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Income Tax Treatment of Cooperatives:

Patronage Refunds

Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Patronage Refunds

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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

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Preface’

The patronage refund is an important concept distinguishing cooperatives from other forms of doing business. It is the vehicle by which cooperatives return earnings to users based on the amount of business conducted with the cooperative, rather than to investors on the basis of equity owned.

Patronage refunds permit cooperatives to operate as typical businesses, earning income in excess of expenses, while still operating “at cost.” By permitting cooperatives to retain a portion of the margins designated as patronage refunds, members provide needed equity without having to write checks to the association.

Application of the single tax principle to patronage refunds reflects the unique nature of the patronage refund, whether the distribution is paid in cash or retained for investment. Single taxation is helpful to accumulation of capital from members since it partially compensates for the lack of liquidity of cooperative equity.

This report contains three chapters, which are part of a larger project on income taxation of cooperatives. These chapters are the first of a series on taxation of patronage-based financing. Other chapters will cover per-unit retains, refund distributions, redemption of patronage equity, and taxation of patrons.

Dr. James R. Baarda, while employed at Agricultural 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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[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.

Highlights

Since 1962, the Internal Revenue Code has contained a specific definition of a patronage refund. Generally, distributions of earnings by cooperatives must conform to that definition to qualify for single tax treatment.

Patronage refunds are amounts paid to patrons by a cooperative on the basis of quantity or value of business done with or for such patrons, under a preexisting obligation, based on net earnings from business with or for patrons. Earnings on patronage business are refunded to patrons based on the level of business they do each year with the cooperative. Generally, only earnings on patronage activity qualify for single tax treatment.*

The problem that has caused the most difficulty in administering the patronage refund provisions of the Code'is differentiating patronage from nonpatronage business. Two tests have evolved for making the distinction. Both are based on the same Treasury Department regulation, and they sometimes suggest conflicting results.

One test classifies income as patronage-sourced if the activities producing that income are directly related to, or actually facilitate, business conducted on a cooperative basis. Income merely incidental to cooperative business is nonpatronage-sourced. The other test categorizes income from certain sources--lease of premises, investment in securities, and the sale of capital assets--as automatically nonpatronage-sourced.

Cooperatives have favored application of the directly related test in distinguishing patronage from nonpatronage business. The Internal Revenue Service has used the nature-of-the-income test when one of the types of income listed in the regulation as nonpatronage-sourced is under consideration. The courts have shown a preference for the directly related standard.

Cooperatives with complex organizational structures or financial arrangements confront several technical issues in classifying income for tax purposes. Different groups of patrons may use different services provided by the cooperative, presenting

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[2] Farmer cooperatives with section 521 tax status also qualify for single taxation of dividends on capital stock and distributions of nonpatronage income to patrons on the basis of patronage.

problems of how to allocate funds available for distribution as patronage refunds among those patron groups. Patronage may not always occur in the same year that the resulting income is realized, producing timing differences. And the use of third-party agents has raised questions about whether certain business is really with or for patrons.

A parallel issue to income classification is the proper allocation of expenses between patronage and nonpatronage business. An expense allocated to nonpatronage business reduces nonpatronage earnings and in the process increases patronage earnings eligible for single tax treatment.

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CHAPTER 4
CODE DEFINITION OF A PATRONAGE REFUND

The principal difference between cooperatives and other business forms is the patronage refund system--allocating earnings to users on the basis of use, rather than to investors on the basis of investment.[3] The Federal income tax treatment of patronage refunds, a single tax liability at either the recipient or cooperative level, reflects public policy recognition of the unique nature of cooperatives and the patronage refund.

A specific definition of a patronage refund[4] was added to the Internal Revenue Code (Code) with enactment of the Revenue Act of 1962, as part of the new subchapter T.[5] Codified at Code section 1388(a), the definition reads as follows:

> (a) Patronage Dividend. - For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies -
>
> (1) on the basis of quantity or value of business done with or for such patron,
>
> (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
>
> (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

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[3] CF Industries, Inc. v. Commissioner, Nos. 92-1579 and 92-2046, slip op. at 1 (7th Cir., May 26, 1993), *modifying* 62 T.C.M. (CCH) 1249 (1991).

[4] Patronage dividend in the Code.

[5] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, 1045-1052 (1962). Subchapter T is codified at I.R.C. §§ 1381-1388.

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

The Code uses the term "patronage dividend" to describe net margins from business done with or for patrons that are allocated to patrons on a patronage basis. "Patronage dividend" was first introduced into the Code by the Revenue Act of 1951.[6] The term had been used before, however, as a synonym for patronage refund.[7]

The origin of the term patronage dividend is unclear. In 1948, A. Ladru Jensen wrote that "'patronage dividend' originated more from historical accident than from any analogy to stock dividends of ordinary business corporations, and that the usage of the phrase has contributed to misunderstanding."[8]

"Patronage refund" rather than "patronage dividend" is used in this report in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

The following subsections examine each of the key elements in the Code's section 1388(a) definition of the patronage refund.

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[6] The Revenue Act of 1951 used the phrase "patronage dividends, refunds, and rebates to patrons with respect to their patronage...." ch. 521, 65 Stat. 492. The phrase was adopted without change when recodified as part of § 522 of the I.R.C. of 1954. 68A Stat. 178. When § 522 was repealed and replaced by subchapter T as part of the Revenue Act of 1962, the single term "patronage dividend" was adopted. 76 Stat. 1049.

[7] T.D. 2737, 20 Treasury Decisions, Internal Revenue 441 (1918).

[8] "Report on Terminology," in *Proceedings of the Section of Corporation, Banking and Mercantile Law*, American Bar Association, cited in Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201,217 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400.

AN AMOUNT PAID TO A PATRON

A patronage refund is “an amount paid to a patron."[9] A cooperative-patron relationship must exist between the cooperative and the recipient of a patronage refund.

While the Code does not define patron, the applicable regulation defines a patron as “any person with or for whom the cooperative association does business on a cooperative basis, whether a member or a non-member of the cooperative....”[10]

As explained in chapter 1, a patron is anyone who has a legal right to share in the cooperative’s margins on a pro rata patronage basis. A cooperative may choose to only do business with members on a patronage basis, or it may treat both members and nonmembers as patrons.[11]

A person who deals with the cooperative but receives no refund is not a patron. In the typical situation the nonpatron has no right to receive patronage refunds. A nonpatron may also be a person who has a right to receive patronage refunds but refuses to accept them or waives the right to receive them.[12]

BY A COOPERATIVE

A payment may only be treated as a patronage refund for purposes of subchapter T if it is paid “by an organization to which part I of this subchapter applies."[13] Thus, a payment with all the characteristics of a patronage refund will not qualify as a patron-

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[9] I.R.C. § 1388(a) and Treas. Reg. § 1.1388-1(a)(1).

[10] Treas. Reg. § 1.1388-1(e).

[11] Farmer cooperatives with § 521 tax status must treat all persons who do business with the cooperative as patrons, whether or not they are members. Treas. Reg. § 1.521-1(a)(1). This rule, and other requirements to utilize § 521 tax status, will be discussed in a subsequent report in this series.

[12] Priv. Ltr. Rul. 8104118 (Oct. 30, 1980).

[13] I.R.C. § 1388(a) and Treas. Reg. § 1.1388-1(a)(1).

age refund unless the paying organization meets subchapter T requirements of operating on a cooperative basis.[14]

ON THE BASIS OF QUANTITY OR VALUE OF BUSINESS DONE WITH OR FOR SUCH PATRON

The "quantity" measure is generally thought of in physical terms, for example, bushels delivered as a proportion of all bushels handled by the cooperative. The "value" measure is related to dollar volume rather than physical volume.

The two measures will not necessarily yield identical refunds to individual patrons, but section 1388(a)(l) of the Code gives cooperatives the option to use either method. And as it is permissible to use either volume or value, it is presumably possible to use a combination of both.

The "with or for" term in Code section 1388(a)(l) provides flexibility, recognizing the variety of relationships a cooperative may have with its patrons.

UNDER A PREEXISTING LEGAL OBLIGATION

The requirement that patronage refunds be made pursuant to a "preexisting legal obligation" to qualify for single tax treatment was established long before enactment of subchapter T.[15] The obligation has to have substance. In one case the court said a "moral obligation" to make returns was insufficient to justify the exclusion.[16] In another, an "understanding" that such returns would be made was held deficient.[17]

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[14] The terms "cooperative" and "operating on a cooperative basis" are not defined in the Code or the regulations.

[15] See, e.g., Peoples Gin Co. v. Commissioner, 118 F.2d 72 (5th Cir. 1941); Farmers Cooperative Co. v. Birmingham, 86 F.Supp. 201, 230-231 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400.

[16] Union Fishermen's Cooperative Packing Co. v. Earle, 121 F.Supp. 373, 377-378 (D. Ore. 1954), 1954-1 U.S.T.C. (CCH) ¶ 9366.

[17] American Box Shook Export Ass'n v. Commissioner, 156 F.2d 629, 631 (9th Cir. 1946), 1946-2 U.S.T.C. (CCH) ¶ 9314, *aff'g* 4 T.C. 758 (1945).

Obligations requiring further action to make them binding upon the cooperative are not sufficient.‘* If the obligation is not established until a declaration is made by the cooperative, the obligation to return net margins is not effective.” An “existing legal” obligation is required.*’

Code section 1388(a)(2) only requires a preexisting obligation. The regulations describe the obligation as being a “valid enforceable *written* obligation."[21] Thus the regulations appear to have added a requirement that in addition to having a legal status (valid and enforceable), the obligation must be in writing. It also must be an obligation “of such organization to the patron to pay such amount.“**

How Established

A valid enforceable written obligation may be established in several ways.

A State law, such as the statute under which the cooperative is incorporated, may require refund payments.[23] Mere statutory direction for the directors to allocate net margins annually, however, may not make the margins deductible. An actual allocation and distribution may still be required. In *Fountain City Co-op Creamery Ass’n v. Commissioner,* the patronage refund deduction was disallowed because the directors allocated net

[18] Farmers Union State Exchange v. Commissioner, 30 B.T.A. 1051 (1934). The cooperative charter said margins would be distributed according to bylaws, but bylaws were not introduced into evidence and may not have been adopted, so deduction was denied.

[19] Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457 (1969). This case concerned tax years 1958 and 1959, which predated enactment of subchapter T.

[20] Colony Farms Cooperative Dairy, Inc. v. Commissioner, 17 T.C. 688,692 (1951).

[21] Treas. Reg. §1.1388-1(a)(1)(ii).

[22] *Id.*

[23] Treas. Reg. § 1.1388-1(a)(l).

margins to reserves rather than making cash or stock distributions to patrons as contemplated by the statute.[24]

The cooperative's articles of incorporation or bylaws may also place a sufficiently enforceable obligation on the cooperative to pay patronage refunds.[25]

A typical bylaw provision creating such an obligation is found in Sample *Legal Documents for Cooperatives?*

> ARTICLE _. OPERATION AT COST AND MEMBERS' CAPITAL
>
> *Section 1. Operation at Cost.* The association shall at all times be operated on a cooperative service-at-cost basis for the mutual benefit of its member patrons.
>
> *Section 2. Margin Allocation.* In order to induce patronage and to assure that this association will operate on a service-at-cost basis in all its transactions with its members, the association is obligated to account on a patronage basis to all member patrons on an annual basis for all amounts received from business conducted with members on a patronage basis, over and above the cost of providing such services, making reasonable additions to reserves, and redeeming capital credits. Such allocation shall be on the basis of the volume (dol-

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

[25] Treas. Reg. § 1.1388-1(a)(l) and Rev. Rul. 83-135, 1983-2 C.B. 149. Bylaw provisions are noted in Land O'Lakes, Inc. v. United States, 675 F.2d 983 (8th Cir. 1982), *aff'g in part, rev'g in part*, 470 F.Supp. 238 (D. Minn. 1979); Smith and Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341 (5th Cir. 1965) *aff'g*, 37 T.C. 861 (1962); and Priv. Ltr. Rul. 8118012 (Jan. 18, 1981). Charter or articles of incorporation provisions are noted in Mississippi Chemical Co. v. United States, 197 F. Supp. 490 (S.D. Miss. 1961), *aff'd*, 326 F.2d 569 (5th Cir. 1964).

[26] Donald A. Frederick, *Sample Legal Documents for Cooperatives*, ACS Cooperative Information Report No. 40 (USDA 1990).

lar value) of product marketed through (purchased from) the association.

The association is hereby obligated to pay all such amounts to the patrons in cash or by credits to a capital account of each member patron.

The binding nature of an obligation established in the bylaws is not necessarily extinguished by payment arrangements between a cooperative, third parties, and ultimate patron recipients.[27]

A written contract between the patron and cooperative may also establish the required obligation.[28]

Preexisting Requirement

The Code requires that the obligation must have "existed before the organization received the amount so paid...."[29]

Before enactment of subchapter T, exclusion or deduction for patronage refunds was based on the status of income as generated by the cooperative always belonging to patrons, not the cooperative business entity.[30] The obligation, the legal mechanism guaranteeing that the income was the patron's, not the cooperative's, had to exist before the income was first received by the cooperative. Otherwise, it necessarily became the coopera-

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[27] Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), 1982-1 U.S.T.C. (CCH) ¶ 9326, *aff'g in part, rev'g in part,* 470 F. Supp. 238 (D. Minn. 1979), 1979-1 U.S.T.C. (CCH) ¶ 9380. In the agreement, an "agent buyer" purchased supplies from the cooperative and distributed them to farmers. The cooperative, by agreement with the agent buyers, paid patronage refunds directly to farmer patrons under cooperative bylaws obligating it to make such payments.

"Treas. Reg. § 1.1388-1(a)(1). A marketing agreement was found to establish the necessary obligation in Sumner Rhubarb Growers' Ass'n v. Commissioner, 10 T.C.M. 465,474 (1951). See also, Western Colorado Producers Corp. v. Commissioner, 1 T.C.M. 697 (1943).

[29] I.R.C. § 1388(a)(2) and Treas. Reg. § 1.1388-1(a)(1)(ii).

[30] See the discussion of Tax Logic and Cooperatives in chapter 2.

tive's and the right to exclude or deduct it from the cooperative's own corporate income was lost.

Two cases involving the same cooperative illustrate what is meant by "preexisting." The cooperative adopted a bylaw creating an obligation to return margins to patrons during the middle of its fiscal year. The Internal Revenue Service (the Service or IRS) challenged the cooperative's patronage refund deduction for that same year. The court upheld the Service on the grounds that when the income was received by the cooperative, there was no obligation to make refunds to the patrons.[31] When the Service questioned the cooperative's patronage refund deductions for a subsequent tax year, the court held for the cooperative. It found the bylaw created a timely obligation for the following tax years.[32]

By the time subchapter T was enacted in 1962, the requirement that the legal obligation be "preexisting" was well established.[33]

Board Discretion

The cooperative, normally through its board of directors, may have discretion to distribute some portion of patronage margins as dividends on capital or to add some portion to reserves. This discretion may reduce the amounts of earnings allocated to patrons on a patronage basis. The issue presented by these circumstances is whether patronage refunds that may be reduced at the cooperative's discretion (the board's discretion), but are not actually reduced, are paid under a legally enforceable obligation.

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[31] Peoples Gin Co. v. Commissioner, 118 F.2d 72 (5th Cir. 1941), 1941-1 U.S.T.C. (CCH) ¶ 9318, *aff'g*, 41 B.T.A. 343 (1940).

[32] Peoples Gin Co. v. Commissioner, 2 T.C.M. 325 (1943).

[33] For summaries of concepts involved, see Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400, and United States v. Mississippi Chemical Co., 326 F.2d 569 (5th Cir. 1964), 1964-1 U.S.T.C. (CCH) ¶ 9181, *aff'g*, 197 F. Supp. 490 (S.D. Miss. 1961), 1961-1 U.S.T.C. (CCH) ¶ 9277.

Patronage or Nonpatronage Allocation

A cooperative may have discretion to allocate some portion of earnings on business with or for patrons on a nonpatronage basis. The portion allocated on a nonpatronage basis cannot qualify as patronage refunds. The issue is whether those amounts allocated on a patronage basis are distributed under a legal obligation to do so given the cooperative's discretion not to make such payments.

Although most cooperatives that issue stock do not pay dividends, most are statutorily able to do so within limits.[34] For example, the bylaws may permit the board of directors to pay dividends on capital stock up to a stated percentage, with the remaining earnings allocated to patrons on a patronage basis.

A number of decisions predating subchapter T held that if the board of directors had discretion to pay a part of the cooperative's net margins as dividends on capital stock, "the legally enforceable obligation to pay patronage refunds is destroyed to the extent that discretion to divert exists."[35] In other words, if the cooperative board had the authority to declare a dividend on stock of up to 8 percent, the level of earnings necessary to pay a dividend at that rate was ineligible for patronage refund treatment, even if the board declared a smaller stock dividend or no stock dividend at all.

Other decisions discussed situations in which, typically by State law, cooperatives could add a certain percentage of each

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[34] James Baarda, Cooperative *Principles and Statutes: Legal Descriptions of Unique Enterprises,* ACS Research Report No. *54* (USDA 1986).

[35] United States v. Mississippi Chemical Co., 326 F.2d 569,571 (5th Cir. 1964), 1964-1 U.S.T.C. (CCH) ¶ 9181, *aff'g,* 197 F. Supp. 490 (S.D. Miss. 1961), 1961-1 U.S.T.C. (CCH) ¶ 9277. See also, Farmers Union Co-op of Guide Rock, Neb. v. Commissioner, wherein the Court said, "Where a portion of such earnings are usable to pay dividends on capital stock without reference to patronage by stockholders, there exists a situation containing the feature of private profit from the enterprise. Such being the situation here, we must conclude that this balance of income over outgo in 1928 was a gain subject to taxation under the Sixteenth Amendment." 90 F.2d 488, 492, 1937-2 U.S.T.C. (CCH) ¶ 9360, *aff'g* 33 B.T.A. 225 (1935).

year's net margins to reserves. In those cases involving reserves, the courts generally did not express the same concern as to the effect of such diversions on the legal obligation to pay patronage refunds.[36]

In a decision involving both issues, the court said discretion to add funds to reserves did not affect the preexisting legal obligation, but discretion to pay dividends on stock destroyed the obligation to the extent discretion existed.[37]

In Revenue Ruling 69-621, IRS held that the amount available for distribution as a patronage refund is computed by deducting only the actual amount paid in stock dividends, not the amount that could have been paid, from patronage-sourced income.[38]

Since the announcement of Revenue Ruling 69-621, discretion to pay stock dividends has not been an issue of contention between IRS and cooperatives.[39]

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[36] Midland Cooperative Wholesale v. Commissioner, 44 B.T.A. 824 (1941). Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400, discussed the Iowa reserve statute at some length and decided the limited right to establish reserves did not destroy the cooperative's obligation to pay patronage refunds. The obligation extended to all refunds actually paid.

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

[38] Rev. Rul. 69-621, 1969-2 C.B. 167.

[39] The Tax Court, in an opinion written in 1972, adopted the old rule that discretion to pay a stock dividend destroys the obligation to pay a patronage refund to the extent that discretion to divert exists. Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 414-415 (1972), *aff'd*, 481 F.2d 812 (10th Cir. 1973), 1973-2 U.S.T.C. (CCH) ¶ 9534, cert. denied, 414 U.S. 1028 (1973). The Tax Court opinion fails to mention Rev. Rul. 69-621. The court may have been influenced by the fact that this case dealt with tax years 1963 and 1964, which were before Rev. Rul. 69-621 was issued. The 10th Circuit opinion does not mention the issue.

Allocations Among Different Groups of Patrons

Subchapter T provides that amounts paid to patrons can't be patronage refunds if different amounts are paid "with respect to substantially identical transactions."[40]

This doesn't apply, however, when different amounts are paid to patrons of different services. IRS has generally accepted the practices of cooperatives with respect to different groups of patrons, except where the board of directors has some discretion to use margins of a profitable service to offset losses on an unprofitable service.

In a 1985 private letter ruling, IRS relied in part on the older decisions on dividend payment discretion to disallow the entire patronage refund deduction claimed by a cooperative that netted gains and losses on patronage business.[41] This ruling was reversed by enactment of section 13210 of the Budget Reconciliation Act of 1985.[42]

BASED ON NET EARNINGS FROM BUSINESS WITH OR FOR PATRONS

Patronage refunds are "determined by reference to the net earnings of the organization from business done with or for its patrons."[43]

The regulations describe "net earnings" as including "the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of expenses or other items."[44]

The Code sets out two further limitations. First, a patronage refund may not include "any amount paid to a patron to the

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[40] I.R.C. § 1388(a), Treas. Reg. § 1.1388-1(a)(2)(ii).

[41] Priv. Ltr. Rul. 8521003 (Jan. 25, 1985).

[42] Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13210, 100 Stat. 82 (1985). This legislation will be discussed in detail in a subsequent report in this series on how cooperatives treat losses for tax purposes.

[43] I.R.C. § 1388(a)(3) and Treas. Reg. § 1.1388-1(a)(1)(iii).

[44] Treas. Reg. § 1.1388-1(a)(1).

extent that...such amount is out of earnings other than from business done with or for patrons...."[45]

Second, a payment will not be recognized as a patronage refund to the extent such amount is paid "out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."[46]

Thus, each year a cooperative must determine what portion of income is from business done with or for patrons and what portion of expenses is properly allocable to such patronage business. The amount of income on patronage business less allocated expenses is the amount the cooperative may distribute as patronage refunds. Finally, it must divide the level of earnings that qualify as patronage refunds among its various patrons during the tax year under consideration.

Income Sources

The first step in calculating net margins is identifying income. Principles used to determine whether a cooperative's revenues should be classified as income or not follow principles similar to those applied to noncooperative corporations.

A cooperative's income may come from almost as wide a range of sources as that for any noncooperative corporation. Typically, the primary source of income is from sale of patrons' goods in raw or processed form in the case of marketing cooperatives and the sale of supplies, equipment, or services to farmer-patrons in the case of supply or service cooperatives.

Most cooperatives also have other kinds of income. Examples include fees for services provided;' gains from dealings

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[45] I.R.C. § 1388(a). Slightly modified language is found in Treas. Reg. § 1.1388-1(a)(2)(i).

[46] I.R.C. § 1388(a) and Treas. Reg. § 1.1388-1(a)(2)(ii).

[47] Miller v. Commissioner, 65 T.C. 612 (1975) (payments for packing services); Producers Livestock Marketing Ass'n of Salt Lake City v. Commissioner, 45 B.T.A. 325 (1941) (regular payments to cover various expenses).

in property (frequently sale of a cooperative asset at a gain), interest income, rentals of real property or equipment, royalties, and dividend income. These sources can, under appropriate circumstances, be an integral part of the cooperative's operation depending on what the cooperative does for patrons and how its business is conducted.

Not all funds received by a cooperative are income. For example, contributions of capital to any corporation, including a cooperative, are not income.[48] This includes payments made pro rata on the basis of shares of stock owned that do not increase the outstanding shares of stock.[49]

As a general rule, payments received in exchange for goods or services from a corporation are income to the corporation, not contributions to its capital.[50] Whether dues or fees paid by patrons to a cooperative are compensation for services or contributions to capital requires analysis of the facts involved.

For example, in United *Grocers, Ltd. v. United States,*[51] a retail grocers' association assessed monthly charges to each member. Originally called "dues," they were later referred to as "contributions to capital."

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[48] "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." I.R.C. § 118(a).

[49] "[I]f a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company." Treas. Reg. § 1.118-1.

[50] "[T]he exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purposes of inducing the taxpayer to limit production." Treas. Reg. § 1.118-1.

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

The payments were not made directly for the purchase of goods or services, but solely to qualify a member to share in patronage refunds. The court said it was obvious the purpose of the payments was to obtain merchandise and services at the lowest possible prices. It was also reasonable to assume no member would continue to make the monthly payments unless a patronage refund was forthcoming.

Neither was there an investment motive in the payments. Members received no equivalent equity interest in the cooperative and no greater right to share in the cooperative on liquidation. Any member who withdrew before liquidation forfeited any right to share in the property of the cooperative. The court said, "While the acquisition of an increased equity or interest in the corporation is not a requisite of a capital contribution, the presence or absence of such interest has a bearing upon the motive of the person making the payment."[52]

The court found no single fact to be decisive, but the arrangement as a whole required that the payments be treated as payments for services from the cooperative. Given all circumstances, the monthly payments were income to the cooperative, not contributions to its capital.

Year Patronage Occurred

Cooperatives usually receive income and incur expenses on a more or less continuous basis. Taxable years, however, are divided into discrete time periods. Income received in one year may be derived from business with patrons of a prior year, and the cooperative must determine what allocation principles to apply.

This is a common occurrence among manufacturing and processing cooperatives and cooperatives that operate in a federated system. For example, a cooperative that processes fruits into juices might take delivery of a crop and process it into a canned or frozen product in one year, and then store it before selling the product well into the subsequent year.

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[52] *Id.* at ***640.***

Or a local cooperative that sells farm supplies might buy some fertilizer from a federated regional cooperative to which it belongs and resell that fertilizer to its farmer-members, all in 1993. The local cooperative probably would not collect any patronage refund resulting from its purchase from the regional until 1994. And the farmer-members probably would not receive their pro rata share of the patronage refund from the regional to the local until they receive their refund from their local in 1995.

The Code recognizes this timing problem. Section 1382(f) provides:

> If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then...the patronage shall, to the extent provided in regulations..., be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income.[53]

The applicable regulation, after restating the Code provision, adds: "Thus, if the cooperative organization pays these earnings out as patronage dividends during the payment period for the taxable year for which the earnings are includible in its gross income, it will be allowed a deduction for such payments under section 1382(b)(1)...."[54]

In other words, section 1382(f) provides that where a cooperative has earnings from patron business in a year subsequent to the year the underlying business took place, the patronage shall be considered to have occurred in the same year the earnings are included in income. This permits the cooperative to distribute the earnings to patrons as patronage refunds and claim the appropriate tax treatment.

The ability of a local cooperative to treat patronage refunds from a federated cooperative as patronage-sourced income in the

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[53] I.R.C. § 1382(f).

[54] Treas. Reg. § 1.1382-6.

year the refund is received was established in *Kingfisher Cooperative Elevator Association v. Commissioner*.[55]

Section 1382(f) also applies to earnings increases realized in tax years after the underlying business event. The change in earnings may be due to changes in inventory valuation method,[56] depreciation recapture,[57] or gain on the sale of a capital asset.[58]

Where the Code assigns the year of recognition, income occurs in that year. Under special Code provisions, timber owners may elect to treat cutting as a sale or exchange.[59] Although appreciation may have occurred over a period of time, gain is recognized in the harvest year if a cooperative owner so elects.[60]

IRS also has applied Section 1382(f) when a cooperative managed a loss by redeeming nonqualified written notices of allocation during the 8 X-month period following the tax year. In a 1979 private letter ruling,[61] the cooperative suffered a loss during the taxable year. It placed each patron's share of the loss in an account receivable. During the 8 X-month payment period that followed the tax year, the cooperative canceled the accounts receivable due from patrons by redeeming the nonqualified equities at less than face value. The transaction was held to relate to patronage during the taxable year in which the loss occurred.

In contrast, when the applicable tax law provides that an adjustment increases income in the years the underlying transactions took place, IRS may refuse to apply section 1382(f).

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[55] Kingfisher Cooperative Elevator Association v. Commissioner, 84 T.C. 600 (1985). This case is discussed in more detail in the section in chapter 6 of this report on "tracing."

[56] Rev. Rul. 79-45, 1979-1 C.B. 284, and Priv. Ltr. Rul. 8023023 (Feb. 28, 1980).

[57] Rev. Rul. 74-84,1974-l C.B. 244.

[58] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

[59] I.R.C. § 631(a).

[60] Rev. Rul. 71-439, 1971-2 C.B. 321, and Rev. Rul. 74-24,1974-l C.B. 244, describe workers' cooperatives owning standing timber from which the cooperative manufactured wood products.

[61] Priv. Ltr. Rul. 7926068 (Mar. 29, 1979).

If the 8 M-month payment period has expired, patronage refund tax treatment may be denied.

Revenue Ruling 74-327[62] held income resulting from the adjustments to depreciation was includible in the cooperative's gross income for the years the incorrect amount of depreciation was claimed. IRS said the fact the amount of depreciation claimed in the prior years was overstated and the overstatement was not discovered until after the returns had been filed for those years did not result in income includible in a later year. Thus, section 1382(f) was not applicable to assign the added income from adjustment to the year the error was discovered and corrected.

[62] Rev. Rul. 74-327, 1974-2 C.B. 173.

CHAPTER 5
PATRONAGE AND NONPATRONAGE BUSINESS

Patronage refunds must be derived out of earnings on business done with or for patrons.

Characterizing business or income as patronage- or nonpatronage-sourced can be approached in two ways. The first distinction deals with how a cooperative treats those with whom it transacts business. For example, if a cooperative purchases products from nonmembers who are not entitled to patronage refunds, the income generated from reselling such products is from nonpatronage sources because the cooperative is not dealing with nonmembers on a cooperative basis. The difference in the status of the persons served by the cooperative is clearly established, so this distinction has generated little legal controversy.

The second means of distinguishing patronage and nonpatronage income is based on the nature of the transaction or operation that generates the income. For example, a cooperative may earn income from the investment of cash reserves. Determining whether income from certain sources, with traits not always associated with operating income, is patronage- or nonpatronage-sourced has been the subject of much controversy between cooperatives and IRS.

SIGNIFICANCE OF CLASSIFYING BUSINESS SOURCES

Whether income is patronage- or nonpatronage-sourced is primarily a concern of cooperatives that do not qualify for section 521 tax status.[63] It is an issue of limited importance to section 521 cooperatives.

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[63] I.R.C. § 521. Under § 521, farmer cooperatives that meet certain organizational and operational tests may, in addition to patronage refunds, also deduct dividends paid on stock and nonpatronage income distributed to patrons on a patronage basis. Section 521 will be discussed in detail in a subsequent report.

To qualify for section 521 tax status a cooperative may not discriminate between member and nonmember patrons.[64] Members and nonmembers alike are entitled to share, on a pro rata basis, earnings distributed as patronage refunds.

The patronage/nonpatronage distinction is also of less concern to section 521 cooperatives because they can deduct both patronage and nonpatronage income allocated to patrons on a patronage basis.[65] A section 521 cooperative will add nonpatronage income to patronage income and allocate total earnings as patronage refunds to everyone it serves, members and nonmembers alike. It can then deduct all earnings distributed as patronage refunds, regardless of whether the earnings came from patronage or nonpatronage sources.

For cooperatives without section 521 status, only patronage-sourced income qualifies for single tax treatment. Nonpatronage income is subject to regular corporate double tax treatment?

Distinguishing patronage and nonpatronage business is significant for another reason. Cooperatives engaged in both patronage and nonpatronage business must separate both income and expenses related to each type of business." This requires the cooperative to maintain adequate records in order to properly

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[64] I.R.C. § 521(b)(l) requires a qualifying cooperative to return earnings from marketing products to "members or other producers" and providing supplies to "members and other persons." The regulations are more specific, stating: "...patronage dividends must be paid to all producers on the same basis...." Treas. Reg. § 1.521-l(a)(l).

[65] I.R.C. § 1381(a)(l) and § 1382(c)(2)(A). Treas. Reg. § 1.1382-3(c).

[66] The Eighth Circuit Court of Appeals put it this way, "...cooperatives that do quality under section 521 are allowed not only the ordinary deductions for patronage dividends and qualified per-unit retain allocations, but also deductions for capital stock dividends and patronage dividends derived from nonpatronage business....A nonexempt cooperative, by contrast, operates as a hybrid; only its patronage income enjoys this kind of treatment." Farm Service Co-op v. Commissioner, 619 F.2d 718, 727 (8th Cir. 1980).

[67] Farm Service Co-op v. Commissioner, 619 F.2d 718, 723-727 (8th Cir. 1980); Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987).

allocate income and expense items between patronage business and nonpatronage business. This complicates the cooperative's accounting system and the computation of its tax liability.

Revenue Ruling 63-58[68] provides an example of how this requirement works. The ruling discusses a cooperative that both stores and markets grain, and that only pays patronage refunds to its members. The ruling states that where cooperatives distribute earnings:

> only to member patrons, . ..it is essential (to) keep permanent records to show business done with nonmembers and that done with members. Where, for example, 20 per cent of the bushels delivered for storage and 60 per cent of the bushels delivered for marketing are attributable to transactions with members, only 20 per cent of the income from storage may be combined with 60 per cent of the income from marketing and the aggregate net profit may be distributed to the members ratably....[69]

TESTS APPLIED TO CLASSIFY BUSINESS

The primary legal authority for distinguishing patronage-sourced from nonpatronage-sourced business is the Code definition of a patronage refund, which is "an amount paid to a patron...which is determined by reference to the net earnings of the organization from business done with or for its patrons."[70]

Further, a patronage refund "does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than business done with or for patrons...."[71]

The phrase "done with or for patrons" provides the basis for tests applied to classify specific business practices or sources of income as patronage-sourced or nonpatronage-sourced. The

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[68] 1963-1 C.B. 109.

[69] *Id.*

[70] I.R.C. § 1388(a)(3).

[71] I.R.C. § 1388(a).

Code gives no further explanation of patronage or nonpatronage business, and "the legislative history of the subchapter T provisions is not helpful."[72]

The variety of circumstances in which patronage business must be distinguished from nonpatronage business has led to the formulation of two general "tests." One line of thought emphasizes the kind of income (such as interest or capital gain). The other focuses on the nature of the transaction generating the income in relation to the cooperative's overall business purposes.

As the issues have developed by IRS rulings and court decisions, a trend has emerged toward application of underlying principles and economic and business realities to facts at hand, and away from classifications based on simple terms applied to the transaction or type of income. This trend is especially evident in judicial opinions.

Regulatory Rules

One reason cooperatives and IRS have difficulty in this area is the somewhat ambiguous wording of the relevant regulations. The regulations do not define patronage income, but Treas. Reg. §1.1382-3(c)(2), dealing with section 521 cooperatives, does define nonpatronage income as

> . ..incidental income derived from sources not directly related to marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, and from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

The two sentences quoted above may be read in two ways. The first sentence presents a "directly related" test, as explained in more detail later, which suggests looking at the nature of the transaction and the economic reality of the situation. The second

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[72] Illinois Grain Corp. v. Commissioner, 87 T.C. 435,451 (1986).

sentence lists three specific examples of income--rent, returns on investments, and gains from the sale of assets--as nonpatronage income. The second sentence can be read as examples subject to the "directly related" test, or as per se nonpatronage income.

Treas. Reg. § 1.1382-3 is titled "special deductions for exempt [§ 521] farmers' cooperatives." The Tax Court has said, "it appears to be generally accepted that this definitional attempt is of equal application to both exempt and nonexempt cooperatives."[73] However, the historical background of the regulation suggests that the primary intent was to deal with nondiscriminatory allocations by exempt cooperatives.

The regulation language in question was adopted in 1953,[74] in response to 1951 legislation which required section 521 farmer cooperatives for the first time to allocate income set aside in reserves to avoid corporate tax.[75] The fundamental requirement for section 521 status is nondiscrimination between member and nonmember patrons. Prior to 1951, in a number of court cases the Commissioner challenged the allocation practices of tax exempt cooperatives as inconsistent with this nondiscrimination requirement for exemption.[76] Subsection (3) of the current regulation[77], which follows the definition in subsection (2), indicates this regulation was adopted to deal primarily with allocation of nonoperating income.

This background may help explain why the courts have not accepted the examples in a regulation concerning special deductions for section 521 cooperatives as conclusively constituting nonpatronage income for cooperatives in general.

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[73] *Id.*

[74] T.D. 6014, 1953-1 C.B. 110, 115, published as Treas. Reg. § 29.101(12)-3(d).

[75] Revenue Act of 1951, Pub. L. No. 183, § 314, 65 Stat. 452, 491-493 (1951), *reprinted in* U.S. Code Cong. & Admin. Serv. 308, 371-372.

[76] See, e.g., Fertile Cooperative Dairy Ass'n v. Huston, 119 F.2d 274 (8th Cir. 1941), *aff'g*, 33 F. Supp. 712 (N.D. Iowa 1940); Western Colorado Producers Cooperative v. Commissioner, 1 T.C.M. (CCH) 697, 702 (1943).

[77] Treas. Reg. § 1.1382-3(c)(3).

The next sections discuss the two types of tests used to distinguish patronage- and nonpatronage-sourced income and how IRS and the courts have handled situations where the two approaches conflict.

Directly Related/Actually Facilitates Test

This test for distinguishing patronage- and nonpatronage-sourced income looks to the transaction or activity generating the income and asks whether it is "directly related to" or "actually facilitates" the cooperative's overall business purpose.

The "directly related" test is based on Treas. Reg. §1.1382-3(c)(2), which states, in part: "'Income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association." Conversely, income that is directly related to the cooperative's activities is patronage-sourced income.[78]

The directly related test first identifies the cooperative's activities with respect to marketing, purchasing, or services performed for patrons. "The same activities that may be directly related to the cooperative enterprise in one case may not be so directly related in another case."[79] For example, a workers' cooperative lease of a plywood plant for its own use is directly related to the cooperative's business.[80] Such a plant, however, may not be directly related to another cooperative's marketing, purchasing, or service activities. The activity meets the directly related test if it relates to business done with or for patrons.

The "actually facilitates" language is credited to Revenue Ruling 69-576.[81] This ruling concerned a cooperative that

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[78] Rev. Rul. 74-160, 1974-1 C.B. 246; Rev. Rul. 75-228, 1975-1 C.B. 278; Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

[79] Illinois Grain Corp. v. Commissioner, 87 T.C. 435,463 (1986).

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

[81] Rev. Rul. 69-576, 1969-2 C.B. 166.

borrowed money from a Bank for Cooperatives to finance the acquisition of supplies for resale to its members. After the close of its fiscal year, the Bank for Cooperatives determined its net margin and paid the borrower/cooperative a patronage refund based on its ratable share of the bank's margin. In holding the patronage refund paid by the Bank for Cooperatives was patronage-sourced income to the cooperative, the Service stated:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative operations, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.[82]

The "actually facilitates" concept enunciated in Revenue Ruling 69-576 has been called the "touchstone or common thread" running through cases and rulings "which enables them to be reconciled" with the regulations, at times facially inconsistent.[83]

In Illinois Grain Corp. *v.* Commissioner, the Tax Court, after reviewing the analysis of patronage-sourced versus nonpatronage-sourced income in a number of prior cases, concluded the characterization in Revenue Ruling 69-576 was correct. The court stated:

> As the cases make clear, such a determination is necessarily fact-intensive. Income derived by a coopera-

[82] Id. at 167.

[83] Illinois Grain Corp. v. Commissioner, 87 T.C. 435,452 (1986).

> tive from its various business activities may indeed be so closely intertwined and inseparable from the main cooperative effort that it may be properly characterized as directly related to, and inseparable from the cooperative's principal business activity, and thus can be found to 'actually facilitate' the accomplishment of the cooperative's business purpose. On the other hand, it is equally possible that a cooperative may undertake business activities which, while profitable, have no integral and necessary linkage to the cooperative enterprise, so that it may fairly be said that the income from such activities does nothing more than add to the taxpayer's overall profitability. It all depends on the facts of each case.[84]

Patronage-sourced income results from activities integrally intertwined with the cooperative's functions in a business context, as opposed to activities that merely produce incidental profits.[85] Analysis should focus on the "totality of the circumstances" to determine how the activity is related to the cooperative's principle business.[86] This includes the facts surrounding the generation of income. For example, income generated from temporary excess cash is judged in the context of the cooperative's cash needs and the fluctuation of those needs as it conducts business on behalf of patrons. Excess cash and its temporary use to generate income may be part and parcel of the business in which the cooperative is engaged.*'

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[84] Id. at 459.

[85] Cotter and Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985), 1985-2 U.S.T.C. (CCH) ¶ 9487, *rev'g*, 6 Ct. Cl. 219 (1984), 1984-2 U.S.T.C. (CCH) ¶ 9773.

[86] 765 F.2d at 1106.

[87] See, e.g., Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987), wherein the cooperative had widely fluctuating and substantial needs for cash reserves as it made purchases for its patrons.

Treas. Reg. §1.1382-3(c)(2), which provides the directly related test, also gives three specific examples of income derived from sources other than patronage: "Income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets."[88]

Efforts have sometimes been made to apply these three examples as tests without regard to the underlying facts or the relation to the cooperative's patronage activities. In this approach, if income falls in any of the three categories, it is considered income from a nonpatronage source without considering whether it may meet a "directly related" or "actually facilitates" test.[89]

The approach that any income falling in a category noted in one of the regulatory examples needs no further analysis to determine its patronage or nonpatronage character has not been generally accepted.[90] The Tax Court has said, "in spite of the

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[88] Treas. Reg. §1.1382-3(c)(2). The list is not without some foundation. A report of the Senate Finance Committee on the 1951 amendment to section 101(12) of the 1939 Code gave a somewhat similar list. It stated: "At the present time...nonoperating income such as interest, dividends, rents, and capital gains and also the income from certain business done with the United States Government or its agencies, is taxable to the ordinary cooperative even when allocated to the accounts of patrons, but are tax-free to the exempt cooperative whether or not allocated." S. Rep. No. 781, 82nd Cong., 1st Sess. 20, 21 (1951), reprinted *in* 1951 U.S. Code Cong. & Admin. Serv. 1989.

[89] "The government contends that all capital gains are not patronage source income and that it is unnecessary to consider whether the lease cancellation payment and [the cooperative's] income from the sale of the machines are otherwise directly related to the cooperative's activities because both are capital gains." Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,348-49 (D. Ore. 1979).

[90] An investigation of the underlying reasons for a transaction was commenced despite the regulations, for example, in Astoria Plywood Corp. v. United States, where the court said, "In my view capital gains may be patronage source income. In each instance, it depends on whether the income is 'directly related' to [the cooperative's] activities." 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979). Similarly,

apparently clear language of the regulation, however, the law, as it has developed, shows that the language does not always mean what it literally says. Both the [IRS] and the courts have played a hand in this evolution of the law...."[91]

At times, the courts have been openly hostile to IRS attempts to narrowly interpret this regulation. The Tax Court rejected attempts by IRS to remove income generated by money management practices (interest income) as "any other business enterprise would have done," from patronage-sourced treatment.'* The court quoted another Tax Court decision that said, "We consider [IRS's] position herein not only contrary to the [law], but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives."[93]

The Court of Claims was similarly harsh on IRS's literal interpretation of Treas. Reg. §1.1382-3(c)(2). In Revenue Ruling 73-497, IRS relied on the regulatory examples to classify interest income earned by a Bank for Cooperatives as nonpatronage-sourced.[94] The interest income came from temporary investments of surplus funds and on bonds the bank was required to buy to comply with Farm Credit Administration liquidity requirements. In *St. Louis Bank for Cooperatives v. United States,* the Claims Court found Revenue Ruling 73-497 to be "inherently defective....The ruling reiterates the language of the regulation, is conclusory in content, and of little persuasive value."[95]

Certified Grocers of California, Ltd. v. Commissioner, noted "it is clear that interest income earned by cooperatives is, in some circumstances, patronage sourced income," 88 T.C. 238,243 (1987), citing Cotter and Co. v. United States, 765 F.2d 1102, 1107 (Fed. Cir. 1985), and Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459-460 (1986).

[91] Illinois Grain Corp. v. Commissioner, 87 T.C. 435,451 (1986).

[92] 87 T.C. at 463.

[93] 87 T.C. at 463, quoting Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729,736 (1977).

[94] Rev. Rul. 73-497, 1973-2 C.B. 314.

[95] St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041, 1050-51 (Cl. Ct. 1980).

TAXPAYER'S BURDEN OF PROOF

Analysis of the patronage- or nonpatronage-sourced nature of a particular business activity is "necessarily fact-intensive."[96]

Cooperatives wishing to establish the patronage nature of a particular activity have the burden of proof to establish the facts necessary to prove IRS's determination incorrect.[97] Income has been found nonpatronage-sourced when the cooperative fails to show the necessary connection between the activity generating the income and the principal business of the cooperative conducted with or for its patrons.[98] As the Tax Court has said:

> Although we realize that cooperatives such as petitioner need cash to operate, the record in this case does not allow us to determine whether the funds that earned the interest income in issue were needed for use in petitioner's cooperative activity. The record does not disclose, for example, the amount of funds that earned the interest, the term for which the funds were placed, petitioner's needs for the funds, and when those needs were expected to occur. [footnote omitted] Lacking such facts, we must hold that petitioner has failed to prove that respondent erred in determining that the remaining interest income was nonpatronage-sourced.[99]

On the other hand, most situations in which the patronage or nonpatronage nature of the income was disputed and in which

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[96] Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459 (1986); Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238,244 (1987).

[97] Certified Grocers, 88 T.C. at 244 (1987).

[98] See, for example, Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979); Washington-Oregon Shippers Cooperative, Inc. v. Commissioner, 52 T.C.M. (CCH) 1406 (1987).

[99] Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238, 245 (1987).

the cooperative's position prevailed resulted from careful explanation of the activity and its relation to the cooperative's business. Examples of these situations are found in the following sections on specific items of income or activities.

RENTAL INCOME

The first example of nonpatronage income listed in the regulation is "income derived from the lease of premises."[100] Two significant court decisions included a discussion of the status of rental income, and both found it patronage-sourced. Both cases eschewed a literal application of the regulatory example in favor of an analysis weighing the totality of the facts.

In Cotter and Company *v.United States*, a hardware cooperative with a growing business built additional warehouse space to meet its current and anticipated future needs. It leased the excess space built to accommodate future growth. The U.S. Court of Appeals for the Federal Circuit, in a reversal of a Claims Court decision, found:

> The rental income earned through the leasing out of temporary excess space is also patronage sourced. The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space.... It is clear from the undisputed facts that Cotter did not go into the warehouse rental business, seeking to enhance corporate profits while hiding behind its label as a cooperative. Indeed, Cotter occasionally must lease space from others as well. Rather, Cotter implemented a reasonable plan to secure the warehousing of its goods at the lowest cost to its patrons; the result is a primary function of Cotter's"'

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[100] Treas. Reg. §1.1382-3(c)(2).

[101] Cotter and Co. v. United States, 765 F.2d 1102, 1109-1110, (Fed. Cir. 1985), *rev'g*, 6 Ct. Cl. 219 (1984). While the IRS Chief Counsel's

In *Illinois Grain Corp. v. Commissioner*, a grain marketing cooperative involved in moving members' grain by barge sublet two of its barges to another barge transportation cooperative of which it was a member-patron. The Tax Court looked at the totality of the facts and determined rental income received from subletting the barges was patronage-sourced. The court concluded:

> We are satisfied that petitioner's leasing and subleasing of barges to its transportation cooperative was not an 'investment' in such barges, intended to produce merely passive rental income, but was . . . clearly linked to petitioner's principal cooperative enterprise, and was not entered into as an independent and unrelated profit-making activity. We accordingly hold that the barge rentals which petitioner derived in the year in issue were patronage sourced income, within the rational of Rev. Rul. 69-576, and consistent with the philosophy expressed in the *Cotter* case.[102]

INVESTMENT INCOME

The second example of income identified as nonpatronage-sourced in Treas. Reg. §1.1382-3(c)(2) is income "from investment in securities." This encompasses both interest earned on funds loaned out by cooperatives and dividends received on equity investments held by cooperatives.

Office did not recommend an appeal of the Cotter decision, it did express disagreement with the outcome. Action on Decision 1986-032 (June 23, 1986).

[102] Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 461-462 (1986). IRS accepted the court's decision that the barge rental income was patronage-sourced. Action on Decision 1990-027 (Sept. 24, 1990).

Interest

A cooperative may make loans for various reasons, and earn interest on the amounts loaned. Whether interest income should be classified as from patronage or nonpatronage sources has proven a difficult issue to resolve.

As a general rule, if the loan enables the borrower to perform some service for the cooperative, the interest is likely to be characterized as patronage-sourced income. The cooperative has been able to meet its burden of establishing the loan as directly related to its cooperative activity.[103]

Cooperatives have been less successful in meeting the "directly related to" and "actually facilitates" standard where the loan is to entities without other business connections to the cooperative.

The first decision in this area, Revenue Ruling 73-497,[104] applied Treas. Reg. §1.1382-3(c)(2) literally to deny patronage-sourced income status to interest income earned by a Bank for Cooperatives on temporary placements of surplus funds and on bonds purchased to comply with liquidity requirements imposed by the Farm Credit Administration. This ruling ignored Revenue Ruling 69-576 and the "directly related to" and "actually facilitates" tests.

In Revenue Ruling 74-160,[105] a plywood workers' cooperative made loans to its chief supplier. The supplier needed the loans to finance equipment necessary to carry out its business operations for the cooperative. This time IRS relied on Revenue Ruling 69-576 and held the loans to purchase equipment facilitated the accomplishment of the cooperative's activities by enabling the cooperative to obtain needed supplies for its operations. Without making the loans, the cooperative would have been unable to procure the necessary supplies. Thus, income generated as a result of the loans was found to be "directly related" to the cooperative's activities.

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[103] See, e.g., Tech. Adv. Mem. 9236001 (May 20, 1992).

[104] Rev. Rul. 73-497, 1973-2 C.B. 134.

[105] Rev. Rul. 74-160,1974-l C.B. 246.

Court decisions analyzing the patronage/nonpatronage character of interest income have uniformly adopted some form of the directly related test. An early court case dealt with the money management activities of a Farm Credit System institution. In *St. Louis Bank for Cooperatives v. United States,*[106] the bank sometimes generated surplus funds from the sale of bonds that temporarily exceeded the needs of its member-borrowers. These funds were invested first with other Farm Credit System institutions and, if no one in the system needed the funds, with brokerage houses that sold Farm Credit System bonds.

The bank also realized interest income on Federal bonds held to meet Farm Credit System liquidity rules. These rules required the bank to keep invested cash equal to between 20 and 25 percent of its capital stock.

The U.S. Court of Claims disavowed the strict literal interpretation of Revenue Ruling 73-497 in favor of the other rulings previously cited. Looking at the totality of the facts, the court found the interest income earned on the investment of the temporary surplus funds and on bonds held to meet the liquidity requirement to be "directly related" to the services the cooperative bank provided its members and "patronage sourced" for tax purposes.[107]

In *Twin County Grocers, Inc. v. United States,*[108] the U.S. Court of Claims also applied the "directly related" test. The court rejected the argument that all interest income was "directly related" to a cooperative's business activity because that income reduced the need for the cooperative to borrow other funds. The court found that prudent money management, absent a showing that it was directly tied to the marketing, purchasing, or service activities of the cooperative, was merely an incidental method of enhancing overall profitability. The cooperative's interest income was held to be from nonpatronage sources.

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[106] St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Ct. Cl. 1979), 1980-2 U.S.T.C. (CCH) ¶ 9509, *rev'g in part, aff'g in part,* 1979-2 U.S.T.C. (CCH) ¶ 9576.

[107] 624 F.2d at 1052-53.

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

The watershed case on this issue, Cotter & Company *v.* United States,[109] involved a wholesale hardware cooperative that had wide seasonal fluctuations in its business. Suppliers often required payment before Cotter could resell merchandise; so Cotter needed temporary cash surpluses available to pay suppliers. Cotter invested its temporary cash surpluses in short-term paper and claimed the interest generated as patronage-sourced income.

The Court of Claims had both St. *Louis Bank* and *Twin County Grocers* to consider in deciding this case. Cotter attempted to distinguish *Twin County Grocers* on the basis that that cooperative failed to show any close connection between the accumulation of surplus funds and its business activity. The Claims Court, however, sided with IRS. The court stated that for interest income to be patronage-sourced "the cooperative must establish a connection between the *transaction* that produced the income and the *basic* services it rendered."[110] This decision appeared to limit St. *Louis Bunk* to situations involving financial service cooperatives.

But on appeal, the U.S. Court of Appeals for the Federal Circuit reversed the Claims Court. Placing substantial reliance on St. *Louis Bunk,* the court said that in determining the status of interest income one should not look at the transaction in a vacuum, but rather should consider "the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function...."[111] It found the money management activity of Cotter directly related to its overall function and held the interest income in dispute patronage-sourced income.

In *Illinois Grain Corp. v. Commissioner,* the Tax Court adopted the approach of the appellate court in Cotter. A grain marketing cooperative established that it operated in a volatile market in

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[109] **Cotter and Co. v. United States, 765 F.2d 1102, (Fed. Cir. 1985), 1985-2 U.S.T.C. (CCH) ¶ 9487, *rev'g,* 6 Ct. Cl. 219 (1984), 1984-2 U.S.T.C. (CCH) ¶ 9773.**

[110] **Cotter and Co. v. United States, 6 Cl. Ct. 219,230 (1984).**

[111] **Cotter and Co. v. United States, 765 F.2d 1102, 1110 (Fed. Cir. 1985), *rev'g* 6 Cl. Ct. 219 (1984).**

competition with large worldwide firms and that it needed surplus funds for flexibility to deal with fluctuations in the marketplace. The court found the short-term placement of these surplus funds to be "inseparably intertwined with the overall conduct of its cooperative enterprise, and the interest income which it earned was therefore patronage sourced...."[112]

The next time the Tax Court considered this issue, the court made it clear cooperatives need to prove a nexus between their business operations and the investment creating the interest income. In *Washington-Oregon Shippers Cooperative, Inc. v. Commissioner,* a freight forwarding cooperative purchased certificates of deposit with excess operating funds and claimed the interest as patronage-sourced income. The court failed to find "the integral and necessary linkage between petitioner's money management activities and its overall conduct of its cooperative enterprise such as we found in *Illinois Grain.* We conclude that petitioner's money management activities did nothing more than add...to its overall profitability."[113] The interest was found to be from nonpatronage sources.

In *Certified Grocers of California v, Commissioner,*[114] the Tax Court found interest earned on the temporary investment of funds borrowed to finance construction of a warehouse was income from patronage sources. But as in *Washington-Oregon Shippers Cooperative,* interest earned on the investment of general surplus funds was nonpatronage income.

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112 Illinois Grain Corp. v. Commissioner, 87 T.C. 435,460 (1986).

113 Washington-Oregon Shippers Cooperative, Inc. v. Commissioner, 52 T.C.M. (CCH) 1406 (1987). The cooperative had also made loans to encourage construction of a freight terminal used by the cooperative in its business and to encourage expansion into new territory. Income received on these notes was conceded to be patronage-sourced income.

114 Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987).

Dundee Citrus Growers Association v. Commissioner[115] involved a citrus marketing association that used a pooling system to equitably distribute earnings to members from the sale of a crop whose price might fluctuate substantially during the marketing year. Rather than make distributions to members during the season, and risk overpaying some members, the cooperative invested proceeds from sales of product and paid members after a pool was substantially sold and could be closed. Some of the loans were to a federated cooperative in which this cooperative held membership.

IRS argued the cooperative could have made preclosing distributions instead of accumulating surplus cash which resulted in the challenged interest. Therefore the investments did not actually facilitate the cooperative's operation, and the income was nonpatronage-sourced.

The court noted, however, the volatile nature of the industry, the difficulty in recovering over-advances, and the benefits of lowering the borrowing costs of the federated cooperative. Given these circumstances, the court concluded the cooperative acted prudently, and "maintenance of the temporary excess of incoming funds over outgoing expenses is both integral to and necessary to petitioner's cooperative functions."[116]

In *CF Industries v. Commissioner*,[117] the Tax Court focused on the length of maturity of the investment instrument. Testimony indicated CF operated in a volatile market and was unable to forecast accurately its cash needs for more than 30 days. On this basis, the U.S. Tax Court said only interest on investments with maturities of 30 days or less would qualify as patronage sourced.[118]

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[115] Dundee Citrus Growers Ass'n v. Commissioner, 62 T.C.M. (CCH) *879 (1991).*

[116] *Id.* at *885.*

[117] CF Industries v. Commissioner, 62 T.C.M. (CCH) 1249 (1991).

[118] The court in Washington-Oregon Shippers Cooperative said it was "troubled by the rather long term involved" in 90-day T-bills, but didn't decide the case on that basis. 52 T.C.M. (CCH) 1406 (1987).

The U.S. Court of Appeals for the 7th Circuit modified the Tax Court opinion by discarding the length-of-maturity test.“’ The appellate court ruled all of CF's interest income was patronage sourced because ". ..the earnings on the money in the cash-management account are generated by the bona fide business dealings of the cooperative, as a producer and seller of fertilizers, with or on behalf of its member-customers. CF is not running a mutual fund for its members on the side."[120]

These cases suggest that determining whether interest income is patronage-sourced is a fact-intensive process. While the nature of the investment vehicle is not determinative, the longer its maturity the more closely a court is likely to look at the reason for the investment. Cooperatives seeking patronage-sourced status must show that the placement of the funds was directly related to their overall business operation, and not just a means of enhancing overall firm profitability.

Dividends

Dividends received on equity investments, like interest on loaned funds, fall within the general topic of income “from investment in securities” listed as an example of nonpatronage-sourced income in the regulation.[121] Once again, the courts have looked beyond the narrow confines of the regulatory examples and found dividend income is patronage-sourced when the equity position is acquired to facilitate the cooperative’s business purpose. As with interest income, the cooperative has the burden of showing the direct relationship between the investment activity and cooperative operations.

In *Lund O'Lakes, Inc. v. United States,*[122] a cooperative was required to purchase stock in a Bank for Cooperatives as a

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[119] **CF Industries v.** Commissioner, Nos. **92-1579 & 92-2046, slip op. (7th Cir. May** 26, 1993), *aff'g* **as** *modified,* **62** T.C.M. (CCH) 1249 (1991).

[120] *Id.* **at 7.**

[121] **Treas. Reg.** §1.1382-3(c)(2).

[122] **Land** O'Lakes, **Inc. v. United States, 67.5** F.2d **988 (8th Cir.** 1982), *aff'g in part, rev'g in part,* **470** F.Supp. **238 (D.** Minn. **1979).**

condition of borrowing funds from the bank. This is a common provision in the cooperative banking system, analogous to requirements for capital contributions of members to their marketing, supply, or service cooperative. While the cooperative could have obtained loans elsewhere, such loans would have been on less favorable terms.

IRS challenged the cooperative's attempt to treat the dividends received on the Bank for Cooperative's stock as patronage income. The court turned back the challenge, holding "because the transactions actually facilitated the cooperative's activities by providing financing on terms favorable to the cooperative, the income from the bank stock was from a patronage source...."[123]

Land O'Lakes[124] also discussed the cooperative's ownership of a chain of convenience stores that marketed both patron and nonpatron products at retail. The cooperative argued that all dividends received from the chain of stores was patronage-sourced income as all sales facilitated the movement of patron product. The court, however, required the cooperative to accept IRS's method of allocating dividends received between patronage and nonpatronage status because the cooperative could not prove that all the sales actually facilitated movement of patron products.

Stock dividends have also been held to be patronage-sourced income when holding the stock is a requirement for obtaining needed services. In *Linnton Plywood Association v. United States,*[125] *two* plywood worker cooperatives shared ownership of a glue factory. The cooperatives received dividends on capital stock in the factory. The court said glue is essential to the manufacture of plywood, and the cooperatives' arrangement to produce glue

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[123] *675* F.2d at 933. A similar situation was not challenged by IRS in M.F.A. Central Cooperative v. Bookwalter, 427 F.2d 1341 (8th Cir. 1970), *rev'g,* 286 F. Supp. 956 (E.D. Mo. 1968).

[124] Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), *aff'g in part, rev'g in part, 470* F.Supp. 238 (D. Minn. 1979).

[125] Linnton Plywood Association v. United States, 410 F.Supp. 1100 (D.C. Ore. 1976).

through a supplier which they owned "is reasonably related to the business done with or for its patrons."[126]

INCOME FROM SALE OF ASSETS

The final specific example of nonpatronage-sourced income given by the regulation is income from the "sale or exchange of capital assets."[127] The term "capital asset" is defined quite broadly in the Code to include all property held by a taxpayer not falling within 5 specific exceptions.[128]

Gain or loss from the sale of capital assets often requires recognition of how much the asset has depreciated at the time of sale or exchange. Some gain from sale or exchange of depreciable property may be a "recapture" of income not recognized during the life of the asset because of the depreciation methods used. If a cooperative has reduced its income by depreciation during the life of a depreciable asset, some income from sale or exchange of the capital asset may be ordinary income and some may be gain from sale or exchange of a capital asset.[129]

Revenue Ruling 74-84 concerned a sale in which the cooperative recognized both ordinary income under the recapture rules of I.R.C. section 1245 and gain on the sale of a capital asset under I.R.C. section 1231. The Service said:

> That portion of the gain from the sale of machinery treated as ordinary income under section 1245 of the Code is considered patronage sourced income because, in effect, the taxpayer is merely recapturing income that otherwise would have been available for distribution as

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[126] Id. at 1108.

[127] Treas. Reg. §1.1382-3(c)(2).

[128] I.R.C. § 1221. With certain limitations, the five exceptions listed in § 1221 are basically inventory, depreciable business property and real estate, intellectual property in the hands of the creator, accounts receivable, and government publications.

[129] I.R.C. § 1245.

> a patronage dividend. That portion of the gain treated under section 1231 as gain from the sale of a capital asset held for more than six months is considered income derived from sources other than patronage and, thus, does not give rise to a deduction to the cooperative when distributed to its patrons.[130]

In St. Louis *Bank for* Cooperatives *v. United States,*[131] the Court of Claims (Trial Division) determined the Service had misclassified an automobile used in business as a capital asset. It found the automobile fell under the exclusion for property used in a trade or business subject to depreciation under I.R.C. section 1221(2).[132] The judge refused the Service's request to mechanically apply the regulatory example to classify the gain as nonpatronage-sourced income. The judge, however, did find that the sale was an isolated transaction not integrally related to the supplying of credit, and on that basis held the gain was nonpatronage-sourced income.

A three-judge panel of the Court of Claims reversed the trial judge's finding. The panel observed that the automobile was used solely for bank business. Over the years it had been depreciated, and the depreciation expense had been treated as a patronage expense that offset patronage-sourced income and reduced patronage refunds paid to members. The gain on the sale was recapture of depreciation, pursuant to Code section 1245.

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[130] Rev. Rul. 74-84,1974-l C.B. 244,245.

[131] St. Louis Bank for Cooperatives v. United States, 1979-2 U.S.T.C. (CCH) ¶ 9576, at 88,098 (Ct. Cl. 1979).

[132] I.R.C. § 1221(2). Treas. Reg. § 1.1221-l(b) reads, in part, "Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term 'capital asset."'

I.R.C. § 167(a)(2) authorizes a depreciation deduction for wear and tear "of property used in the trade or business." Automobiles can be depreciated to the extent they are used for business, as opposed to personal, activities.

The panel noted the Service, in Revenue Ruling 74-84,[133] held depreciation recapture was patronage-sourced income when the cooperative was merely recapturing income that otherwise would have been available for distribution as a patronage refund. The panel found it "would be anomalous to treat the gain upon the sale of the automobile resulting from the recapture of excess depreciation as nonpatronage sourced when the depreciation itself was treated as patronage sourced."[134]

In *Lamesa Cooperative Gin v. Commissioner,* the Service conceded that recapture of depreciation on trailers, tractors, and manufacturing equipment was patronage-sourced income.[135]

Astoria Plywood Corp. v. United States involved a firm that converted from noncooperative to cooperative status. It was not able to use patronage income treatment for the recapture of depreciation taken before the business became a cooperative. The court said: "This income reflects the appreciation in value of the machines over the costs Astoria had already recovered through depreciation and is not directly related to the activities of the cooperative."[136]

Transactions not formally sales of property may be so treated under the Code in certain circumstances. For example, section 631(a) of the Code provides, in part, that the owner of standing timber may elect to treat the cutting of that timber as a sale or exchange of the timber.

In Revenue Ruling 71-439, a workers' cooperative was engaged in the manufacture and sale of wood products. The cooperative owned the standing timber that served as the raw material for its wood products business. When the cooperative made the election to treat the cutting of timber as a sale or

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[133] Rev. Rul. 74-84,1974-l C.B. 244.

[134] St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041, 1054 (Ct. Cl. 1980), 1980-2 U.S.T.C. (CCH) ¶ 9509, *rev'g in part, aff'g in part*, 1979-2 U.S.T.C. (CCH) ¶ 9576 (Ct. Cl. 1979).

[135] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894, 900 (1982).

[136] Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979).

exchange, it realized gain from the sale of a capital asset. The Service sanctioned patronage-sourced income treatment of that gain, saying:

> The gain recognized by the instant taxpayer pursuant to a section 631(a) election represents the unrealized appreciation in value of timber cut during the year which, in the absence of an election under section 631(a) of the Code, would have been reflected in the taxpayer's ordinary income from the sale of wood products and be included in amounts available for patronage dividend distribution. The election permits an earlier recognition at capital gains rates of an amount that ultimately may be realized by the taxpayer when the finished products of its timber is sold. The actual realization of the appreciation in value of the standing timber (when the finished product is sold) is brought about through the cooperative efforts of the members. Accordingly...it is held that the gain recognized by the taxpayer pursuant to an election under section 631(a) of the Code is income from a patronage source.[137]

A capital asset may also be created by tax law. An example is income received from cancellation of a lease. The Code provides that amounts received from cancellation of a lease shall be considered amounts received in exchange for the lease.[138] If the lease covers capital assets used in the cooperative's business, and the cooperative accepts a payment to cancel the lease, the income received is treated, for tax purposes, as income from the sale of a capital asset.[139]

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[137] Rev. Rul. 71-439, 1971-2 C.B. 321,322. Followed in Rev. Rul. 74-24,1974-l C.B. 244, and Stevenson Co-Ply, Inc. v. Commissioner, 76 T.C. 637 (1981).

[138] I.R.C. § 1241.

[139] The lease was property used in the trade or business under Treas. Reg. § 1.1231-1.

In Rev. Rul. 74-160, the Service ruled income from the cancellation of a lease on a veneer plant operated by a plywood workers' cooperative was nonpatronage-sourced income. The Service relied on the literal wording of the capital assets example provided in Treas. Reg. 1.1382-3(c)(2).[140]

A contrary conclusion was reached by the U.S. District Court in Oregon a few years later on identical facts. The court applied the "directly related" test and found the capital gain was patronage-sourced income "because it is directly related to its cooperative activities."[141]

In late 1987, the Service focused cooperative attention on the status of the sale of an asset with the issuance of a controversial ruling, Technical Advise Memorandum (TAM) 8815001.[142] This ruling concerned a cooperative that formed a subsidiary to operate as a major source of a raw material necessary for the cooperative to provide an important farm supply to its patrons. In a later year, the cooperative, faced with operating losses, sold all the stock in the subsidiary for a substantial gain. On its tax return, the cooperative treated the gain as patronage-sourced income and sought to offset operating losses on patronage operations against the gain.

The TAM also concerned losses suffered by the cooperative based on (1) the surrender of all of its stock in a corporation organized to make collective purchases of product in large volume and (2) the dissolution of a company involved in transporting product in which it held stock.

TAM 8815001 held the gain on the stock sale to be income from a nonpatronage source. The Service cited both Treas. Reg. § 1.1382-3(c)(2) and Revenue Ruling 69-576[143] and then ruled:

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[140] Rev. Rul. 74-160, 1974-1 C.B. 245, 246.

[141] Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979). The court had just stated "In my view, capital gains may be patronage sourced income. In each instance, it depends on whether the income is 'directly related' to [the cooperative's] activities." Id.

[142] Tech. Adv. Mem. 8815001 (Nov. 3, 1987).

[143] Rev. Rul. 69-576, 1969-2 C.B. 166.

> Under certain circumstances, income producing transactions included in the list of examples of nonpatronage source income (in the Treas. Reg.) may still be categorized as income derived from patronage sources by meeting the 'directly related' test (in the Rev. Rul.). However, Taxpayer sold its stock in Subsidiary in order to ease the financial burdens Subsidiary was imposing on Taxpayer. . . .Although Taxpayer may have made a sound business decision in selling Subsidiary's stock, the income resulting from this sale merely enhanced Taxpayer's profitability and therefore is not income derived from sources directly related to Taxpayer's cooperative functions.[144]

The Service also held, however, that the losses on stock in the other two companies were patronage-sourced as those activities were directly related to the cooperative's business operations.

The issue was complicated by a contemporaneous dispute between the business community as a whole and the Service over the status of the so-called "Corn Products" doctrine. In Corn Products Refining Co. *v. Commissioner*,[145] the Supreme Court held that assets not within the 5 exclusions to the section 1221 definition of "capital asset" were nonetheless to be treated as ordinary assets if they were acquired as an integral and necessary part of the taxpayer's business. As each of the three transactions discussed in TAM 8815001 concerned the disposition of stock acquired by the cooperative for a business purpose without any substantial investment motive, it would appear the stock was not a "capital asset" under Corn Products and thus arguably not covered by the example in Treas. Reg. § 1.1382-3(c)(2).

At the time TAM 8815001 was released, the Supreme Court had granted certiorari in *Arkansas* Best *v. Commissioner*,[146] which had rejected the business purpose test of Corn Products and taken

[144] Tech. Adv. Mem. 8815001 at 5 (Nov. 3, 1987).

[145] Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

[146] Arkansas Best v. Commissioner, 800 F.2d 215 (8th Cir. 1986), *cert. grunted* 480 U.S. 930 (1987).

a literal reading of Code section 1221 to require all capital stock to be treated as a capital asset. In early 1988, the Supreme Court affirmed the appellate court decision in *Arkansas Best*.[147]

In mid-1989, the Service reconsidered TAM 8815001. In TAM 8941001 the Service cited *Arkansas Best* as grounds to now consider all 3 of the stock dispositions by the cooperative to be sales or exchanges of capital assets.[148] The Service dismissed arguments by the cooperative that the "directly related" and "actually facilitates" standards called for patronage-sourced income treatment. Placing greater emphasis on Treas. Reg. § 1.1382-3(c)(2), the Service now determined both the gains and losses were from sources other than patronage.

The cooperative community responded to these rulings by developing draft legislation to permit cooperatives to elect ordinary patronage-sourced treatment for gain or loss from the sale or other disposition of any asset, provided the asset had been used to facilitate the conduct of business done with or for patrons.[149]

The Treasury Department expressed reservations about two aspects of the bills: (1) the elective factor that lets a cooperative choose patronage or nonpatronage income treatment of assets used to facilitate business with or for patrons, and (2) the retroactive application of the election.

Modified legislation was introduced in the 103rd Congress. The bills applied only to farmer cooperatives and made the election prospective only.[150] As of this writing, Congress has not passed this legislation. The cooperative involved in the TAM's is pursuing further administrative remedies with IRS and, if unsuccessful, may initiate litigation.

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[147] Arkansas Best v. Commissioner, 485 U.S. 212 (1988).

[148] Tech. Adv. Mem. 8941001 (June 14, 1989).

[149] In the 100th Congress, H.R. 4542 (May 5, 1988), and S. 2669 (July 29, 1988); in the 101st Congress, H.R. 2353 (May 16, 1989), and S. 1273 (June 23, 1989); and in the 102nd Congress, H.R. 2360 (May 15, 1991), and S. 1522 (July 22, 1991).

[150] H.R. 1931 (Apr. 29, 1993) and S. 545 (Mar. 10, 1993).

INCOME FROM OTHER EVENTS

Disputes have arisen over the patronage or nonpatronage status of income created from events not specifically mentioned in Treas. Reg. §1.1382-3(c)(2). Some of these situations are discussed in this section.

Change in Accounting Method

A change in accounting method may result in an adjustment to income in the year of change.[151] Revenue Ruling 79-45[152] describes a cooperative changing from the last-in, first-out inventory method to the first-in, first-out method, using lower of cost or market. The change resulted in a positive adjustment to income in the year of change.

Without further describing the cooperative's operation or the nature of the inventory, the Service said the adjustment resulted in patronage-sourced income. The Service reasoned that had the new method of inventory valuation been used in earlier years, patrons of those years would have been entitled to larger patronage refunds, reflecting the results of using the new valuation methods.

Section 1382(f) was applied to the income, so that the patronage to which the income related was considered to have occurred in the year of adjustment. The cooperative requested, and was granted, permission to allocate the earnings to patrons of the prior years.[153]

CCC Storage Fees

Under certain price support programs administered by the USDA Commodity Credit Corporation (CCC), loans are made to producers with the producer's crop serving as collateral for the

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[151] See I.R.C. § 481.

[152] Rev. Rul. 79-45,1979-l C.B. 284.

[153] For further discussion of I.R.C. § 1382(f), see the section of chapter 4 titled "Year Patronage Occurred."

loan. The producer has the option, for a specified period, to repay the loan and reclaim the crop. If the producer does not exercise the option, the producer "defaults" on the loan. The producer keeps the loaned funds, and CCC takes title to the crop.

Cooperatives frequently store crops under CCC programs, both for the farmer before default and for CCC after default. Under the programs, CCC customarily pays the storage fees to the cooperative from the time the crop enters the program until it is either reclaimed, or default occurs and CCC subsequently moves or disposes of the crop. While the farmer holds title to the crop, the storage fees are deducted from the loan proceeds.

In the 1950's, some cooperatives were claiming that all CCC payments derived from handling and storing grain produced by patrons were patronage-sourced income. IRS agents were disallowing attempts to deduct patronage refunds to the extent they were based on earnings from storage that occurred after the producer defaulted on the loan and title to the grain was transferred to CCC.

The U.S. Tax Court sided with the Service. In Pomeroy Cooperative Grain Co. *v. Commissioner*,[154] the court classified Government storage payments to a cooperative as patronage- or nonpatronage-sourced income depending on whether the grower still owned the grain. Before loan default, the farmer patron held title to the grain, and storage income received by the cooperative was characterized as patronage-sourced. After default, ownership resided in the CCC, and storage income was nonpatronage sourced.

IRS adopted the ownership test in Rev. Rul. 59-107.[155] The validity of the standard was upheld in *Juniata Farmers Cooperative v. Commissioner*.[156]

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[154] Pomeroy Cooperative Grain Co. v. Commissioner, 31 T.C. 674 (1958), *rev'd in part, aff'd in part*, 288 F.2d 326 (8th Cir. 1961); See also, Minbum Cooperative Elevator v. Commissioner, 18 T.C.M. (CCH) 93 (1959).

[155] Rev. Rul. 59-107,1959-l C.B. 20.

[156] 43 T.C. 836 (1965), *acq.*, 1966-1 C.B. 2.

Revenue Ruling 70-25[157] described cooperative income received from CCC for crop storage under a "reseal" program. Under the reseal program, farmers obtained a CCC price support loan by pledging the crop and storing it with a cooperative during the period of the loan. The program provided for an automatic extension of the loan for 12 months if the farmer did not satisfy the obligation by the original maturity date.

Under the program, CCC is solely liable for handling and storage charges for the 12 month extended period even though title to the grain remains with the farmer-producer. Revenue Ruling 70-25 held that the handling and storage charges paid to the cooperative association under the reseal program by CCC, for which CCC is solely liable, is income to the cooperative association derived from business done with or for the United States or any of its agencies and is income derived from nonpatronage sources.

The status of storage payments before default under a reseal program was reviewed by a Federal District Court in *Caldwell Sugars Co-up Inc. v. United States.*[158] *The* court discussed Rev. Rul. 59-107 and Rev. Rul. 70-25 and concluded Rev. Rul. 70-25 was illogical and incorrect. The court viewed the extension of time to redeem the crop under the reseal aspect of the program as irrelevant. The true test was ownership of the crop. The court stated, ". ..(I)f the property stored belongs to the farmer, the income derived from such storage is income derived from that farmer, and therefore patronage income. Where the property stored is the property of the Government, then the income yielded by such storage is income yielded from doing business with the Government" and nonpatronage sourced.[159]

Shortly thereafter IRS issued Revenue Ruling 89-97.[160] While this ruling did not mention *Caldwell Sugars,* it adopted the holding of the case and revoked Revenue Ruling 70-25.

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[157] Rev. Rul. 70-25,1970-l C.B. 17.

[158] Caldwell Sugars Co-op Inc. v. United States, 692 F.Supp. 659 (E.D. La. 1988), 88-2 U.S.T.C. (CCH) ¶ 9509.

[159] 692 F.Suppat662.

[160] Rev. Rul. 89-97, 1989-2 C.B. 217.

Judicial Settlements

In two private letter rulings concerning amounts received as settlements from a lawsuit filed under Federal antitrust laws, IRS has taken a middle-of-the-road position toward the tax status of the money received. In the first,[161] the cooperative was permitted to treat the portion of the amount received that covered actual damages claimed as patronage-sourced. Money received in excess of the amount actually claimed was classified as nonpatronage-sourced income.

In the second,[162] the cooperative was granted patronage income treatment of the compensatory damages paid as part of the settlement of the case, but had to treat interest paid as part of the settlement as nonpatronage income.

In a Tax Court case, income from a judgment against a party who wrongfully removed the cooperative's property was not patronage-sourced income when the event took place before the organization was a cooperative.[163]

Partnership Earnings

In Private Letter Ruling 9033006,[164] a farm supply cooperative owned a plant that processed a raw material into a valuable agricultural input, which the cooperative then sold to its patrons. The cooperative proposed entering into a partnership with a non-cooperative corporation with a reliable supply of the raw product.

Under the partnership agreement, the cooperative would sell an interest in the plant to the corporation. The partnership would acquire substantially all its raw material from the corporation and sell substantially all the processed product to the cooperative. The cooperative would then resell substantially all of the input to its patrons.

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[161] Priv. Ltr. Rul. (EIN 75-0235810), Mar. 8, 1976.

[162] Priv. Ltr. Rul. 8340012 (June 24, 1983).

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

[164] Priv. Ltr. Rul. 9033006 (May 14, 1990).

The Service ruled that any income arising from product sales to patrons was patronage-sourced, whether received individually by the cooperative, or in its capacity as a partner. IRS observed:

> In this situation, Coop is buying the (processed input) from a supplier that it partially owns: the partnership. When Coop sells this product to its patrons, those sales are "with' its patrons within the meaning of section 1388(a) of the Code. Accordingly, any net margin from these sales that is returned to the patrons is eligible for the patronage dividend deduction because the Coop is, in essence, rebating to the patron a portion of the cost of goods purchased. Similarly, when Coop receives its distributive share of partnership operating income, the portion of that income that is attributable to Coop's sales to its patrons is akin to a rebate of the cost of the (input) purchased by Coop for resale to its patrons and, when ultimately returned to the patrons, is a rebate of the cost of their purchases of the (input).[165]

DISC Earnings

Revenue Ruling 75-228[166] concerned a fruit processing and marketing cooperative. The cooperative organized a wholly owned Domestic International Sales Corporation (DISC) to handle its export sales. The cooperative paid a commission to the DISC for its sales, and received back a distribution of any earnings realized by the DISC. Neither the cooperative nor the DISC handled fruit for nonmembers of the cooperative.

The Service held the distribution from the DISC to the cooperative was patronage-sourced income because it was produced by a transaction directly related to marketing patrons' products.

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[165] **Id. at 4.**

[166] **Rev. Rul. 75-228,1975-l C.B. 278.**

CHAPTER 6
OTHER PATRONAGE REFUNDS ISSUES

Many situations pose special problems in determining the proper accounting and tax treatment of cooperative financial results. This chapter discusses common occurrences that require careful analysis in the patronage refund area.

SIMULTANEOUS PATRONAGE AND NONPATRONAGE OPERATIONS

Income that a cooperative generates in providing marketing, supplies, or services may not be entirely attributable to patronage income if the cooperative conducts that business with or for persons who aren't patrons of the cooperative.

While "patron" is not defined in the Code, it is defined in the regulations as "any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association."[167]

Thus, any time a cooperative conducts business with someone on a noncooperative basis, that activity is nonpatronage business and the resulting earnings are not eligible for tax treatment as patronage refunds.

It is common for cooperatives to provide like services to members and nonmembers, but only make patronage refund distributions to members. Cooperatives that conduct both patronage and nonpatronage business must be diligent in separating patronage and nonpatronage earnings.

For example, in Revenue Ruling 74-160 the Service ruled interest income from loans made to a supplier, under

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[167] Treas. Reg. § 1.1388-1(e).

circumstances permitting it to be classified as patronage-sourced income, cannot be allocated solely as patronage-sourced net margins if part of that income is attributable to business with nonmembers on a nonpatronage basis. The Service said:

> . ..to the extent such income is allocable to the member patrons on the basis of business done with or for those patrons, the income is patronage sourced income that may be distributed as patronage dividends. However, to the extent the interest income is allocable to nonmember business it constitutes nonpatronage sourced income that must be taken into account in computing the Federal income tax of taxpayer (cooperative).[168]

In Caldwell Sugars Co-op Inc. v. United States,[169] the association did 87.555 percent of its business with member patrons and the remainder with nonpatrons. The cooperative was entitled to claim 87.555 percent of its income as patronage-sourced.

A cooperative may not make spurious adjustments to its usual method for calculating patronage- and nonpatronage-sourced income, especially when it shifts business from nonpatronage to patronage sources. A workers' cooperative that distributed net margins only to members was not permitted to arbitrarily multiply hours worked by members by 40 percent. The result was "to distribute to the member workers income of the [cooperative] that is attributable in part to net earnings from the efforts of the nonmember workers."[170]

The cooperative's membership may decide not to conduct some or all of its business with the cooperative on a patronage basis. Access to the patronage refund deduction is an option, not a mandatory step for associations otherwise operating on a cooperative basis. The earnings from nonpatronage business are

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[168] **Rev. Rul. 74-160,1974-l C.B. 245,246.**

[169] **Caldwell Sugars Co-op Inc. v. United States, 692 F.Supp. 659 (E.D. La. 1988), 88-2 U.S.T.C. (CCH) ¶ 9509.**

[170] **Rev. Rul. 74-20,1974-l C.B. 242,243.**

taxed at the corporate level. If the earnings are distributed at a later date, they are subject to a second income tax at the recipient level.

Individual members also may choose to "waive" their patronage refund. The cooperative "will not be dealing with these producers on a patronage basis, [and] the net earnings from these transactions will not be available for distribution as patronage dividends but must be included in [the cooperative's] taxable income."[171]

MULTIPLE SERVICE COOPERATIVES

Cooperatives can face complicated allocation decisions when providing more than one service to patrons. Differences in services range from those that are essentially integral parts of the same service, such as storage in a grain marketing operation,[172] to services that are quite distinct, as in the case of a cooperative that markets farmers' commodities and purchases supplies for farm production input.[173] In some instances, the same set of services is provided to essentially the same group of patrons. In others, the cooperative may deal with different, although somewhat overlapping, sets of patrons.

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[171] Priv. Ltr. Rul. 8104118 (Oct. 30, 1980).

[172] See, e.g., Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), 1961-l U.S.T.C. (CCH) ¶ 9316, *rev'g in part, aff'g in part,* 31 T.C. 674 (1958) (handling, storage, conditioning grain by a grain marketing cooperative); Priv. Ltr. Rul. 7729062 (no date, 1977) (fertilizer supply cooperative dividing its operation into nitrogen products and mixed products); Priv. Ltr. Rul. 7819019 (Feb. 7, 1978) (two types of marketing arrangements for the same commodity); and Priv. Ltr. Rul. 8531002 (Feb. 28, 1985) (different kinds of supplies).

[173] See, e.g., Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400; Juniata Farmers Cooperative v. Commissioner, 43 T.C. 836 (1965), *acq.,* 1966-1 C.B. 1; and Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), 1961-l U.S.T.C. (CCH) ¶ 9316, *rev'g in part, aff'g in part,* 31 T.C. 674 (1958).

Several factors make allocation decisions in multiple service cooperatives challenging. The cooperative may deal with one group of patrons with respect to one service, and a different group with respect to another service. Net margins attributable to each service will usually differ. Patrons of one service may use the cooperative to a different degree than patrons using another service.

Multiple service cooperatives have two basic options in allocating margins, although numerous modifications are used. First, a cooperative may combine the financial results of all operations to determine net margins available for distribution. These margins are then allocated to patrons based on business done with the cooperative without regard to which services were used by each patron.

On the other hand, the cooperative can segregate its services and calculate net margins separately, assigning gross income and expenses almost as if a different cooperative provided each service. Net margins are then allocated to patrons of each unit in proportion to business done with each unit.

It is probable that the two allocation methods will yield a different patronage refund for a patron doing the same amount of business with the cooperative.

Except for a technical amendment covering the netting of earnings and losses among allocation units,[174] the Code doesn't specifically address multiple service cooperatives and their methods of calculating and allocating net margins.

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[174] The Consolidated Omnibus Budget Reconciliation Act of 1985 added a new Subsection (j) to Section 1388 of the Code. Cooperatives are given the option to offset patronage losses attributable to one or more allocation units (whether such units are functional, divisional, departmental, geographic, or otherwise) against patronage earnings in one or more other allocation units. Pub. L. 99-272, § 13210,100 Stat. 82 (1985).

EQUITABLE ALLOCATION AMONG PATRON GROUPS

Code section 1388(a), in defining "patronage dividend (refund)," provides the term "does not include any amount paid to a patron to the extent that...(B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."

This language had been implemented through an "equitable allocation" concept, suggesting patronage refunds be equitably distributed among the patrons who have transacted business with the cooperative. Courts that have discussed equitable allocation have approved the concept in principle, but have not accepted it as a precise accounting requirement limiting the flexibility of cooperatives and their user-owners to agree on various methods of allocation among groups.

In *Pomeroy Cooperative Grain Company v. Commissioner*, decided just before subchapter T adoption, the Eighth Circuit Court of Appeals addressed an "equitable allocation" argument involving a grain marketing cooperative that also generated income from storing members' grain.[175] IRS argued that allocating grain storage income to grain marketing patrons in proportion to their grain marketing activities violated the equitable allocation principle.

The court said, there "is some doubt whether the Commissioner has sufficient standing to object to the taxpayer's method of allocating what would normally be income excludable to the taxpayer among its member-patrons in a manner apparently acceptable to such members as an equitable distribution of profits."[176]

After discussing the close connection between marketing and storage activities, the court rejected IRS's argument that allocating

[175] 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).**

[176] **288 F.2d** at **332.**

the net margins from the two activities to one allocation unit was inequitable. The court asserted:

> ...from a revenue standpoint, the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members. As stated in the Birmingham case..."the crucial question involved in determining the taxability of patronage dividends is whether they constitute income to the cooperative, or to the patron, or to both."[177]

In *Lamesa Cooperative Gin v. Commissioner,*[178] the cooperative primarily performed marketing services for its patrons but also purchased small quantities of farm supplies that it resold to patrons approximately at cost. The cooperative based its allocation of patronage refunds solely on the patronage of its marketing operation. The Tax Court approved the cooperative's policy of combining the financial results of these distinct activities and making a single distribution based only on marketing patronage, noting that neither the operation-at-cost principle nor the concept of equitable allocation required any particular accounting method.

Recent decisions have addressed the equitable allocation issue when one or more units within a cooperative suffer a loss. While handling of losses will be the subject of a separate chapter, a brief discussion of the issue is presented here.

Treatment of losses by multiple service cooperatives can present a difficult situation, especially where different groups of

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[177] 288 F.2d at 333 (quoting Farmers Cooperative v. Birmingham, 86 F. Supp. 201,213 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400). The District Court did suggest that the equitable allocation principle required that marketing and supply margins should be kept separate. 31 T.C. 674,686 (1958). Upon review, the Eighth Circuit Court of Appeals said, "it is not entirely clear just what standards the Tax Court intended to apply by [this] requirement." 288 F.2d at 329 (8th Cir. 1961).

[178] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

patrons use distinct services of the cooperative that generate vastly different financial results. The Service has argued that combining such divergent results is inequitable.

Courts have not interpreted the equitable allocation rule as strictly prohibiting such combination of margins and losses among different groups of patrons. In *Ford-Iroquois FS, Inc. v. Commissioner,*[179] the cooperative carried operating losses on supply and grain marketing functions forward to offset earnings on supply operations in a later year, pursuant to Code section 172. The method of handling losses did not impose losses directly on patrons of the loss units in proportion to their business done with the cooperative.

IRS argued that the operation at cost and equitable allocation concepts required the losses be charged to the patrons whose business produced the losses. The court disagreed with IRS, and permitted the cooperative's method of carrying the losses forward and assigning them to different functions and patrons. The court referred to the substantial overlap in members using both supply and marketing functions and the fact that members found the allocation to be acceptable to support its decision.

In a 1985 private letter ruling, IRS put forward some specific criteria for the equitable allocation of cooperative losses:

> Whether a cooperative is allocating its losses (i.e. costs) in an equitable manner is a question of fact to be answered according to the circumstances of each case. In this regard we believe that there is evidence of inequity in the netting of losses attributable to one group of patrons with the gains of another group when they deal in wholly different commodities, are geographically separated, and have no knowledge that risk sharing to this degree is taking place.
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> On the other hand, there is evidence of equity in the netting of losses between groups of patrons when the patrons of one department are often the patrons of others, the commodities involved are similar,

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

> geographical separation is limited, and the various patrons of the department are adequately informed of the risk sharing arrangement before the loss transaction occurs.[180]

One factor frequently mentioned in equitable allocation decisions, at least in recent ones, is the role members play in deciding what is "equitable." The courts have given great weight to the members choosing, as owners and users, the method for distributing benefits and risks of cooperative operations.[181]

Cooperatives consider a number of factors when determining how the activities within the organization are to be divided for accounting, financial analysis, and allocation purposes.

Management practices may suggest that units be divided into relatively narrow activities so that performance can be monitored. On the other hand, the difficulties of accounting separately for many closely related activities, especially if allocation decisions will be tied to them, may push the leadership toward bundling the results of different activities. Member views on the degree that they want to share the risks with users of other services are also an important consideration.

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[180] Priv. Ltr. Rul. 8521003 (Jan. 25, 1985). This ruling described an interesting fact situation and applied several rather strict rules to the situation in addition to the equitable allocation principle. In response to this ruling, legislation was enacted permitting cooperatives to net margins and losses among units. The Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, § 13210,100 Stat. 82 (1985).

[181] Examples include Juniata Farmers Cooperative v. Commissioner, 43 T.C. 836,841 (1965), *acq.,* 1966-1 C.B. 1 (The cooperative's "method of allocation is a fair and equitable one, fully acceptable to its patrons."); and Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213, 1222 (1980) (With respect to losses carried forward to a new set of patrons, "the allocation of losses among a cooperative's past, continuing and future members is properly the concern of the membership and the board of directors"), quoted with approval in Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894,905 (1982).

Matching Patronage and Allocation - Tracing

A cooperative may receive income in a year subsequent to the year in which the patronage activity occurred that generated the income. Code section 1382(f) applies to this situation. This provision states:

> If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then...the patronage (income) shall, to the extent provided in the regulations.. ., be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income.

The applicable regulation, after restating the Code provision, adds: "Thus, if the cooperative organization pays these earnings out as patronage dividends during the payment period for the taxable year for which the earnings are includible in its gross income, it will be allowed a deduction for such payments under section 1382(b)(1)...."[182]

For some time, both the Service and cooperatives generally interpreted this language to mean income realized in one year from a prior year's patronage was allocable to patrons of the year of receipt on the basis of business done during the year of receipt.[183]

In Revenue Ruling 79-45,[184] the Service shifted its position. A change in a cooperative's inventory accounting method caused a positive adjustment in the cooperative's income in the year of change. The cooperative requested, and was granted, permission to allocate the gain to patrons of the cooperative during the 3 years in which the old inventory accounting method was used,

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[182] Treas. Reg. § 1.1382-6.

[183] See Rev. Rul. 69-576, 1969-2 C.B. 166; Rev. Rul. 70-249, 1970-l C.B. 181.

[184] Rev. Rul. 79-45,1979-l C.B. 284.

the patrons whose business with the cooperative resulted in the adjustment.

The Service went on to state that not only was the cooperative permitted to distribute the gain to patrons of the years it was earned, the cooperative was required to do so. IRS said:

> The payment of a patronage dividend that is based on income subject to the treatment of section 1382(f) of the Code necessitates a tracing of the allocation of this income to patrons that may no longer be members of the cooperative because it was their business with the cooperative that resulted in this income. In situations where that income is related to business done with patrons over an extensive period of time, the payment of a patronage dividend with respect to this income should be made in proportion, in so far as practicable, to the amount of business done by or for such patrons during the period to which such income is attributable.[185]

Following Revenue Ruling 79-45, the Service denied patronage refund treatment to a local cooperative that distributed a refund from a federated cooperative to its patrons of the year of receipt rather than to patrons of the year the underlying business transactions occurred.[186]

Farmer cooperatives were greatly distressed over this ruling. Local cooperatives that were member patrons of federated supply and marketing associations faced an extreme administrative burden if required to trace and allocate every refund from the federated cooperatives back to the specific members' business that generated those margins. And in the early 1980's, IRS auditors began challenging the tax returns of numerous local cooperatives over the tracing issue. Shortly thereafter, however, two court decisions checked IRS's efforts in enforcing stringent tracing requirements.

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[185] 1979-1 C.B. at 285.

[186] Tech. Adv. Mem. 8023023 (Feb. 28, 1980).

Lamesa Cooperative Gin *v. Commissioner*[187] concerned a cooperative that sold equipment in 1974 on which it had deducted depreciation in prior years. All the gain from the sale of the equipment was reported on Lamesa's 1974 tax return as ordinary income under Code section 1245. In determining the amount to be paid as patronage refunds, the cooperative allocated all this gain to its patrons during the 1974 taxable year in proportion to their patronage during that year.

IRS denied the patronage refund deduction, asserting that the concepts of operation at cost and equitable allocation required the cooperative to allocate the gain in proportion to patronage that occurred during the years in which the equipment was depreciated.

The Tax Court in *Lamesa* disagreed with the Service and upheld the cooperative's allocation to current year patrons only, thus entitling the cooperative to deduct the entire amount of the gain. The court reasoned as follows:

> The requirement of 'equitable allocation' should not be seen as a strict accounting requirement but only as a general principle to prevent inequitable treatment to some patrons at the expense of others. As a principle of equity, the overall scheme of allocation should be examined, including the practicalities of making allocations, the democratic nature of cooperatives, and the extent of patronage to the cooperative by nonmembers who have no say over how patronage dividends are distributed.[188]

The Tax Court dealt with the applicability of tracing to federated cooperatives in *Kingfisher Cooperative Elevator Association v. Commissioner*.[189] Kingfisher, a local cooperative, belonged to

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[187] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

[188] 78 T.C. at 903.

[189] Kingfisher Cooperative Elevator Association v. Commissioner, 84 T.C. 600 (1985). A federated cooperative is a cooperative whose members are other, usually local cooperatives. This is distinguished

four federated marketing, supply, and finance cooperatives. Kingfisher included patronage refunds received from the federated cooperatives in its gross income in the year of receipt. In computing its patronage refunds for its member-patrons, Kingfisher allocated net income to its patrons according to their patronage during that year. Prior year's patronage activities were not taken into account. Kingfisher's allocation was adopted by its board of directors and ratified annually by its members.

The Tax Court, following *Lamesa Cooperative Gin,* held that Kingfisher's allocation method was equitable. The court was impressed by the stability of Kingfisher's membership, the practical difficulties of tracing the allocations, and the approval of the method by its members.

The tracing issue has not been raised in IRS audits of cooperatives since the decisions in *Lamesa* and *Kingfisher.*

Unequal Allocations

The Code states a patronage refund cannot include any amount paid "out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."[190]

Situations exist, however, in which a cooperative may have legitimate reasons to treat patrons who appear to be dealing with the cooperative on a "substantially identical" manner differently. If the cooperative does treat them differently, it has the burden of proving it falls within the scope of the equitable allocation rule.

Some characteristics of a transaction between cooperative and patron may distinguish one patron's dealing with the cooperative from another patron. For example, the product delivered may be subject to variation in quality, justifying differential treatment in calculating and returning patronage refunds. An example is a bonus program giving higher returns in the form of premium

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from a centralized cooperative, wherein individual producers are the direct members.

[190] I.R.C. § 1388(a) and Treas. Reg. § 1.1388-1(a)(2)(ii).

payments to producers who deliver higher quality milk to a milk marketing cooperative.[191]

A marketing cooperative may use its members' product in different ways, and treat patrons according to the use made of the product. For example, a grain marketing cooperative sold debentures to members to finance a feed manufacturing facility. The debentures carried rights to deliver grain to the feed plant. The cooperative was permitted to calculate and allocate margins on grain delivered to the feed mill differently than grain delivered and sold under the regular grain marketing program.[192]

The Service has permitted variations in patron treatment if based on market factors prevailing when product is delivered to or sold by the cooperative. Revenue Ruling 66-98 described a cooperative formed by department stores to purchase their accounts receivable. The discount charged was based on current market discount rates that varied during the year. The ruling held cooperative operation of a finance corporation did not require it to purchase accounts receivable "on a basis different from that on which such receivables would customarily be acquired by a comparable commercial institution."[193]

Small allocations can cause considerable bookkeeping expense. In response, the Service has permitted cooperatives to eliminate small allocations, technically resulting in inequitable treatment.[194] Likewise, a cooperative with a very small patronage

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[191] Rev. Rul. 75-110,1975-l C.B. 167, relating to qualification for § 521; see also Rev. Rul. 66-98, 1966-1 C.B. 200 in which a cooperative formed by department stores to purchase accounts receivable required different "hold backs" for losses based on past loss record.

[192] Rev. Rul. 74-567, 1974-2 C.B. 174.

[193] Rev. Rul. 66-98,1966-l C.B. 200, 201-202.

[194] Rev. Rul. 55-141,1955-l C.B. 337. Allocations of less than $1 and all cents in excess of whole dollar amounts were set aside in a fund to defray recordkeeping expenses. See *also* Priv. Ltr. Rul. 9049026 (Sept. 10, 1990) (nondistribution of patronage refund below unspecified de minimis level approved).

sideline function may allocate margins earned from the function on the basis of its primary patronage business.[195]

Section 1388(a) and the requirement that patrons be treated equally with respect to substantially identical transactions have caused problems for cooperatives with farm owners as members that also market the production of the tenants of the members. In *Smith & Wiggins Gin, Inc. v. Commissioner*,[196] the cooperative ginned cotton delivered by both members and tenants of members. When the patronage refunds of the members were computed, each member was credited not only with the cotton which the member grew and brought to the gin but also with that of the member's tenants. The refund was made to the member and not to the tenants. The court denied patronage refund deductions for the amounts based on cotton delivered by the tenants. The court reasoned the tenants, not the member/landlords, were the proper "patrons" for such distributions.

A similar result was reached in *Iberia Sugar Cooperative, Inc. v. United States*.[197] In this case the cooperative contended that because its bylaws and marketing agreements with members required members to deliver all of the crop, including the nonmember tenants' shares of the crop, the business was transacted only with members. The court disagreed stating patronage refunds, to be deductible, cannot be paid out of earnings based on the production of nonmembers to whom no amounts are paid with respect to substantially identical transactions. The court held refunds paid to members based on product grown by tenants were out of nonpatronage income.

[195] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894, 907-910.

[196] Smith & Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341 (5th Cir. 1965).

[197] Iberia Sugar Cooperative, Inc. v. United States, 480 F.2d 548 (5th Cir. 1973), 1973-1 U.S.T.C. (CCH) ¶ 9465, *aff'g*, 360 F. Supp. 967 (W.D. La. 1972).

USE OF THIRD-PARTY AGENTS

Another interesting line of cases involves the tax status of payments to member-patrons who have assigned their right to do business with the cooperative to third parties.

In *Mississippi Valley Portland Cement Co. v. United States,*[198] a small group of investors formed an alleged cooperative to manufacture cement. The investors purchased stock in the cooperative, which gave them rights to purchase quantities of cement from the cooperative. These rights were assigned to a common sales agent that resold the cement to the general public. Earnings of the manufacturer were returned to its members on the basis of stock ownership. The association claimed a patronage refund deduction on its income tax return.

The court found the distributions were not made out of earnings from "business with or for patrons" and therefore not excludable from the corporation's taxable income. The court cited two factors as particularly important. First, the record showed the business was operated "not to supply its shareholders with cement at a reduced cost but to supply them with a return on their invested capital."[199]

Second, the owners lacked the common business interest of true member-patrons of a real manufacturing cooperative.

In *Lund O'Lakes, Inc. v. United States,*[200] the cooperative, in an "agent-buyer" arrangement, sold supplies to independent companies, which resold the supplies to farmer members of the cooperative. The agents entered into contracts with the cooperative under which the patronage refunds, normally payable to the agents, were paid directly to the farmer-customers of the agents.

[198] Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827 (5th Cir. 1969), cert. *denied*, 395 U.S. 944 (1969), *aff'g* 280 F. Supp. 393 (S.D. Miss. 1967).

[199] 408 F.2d at 834.

[200] Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), *aff'g* in part, *rev'g in part,* 470 F. Supp. 238 (D. Minn. 1979).

The court noted that the Land O'Lakes bylaws created the necessary preexisting obligation to make patronage refunds to the members, and the members had consented to include the refunds in their taxable income. The court acknowledged that an argument could be made that the agents, not the farmers, were the patrons of Land O'Lakes. The court observed, however, that the Code section 1388(c)(l)(B) definition of a qualified written notice of allocation provides for consent from the "distributee." The court held "distributee" has a broader meaning than "patron," encompassing the members of Land O'Lakes. Since the members would recognize the tax obligation, the refunds paid to the farmer-customers under the agent-buyer agreements were properly deductible by Land O'Lakes as patronage refunds.

In *Mississippi Chemical Corp. v. Commissioner,*[201] several members of a fertilizer manufacturing cooperative formed a separate corporation to buy and sell fertilizer. The corporation also became a member of the cooperative.

The corporation assigned its rights to buy fertilizer from the cooperative to third parties, two of whom were members of the cooperative and one who was a nonmember. The assignees agreed to assign back to the corporation any patronage refunds they might receive as a result of the purchases from the cooperative.

The cooperative, which paid patronage refunds only to members, distributed earnings on all sales under the assignments to the corporation pursuant to its status as a member of the cooperative.

The court held that when the corporation's right to purchase fertilizer was assigned to another member of the cooperative, the distribution paid to the corporation qualified as a patronage refund.

But when the right to purchase fertilizer was assigned to a nonmember, the cooperative could not deduct the payment as a patronage refund. And the payments could not be deducted as an agreed-upon refund of purchase price either.

[201] Mississippi Chemical Corp. v. Commissioner, 86 T.C. 627 (1986).

The court also noted that, after the tax year in question, the cooperative amended its bylaws to permit payment of patronage refunds to nonshareholders. This suggests the court would have permitted deductibility of all distributions to the corporation, had all the assignees been patrons of the cooperative. This, in turn, highlights the important distinction between a member and a patron for tax purposes.

EXPENSES

Two factors jointly determine net margins-gross income and business expenses, including dividends and taxes. Patronage refunds are based on the net earnings of the cooperative, computed only after taking expenses into account.[202]

There are no special rules on computing total expenses for cooperatives. Cooperatives are entitled to the same operating expense deductions as noncooperative firms in similar lines of business.

But special situations do arise for cooperatives in allocating expenses to different classifications of business activity. Cooperatives that calculate net margins for separate units within the cooperative must allocate expenses to the appropriate units to determine net margins for each unit.

Cooperatives with patronage and nonpatronage income must also allocate expenses between the business activities generating the two classifications of income so that patronage-sourced earnings can be computed for distribution as deductible patronage refunds. As stated by the Tax Court:

> . ..expenses must be assigned to the type of income to which they apply and may not be arbitrarily assigned to reduce one type of income or the other.
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> The first step in determining whether an item of expense is nonpatronage sourced is to establish how the expense arises. If the expense is incurred with respect to

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[202] Treas. Reg. §1.1388-1(a)(1)(iii), and the explanation below subsection (iii).

business done with or for patrons, it is patronage sourced.[203]

The rule is applied in the same way as the rules for determining if income is from patronage or nonpatronage sources. For example, interest expenses paid to patrons for their deposits in the cooperative are patronage-sourced expenses, as is interest on commercial borrowing done as a necessary part of the cooperative's business with or for its patrons.[204]

The Service has held that administrative expenses and interest costs associated with collection of late payment fees from patrons are patronage-sourced expenses and can be offset against income from patronage sources "in accordance with generally acceptable accounting principles."[205]

IRS has also permitted a marketing cooperative to treat payments made to settle a private civil antitrust lawsuit as patronage-sourced expenses for purposes of determining net patronage earnings available for allocation as patronage refunds.[206]

But interest expenses associated with borrowings a cooperative makes to redeem per-unit retain certificates early, at less than face value, have been characterized as nonpatronage expenses by IRS. The Service considers the income generated from redemption at less than face value to be nonpatronage-sourced; thus any expenses arising from that activity are likewise nonpatronage in nature.[207]

As a general rule, cooperatives may not use patronage-sourced expenses to reduce income from nonpatronage sources.

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203 Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238,246 (1987).

204 88 T.C. 238. Patron grocery stores purchased from a wholesale food supply cooperative. The patrons were required to maintain cash deposit balances with the cooperative in proportion to the amount of purchases made from the cooperative.

205 Priv. Ltr. Rul. 8531002 at 6 (Feb. 28, 1985).

206 Priv. Ltr. Rul. 9238010 (June 16, 1992).

207 Priv. Ltr. Rul. 8033070 (May 22, 1980).

The cooperative in Certified *Grocers of California, Ltd. v. Commissioner* argued its surplus funds, which it used to earn interest from bank instruments, could have been utilized to reduce its debt used to finance operations that generated patronage-sourced income. This would have reduced interest expense properly allocated to patronage operations. Therefore, the cooperative asserted it should be allowed to set off interest expenses incurred on patronage operations against interest income earned on the bank instruments.

The Tax Court found the argument:

> . . .entirely speculative and unconvincing. There is nothing in this record to show to what extent, if any, [the cooperative] could have used the excess cash which it temporarily had in its hands, from time to time, for the reduction of other indebtedness on which it was obligated, consistent with maintaining the liquidity necessary for the operation of its business. In any event, it was not done. [The cooperative] chose the manner in which it operated its business, and it must abide the tax results flowing from those choices.[208]

Subchapter T prohibits the payment of patronage refunds out of income from nonpatronage sources.[209] Reducing nonpatronage-sourced income by patronage-sourced expenses would evade this principle by increasing net margins available for distribution as patronage refunds under the single tax rule for patronage refunds. This would then decrease the nonpatronage-sourced income otherwise fully taxable at the cooperative level, at least for nonsection 521 cooperatives.[210]

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[208] Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238,247 (1987).

[209] I.R.C. §§ 1382(b) and 1388(a).

[210] This result is noted in Des Moines County Farm Service Co. v. United States, 448 F.2d 776 (8th Cir. 1971), 1971-2 U.S.T.C. (CCH) ¶ 9665, *aff'g,* 324 F. Supp. 1216 (S.D. Iowa), 1971-l U.S.T.C. (CCH) $9200; Farm Service Cooperative v. Commissioner, 619 F.2d 718 (8th Cir. 1980),

A cooperative that operates on a patronage basis with respect to members and on a nonpatronage basis with respect to nonmembers may find some expenses should be assigned to only one group or the other. For instance, a State may impose an income tax on the net margins derived from nonmember, nonpatronage business but not on net margins from the patronage business if returned to members on a patronage basis. In such a case, earnings from business done with members must be segregated from nonmember business earnings. The income tax is then assessed only against nonmember earnings. Member earnings distributed as patronage refunds are not affected by the tax.[211]

Similarly, Federal income taxes paid on nonpatronage income are not applied to reduce patronage refunds payable to patrons with whom the cooperative did business on a cooperative basis.[212]

Certain presumptions may affect the allocation of expenses, or at least the need to calculate them separately. An early IRS ruling[213] established a presumption that for patronage and nonpatronage business involving the same activity, the patron and nonpatron portions of a cooperative's business were equally profitable. While that presumption is rebuttable, the burden of proof falls on the cooperative.[214]

1980-l U.S.T.C. (CCH) ¶ 9352, *rev'g*, 70 T.C. 145 (1978); and Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987).

[211] Rev. Rul. 74-161,1974-l C.B. 247. This is distinguished from a tax imposed on the total net earnings from all operations, which the Service has said must be allocated to both patronage- and nonpatronage-sourced income. Rev. Rul. 82-76,1982-l C.B. 118.

[212] An early Board of Tax Appeals decision, Farmers Union Cooperative Exchange v. Commissioner, 42 B.T.A. 1200 (1940), noted this position, basing its decision, in part, on A.R.R. 6967, III-1 C.B. 287 (1924), superseded by Rev. Rul. 68-228,1968-l C.B. 385, *modified by* Rev. Rul. 72-602, 1972-2 C.B. 510.

[213] A.R.R. 6967, III-1 C.B. 287 (1924), *superseded by* Rev. Rul. 68-228, 1968-1 C.B. 385, *modified by* Rev. Rul. 72-602, 1972-2 C.B. 510. See also Valparaiso Grain & Lumber Co. v. Commissioner, 44 B.T.A. 125 (1941), for statement of this presumption.

[214] Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397 (1972), *aff'd*, 481 F.2d 812 (10th Cir. 1973), 1973-2 U.S.T.C. (CCH) ¶

In Land O'Lakes, Inc. v. United States,[215] a cooperative operated retail outlets that sold both member product and nonmember goods. All income from the store was designated income from patronage sources, with no profit allocated to nonpatronage-sourced income. Reversing a U.S. District Court decision, the Eighth Circuit Court of Appeals disagreed with designating all the income as patronage-sourced.

The appellate court ruled the cooperative failed to produce sufficient evidence to overcome the presumption that sales for member and nonmember marketing were equally profitable. The cooperative did not produce sales records for the year in question (1963). And while the cooperative did introduce into evidence a week long study performed in 1970 which based its cost allocation on observation of labor costs, the appellate court found the analysis flawed and of doubtful validity. As a result, the presumed correctness of IRS's assessment was not overcome.

Some expenses cannot be assigned solely to patronage or nonpatronage activity. Instead, they are "organization wide" in their impact. These expenses or payments may not be used to selectively reduce patronage- or nonpatronage-sourced income but must be applied proportionately to reduce both.

The principle applies as well to payment of dividends on capital stock. Net earnings available for distribution as patronage refunds "shall be" reduced by "dividends paid on capital stock or other proprietary capital interests."[216] A nonsection 521 cooperative that deals with nonmember patrons on a noncooperative basis may not reduce the nonpatronage-sourced income by the entire amount paid as dividends on capital stock. Such a cooperative must apportion the amount paid as dividends on capital ratably between earnings on member and nonmember business.[217]

9534, *cert. denied,* **414 U.S. 1028 (1973).**

[215] **Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), 1982-1 U.S.T.C. (CCH) ¶ 9326,** *aff'g in part, rev'g in part,* **470 F. Supp. 238 (D. Minn. 1979), 1979-1 U.S.T.C. (CCH) ¶ 9380.**

[216] **Treas. Reg. § 1.1388-1(a)(1).**

[217] **Des Moines County Farm Service Co. v. United States, 448 F.2d 776 (8th Cir. 1971), 1971-2 U.S.T.C. (CCH) ¶ 9665,** *aff'g,* **324 F. Supp. 1216**

The requirement that dividends on capital stock be charged ratably against all net earnings rests on the definition of a patronage refund. According to Revenue Ruling 68-228, "to permit a cooperative to pay dividends on its capital stock solely out of earnings derived from nonmember business would have the effect of permitting a cooperative to deduct amounts distributed to its members out of the earnings from nonmember business under the guise of patronage dividends."[218]

Other reductions in net margins required to reach taxable income are treated similarly. For example, amortization of a facility is apportioned between patronage and nonpatronage business to apply proper deduction to net margins available for payment as patronage refunds.[219]

(S.D. Iowa), 1971-1 U.S.T.C. (CCH) ¶ 9200; FCX, Inc. v. United States, 531 F.2d 515 (Ct. Cl. 1976), 1976-1 U.S.T.C. (CCH) ¶ 9294; Union Equity Cooperative Exchange v. Commissioner, 481 F.2d 812 (10th Cir. 1973), 1973-2 U.S.T.C. (CCH) ¶ 9534, *cert. denied,* 414 U.S. 1028, *aff'g,* 58 T.C. 397 (1972); Priv. Ltr. Rul. 8547039 (Aug. 27, 1985). Rev. Rul. 68-288, 1968-1 C.B. 385 superseded A.R.R. 6967, III-1 C.B. 287 (1924), establishes the same rule in principle. See also Valparaiso Grain & Lumber Co. v. Commissioner, 44 B.T.A. 125 (1941).

[218] Rev. Rul. 68-228,1968-l C.B. 385,386.

[219] Rev. Rul. 54-297, 1954-2 C.B. 132.

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