations, not themselves engaged in agricultural or horticultural pursuits, but which, by means of awards, premiums, etc., are intended to encourage better production and no *part of whose income inures to the benefit of any private stockholder or individual* (emphasis added)."[180]

Since these early rulings, farmer cooperatives have been denied use of the agricultural organizations exemption.[181] An attempt by a cooperative to qualify for tax exempt status as a business league was also unsuccessful.182

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178 Art. 92 of Income Tax Regulations No. 33 (Jan. 5, 1914), published at 16 Treas. Dec. Int. Rev. 29, 62 (1914).

179 T.D. 1996, 16 Treas. Dec. Int. Rev. 100 (June 15, 1914) (Art. 92 revoked). In their returns, such cooperatives were allowed to include in their deductions from gross income the amount "actually paid" to members and patrons for milk, but any amount retained at the end of the year over and above expenses was regarded as net income and taxable to the cooperative.

180 T.D. 2090, 16 Treas. Dec. Int. Rev. 259,276 (Dec. 14, 1914). This ruling was based on a Treasury Decision holding a corporation engaged in agricultural pursuits for profit was not exempt under § 38 of the 1909 Act. T.D. 1737, 14 Treas. Dec. Int. Rev. 118 (1911).

181 The agricultural and horticultural organizations exemption is currently codified at I.R.C. § 501(c)(5). An attempt by a cooperative to revive the issue and use the exemption to avoid paying employment taxes under the Social Security Act was unsuccessful. Squire v. Sumner Rhubard Growers' Ass'n, 184 F.2d 94 (9th Cir. 1950).

182 Growers Cold Storage Co. v. Commissioner, 17 B.T.A. 1279 (1929).

Early Cooperative Exemption: 1916-l 926

The first specific statutory exemption for agricultural cooperatives was contained in the Revenue Act of 1916. Exempt status was provided to:

> Farmers', fruit growers', or like association, organized and operated as sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them.[183]

This language was repeated, with insignificant editorial changes, as section 231(11) of the Revenue Act of 1918,[184] the Revenue Act of 1921,[185] and the Revenue Act of 1924.[186]

Administrative Interpretations of the Early Revenue Acts

On its face, the exemption appeared quite narrow. Early Treasury Department interpretations of the "marketing cooperative" language held marketing activity was covered only if (1) the cooperative did all its marketing business with members and (2) functioned strictly as a sales agent.187

The early 1920's was a period of significant growth in the number, size, and complexity of cooperative organizations.

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[183] Revenue Act of 1916, ch. 463, §11(a) Eleventh, 39 Stat. 756,767 (1916).

[184] Revenue Act of 1918, ch. 18, §231(11), 40 Stat. 1057, 1076 (1919).

[185] Revenue Act of 1921, ch. 136, §231(11), 42 Stat. 227,253 (1921).

[186] Revenue Act of 1924, ch. 234, §231(11), 43 Stat. 253,283 (1924).

[187] Article 75, Regulations No. 33 (revised), published as T.D. 2690, 20 Treas. Dec. Int. Rev. 126, 175 (Jan. 2, 1918); Article 522(a), Regulations No. 45, published as T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 287-288 (Apr. 16, 1919). "The reference in the statute is to associations operating exclusively as sales agents for their members. Where an association departs from this purpose and engages in an ordinary business pursuit-such as the buying and selling of fruit-it is thereby removed from the exempted class." Sol. Memo. 952, 1 C.B. 207,208 (1919).

Regulatory decisions during this period facilitated that growth by broadening the scope of the tax exemption for agricultural cooperatives.[188]

Capital stock. A 1920 opinion of the Solicitor of Internal Revenue found nothing in the statutory language to bar exemption for a farm marketing cooperative "having capital stock on which it pays a fixed dividend amounting to the legal rate of interest, and all of which capital stock is owned by such farmers."[189] In early 1921, the Solicitor's language was added virtually verbatim to article 522 of the regulations.[190]

A 1923 regulatory amendment modified the rule that all capital stock had to be owned by farmer-patrons to only require "substantially" all stock be so owned.[191] Regulations published in 1924 first relaxed this standard to only require that "voting control is retained by the shareholders who are actual producers,"192 and then reinstated the "substantially all" rule.[193]

An 8 percent upper limit on dividends payable by an exempt cooperative was added to the regulations in 1924.[194]

Reasonable reserves. Regulations issued in 1922 authorized the accumulation of reasonable reserves "for depreciation or possible losses or a reserve required by State statute."[195] The list of purposes for which permissible reserves could be

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[188] The various Treasury Department promulgations were issued as interpretations of the revenue act in effect at the time. Since the language of the cooperative exemption was stable throughout this period, a ruling was applicable to subsequent revenue acts until the cooperative exemption was rewritten in 1926.

[189] Sol. Op. 57, 3 C.B. 241,243 (1920).

[190] Article 522(a), Regulations No. 45 (1920 ed.), published as T.D. 3146, 23 Treas. Dec. Int. Rev. 352,492 (Jan. 28, 1921).

[191] Article 522(a), Regulations No. 62 (amended), T.D. 3511, 25 Treas. Dec. Int. Rev. 298-299, II-2 C.B. 201-202 (Sept. 6, 1923).

[192] Article 522(a), Regulations No. 65, published as T.D. 3640, 26 Treas. Dec. Int. Rev. 745,899 (Oct. 6, 1924).

[193] Article 522(a), Regulations No. 65 (amended), published as T.D. 3658, 26 Treas. Dec. Int. Rev. 1234 (Dec. 20, 1924).

[194] Article 522(a), Regulations No. 65, published as T.D. 3640, 26 Treas. Dec. Int. Rev. 745,899 (Oct. 6, 1924).

[195] Article 522(a), Regulations No. 62 (1922 ed.), published as T.D. 3295, 24 Treas. Dec. Int. Rev. 207, 363-364 (Feb. 15, 1922).

accumulated was subsequently expanded to also include "a reasonable sinking fund or surplus to provide for the erection of buildings and facilities required in business, or for the purchase and installation of machinery and equipment, or to retire indebtedness incurred for such purposes."[196]

Resale ***cooperatives.*** The requirement that exempt cooperatives operate strictly as agents for their farmer-patrons was relaxed in 1923 to permit exempt associations to take title and directly market farm products.[197]

Nonmember ***business.*** The term "member" was deleted or replaced with "producer" in several places in the 1923 regulations, clearing the way for limited dealings with nonmembers.[198]

Federated cooperatives. In 1924, the Treasury Department issued a brief statement to the effect that federated farmer cooperatives were entitled to exemption from taxation.[199] This ruling was not reflected in the regulations, nor is the status of federated cooperatives mentioned in subsequent legislation.

Purchasing and Dual-Function Cooperatives

Regulations promulgated to implement early versions of the farmer cooperative exemption noted that cooperative associations acting as purchasing agents were not expressly exempt from tax. Such associations were, however, permitted to exclude patronage refunds from taxable income.[200]

In 1921 the farmers' cooperative exemption was broadened to cover cooperative purchasing of farm supplies. The new language covered cooperatives:

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[196] Article 522(a), Regulations No. 62 (amended), published as T.D. 3511, 25 Treas. Dec. Int. Rev. 298-299, II-2 C.B. 201 (Sept. 6, 1923).

[197] Id.

[198] T.D. 3511, II-2 C.B. at 201-202.

[199] I.T. 2000, III-l C.B. 290 (1924).

[200] Article 522(b), Regulations No. 45, published as T.D. 2831, 21 Treas. Dec. Int. Rev. 170,288 (Apr. 16, 1919); Article 522(b), Regulations No. 45 (1920 ed.), published as T.D. 3146, 23 Treas. Dec. Int. Rev. 352, 492-493 (Jan. 28, 1921). The tax treatment of patronage refunds issued by nonexempt cooperatives during this period is discussed in a prior section of this chapter.

organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses.201

After the cooperative exemption was expanded to include purchasing cooperatives, the regulations were updated to acknowledge that supply cooperatives also qualified for exempt status, provided they only acquired farm supplies for members and had no net income for their own accounts.[202] The regulations were further amended to permit purchasing cooperatives to accumulate reasonable reserves for the same purposes as marketing cooperatives and to do business with nonmember farmers.203

The regulations also recognized that the same cooperative association could provide both marketing and purchasing services for its members. These dual-function cooperatives were permitted exempt status, provided each function met the requirements for exemption applicable to that function.[204]

Revenue Act of 1926

Legislative history leading to enactment of the Revenue Act of 1926 indicates general agreement existed that the regulations were somewhat more generous to cooperatives than the underlying statutes. The record also suggests that revenue bureau agents were ignoring the regulations and denying applications for exempt status if the cooperative, for example,

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[201] Revenue Act of 1921, ch. 136, §231(11), 42 Stat. 227,253 (1921).

[202] Article 522(b), Regulations No. 62 (1922 ed.), published as T.D. 3295, 24 Treas. Dec. Int. Rev. 207,364 (Feb. 15, 1922).

[203] Article 522(b), Regulations No. 62 (amended), published as T.D. 3511, 25 Treas. Dec. Int. Rev. 298-299, II-2 C.B. 201-202 (Sept. 6, 1923).

[204] Article 522(b), Regulations No. 62 (1922 ed.), published as T.D. 3295, 24 Treas. Dec. Int. Rev. 207,364 (Feb. 15, 1922), and all subsequent regulations published through 1926.

had any outstanding stock owned by persons other than producer/patrons or did even limited nonmember business.[205]

At the urging of cooperatives, these regulatory opinions were all written into law in the Revenue Act of 1926. Section 231(12) of the 1926 act introduced the definition of a farmer cooperative contained in section 521 of the current Code, with the exception of the "government business" provision.[206] The government business calculation provision was added in 1934.[207]

In summary, the section 231(12) of the Revenue Act of 1926 and the subsequent reenactments provided these guidelines for cooperatives qualifying for tax-exempt status:

1. They must be organized by farmers on a cooperative basis.

2. A cooperative may act as principal as well as agent and thus take title to goods marketed or purchased.

3. Proceeds in excess of expenses and permitted reserves must be returned to all patrons (members and nonmembers alike) on the basis of the proportion of the cooperative's business attributable to each patron.

4. A cooperative may issue capital stock, provided the dividend rate on such stock does not exceed the legal rate of interest in the State of incorporation, or 8 percent, whichever is greater.

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[205] Revenue Act of 1926: Hearings on H.R. 1 Before the Senate Committee on Finance, 69th Cong., 1 st Sess. (July 1926), 261-274. Testimony of George R. Wicker, representing the Illinois Agricultural Association, and testifying on behalf of several national and State cooperative and farm organizations.

[206] Revenue Act of 1926, ch. 27, §231(12), 44 Stat. 9, 40-41 (1926). The language of the 1926 act was repeated in the Revenue Act of 1928, ch. 852, §103(12), 45 Stat. 791, 813-814 (1928), and the Revenue Act of 1932, ch. 209, §103(12), 47 Stat. 169, 193-194 (1932).

[207] The Revenue Act of 1934, ch. 277, §101(12), continued the previous provisions and added, "business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph." 48 Stat. 680,701 (1934). The language of the 1934 act was repeated in the Revenue Act of 1936, ch. 690, §101(12), 49 Stat. 1648, 1674-75 (1936); the Revenue Act of 1938, ch. 289, §101(12), 52 Stat. 447, 481-82 (1938); and the Internal Revenue Code of 1939, ch. 2, § 101(12), 53 Stat. 1, 33-34 (1939).

5. Substantially all stock except nonvoting, nonprofit-sharing preferred stock must be owned by producers who market their products and purchase their supplies through the cooperative.

6. Reserves required by State law, and reasonable reserves for any necessary purpose, may be accumulated.

7. Nonmember business is permissible. The value of member marketing business and member purchasing business must exceed like nonmember business. Also, purchases for person who are neither members nor producers must not exceed 15 percent of the value of all purchases.[208]

In applying the language of the 1926 act, the courts held that for a cooperative to be exempt, it must not only be organized as required by the Code, it must be operated that way.[209] The fact that a cooperative was organized and operated under a State statute governing farmer cooperative associations did not make the cooperative a tax-exempt entity. Whether an association qualified for tax-exempt status depended solely on meeting the requirements of Federal tax law.[210]

The definition of a farmer cooperative found in the Revenue Act of 1926 has remained unchanged, although com-

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[208] Some aspects of the Revenue Act of 1926 were borrowed from the Capper-Volstead Act of 1922 (7 U.S.C. §§ 291-292, establishing limited antitrust exemption for farmers who market on a cooperative basis), notably the 8-percent limit on capital stock dividends and the requirement a majority of business be for members. Revenue Act of 1926, Hearings on H.R. 1 Before the Senate Committee on Finance, 69th Cong., 1st Sess. (July 1926), 267-268. The nuances of these various requirements will be discussed in more detail in a separate report on section 521 tax status.

[209] Burr Creamery Corporation v. Commissioner, 62 F.2d 407,409 (9th Cir. 1932), cert. ***denied, 289*** U.S. 730 (1933).

[210] Farmers Union Co-op Co. of Guide Rock, Neb., v. Commissioner, 90 F.2d 488,492 (8th Cir. 1937).

plete exemption gave way to limited exemption in 1951.[211] This consistency permits citation of administrative rulings and judicial decisions predating the current tax scheme for cooperatives to explain present day requirements in the Code.

REVENUE ACT OF 1951

The exclusion of patronage refunds by cooperatives was the subject of vigorous attack in the late 1940's.[212] In spite of this attack, Congress passed legislation in 1951 only affecting the exemption for agricultural cooperatives, but rejecting efforts to include patronage refunds in gross income of cooperatives. In doing so, Congress recognized and retained the long-established single tax concept on the assumption that noncash allocations were taxed to patrons as if distributed in cash and reinvested in the cooperative.

The Revenue Act of 1951[213] retained the definition of farmer cooperative previously used to describe qualification for tax exemption, the definition found in the current section 521 .[214] Qualifying cooperatives were, however, no longer

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[211] The definition was redesignated as section 101(12)(A), but otherwise unchanged, **when true tax exempt status was removed** in the Revenue Act of 1951, 65 Stat. 452, 491-493 (1951). When the Internal Revenue Code was recodified in 1954, the definition of an "exempt" cooperative, with immaterial technical changes, was relocated as § 521. 68A Stat. 3, 176-177 (1954). This section was left alone when Subchapter T was enacted as part of the Revenue Act of 1962.76 Stat. 960 (1962).

[212] For example, there were 17 days of Congressional hearings on the subject in 1947. Part 4 Tax-Exempt Organizations (Cooperative Organizations), Hearings Before The Comm. on Ways and Means, House of Representatives, 80th Cong., 1st Sess. (3,161 pages of transcript of hearings on this subject).

[213] Revenue Act of 1951, ch. 521, § 314, 65 Stat. 452, 491-493 (1951).

[214] The definition was designated § 101(12)(A) in the Revenue Act of 1951. It was renumbered § 521 in the Internal Revenue Code of 1954.
[215] Section 314(a)(2) of the Revenue Act of 1951, 65 Stat. 452,492 (1951). This provision was recodified, with immaterial technical changes, as I.R.C. § 522 in the Internal Revenue Code of 1954, 68A Stat. 3, 177-178 (1954). Section 522 was repealed and replaced by subchapter T in the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962), reprinted in 1962-3 C.B. 111.

exempt from all tax. A new tax system for previously exempt cooperatives was introduced,[215] and longstanding administrative practice related to treatment of patronage refunds made by nonexempt cooperatives was recognized, although in passing, in statutory language.

The Revenue Act of 1951 made several changes in the existing statutory law on cooperative income tax treatment. First, it made previously exempt cooperatives subject to corporate income tax, while still referring to them, now erroneously, as "exempt."[216]

The 1951 act granted previously exempt cooperatives two deductions that still distinguish section 521 cooperatives' taxation from other cooperatives. In computing its taxable income, a previously exempt cooperative could deduct from gross income "amounts paid as dividends during the taxable year on capital stock,"[217] and "amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year)."[218] These two deductions were "in addition to other deductions allowable under this chapter."[219]

The act acknowledged the exclusion of patronage refunds from taxable income by nonexempt cooperatives.

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[215] Section 314(a)(2) of the Revenue Act of 1951, 65 Stat. 452,492 (1951). This provision was recodified, with immaterial technical changes, as I.R.C. § 522 in the Internal Revenue Code of 1954, 68A Stat. 3, 177-178 (1954). Section 522 was repealed and replaced by subchapter T in the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962), *reprinted in* 1962-3 C.B. 111.

[216] Section 314(a)(2) of the Revenue Act of 1951, codified as § 101(12)(B) of the Internal Revenue Code of 1939, and recodified as § 522(a) in the Internal Revenue Code of 1954.

[217] Section 314(a)(2) of the Revenue Act of 1951, codified as § 101(12)(B) of the Internal Revenue Code of 1939, and recodified as § 522(b)(l)(A) in the Internal Revenue Code of 1954.

[218] Section 314(a)(2) of the Revenue Act of 1951, codified as § 101(12)(B) of the Internal Revenue Code of 1939, and recodified as § 522(b)(l)(B) in the Internal Revenue Code of 1954.

[219] Section 314(a)(2) of the Revenue Act of 1951, codified as § 101(12)(B) of the Internal Revenue Code of 1939, and recodified as § 522(b)(l) in the Internal Revenue Code of 1954.

Patronage refunds made by previously exempt cooperatives were to be "taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under subparagraph (A)."[220]

The act described noncash distributions in terms foreshadowing written notices of allocation. Patronage refunds could be "paid" in "capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate."[221]

The concept now called the "payment period" was noted in the act by saying allocations made after the close of the cooperative's taxable year but by the 15th day of the 9th month following the close of the taxable year were to be considered made on the last day of the taxable year, but only to the extent allocations were attributable to income derived before the close of the taxable year.[222]

The 1951 act also introduced the term "patronage dividend" into the tax code.[223]

Purpose

The Revenue Act of 1951 was intended to implement a single tax principle for all cooperative organizations. It was thought the act, along with existing rulings on nonexempt cooperatives, would combine to achieve that goal. As stated in the Senate Report on the legislation:

> As a result of this action, all earnings or net margins of cooperatives will be taxable either to the cooperative, its patrons or its stockholders with the exception of amounts which are paid or allocated to patrons on the basis of purchase of personal, rather than business, expense items.

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[220] Section 314(a)(2) of the Revenue Act of 1951, codified as § 101(12)(B) of the Internal Revenue Code of 1939, and recodified as § 522(b)(2) in the Internal Revenue Code of 1954.

[221] Id.

[222] *Id.*

[223] *Id.*

> With this exception, funds which are allocated to the accounts of patrons, or paid in cash or merchandise, are taxable to them. This is true in the case of either taxable or tax-exempt cooperatives.[224]

This purpose was implemented by IRS rulings holding that because cooperatives were permitted to deduct or exclude the full amount of patronage refunds, even if retained as capital, the full face amount of distributions, cash or otherwise, should be includable in the patrons' gross income.225

Judicial Interpretation

A series of judicial decisions in the mid-1950's are usually said to have defeated the general tax scheme for cooperatives apparently intended by the Revenue Act of 1951.

The Ninth Circuit Court of Appeals decision in Caswell's *Estate v. Commissioner*[226] suggested the taxation of noncash patronage refunds was not as established as might be expected from the phrase in the Revenue Act of 1951 that refunds were to be treated "in the same manner as in the case of a cooperative organization not exempt under section 521."

Caswell's Estate concerned "commercial reserve fund certificates" representing refunds withheld from patrons in 1945. The court held the certificates were mere evidences of patrons' contingent rights in the commercial reserve fund. Distribution of the fund was to be made on the happening of certain events, none of which had occurred. No distribution to

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[224] S. Rep. No. 781, 82nd Cong., 1st Sess. 20-21 (1951), reprinted *in* 1951 U.S. Code Cong. & Admin. News 1969, 1989-1990. This viewpoint that the intent of the 1951 Act was to create a single tax at either the cooperative or the patron level is also reflected in the legislative history of the Revenue Act of 1962. H.R. Rep. No. 1447, 87th Cong., 2d Sess., reprinted in 1962-3 C.B. 405,482; S. Rep. No. 1881, 87th Cong. 2d Sess., reprinted *in* 1962-3 C.B. 707,817, and 1962 U.S. Code Cong. & Admin. News 3297, 3414-3415.

[225] T.D. 6014,1953-l C.B. 110; Rev. Rul. 54-10,1954-l C.B. 24.

[226] Caswell's Estate v. Commissioner, 211 F.2d 693 (9th Cir. 1954), *rev'g*, 17 T.C. 1190 (1952).

patrons was ever made, and patrons received no income "to any extent whatever."[227]

In Commissioner *v. Carpenter,*[228] a cooperative member accounting on a cash basis received "revolving fund certificates" from a cooperative for fiscal years 1946-49. Such certificates were redeemable only at the board of directors' discretion, bore no interest, were of limited transferability, were subordinated to debt, and could be redeemed only by consent of a lending bank. The court found the certificates had no fair market value when issued, and therefore did not constitute income to the recipient patron.

Two years later, in Long Poultry *Farms,* Inc. *v. Commissioner,*[229] the Fourth Circuit Court of Appeals reached a similar conclusion in the case of a corporate member on the accrual basis of tax accounting. In this instance the patronage refunds were issued in 1953, after enactment of the Revenue Act of 1951. In discussing the 1951 act, the court said:

> Congress while granting the right to the deductions by the cooperative left the matter of taxing the dividends to the recipients to be dealt with by existing law, making no change with regard thereto, with the result that cash basis taxpayers will report as income patronage dividends such as are here involved in the year 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.230

Regulations to implement the Revenue Act of 1951 provided that noncash patronage refunds, such as revolving fund certificates, were taxable to the patrons at face value.[231] This

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[227] *Id.* at 696.

[228] Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955), *aff'g,* 20 T.C. 603 (1953), *acq.* 1958-1 C.B. 4.

[229] Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957), *rev'g,* 27 T.C. 985 (1957).

[230] 249 F.2d at 731.

[231] Treas. Reg. 111 § 29.22(a)-23, T.D. 6014,1953-l C.B. 110,117; Treas. Reg. 118 § 39.22(a)-23, Rev. Rul. 53-226, 1953-2 C.B. 500.

regulation, "to the extent (it) attempts to tax as income what is not income under law," was held void in Long *Poultry*.[232]

After its acquiescence in Carpenter in 1958, the Service amended its corresponding regulations.[233] Under the amended provisions, if the allocation was in cash, the patron included the amount of cash received in reportable income[234]. Allocation in the form of capital stock was included in the patron's gross income at its fair market value, if any, at the time of receipt by the patron.[235]

The most critical provision in the 1959 amendments to the regulations addressed the status of revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or other similar documents issued to evidence a temporary investment in the cooperative based on patronage. The patron was to include the fair market value of the document as gross income. The regulations defined circumstances under which a document was considered to have a fair market value. "Any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron." Documents were not considered to have a fair market value if they were payable "only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron. . . . unless it is clearly established to the contrary."[236]

The Service also responded to the Carpenter and Long Poultry Farms cases by urging the courts to permit the Service to reverse its longstanding position that noncash patronage refunds were excludable by nonexempt cooperatives. The Service asserted the income should be taxable to someone, and since the courts had held it was not taxable to the patrons,

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[232] 249 F.2d at 731.

[233] T.D. 6428, 1959-2 C.B. 26 (amendment to regulations issued under the I.R.C. of 1954) and T.D. 6429, 1959-2 C.B. 452 (amendment to regulations issued under the Revenue Act of 1951).

[234] reas. Reg. 1.61-5(b)(l)(i), T.D. 6428, 1959-2 C.B. 26. This note and the related ones that follow cite the amendment to the regulations for the I.R.C. of 1954. Identical changes were made in superseded regulations for years covered by the Revenue Act of 1951.

[235] Treas. Reg. 1.61-5(b)(1)(iv), T.D. 6428, 1959-2 C.B. 26.

[236] Treas. Reg. 1.61-5(b)(1)(iii), T.D. 6428, 1959-2 C.B. 26.

it should be taxable to the cooperative. This issue reached the Eighth Circuit Court of Appeals, which rejected the Service's argument and sustained the excludability of noncash patronage refunds[237].

REVENUE ACT OF 1962

In a message to Congress on April 20, 1961, President Kennedy included the following:

> I recommend that the law be clarified so that all earnings are taxable to either the cooperatives or to their patrons, assessing the patron on earnings that are allocated to him as patronage dividends or refunds in script or in cash.[238]

The Revenue Act of 1962[239] responded to this call. Section 521 of the Revenue Act of 1951 was retained as a definition for so-called "exempt" farmer cooperatives. Section 521 tax preferences were continued, including the special deductions for dividends on capital stock and nonpatronage-sourced income allocated on a patronage basis.

Section 522 of the 1951 act was repealed and replaced with subchapter T of the current Code. Qualifying patronage refunds of "any corporation operating on a cooperative basis" were not to be taken into account in computing taxable income, thus continuing single tax treatment of cooperative patronage refunds. Either the cooperative would pay the tax on the amount or the patron would.

Effective dates were generally for taxable years beginning after 1962. Pre-subchapter T law would continue to apply with respect to distributions made prior to the effective dates

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[237] Farmers Cooperative Co. v. Commissioner, 288 F.2d 315 (8th Cir. 1961), *rev'g* 33 T.C. 266 (1959); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), *rev'g* 31 T.C. 674 (1958).

[238] President's 1961 special message to Congress on Our Federal Tax System, *reprinted in 1961* U.S. Code Cong. & Admin. News 1129, 1137.

[239] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962), *reprinted in* 1962-3 C.B. III.

of subchapter T, and in some instances to associations not covered by subchapter T.[240]

Subchapter T continues the statutory authorization found in the Revenue Act of 1951 for the exclusion of patronage refunds from the taxable income of nonexempt cooperatives.[241] "Although Congress did not speak to the question of how the exclusion is to be computed, it chose to treat the patronage dividend concept in essentially the same manner as did prior administrative interpretations and decisional law."[242]

The bulk of cooperative taxation discussed in subsequent reports in this series is based on subchapter T. However, as a matter of statutory interpretation, the legislative intent was to continue the basic pre-1962 single tax treatment within a new patron consent structure to assure current inclusion of all cooperative margins in the taxable income of either the patrons or the cooperative.

SUBSEQUENT LEGISLATION

With limited exceptions, subchapter T and section 521 remain as enacted in 1962. This does not mean tax law has remained static. In the years since 1962, a number of dramatic changes in enforcement and interpretation have provoked discussion and thought about some important issues in cooperative taxation.

Two subchapter T amendments clarified treatment of per-unit capital retains. The Revenue Act of 1966[243] affirmed prior administrative recognition of per-unit retain alloca-

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[240] Pre-subchapter T continues to apply to nonexempt rural electric cooperatives and telephone cooperatives (Rev. Rul. 83-135, 1983-2 C.B. 149) and governs the tax treatment of patronage refunds paid by exempt farm credit institutions (Rev. Ruls. 71-556, 71-557, and 71-558, 1971-2 C.B. 79, 80, and 81).

[241] Geauga Landmark, Inc. v. United States, Docket No. 81-942 (N.D. Ohio, April 29, 1985).

[242] Des Moines County Farm Service Co. v. United States, 324 F. Supp. 1216, 1219 (S.D. Iowa 1971), *aff'd*, 448 F.2d 776 (8th Cir. 1971).

[243] Revenue Act of 1966, Pub. L. No. 89-809, § 211, 80 Stat. 1539, 1580 (1966).

tions.[244] The Tax Reform Act of 1969 confirmed the excludability of per-unit retains paid in money.245

Persons who think cooperative taxation is somehow above question are reminded that in 1969 the House of Representatives passed a provision to require that patronage refunds and per-unit retains be revolved out over a period not to exceed 15 years and that at least 50 percent of a patronage refund be paid in cash.[246] The proposed limitations were not included in the Senate version of the legislation. The conference that produced the Tax Reform Act of 1969 concurred with the Senate.247

In 1978, two special situations were addressed-cooperative use of the completed crop pool method of accounting248 and the investment tax credit.249

Cooperatives serving different groups of farmers faced a major challenge to the way many elected to combine revenues, expenses, resources, and finances when the Service sought to limit such unitary cooperative effort where one group suffered a loss and another realized net margins.[250] Legislation was sought to give cooperatives a range of choices in how they would handle these internal matters. The Consolidated Omnibus Budget Reconciliation Act of 1985[251] permitted interunit netting of gains and losses under defined circumstances.

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[244] Rev. Rul. 54-10,1954-l C.B. 24.

[245] Tax Reform Act of 1969, Pub. L. No. 91-172, § 911, 83 Stat. 487,722 (1969).

[246] H.R. Rep. No. 413, 91st Cong., 1st Sess. (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1652, 1820-1823.

[247] Conf. Rep. No. 782, 91st Cong., 1st Sess. (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 2392, 2438.

[248] Act of August 15, 1978, § 3, 92 Stat. 481, 483-484 (1978).

[249] Revenue Act of 1978, § 316, 92 Stat. 2763, 2829-2830 (1978). Repealed by the Revenue Reconciliation Act of 1990, Title XI of the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, § 11813,104 Stat. 1388-536 (1990).

[250] Tech. Adv. Mem. 8521003 (Jan. 25, 1985).

[251] Pub. L. 99-272, § 13210,100 Stat. 82,323 (1985).

LEGISLATIVE HISTORY

The following list gives statutes directly dealing with Federal income taxation of cooperatives.[252] The list includes references to the more important Congressional reports associated with the recent acts.

Revenue Act of 1916, ch. 463, § 11(a)Eleventh, 39 Stat. 756, 767 (1916)

Revenue Act of 1918, ch. 18, §231(11), 40 Stat. 1057, 1076 (1919)

Revenue Act of 1921, ch. 136, §231(11), 42 Stat. 227,253 (1921)

Revenue Act of 1924, ch. 234, §231(11), 43 Stat. 253,283 (1924)

Revenue Act of 1926, ch. 27, §231(12), 44 Stat. 9, 40-41 (1926)

Revenue Act of 1928, ch. 852, §103(12), 45 Stat. 791, 813-814 (1928)

Revenue Act of 1932, ch. 209, §103(12), 47 Stat. 169, 193-194 (1932)

Revenue Act of 1934, ch. 277, §101(12), 48 Stat. 680,701 (1934)

Revenue Act of 1936, ch. 690, §101(12), 49 Stat. 1648, 1674-75 (1936)

[252] Of course, all statutes relating to businesses and business transactions affect cooperatives. They are not identified in this list, and even the history of some laws directly affecting cooperatives are not listed, such as all special provisions for investment tax credit, return filing, alternative minimum tax, etc.

Revenue Act of 1938, ch. 289, §101(12), 52 Stat. 447, 481-82 (1938)

Internal Revenue Code of 1939, ch. 2, §101(12), 53 Stat. 1, 33-34 (1939)

Revenue Act of 1951, ch. 521, § 314, 65 Stat. 452, 491-493 (1951), reprinted in 1951 U.S. Code Cong. & Admin. Serv. 308, 371-372

S. Rep. No. 781, 82nd Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 458 and 1951 U.S. Code Cong. & Admin. Serv. 1969, 1988-1990

Internal Revenue Code of 1954, ch. 736, §§521-522, 68A Stat. 3, 176-178 (1954)

Revenue Act of 1962, Pub. L. No. 87-834, § 17, 76 Stat. 960, 1045-1052 (1962), reprinted in 1962-3 C.B. III

H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 C.B. 402

S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 C.B. 703 and 1962 U.S. Code Cong. & Admin. News 3304, 3414-3420

Revenue Act of 1966, Pub. L. No. 89-809, §211, 80 Stat. 1539, 1580-l 584 (1966)

H.R. Rep. No. 13103, 89th Cong., 2d Sess. (1966), reprinted in 1966-2 C.B. 1107

S. Rep. No. 1707, 89th Cong., 2d Sess. (1966), reprinted in 1966-2 C.B. 1055 and 1966 U.S. Code Cong. & Admin. News 4446, 4514-4517

H.R. Rep. No. 1450, 89th Cong., 2d Sess. (1966), reprinted in 1966-2 C.B. 1108.

Tax Reform Act of 1969, Pub. L. No. 91-172, §911, 83 Stat. 487,722 (1969)

H.R. Rep. No. 413, 91st Cong., 1st Sess. (1969), reprinted in 1969 U.S. Code Cong. & Admin. News 1645, 1652, 1820-1823

S. Rep. No. 552, 91st Cong., 1st Sess. (1969), reprinted in 1969-3 C.B. 608 and 1969 U.S. Code Cong. & Admin. News 2027, 2331-2332

Conf. Rep. No. 782, 91st Cong., 1st Sess. (1969), reprinted in 1969 U.S. Code Cong. & Admin. News 2392, 2438

Act of August 15, 1978, Pub. L. No. 95-345, §3, 92 Stat. 481, 483-484 (1978)

S. Rep. No. 762, 95th Cong., 2d Sess. (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 1286, 1296-1297

Revenue Act of 1978, Pub. L. No. 95-600, §316, 92 Stat. 2763, 2829-2830 (1978), reprinted in 1978-3 C.B. (Vol.1)

S. Rep. No. 1263, 95th Cong., 2d Sess. (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 6761, 6881-6884

H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. (1978), reprinted in 1978-3 (Vol.1) C.B. 521 and 1978 U.S. Code Cong. & Admin. News 7198, 7229-7230

Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, § 13210,100 Stat. 82, 323-324 (1986)

S. Rep. No. 146, 99th Cong., 1st Sess, (1985), reprinted in 1985 U.S. Code Cong. & Admin. News 43, 334-337

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