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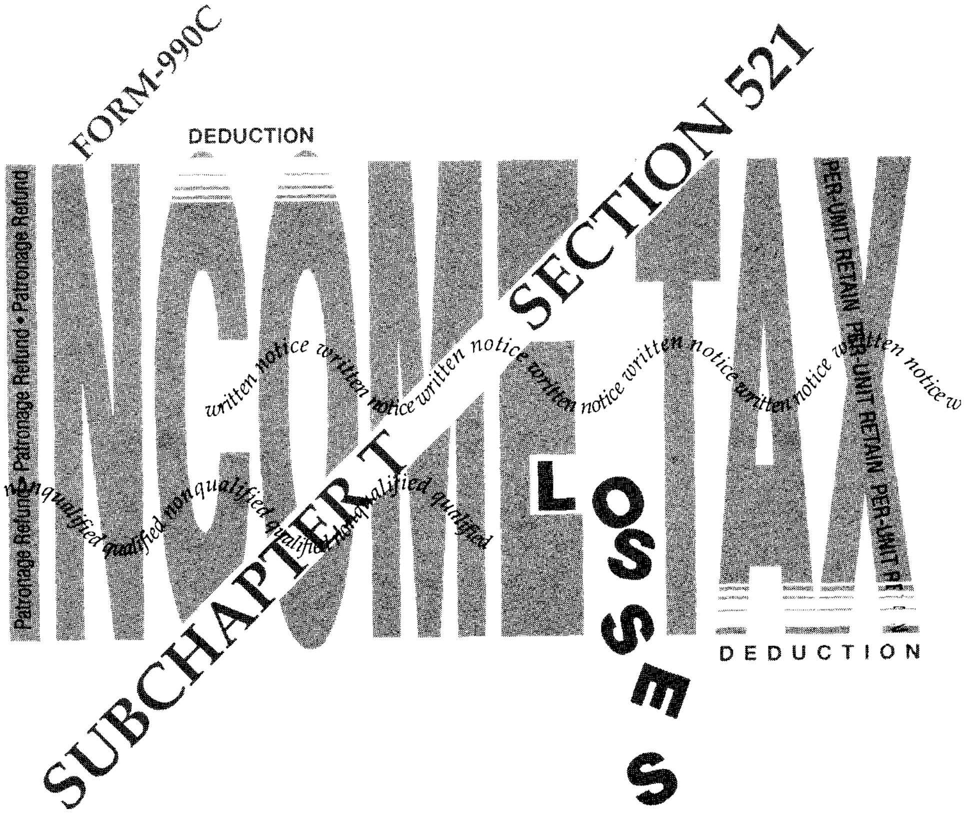
Income Tax Treatment of Cooperatives:

Distribution, Retains, Redemptions, and Patrons' Taxation



Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Distributions, Retains, Redemptions and Patrons' Taxation

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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[1]

The correlation between cooperative finance and taxation involves several elements of the cooperative/patron relationship. Earnings are allocated to patrons on the basis of the amount of business they do with the cooperative, not to investors on the basis of equity ownership. Tax law recognizes that cooperative margins are allocated directly to patrons and permits cooperatives to pass through those earnings to patrons much as a partnership passes through its earnings to its partners.

To accommodate the unique association between a cooperative and its patrons, the Internal Revenue Code (Code) has special and sometimes complex rules creating a single tax on cooperative margins. Part II of this series described the patronage refund, the basic vehicle for cooperatives to distribute margins to patrons and for patrons to provide equity capital--through retained patronage refunds--to their cooperative. This report examines the additional elements of the cooperative/patron relationship. It covers how patronage refunds are distributed to patrons, how the per-unit retain operates as another tool of equity accumulation for marketing cooperatives, the operation and tax treatment of methods cooperatives use to redeem outstanding equity, and looks specifically at how various patronage financing developments are taxed at the patron level.

The information does not represent USDA policy or recommendations regarding Internal Revenue Service (IRS) regulations. Rather, cooperatives and their members should seek tax-related advice from their tax and/or legal advisors.

[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

subject to Federal income taxation. Ultimately, if not immediately, that tax burden falls on the patron. The timing and extent of that tax burden depend on the way those earnings are distributed. Some cooperative distributions from nonpatronage sources and patronage-based funds not distributed according to specific rules in the Code may be taxable to the patron even though a tax was already paid by the cooperative.

The characteristics of payments from a patron to a cooperative are important in determining if they are deductible business expenses or nondeductible contributions to capital.

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CHAPTER 7
PATRONAGE REFUND DISTRIBUTIONS

After a cooperative determines its earnings and reviews its capital needs, it must decide the amount and form of patronage refunds' to be distributed to its patrons. Generally, a cooperative pays the patronage refund in two forms--in money or with a document representing an equity or debt interest in the cooperative.

Timely distributions of patronage refunds in money automatically qualify for single taxation. To likewise qualify for single tax treatment, the noncash payment document must comply with the Internal Revenue Code (Code) requirements to be a "written notice of allocation."

Cooperatives can place the tax obligation for refunds issued as written notices of allocation on either the cooperative or the patrons. But whatever method of allocation is chosen, it is subject to the basic public policy underlying the enactment of subchapter T of the Code,[3] a single tax is immediately due on the underlying cooperative margins.

Some Code requirements relating to the distribution of patronage refunds are mandatory in whatever form paid. Other constraints apply to specific distribution methods. This chapter describes the forms in which patronage refunds may be paid to qualify for cooperative tax treatment and the tax collection method applicable to each form.

TAX TREATMENT

Alternative tax treatments are often an important factor in determining the form of a patronage refund, so taxation will be discussed before the technical aspects of the refund options.

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[2] The term "patronage refund" (rather than "patronage dividend" as used in the Internal Revenue Code) is used in this report in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

[3] I.R.C. §§ **1381-1388.**

Code Provisions

Code section 1388(a) defines a patronage refund. Rulings and cases interpreting this definition are covered in chapter 4 of these reports.[4] In summary, a patronage refund is an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or for such patron. The payment must be made pursuant to a legal obligation that existed before the transaction occurred that produced the margin being refunded. The payment must also be based on net earnings of the cooperative from business with of for patrons.

The basic rules governing taxation of patronage refunds are in Code sections 1382(a) and 1382(b)(l). Section 1382(a) states single tax treatment of payments from a cooperative to its patrons is only available for distributions described in section 1382(b).

In determining the taxable income of a cooperative, section 1382(b) provides "...there shall not be taken into account amounts paid during the payment period for the taxable year" in four specific circumstances. The first is the subject of this chapter[5] and is set forth in Code section 1382(b)(l) as follows:

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

As section 1382(b)(l) suggests, several other Code definitions bear directly on the proper distribution of patronage refunds.

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[4] Frederick and Reilly, Income *Tax Treatment of Cooperatives: Patronage Refunds,* ACS Cooperative Information Report 44, Part 2 (USDA 1993), pp. 1-19.

[5] The other three distributions are redemptions of nonqualified written notices of allocation, qualified per-unit retain allocations, and redemptions of nonqualified per-unit retain allocations. Each is discussed in later chapters of this report.

These include the payment period,[6] written notice of allocation,’ qualified written notice of allocation: nonqualified written notice of allocation,’ and determining the amount paid or received.”

Taxation in General

Patronage refunds fall into one of three categories: money or other property, qualified written notices of allocation, and nonqualified written notices of allocation. This section explains an important difference between the tax treatment of nonqualified written notices of allocation and other forms of patronage refunds. This is a key consideration in deciding how the patronage refund allocation should be structured.

Payments in money or other property are deductible by the cooperative in the year the underlying patronage business occurs.[11] The payments are included in the gross income of the patron recipients in the year of receipt.” Money is valued at face value. Property is valued at its fair market value.[13]

Patronage refunds paid in the form of qualified written notices of allocation are taxed essentially as cash. Qualified written notices of allocation are deductible by the cooperative in the taxable year the underlying patronage business occurs.[14] The payments are included in the gross income of the patron recipients in the year of receipt.[15] Qualified written notices of

[6] I.R.C. § 1382(d).

[7] I.R.C. § 1388(b).

[8] I.R.C. § 1388(c).

[9] I.R.C. § 1388(d).

[10] I.R.C. § 1388(e).

[11] Treas. Reg. § 1.1382-2(b)(1).

[12] I.R.C. § 1385(a)(l), Treas. Reg. § 1.1385-1(a). The tax treatment of patrons is discussed in chapter 10 of this report.

[13] I.R.C. § 1388(e)(l), Treas. Reg. § 1.1382-2(b)(1).

[14] Treas. Reg. § 1.1382-2(b)(1).

[15] I.R.C. § 1385(a)(l), Treas. Reg. § 1.1385-1(a).

allocation are taken into account at their stated dollar amount.[16]

Example A illustrates the tax consequences of a patronage refund paid in cash, other property, or as a qualified written notice of allocation. Assume a marketing cooperative pays one producer $600 for a crop, incurs $300 in additional business expenses for processing and marketing the crop, and sells it for $1,000.

EXAMPLE A. Patronage Refund Paid in Cash, Other Property, or Qualified Written Notice Of Allocation

Cooperative			Patron	
Income		$1,000		
Expenses			Income	
Crop	$600		Crop	$600
Other	$300			
Total		$900		
Margin		$100	Refund	$100
Taxable Income		0	Taxable Income	$700

Any business is allowed to deduct the payment to the patron for the crop ($600) and other expenses ($300). A cooperative may also deduct the margin earned when it sells the producer's crop ($100), provided the cooperative returns the margin to the patron as a patronage refund paid in cash, other property, or a qualified written notice of allocation. This leaves the cooperative with no taxable income on its business conducted on a cooperative basis.

[16] I.R.C. § 1388(e)(2), Treas. Reg. § 1.1382-2(b)(1).

The patron includes the $600 crop payment and the $100 patronage refund in gross income, for a total taxable income of $700. The patron must include the entire $100 patronage refund in gross income, even if part was paid as a qualified written notice of allocation.

Example B illustrates the same situation, only the patronage refund is paid as a nonqualified written notice of allocation.

EXAMPLE B. Patronage Refund Paid as a Nonqualified Written Notice Of Allocation

Coooerative			Patron	
Income		$1,000		
Expenses			Income	
Crop	$600		Crop	$600
Other	$300			
Total		$900		
Margin		$100	Refund	$100
Taxable Income		$100	Taxable Income	$600

When a noncash patronage refund payment is made using a nonqualified written notice of allocation, the current obligation to pay tax on the underlying margin remains with the cooperative. The cooperative is allowed the $900 in normal business deductions, including the $600 deduction for the payment to the patron for the crop. But the $100 margin is taxable income to the cooperative in the year the patronage occurs.

The patron includes the $600 payment for the crop in gross income. The patron has no immediate tax liability, however, for the value of the nonqualified allocation.

When the cooperative redeems the nonqualified written notice of allocation, the tax obligation is transferred to the patron. The cooperative is allowed to deduct the value of the money or other property distributed to the patron." And the patron includes the value of the money or property received in gross income in the year of receipt."

Therefore, in the year the cooperative redeems the $100 patronage refund issued as a nonqualified written notice of allocation, the cooperative claims a $100 deduction from gross income and the patron includes the $100 payment in gross income.

The use of nonqualified allocations places a temporary tax obligation on the cooperative and postpones any tax obligation for the patron until the patron receives cash or other property to redeem the nonqualified allocation.

REFUND DISTRIBUTION BASICS

This section details the fundamental requirements that must be met to protect access to single tax treatment for patronage refunds. While the rules may seem cumbersome at times, it should be remembered that a series of court decisions had permitted cooperatives and patrons to avoid the current single tax obligation which Congress had intended to create under the Revenue Act of 1951.[19] Subchapter T of the Code was enacted as part of the Revenue Act of 1962[20] to make sure the single tax due

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[17] I.R.C. § 1382(b)(2), Treas. Reg. § 1.1382-2(c).

[18] I.R.C. § 1385(c), Treas. Reg. § 1.1385-1(b).

[19] Caswell's Estate v. Commissioner, 211 F.2d 693 (9th Cir. 1954), *rev'g*, 17 T.C. 1190 (1952); Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955), *aff'g*, 20 T.C. 603 (1953), acq. 1958-1 C.B. 4; Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957), *rev'g*, 27 T.C. 985 (1957). These cases are discussed in chapter 3 of these reports, Frederick and Reilly, Income *Tax Treatment of Cooperatives: Background,* ACS Cooperative Information Report 44, Part 1 (USDA 1993) pp. 88-91.

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

was collected on a current basis.[21]

Actual Payment to Patrons

The first rule in establishing tax deductibility at the cooperative level is that an actual payment must be made to the patrons. This requirement is based on the Code definition of a patronage refund as "an amount paid to a patron by (a cooperative)..."** This requirement has two parts, the first is "actual payment" and the second is the payment must be made to a "patron."

The first condition, actual payment, has been addressed in the case of Seiners *Association v. Commissioner.*[23] Seiners Association didn't distribute the cash portion of its patronage refunds within the permissible time period for tax deductibility." Rather, patrons had the right to withdraw the cash portion of their refund before the expiration of the payment period. The cooperative argued that this constituted constructive receipt sufficient to satisfy the Code requirements. The U.S. Tax Court disagreed, holding an actual payment must occur for a distribution of money to be deductible as a patronage refund.

A cooperative may meet its payment obligation by mailing the money or written notice of allocation to the last known address of the refund recipient. Such refunds are considered paid on the date they normally would be received by the recipients, including any distributions returned when the addressee cannot

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[21] S. Rep. No. 1881, 87th Cong., 2nd Sess. 111 (1962), reprinted in 1962-3 C.B. 703, and 1962 U.S. Code Cong. & Admin. News 3304,3414-3415; S. Rep. No. 1707,89th Cong., 2nd Sess. (1966), *reprinted in* 1622-2 C.B. 1055, 1108 and 1966 U.S. Code Cong. & Admin. News 4446, 4515.

[22] I.R.C. § 1388(a). The provision covering deductibility of patronage refunds also requires that they be "paid." I.R.C. §1382(b).

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

[24] The time periods within which cooperatives can distribute patronage refunds, called "payment periods," are discussed in a subsequent section of this chapter.

be located by postal authorities and held by the cooperative subject to the rightful owner's claim.[25]

The second condition requires that the patronage refunds be paid to "patrons."[26] Under most circumstances, a cooperative should have little difficulty determining to whom the patronage refund is paid. Patronage refunds are paid to patrons whose business with the cooperative produced the margin being returned.

Sometimes payment to patrons will be impossible or impractical. This following discussion reviews how cooperatives have handled some of those situations.

Occasionally, a cooperative may find it impossible to locate patrons to whom refunds are owed. Many States have so-called escheat laws that require such unclaimed funds be paid to the state. In Revenue Ruling 68-423,[27] a section 521 cooperative, having ceased operations some years before, attempted to make a cash distribution of nonpatronage income in a bank account to former patrons as part of its final liquidation.** Under the State's escheat law, the cooperative was obligated to turn the funds over to the state at the time of liquidation.

The IRS permitted the cooperative to deduct the payments, even though the funds were paid to the State and not the patrons. IRS noted payment was made to the State within the applicable payment period for such distributions. It said the State's escheat law was "custodial" in nature, meaning the rightful owners of the unclaimed property (cash) paid to the State by the cooperative could obtain this money by presenting evidence of ownership. The same logic appears to apply to unclaimed patronage refunds paid to the State under escheat.

In some circumstances, payment may be made to a patron's successor in interest, such as the estate of a deceased individual

[25] Rev. Rul. 55-141,1955-l C.B. 337.

[26] Treas. Reg. §1.1382-2(b)(1).

[27] 1968-2 C.B. 373.

[28] A section 521 cooperative is permitted to deduct patronage-based allocations of nonpatronage income under I.R.C. § 1382(c). Special rules for section 521 cooperatives will be discussed in a later report in this series.

patron[29] or a successor in interest of a corporate or partnership patron.

Another example of payment to someone other than the patron occurs when an intermediary is imposed between the cooperative and the person whom the cooperative wishes to treat as its patron. In Land O'Lakes, *Inc. v.* United *States,*[30] part of the cooperative's business consisted of selling agricultural supplies to agent-buyers who resold the supplies to members and other patrons. The agent-buyer, a nonmember-nonproducer, was used in geographical areas where the cooperative had no member-cooperatives or company stores. The agent-buyer executed a contract with the cooperative to agreeing to provide the cooperative with all invoices based on sales of supplies to producers.

At the end of each year, the cooperative distributed patronage refunds directly to producers who purchased supplies from the agent-buyer as reflected by the invoices. The cooperative treated the agent-buyer as an agent of the farmer producers. The courts ultimately concurred with this treatment. While several decisions emanated from this litigation, the original U.S. District Court opinion addresses this issue most succinctly:

> Plaintiffs reliance on agency principles to support its argument that the agent-buyer was acting in a fiduciary capacity on behalf of the producer-customers appears to

[29] Rev. Rul. 73-93,1973-l C.B. 292.

[30] This dispute first arose over whether Land O'Lakes, Inc., was entitled to section 521 tax status. The first District Court opinion held the cooperative was eligible for section 521 status. Land O'Lakes, Inc. v. United States, 362 F. Supp. 1253 (D. Minn. 1973), 1973-2 U.S.T.C. ¶ 9644. This finding was reversed, 514 F.2d 134 (8th Cir. 1975), 1975-1 U.S.T.C. ¶ 9431, cert. *denied, 423* U.S. *926. The* case was remanded to the District Court to determine issues resulting from the cooperative's non-section 521 status. The District Court found the agent-buyer arrangement permissible, and this determination was affirmed. Land O'Lakes, Inc. v. United States, 470 F. Supp. 238 (D. Minn. 1979), 1979-1 U.S.T.C. ¶ 9380, *aff'd in part, rev'd in part, 675* F.2d 988 (8th Cir. 1982), 1982-l U.S.T.C. ¶ 9326.

> be a strained legal position, but the Court believes the contract between Land O'Lakes and the agent-buyers was a permissible arrangement and not violative of the statute. The evidence established that the use of the agent-buyer was necessitated by a lack of other facilities to adequately provide for the supply needs of the producer-customers. The government has not made any showing that the agent-buyers breached the contract or acted in any manner contrary to the intended purpose of the arrangement to supplement the lack of supply outlets for the benefit of the producer-customers.[31]

The final opinion in this case found Code support for Land O'Lakes' position. The court noted that Code section 1388(c)(l) defines a qualified written notice of allocation as a notice which the "distributee" consents to include in his own income. The court interpreted the word "distributee" to be broader than "patron," and concluded that the refunds paid directly to the farmer-customers pursuant to the agent-buyer agreements were properly deductible by Land O'Lakes as patronage refunds.[32]

Payment Period

A cooperative's ability to deduct patronage refunds is conditioned not only on actual payment to patrons but also on such payments being made within a certain time period.

The Code requires cooperative payment of patronage refunds to take place "during the payment period for the taxable year."[33] The "payment period" for payment of patronage refunds "is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the

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[31] Land O'Lakes, Inc. v. United States, 362 F. Supp. 1253, 1261 (D. Minn. 1973).

[32] Land O'Lakes, Inc. v. United States, 675 F.2d 988, 991 (8th Cir. 1982).

[33] I.R.C. § 1382(b).

close of such year."[34] This encompasses the cooperative's taxable year plus the following 8½ months. For example, a cooperative on a calendar-year tax year has until September 15th of the following year to distribute its patronage refunds.

Although refunds to patrons may be made before the end of a cooperative's taxable year, in most cases it is impossible to complete the process by the last day of the taxable year. The cooperative's financial results for the year have to be computed before the actual margin available as a patronage refund can be determined. The Code, therefore, allows cooperatives a grace period following their taxable year to complete the payment process. However, payment may not be delayed beyond the period established by the Code.

The payment period is coordinated with the tax return filing deadline for cooperatives. Generally, qualifying cooperatives have 8 ½ months following the end of the taxable year to file their income tax returns.[35] This provides time for cooperatives to compute, allocate, and distribute their patronage refunds before finalizing their tax return for the year.

If a refund is not paid to patrons during the permitted payment period to which the refund relates, the payment no longer qualifies for cooperative single tax treatment. The U.S. Tax Court held that a refund that met all the other requirements of the Code, but was paid 3 days late, was not deductible.[36]

If the cooperative's actions regarding patronage refunds during the payment period fail to qualify as a "payment," subsequent actions can't retroactively cause such distributions to become acceptable. In *Seiners Association v. Commissioner,*[37] the cooperative provided its patrons with financial statements during the payment period. The statements contained figures from which a patron could calculate the refunds due assuming the

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[34] I.R.C. § 1382(d).

[35] I.R.C. § 6072(d).

[36] Seiners Ass'n v. Commissioner, 58 T.C. 949 (1972). The payment period ended August 15. Payments on August 18 of one year and September 18 the next failed to qualify for cooperative tax treatment.

[37] 58 T.C. 949 (1972).

patron kept all records of transactions with the cooperative for the year. After the payment period expired, the cooperative distributed cash and written notices of allocation.

The Tax Court held (1) the actions taken during the payment period did not qualify as payment in cash or as written notices of allocation and (2) the cooperative's subsequent actions could not correct deficiencies occurring during the payment period. The court said a cooperative must meet "very definite rules to deduct patronage (refunds) from its taxable income."[38]

A cooperative's patronage refund payments may be made within the payment period and qualify as patronage refunds for the taxable year even though the cooperative lost its cooperative character as of the last day of its taxable year. IRS permitted a cooperative that converted to a noncooperative corporation and terminated its taxable year upon the conversion to deduct patronage refunds paid to former patrons after the conversion, but before the expiration of the payment period.[39]

Timing Problems

The Code includes the general rule that a patronage refund deduction must be based on patronage occurring during the tax year the deduction is claimed.[40] In several instances, a cooperative may not be able to make a final determination of its margins until well after the end of the payment period for the year the patron conducted the business that generated the margin. The cooperative must determine the tax year the patronage occurred because patronage refunds can only be paid in the payment period for that year.

Income Received in a Subsequent Year

Cooperatives may receive income based on patronage which took place in prior years. A patron may deliver product to a marketing cooperative in one year. The cooperative processes

[38] *Id.* at 955.

[39] Priv. Ltr. Rul. 8604011 (October 25, 1985).

[40] I.R.C. § 1382(b)(l).

and stores the product and doesn't sell the processed product until the following year. While patronage occurred in the tax year delivery was made, the income generated from that patronage is not created until a subsequent year. A similar result may arise when the patron and cooperative have different tax years.[41]

Code section 1382(f) recognizes this timing difference by assigning patronage to the taxable year that income is created. The cooperative recognizes the income for tax purposes in the year of receipt. The margin on that business qualifies for single tax treatment if allocated and distributed in an appropriate manner within the payment period for the year of receipt.[42]

Federated Cooperatives

A common situation leading to receipt of income by a cooperative in years following its dealings with patrons occurs when the cooperative is part of a federated system. A local cooperative may deliver patrons' products to a federated cooperative for further processing and marketing. A period of one or more years commonly passes before the local receives a patronage refund based on that business from the federated.

The U.S. Tax Court, citing section 1382(f), held that a local cooperative may include a patronage refund from a federated in gross income in the year of receipt and pass the amount received through to patrons of that year as a deductible patronage refund.[43]

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[41] For example, Priv. Ltr. Rul. 7936017 (May 31, 1979).

[42] I.R.C. § 1382(f) and Treas. Reg. § 1.1382-6. See, e.g., Priv. Ltr. Rul. 7951127 (Sept. 24, 1979) (income realized by a § 521 cooperative from the sale of a capital asset on the installment basis); Priv. Ltr. Rul. 8142166 (July 24, 1981) (raw product delivered in one year is processed and the finished goods sold in a subsequent year).

[43] Kingfisher Cooperative Elevator Ass'n. v. Commissioner, 84 T.C. 600 (1985).

Pooling

If a cooperative markets under a pooling arrangement and the pool isn't closed until a tax year (or several tax years) following the patrons' delivery of product into the pool, the calculation of patronage refunds must await the final accounting for that pool.

The Code has a special provision dealing specifically with products marketed under a pooling arrangement. Section 1382(e) recognizes the timing problem inherent in pooling by assigning all patronage to "the taxable year in which the pool closes."[44] The regulations provide that the circumstances of each case will be considered in determining when a pool is closed, but generally the procedures of the cooperative will be followed.[45]

Accounting Method Adjustments

The requirement that patronage refunds be paid during the statutory payment period may cause hardship to cooperatives whose accounting methods are adjusted in years following the taxable year. The determinative factor is the tax year in which income is recognized.

Patronage-sourced income may be created in one tax year, but not refunded to patrons within the payment period for that tax year because the income wasn't recognized in time to make payments. In that case, any subsequent payment of refunds based on that income may not qualify as payment during the payment period. For example, in Rev. Rul. 74-327[46] an IRS audit conducted in 1973 resulted in a disallowance of a portion of the depreciation claimed by a cooperative in 1970 and 1971. IRS held the income resulting from adjustments to depreciation was correctly included in the cooperative's gross income for the years under examination. While noting Code section 1382(f), IRS found it inapplicable.

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[44] I.R.C. § 1382(e)(l) and Treas. Reg. § 1.1382-5. The regulation contains a simple example illustrating this point.

[45] Treas. Reg. § 1.1382-5.

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

On the other hand, if income relating to a cooperative's patronage during one tax year is recognized as patronage income in a subsequent tax year, the payment period for the subsequent tax year applies.[47]

Qualified Checks

Patronage refunds paid in qualified checks[48] also raise a timing consideration. The Code says a qualified check issued during the payment period is to be treated as an amount paid in money during that payment period if it is "endorsed and cashed" on or before the 90th day after the period closes.[49] Tax treatment of a qualified check depends on whether the recipient cashes it, a fact that may not be known until after the payment period ends. A cooperative that issues qualified checks may have to file its income tax return as much as 90 days before it knows whether some payments are qualified or nonqualified.[50]

PAYMENT IN MONEY OR OTHER PROPERTY

Most cooperatives pay at least some of their patronage refunds in "money." The term "money" covers cash, regular bank checks, and "qualified checks."[51] Payment of patronage refunds in money requires more than a right to receive payment from the cooperative. It requires actual payment.[52]

Patronage refunds may also be paid in the form of property. While this is not a usual form of payment, it may give the cooperative a mechanism to satisfy its patronage refund obligations without a cash drain on the cooperative or requiring patrons to take an equity interest in the cooperative.

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[47] I.R.C. § 1382(f), Treas. Reg. § 1.1382-6.

[48] Qualified checks are defined at I.R.C. § 1388(c)(4). They are discussed in more detail later in this chapter.

[49] I.R.C. § 1382(d).

[50] See Priv. Ltr. Rul. 7728030, (no date), 1977.

[51] Treas. Reg. §§ 1382-2(b)(1), 1.1388-1(c)(1)(ii).

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

When patronage refunds are paid in property, the value of the property determines the amount of the cooperative's deduction and the patron's income. The Code states that property shall be taken into account at its fair market value.[53]

In one instance, a cooperative was acquired by another corporation. In its last taxable year prior to merger, the cooperative became obligated to pay patronage refunds to patrons. It paid the refunds partly in money and partly in shares of stock of the acquiring corporation. The acquiring corporation's stock was valued at par value in computing the permissible patronage refund deduction.[54]

WRITTEN NOTICE OF ALLOCATION

Payment of patronage refunds with a document evidencing an equity or debt interest in the cooperative rather than payment in cash was a recognized practice before the formal definition of a written notice of allocation appeared in Subchapter T in 1962.[55]

Payment through such a written notice was considered payment in money to the patron, followed by either reinvestment in the cooperative's capital or a loan to the cooperative.[56]

Written notices of allocation permit cooperatives to combine the payment of refunds with other financing objectives. Patrons receive these notices as a return based on proportion of business done with their cooperative. They represent the culmination of a patronage relationship between the cooperative and patron. At the same time, written notices of allocation are a means of acquiring patron financing through capital contributions in proportion to use of the cooperative's services.

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[53] I.R.C. § 1388(e)(l); see also, Treas. Reg. §1.1382-2(b)(1).

[54] Priv. Ltr. Rul. 7738016 (June 22, 1977).

[55] For description of such practices, see Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949); and Farmers Cooperative Co. v. Commissioner, 288 F.2d 315 (8th Cir. 1961), *rev'g*, 33 T.C. 266 (1959).

[56] Rev. Rul. 55-66,1955-l C.B. 282.

These notices are an important determinant in taxable events. They represent payments to patrons by the cooperative, the receipt of income by patrons, the cooperative's receipt of capital contributions, and capital investments by patrons.

The following sections describe the character of written notices of allocation, the form they may or must take, their contents, and how they are distributed.

Character

A written notice of allocation is a disclosure to each patron of that patron's patronage payment. Treasury Department regulations provide that the notice shall report the entire "stated dollar amount allocated [to the patron] on the books of the cooperative."[57]

A written notice of allocation usually evidences a contribution to the cooperative's equity capital. It is not restricted, however, to equity. This notice can represent a loan to the cooperative. The Code definition of a written notice of allocation includes the term "certificate of indebtedness."[58]

Form

These notices of allocation must be in writing. A mere credit to a patron's account on the cooperative's books, without written disclosure to the patron, does not qualify.[59]

The cooperative must issue a written notice of allocation to each patron receiving a patronage refund (unless the patronage refund is to be paid entirely in money). The Code lists documents that may qualify as written notices of allocation including "capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice.'@'

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[57] Treas. Reg. § 1.1388-1(b).

[58] I.R.C. § 1388(b).

[59] Treas. Reg. § 1.1388-1(b).

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

If capital stock is part of a written notice of allocation, it is usually issued as some form of preferred stock.[61] Common stock usually certifies membership. Its issuance is unrelated to the amount of business conducted with the cooperative. Preferred stock issued as a written notice of allocation can have all the attributes of ordinary preferred stock, including transferability, right to dividends on capital stock, and preferences of various kinds.[62] Cooperatives may use a special class of common stock rather than preferred stock as part of a written notice of allocation.[63]

The Code doesn't elaborate further on the form of a written notice of allocation. However, certain information must be included in a written notice of allocation regardless of its form.

Contents

The Code states a written notice of allocation must disclose to the recipient "the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage [refund]."[64] This awkward language is usually applied by cooperatives so that the notice reports: (1) the total patronage refund allocated to the patron, (2) the amount returned at the time of the allocation in the form of money or other property, and (3) the amount retained as a contribution to capital (1 less 2).

The written notice can't be presented in a manner that requires the recipient to compute the payment amount. In *Seiners Association v. Commissioner*,[65] each member received a receipt or invoice at the time it purchased supplies from the cooperative.

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[61] Priv. Ltr. Rul. 8138144 (June 26, 1981).

[62] Preferred stock with these characteristics was described in Agway Inc. v. United States, 524 F.2d 1194 (Ct. Cl. 1975), 1975-2 U.S.T.C. ¶ 9777, a pre-subchapter T situation, thus not a "written notice of allocation."

[63] See Priv. Ltr. Rul. 8505001 (May 15, 1984) where the cooperative issued two classes of common stock. The class issued as a written notice of allocation was nonvoting.

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

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

The patronage refund due each member could be calculated by multiplying the member's total purchases for the year by a percentage factor set forth in the cooperative's financial statements issued at the annual meeting following the taxable year. The financial statements reported the cooperative's earnings for the year, the total amount available for "members' rebates," and the percentage factor upon which individual rebates could be calculated.

Members, who kept all of their purchase records for the year, could determine their allocable patronage refund by multiplying the percentage figure given in the financial statements by the amount of their purchases. However, the financial statements distributed at the annual meetings did not by themselves contain sufficient information for the members to compute their allocable shares.

The court ruled the combination of financial statements and receipts provided by the cooperative did not constitute a written notice of allocation. The court stated:

> Even assuming that the members kept adequate records, they would still have been put to the task of making correct calculations to determine the allocable stated dollar amount. Therefore it is obvious that on their face these documents did not reveal a stated dollar amount. The available documents showed no individual dollar amounts whatsoever. Clearly the type of instrument intended by Congress as sufficient to meet the requirements of a written notice of allocation is that notice which petitioner sent out after the close of the payment periods.[66]

The written notice of allocation must disclose to the patron the portion of the allocation, if any, which constitutes a patronage refund.[67] If the notice partly represents an allocation of a patronage refund eligible for single tax treatment and partly a

[66] Id. at 957.

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

distribution of cooperative income not qualifying for a patronage refund deduction, the patron must be informed of that fact in the notice. The portion constituting a patronage refund may be disclosed either as a stated dollar amount or a percentage of the face amount of the written notice of allocation.[68]

Distribution

Just as the money portion of a patronage refund must be "paid," so written notices of allocation must be distributed to patrons entitled to receive them. Most are distributed by mail. The process must assure that all portions of a written notice of allocation are actually distributed.[69]

QUALIFIED WRITTEN NOTICE OF ALLOCATION

A "qualified" written notice of allocation is a special kind of notice. Notices are qualified in two ways. One way is based on redemption rights assigned to the written notice of allocation by the cooperative when issued.[70] The other is to have the recipient consent to include the stated dollar amount of the notice in gross income for tax purposes in the year of receipt.[71] In either case, at least 20 percent of the patronage refund reported by the written notice must be paid in money or by qualified check.[72]

If a written notice is "qualified," then the portion of the patronage refund retained by the cooperative is taxed essentially the same as a cash distribution. The retained funds are deductible by the cooperative in the taxable year the underlying margin was earned. Both the cash distribution and the retained funds must be included in gross income of the recipient in the year of receipt.

For purposes of determining the dollar amounts paid by the cooperative and received by patrons, a qualified written notice of

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[68] Treas. Reg. §1.1388-1(b).

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

[70] See I.R.C. § 1388(c)(l)(A) and Treas. Reg. §1.1388-1(c)(2).

[71] See I.R.C. § 1388(c)(l)(B) and Treas. Reg. §1.1388-1(c)(3).

[72] I.R.C. § 1388(c)(l).

allocation "shall be taken into account at its stated dollar amount."[73] Both the deduction taken by the cooperative and the income received by patrons are based on the stated dollar amount of the notice.

Redeemable Notice

One method of qualifying a written notice of allocation is based on the document's redemption characteristics. The Code defines a qualified written notice in redeemable form as:

> (A) written notice of allocation which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation...[74]

A written notice relying on redemption rights for qualification must be redeemable in cash at its stated dollar amount.[75] The cooperative must stand ready to give the patron full cash payment of the stated dollar amount at any time during the appropriate payment period. That period begins on the date the written notice is "paid" (distributed to the patron) and continues for 90 days.[76]

If a patron chooses not to redeem the notice during the specified time period, the cooperative may redeem the notice as it would any other written notice of allocation. The patron's choice not to redeem does not destroy the notice's qualified status.

The recipient of a redeemable written notice of allocation must also receive written notification of the right to redeem it in

[73] I.R.C. § 1388(e)(2).

[74] I.R.C. § 1388(c)(l)(A).

[75] I.R.C. § 1388(c)(l)(A) and Treas. Reg. § 1.1388-1(c)(2).

[76] I.R.C. § 1388(c)(l)(A). The cooperative may, if it wishes, give patrons a longer time period in which to exercise the redemption option.

cash. The notification and the written notice of allocation must be separate documents but may be given simultaneously to each patron." Publishing the notification in a newspaper or posting it at the cooperative's place of business is not sufficient."

A cooperative can deduct the full face value of a redeemable qualified written notice of allocation,[79] provided at least 20 percent of the entire patronage refund was paid in cash when the redeemable notice as distributed.[80] If the patron does not seek redemption during the given redemption period, the cooperative has no further cash outlay until redeeming the written notice of allocation at some later date.

Qualification Based on Patron Consent

A second way to qualify a written notice of allocation requires the distributee to consent to include the stated dollar amount of the allocation in gross income in the year received."[81]

The patron consent requirement is satisfied through a written consent agreement,[82] a bylaw provision,[83] or the distributee endorsing and cashing a qualified check.[84] These are the only permissible means for obtaining patron consent.[85]

Written Consent

One way to obtain patron consent is through a written statement, signed by the distributee, and furnished to the

[77] I.R.C. § 1388(c)(l)(A) and Treas. Reg. § 1.1388-1(c)(2).

[78] Treas. Reg. § 1.1388-1(c)(2).

[79] I.R.C. § 1382(b)(1).

[80] I.R.C. § 1388(c)(l).

[81] I.R.C. § 1388(c)(l)(B) and Treas. Reg. § 1.1388-1(c)(3).

[82] I.R.C. § 1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3)(i).

[83] I.R.C. § 1388(c)(2)(B) and Treas. Reg. § 1.1388-1(c)(3)(ii).

[84] I.R.C. § 1388(c)(2)(C) and Treas. Reg. § 1.1388-1(c)(3)(iii).

[85] See Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001 (1981).

cooperative.[86] No specific form or words are needed as long as the document "clearly discloses the terms of the consent."[87]

The regulations provide a general consent form for per-unit retains which can be used for written notices of allocation with appropriate changes in the instrument's description.[88] The sample language reads:

> I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any per-unit retain certificates issued to me on or after ____________ as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.[89]

A written consent may refer to written notices of allocation generally without being precise as to the name of the document. The Service approved a consent provision in a membership agreement that said:

> The producer agrees the amount of any allocation with respect to his patronage occurring after October 1, 1963, indicated in written notice of allocation received by him from the Association, will be reported by him to the Director of Internal Revenue as income in the taxable year in which the notice of allocation is received.[90]

According to the regulations, written consent may be on "a signed invoice, sales slip, delivery ticket, marketing agreement, or

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[86] I.R.C. § 1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3)(i).

[87] Treas. Reg. § 1.1388-1(c)(3)(i).

[88] See Treas. Reg. § 1.61-5(d)(2)(ii) and Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001, 1016, n. 25 (1981).

[89] Treas. Reg. § 1.61-5(d)(2)(ii).

[90] Priv. Ltr. Rul. 8023018 (Feb. 27, 1980). This ruling focused on bylaw provisions whose terminology did not correspond exactly to the names given the written notices of allocation.

other document, on which appears the appropriate consent."[91] A membership agreement containing a required consent provision in express terms is also effective.[92]

However, a signed membership agreement in which the member agrees to abide by the cooperative's "rules and regulations" will not make a bylaw provision effective as a written consent.[93] Similarly, an endorsed patronage refund check may provide written consent, but only if it contains "express terms by which the signer" gives consent.[94]

Written consent is effective for anyone signing the consent document. It doesn't depend on membership in the cooperative.[95] The cooperative should choose the most appropriate document based on convenience and its method of operation. In some circumstances, a separate document whose only content is a consent provision may be the only appropriate means.[96]

Bylaw Consent

Another way of obtaining patron consent to qualify a written notice of allocation is through a cooperative bylaw provision.[97] Bylaw consent[98] differs from written consent in that bylaws are not documents signed by members. As a result, the formalities for bylaw consent are devised to insure that consent is an informed consent despite the absence of a signature. The bylaw

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[91] Treas. Reg. § 1.1388-1(c)(3)(i).

[92] Priv. Ltr. Rul. 8023018 (Feb. 27, 1980) and Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).

[93] Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001 (1981). The bylaw consent was not effective standing alone because a copy of the provision was not provided to members.

[94] Id. at 1014, n.20.

[95] Compare with bylaw consent which applies only to members.

[96] Such as when a cooperative deals with nonmembers on a patronage basis (eliminating the membership agreement option).

[97] I.R.C. § 1388(c)(2)(B) and Treas. Reg. § 1.1388-1(c)(3)(ii).

[98] Sometimes referred as consent by membership, as in Treas. Reg. § 1.1388-1(c)(3)(ii).

provision must meet certain requirements as to form and applies only to cooperative members who have been properly notified.

A consent provision in the bylaws must provide "that membership in the organization constitutes such consent"[99] and that the recipient agrees to take the distribution "into account at its stated dollar amount...."[100] The regulations provide an example of an appropriate bylaw consent provision. It states:

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after....., which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him."'

The sample provision doesn't name a particular document to serve as the written notice of allocation. Under this language, any written instrument otherwise conforming to the Code requirements can suffice. If a bylaw consent provision adopts more specific terminology, the instrument issued must conform to the bylaw provision."'

Bylaw consent is effective for current members at the time the provision is adopted and for members who join a cooperative with a consent provision in place.[103] "Member means a person who is entitled to participate in the management of the

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[99] I.R.C. § 1388(c)(Z)(B)(i).

[100] I.R.C. § 1388(c)(l)(B).

[101] Treas. Reg. § 1.1388-1(c)(3)(ii)(b).

[102] Priv. Ltr. Rul. 8023018 (Feb. 27, 1980).

[103] I.R.C. § 1388(c)(2)(B).

cooperative organization."[104] A bylaw consent provision applies only to members.[105] Cooperatives must use one of the two other consent methods for qualifying written notices with respect to nonmember patrons.

Being a member of a cooperative with a consent provision in its bylaws does not, by itself, meet the Code requirement for bylaw consent. Members at the time the bylaw is adopted, and persons who become members later, must receive "a written notification and copy of such bylaw...."[106]

This notice must inform patrons that the bylaw has been adopted and state its tax significance."' Both notification and a copy of the bylaw must be given to each member or prospective member.[108] A written notice and bylaw can't be merely published in a newspaper or posted at the cooperative's place of business.[109]

The notice and bylaw can be mailed; and a member or prospective member is "presumed to have received" the notice and bylaw if they are sent to the last known address by "ordinary mail.""' For prospective members, both documents must be received prior to obtaining membership for consent to be effective."'

Whether a cooperative uses written or bylaw consent, it must meet all requirements to make the consent effective. In *Independent Cooperative Milk Producers Ass'n v. Commissioner,*[112] the Tax Court did not allow one signed document that lacked the express consent provision (marketing agreement) to incorporate another document (bylaws) that contained the necessary consent

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[104] Treas. Reg. §1.1388-1(c)(3)(ii)(c).

[105] Treas. Reg. §1.1388-1(c)(3)(ii)(a).

[106] I.R.C. §1388(c)(2)(B)(ii); Treas. Reg. 1.1388-1(c)(3)(ii)(a).

[107] Treas. Reg. §1.1388-1(c)(3)(ii)(a).

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001 (1981).

language. The court believed explicit reference to the patron's consent on the face of the writing "is best suited to achieve the certainty the statute was intended to produce."[113]

The Tax Court also looked to the regulations which indicate the signature and consent must appear in the same document[114] and concluded that the specificity of all Code consent requirements suggests a strict approach requiring "unambiguous, affirmative acts of consent...."[115]

Qualified Check

A third means of qualifying written notices of allocation is to issue a "qualified check," defined by the Code as:

> . . .a check (or other instrument which is redeemable in money) which is paid as a part of a patronage [refund]... on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage [refund] or payment of which such qualified check is also a part.[116]

A check must meet requirements as to its form, the payment it represents, the recipient, and the consent statement to be "qualified." And this type of consent is effective only if the recipient takes specific action.

The instrument must be in the form of a check or "other instrument which is redeemable in money."[117] It doesn't have to

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[113] *Id.* at 1015.

[114] Citing Treas. Reg. §1.1388-1(c)(3)(i).

[115] Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001, 1017 (1981).

[116] I.R.C. § 1388(c)(4).

[117] I.R.C. § 1388(c)(4).

be an ordinary check payable through the banking system. It can be an instrument redeemable in money by the cooperative.[118]

A qualified check must be paid as part of a patronage refund.[119] Section 521 cooperatives may also use qualified checks to distribute nonpatronage sourced income.[120] Consent obtained by means of a qualified check relates only to those written notices of allocation which are part of the same patronage refund or payment as the qualified check.[121]

Finally, the consent language for a qualified check must be "clearly imprinted" on the check itself.[122] The consent form may not be a loose enclosure mailed or delivered to the patron, nor may the consent be attached to the check.[123] The recipient of a qualified check gives consent by "endorsing and cashing" the check.[124]

A qualified check must be endorsed and cashed "on or before the 90th day after the close of the payment period for the taxable year of the organization for which such patronage dividend or payment is paid."[125] The cooperative may set an earlier deadline for endorsing and cashing the qualified check.[126]

A qualified check is presumed to have been endorsed and cashed within the 90-day period if the earliest bank endorsement is dated no later than 3 days after the end of the 90-day period (excluding Saturdays, Sundays, and legal holidays)."[127]

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[118] Treas. Reg. §1.1388-1(c)(3)(iii)(b).

[119] I.R.C. § 1388(c)(4).

[120] I.R.C. § 1388(c)(4); Treas. Reg. §§1.1388-1(c)(3)(iii)(a) and (b).

[121] Treas. Reg. §1.1388-1(c)(3)(iii)(a).

[122] I.R.C. § 1388(c)(4).

[123] *Id.*

[124] I.R.C. §1388(c)(2)(C).

[125] *Id.*

[126] Treas. Reg. §1.1388-1(c)(3)(iii)(a). Compare with redeemable written notices of allocation, where the redeemable period must extend for at least 90 days. I.R.C. § 1388(c)(l)(A).

[127] Treas. Reg. §1.1388-1(c)(3)(iii)(a).

Effective Consent Period

For qualified written notices of allocation based on consent, qualification applies only to patronage that occurs while the consent is effective. The consent period is different for written consent, bylaw consent, and qualified check consent. For consent based on a writing or a bylaw provision, it is necessary to consider the initial effective date, duration of the consent period, and conditions for revocation.

Written Consent

Written consent is effective for all patronage occurring during the cooperative's taxable year in which the consent is given,[128] unless it specifically provides to the contrary.[129] The written consent remains in effect for "all subsequent years of the organization" until revoked.[130]

The applicable tax year in which patronage is considered to have occurred may follow the year in which the patron conducted business with the cooperative. In pooling arrangements, for example, patronage is treated as having occurred during the taxable year in which the pool closes.[131] A written consent made any time before the end of the cooperative's taxable year during which the pool closes "shall be effective with respect to all patronage under that pool."[132]

Written consent can be revoked only by "the distributee."[133] The revocation must be in writing,[134] signed by the patron,[135] and

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[128] I.R.C. § 1388(c)(3)(A)(i). Thus written consent can apply retroactively to cover patronage that occurred from the beginning of the cooperative's tax year until the consent became effective.

[129] Treas. Reg. § 1.1388-1(c)(3)(i).

[130] I.R.C. §§ 1388(c)(3)(A)(i) and 1388(c)(3)(B), and Treas. Reg. § 1.1388-1(c)(3)(i).

[131] I.R.C. § 1382(e), cited in I.R.C. § 1388(c)(3)(A)(i).

[132] Treas. Reg. § 1.1388-1(c)(3)(i).

[133] I.R.C. § 1388(c)(3)(B)(i).

[134] *Id.*

[135] Treas. Reg. § 1.1388-1(c)(3)(i).

is effective only when filed with the cooperative.[136]

Written consent can be revoked at any time. An irrevocable written consent cannot qualify a written notice of allocation.[137] Absent revocation, a patron's written consent remains in effect for all taxable years subsequent to the year in which such consent is given.[138]

Revocation of written consent doesn't take effect immediately upon patron signature and delivery to the cooperative. The written consent remains in force for all patronage conducted up to the close of the cooperative's taxable year in which the revocation is filed.[139] Thus, a cooperative using written consent can predict its tax position regarding patronage refunds for the taxable year.

In a pooling arrangement, revocation of written consent is not effective for any pool "to which the distributee has been a patron before such revocation."[140] Written consent remains in effect for any pools in which the patron participated prior to revocation.[141]

Bylaw Consent

Unlike written consent, bylaw consent cannot be retroactive to the beginning of the cooperative's tax year. Bylaw consent applies only to patronage occurring after a patron has received written notification of the adoption of the bylaw provision, a copy of the bylaw, and has attained member status in the cooperative.[142]

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[136] *Id.*

[137] *Id.*

[138] I.R.C. § 1388(c)(3)(A)(i) and Treas. Reg. §1.1388-1(c)(3)(i).

[139] I.R.C. § 1388(c)(3)(B)(i) and Treas. Reg. §1.1388-1(c)(3)(i).

[140] I.R.C. § 1388(c)(3)(B)(i).

[141] Treas. Reg. §1.1388-1(c)(3)(i).

[142] "A consent...shall be effective only with respect to patronage occurring after the patron has received a copy of the bylaw and the prerequisite notice and while he is a member of the organization." Treas. Reg. §1.1388-1(c)(3)(ii)(a).

The Code provision on pooling arrangements,[143] which assigns patronage to the year the pool closes, does not apply to bylaw consent situations.[144] In pooling arrangements, bylaw consent applies only to patronage that occurs after notification and bylaw copy are received, even though for income and distribution purposes patronage occurs in the year the pool closes.[145]

Bylaw consent remains in force so long as the patron remains a member of the cooperative and the bylaws contain the required consent provision.[146] Bylaw consent ends once the distributee "ceases to be a member" of the cooperative or the cooperative's bylaws "cease to contain" the required consent provision.[147]

In pooling situations, bylaw consent no longer is effective "with respect to any patronage under a pool after the patron ceases to be a member of the cooperative organization or after the bylaw provision is repealed by the organization."[148]

Qualified Check

Consent by qualified check applies to all patronage represented by the written notice of allocation to which the qualified check relates. Consent is effective upon endorsement and cashing of the check within 90 days after the close of the cooperative's payment period.[149] No opportunity to revoke exists after this occurs.

If an otherwise qualified check is not endorsed and cashed within the permissible period, the distribution becomes a nonqualified written notice of allocation.[150] The regulations pro-

[143] I.R.C. § 1382(e).

[144] I.R.C. § 1388(c)(3)(A)(ii).

[145] Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

[146] I.R.C. § 1388(c)(3)(A)(ii).

[147] I.R.C. § 1388(c)(3)(B)(ii) and Treas. Reg. § 1.1388-1(c)(3)(ii)(a)

[148] Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

[149] Treas. Reg. § 1.1388-1(c)(3)(iii)(a).

[150] I.R.C. § 1388(d), and Treas. Reg. § 1.1388-1(d).

vide that if the patron then cashes the check, the action is treated as a redemption of a nonqualified written notice of allocation.[151]

Deceased Patron's Estate

The death of a patron raises special concerns about the continuing effectiveness of that patron's consent. Written notices of allocation may be distributed to the estate of a deceased patron. In Revenue Ruling 73-93,[152] the Service addressed the issue of whether bylaw consent, applicable to a deceased member while alive, was sufficient to qualify a written notice of allocation paid to the deceased member's estate. IRS found that the member's consent was still effective for business conducted with the cooperative during the part of the year prior to the patron's death, and the portion of the written notice covering that time period was qualified.

However, the member's consent did not cover business conducted on behalf of the estate after the member's death. Written notices of allocation relating to business with the estate itself would only be qualified if the required consent was specifically granted by the estate. If the estate is to qualify under bylaw consent, the estate must follow normal procedures for membership, including receipt of a bylaw consent provision and formal membership in the cooperative.[153]

The 20-Percent in Money Requirement

Another requirement to qualify a written notice of allocation is that at least 20 percent of the total patronage refund must be "paid in money or by qualified check."[154]

This requirement was enacted as part of Subchapter T to ensure that cooperatives provided patrons with sufficient cash to

[151] Treas. Reg. §1.1388-1(c)(3)(iii)(c)(Example 2).

[152] 1973-1 C.B. 292.

[153] *Id.*

[154] I.R.C. § 1388(c)(l).

pay the first bracket tax bill on qualified allocations immediately taxable to the patrons.[155]

"Payment in money" can be made in cash or by a bank check.[156] If the patron has consented to include the entire allocation in taxable income, by either a written agreement or bylaw consent, a regular check is sufficient. However, if consent has not been attained, the 20 percent payment must be by "qualified check" as defined in Code section 1388(c)(4) and discussed previously.

Some cooperatives with a written consent or bylaw consent program nonetheless make the "money" payment by a check that meets the requirements of a qualified check. Then, if other consent methods are found invalid for any reason, they can fall back on the qualified check option to substantiate its patronage refund deductions.

IRS has held that the payment in money must be made at the same time the patron receives the written notice of allocation. The Service reasoned that if the cash payment were made before or after receipt, the patron could face the same problems the 20-percent payment in money requirement was intended to eliminate.[157]

Basis of Calculation

The 20 percent calculation is based on the total dollar amount of the written notice of allocation. This includes, in the case of a section 521 cooperative, any nonpatronage-sourced income distributed on a patronage basis.

Any portion paid in nonqualified written notices of allocation "may be disregarded" in determining the 20 percent amount.[158] In

[155] Rev. Rul. 65-221, 1965-2 C.B. 320; S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 C.B. 707, 818 and 1962 U.S. Code Cong. & Admin. News 3304, 3415-3416. A minimum tax rate of 20 percent was included in the Internal Revenue Code of 1954, §1, 68A Stat. 5 (1954), and remained unchanged until reduced to 14 percent in 1964.

[156] Treas. Reg. § 1.1388-1(c)(1).

[157] Priv. Ltr. Rul. 7746080 (August 22, 1977).

[158] Treas. Reg. § 1.1388-1(c)(1).

an example provided in the regulations,[159] cooperative A paid a patronage refund of $100 in the form of a nonqualified written notice of allocation with a stated dollar amount of $50, a written notice with a stated dollar amount of $40, and money in the amount of $10. The written notice with a stated dollar amount of $40 would constitute a qualified written notice if all other requirements under section 1388(c) are met. The $10 payment in money accompanying the $40 written notice satisfies the 20-percent-payment-in-money requirement.

Prohibited Payment Forms

The regulations prohibit certain noncash payments in lieu of money.

Offsetting a Debt. A credit by a cooperative against amounts a patron owes it, in lieu of payment to the patron, doesn't satisfy the "paid in money" requirement.[160] Revenue Ruling 65-221 states this is because the patron "does not have the opportunity to use the money he is entitled to have made available to him from the cooperative to pay his taxes."[161]

Paying Membership Fee. Cooperatives and prospective members may find it convenient to apply patronage refunds due nonmember patrons toward the cost of membership stock or a membership certificate. The patron isn't required to make an initial payment for membership, yet gains the benefits of membership in the course of time.

There is no prohibition against this practice. However, amounts applied towards membership costs cannot reduce the money portion paid in connection with written notices of allocation below the 20 percent requirement for qualification. As noted in the regulations, payment in money does not include "a credit against the purchase price of a share of stock or of a membership in such organization."[162]

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[159] *Id.*

[160] Treas. Reg. §1.1388-1(c)(1).

[161] Rev. Rul. 65-221, 1965-2 C.B. 320,320321.

[162] Treas. Reg. §1.1388-1(c)(1).

Documents Redeemable by the Cooperative. The regulations also provide payment in money does not include a document redeemable by the cooperative for money.[163] A check drawn on a bank is the preferred method of distributing the money portion of a qualified patronage refund.

Constructive receipt. Although not specifically mentioned in the regulations, the payment in money requirement also is not met through "constructive receipt," whereby a patron has the right to collect the money at any time after its availability is "declared."

In *Seiners Association v. Commissioner,*[164] the U.S. Tax Court found that allowing constructive receipt would completely negate the 20 percent money payment rule. Money not actually received cannot be applied towards the patron's tax liability that results from recognizing the full value of the qualified written notice as taxable income. In addition, the words of the statute calling for payment in the form of "money" (or qualified check) are not compatible with the constructive receipt concept. The court noted that there is "little room for doubt that when a statute requires a distribution of money its requirements cannot be met by the application of the constructive receipt doctrine."[165]

Patrons' Discretion

The discussion in the previous subsection involved situations where the cooperative might determine that a noncash distribution would be made as a "payment in money." In each instance, the noncash distribution was not sufficient to qualify the patronage refund of which it was a part.

IRS has, however, permitted noncash distributions to satisfy the payment in money requirement where the patron had the option to receive a cash or bank check payment, but voluntarily agreed to direct the funds elsewhere.

For example, in Revenue Ruling 65-128[166] the Service allowed an arrangement where the patron, by contract with the

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[163] *Id.*

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

[165] *Id.* at 959.

[166] Rev. Rul. 65-128,1965-l C.B. 432.

cooperative, agreed to apply the entire patronage refund, including the 20 percent mandatory payment in money, against an annual minimum payment for equipment purchased under a conditional sales contract.[167]

In Revenue Ruling 65-221,[168] the IRS discussed the authority of a patron to direct the cooperative to make the payment in money to a third party. Three situations were presented:

> (1) The bylaws of cooperative X said it could deduct from patronage refunds otherwise payable to a member an annual amount for dues to a farmers' educational organization. Before the cooperative could deduct the amount for dues, the member had to authorize the "check-off" in writing.
>
> (2) Cooperative Y had a similar bylaw provision except it automatically paid the dues unless the member notified the cooperative in writing that it did not want the funds deducted.
>
> (3) Cooperative Z's bylaws provided simply for check-off of dues to a farmers' education organization. The members were not given authorization either to deduct the dues or to discontinue the deduction. If a member did not want dues deducted, the only alternative was withdrawal from membership in the cooperative.

IRS said that in the cases of both cooperative X and cooperative Y, the member makes the election as to the deduction from their patronage refund. Consequently, the amounts applied to the educational organization's dues by both cooperatives would satisfy the 20 percent "paid in money" requirement. The dues check-off by cooperative Z, however, could not be treated as a patronage refund "paid in money" because the payments were not made at the option of the individual member for whom the dues were paid. The Service stated:

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[167] While not entirely clear, the ruling approved the payment as a qualified check rather than as a credit paid in money.

[168] Rev. Rul. 65-221, 1965-2 C.B. 320.

> . ..where the disposition of the money the patron is entitled to receive from the cooperative is beyond the control of the cooperative, a payment by the cooperative to a third party at the option of the patron can be treated as a payment in money to the patron. The cooperative, in effect, has made the money available to the patron and is simply following his authorization as to payment.[169]

The importance of patron choice also was emphasized in a subsequent letter ruling."' Here, a supply cooperative met its payment in money requirement by having the funds credited to each patron's account. The credit could be used by the patron to purchase merchandise within 8 ½ months after the close of the cooperative's fiscal year. Checks were sent to the patrons for any unused credits before the end of the 8 %-month period. The patrons also had the option to request the cooperative to send them the remaining part of their patronage refund in money rather than establish a credit.

The ruling outlines the general rule against crediting accounts in lieu of actual cash payment.[171] However, relying on Revenue Ruling 65-221, IRS stated:

> . ..where the patron has the option of receiving the money he is entitled to receive from the cooperative, in cash, rather than as a credit to his account with the cooperative; the cooperative, in effect, has made the money available to the patron and is simply following his authorization in regard to payment, whether such authorization is given either actively or passively.'"

In another instance, a wholesale hardware cooperative had a policy whereby when a membership was terminated and the

[169] Id. at 321.

[170] Priv. Ltr. Rul. 7850073 (Sept. 18, 1978).

[171] See Treas. Reg. §1.1388-1(c)(1).

[172] *Id.*

member was indebted to the cooperative, returns of retained refunds could be applied against the debt. The cooperative proposed a bylaw change in which the cash portion of qualified written notices of allocation could be applied against the debt unless timely request for payment of an amount equal to 20 percent of the total allocation in cash was made by the member.

The Service approved the cooperative's bylaw change. The payment in money requirement was met because the patron could receive cash upon request.[173]

NONQUALIFIED WRITTEN NOTICE OF ALLOCATION

The Code uses the term "nonqualified written notice of allocation" to cover two documents, a written notice of allocation that does not meet the requirements for qualified status set out in Code section 1388(c) and a qualified check that is not cashed within 90 days after the close of the payment period.[174]

A nonqualified written notice of allocation can be in any form allowable for a written notice of allocation. For example, a cooperative may pay all its patronage refunds as nonqualified written notices of allocation in the form of preferred stock.[175]

Nonqualified notices must comply with the general requirements covering all written notices of allocation, or else single tax treatment is forfeited. The unique aspect of nonqualified notices is the method by which single tax treatment is achieved.

When a nonqualified notice is issued, the cooperative is not entitled to an immediate deduction from gross income and the patron recipient is not required to include as income in the year received the stated dollar amount of the allocation. Instead, deduction by the cooperative and income recognition by the patron take place in the taxable year in which the nonqualified

[173] Priv. Ltr. Rul. 8006112 (Nov. 20, 1979).

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

[175] Priv. Ltr. Rul. 8138144 (June 26, 1981).

notice is redeemed.[176] Therefore, single tax treatment for both the cooperative and patron is finalized in the taxable year of redemption.

A written notice of allocation will acquire nonqualified status if the payment in money is not included with the notice at the time of distribution,[177] the payment is less than 20 percent of the amount of the patronage refund, or the proper patron consent is not attained.[178]

Sometimes written notices of allocation inadvertently attain nonqualified status. But issuing a nonqualified notice might also reflect the members' preference for the cooperative to assume the tax liability attributable to the allocation in the year of issue, while deferring the patron's tax burden until the time of redemption.

Cooperatives have considerable flexibility to issue patronage refunds as a combination of cash, qualified written notices of allocation, and nonqualified written notices of allocation. The only limit is that at least 20 percent of a qualified allocation package be paid in money.

The regulations include an example in which a cooperative pays a patronage refund of $100 consisting of a $50 nonqualified written notice of allocation, a $40 qualified written notice of allocation, and $10 in money. The $40 written notice of allocation was qualified because the $10 payment in money is at least 20 percent of the total allocation package comprised of the qualified notice and the payment in money.[179]

The Service has also approved a patronage refund distribution scheme using only cash and nonqualified written notices of allocation.[180]

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[176] I.R.C. §§ 1382(b)(2) and 1385(c). Redemption of patronage equity is discussed in another chapter.

[177] Priv. Ltr. Rul. 7728030, (no date), 1977.

[178] Priv. Ltr. Rul. 7825095 (March 27, 1978). The Service approved the cooperative's proposal to retroactively reclassify the written notices of allocation from qualified to nonqualified status and to deduct payments to patrons in redemption of the notices.

[179] Treas. Reg. § 1.1388-1(c)(1).

[180] Priv. Ltr. Rul. 8142166 (July 24, 1981).

CHAPTER 8
PER-UNIT RETAIN ALLOCATIONS

The traditional tool of cooperative finance, both to return earnings to members and to acquire equity capital, is the patronage refund. However, a second patronage-based financing mechanism, the per-unit retain allocation, is an important source of capital for certain marketing cooperatives.

WHAT IS A PER-UNIT RETAIN?

A per-unit retain allocation[181] is a distribution by a cooperative to a patron based on the quantity of products, measured by physical volume or dollar value, marketed through the cooperative by the patron.

Per-unit retains can be distributed in money, certificates, or other property[182] and receive single tax treatment as long as payment or allocation occurs during the cooperative's taxable year or within 8 ½ months after the close of the taxable year.[183]

A cooperative's authority to issue per-unit retains usually appears in the association's bylaws, the member marketing agreement, or both.

How Per-Unit Retains Are Used

The primary role of per-unit retains is to generate member-contributed capital. In a typical transaction, a cooperative markets a certain number of units of a patron's product resulting in a given price per-unit. Under the marketing agreement between

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[181] The formal Code term "per-unit retain allocation" is often shortened to "per-unit retain" or "per-unit retains."

[182] I.R.C. §§ 1382(b)(3)-(4).

[183] The payment period may last longer in situations where the cooperative has a pool remaining open over more than one taxable year. See discussion under "Pooling and Statutory Payment Period" in this chapter.

the cooperative and the patron, the cooperative deducts a fixed amount of money per-unit of product marketed from the check it sends the patron for sales proceeds as a patron equity or debt interest in the cooperative. The patron receives a per-unit retain certificate evidencing the particular interest. The certificate's stated value is the amount invested in the cooperative.[184]

Capital generated from per-unit retain certificates might be used to replenish a cooperative's working capital,[185] targeted for general capitalization uses,[186] or used as a reserve for a special purpose. An example of the latter would be withholding a fixed amount each month to establish a reserve fund for guaranteeing payments to patrons in case a buyer fails to pay for product delivered.“'

Cooperatives often use the funds generated from per-unit retain certificates to redeem certificates issued previously. This enables a cooperative to revolve capital accounts so that patron investment is more nearly related to current patronage or use.

Cooperatives with marketing operations may use both per-unit retains and patronage refunds in their financial plan. When members deliver products, the cooperative may deduct a per-unit retain from the cash advance it pays to the members. After the fiscal year end (or, if a pool is involved, when the pool closes), the cooperative calculates the appropriate net margins and pays each patron a patronage refund (in cash or noncash allocations) based on the amount of product that patron delivered.

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[184] See Neely & Hulbert, *Legal Phases of Farmer Cooperatives*, FCS Information 100 (USDA 1976), at 443. The authors comment that use of “the term ‘retains’ is unfortunate because it carries the connotation that the cooperative is ‘withholding’ money or funds from its patrons--perhaps arbitrarily. This, of course, is not the case. These funds are provided by patrons under specific agreements with the cooperative and are, in fact, capital *investments.”*

[185] Riverfront Groves v. Commissioner, 60 T.C. 435 (1973); Priv. Ltr. Rul. 8033070 (May 22, 1980).

[186] Priv. Ltr. Rul. 8023018 (Feb. 27, 1980).

[187] See Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001 (1981).

Per-unit retains also can be paid in money or in certificates which are redeemed shortly after issuance. This is really a device for making cash payments to patrons rather than a means of financing the cooperative. Since per-unit retains are not tied to a cooperative's earnings, they can be paid to patrons before the end of the tax year.

Cash per-unit retains are predominantly used by cooperatives that market member products on a pooled basis and don't close their pools until after the end of the taxable year in which the product was delivered. Patronage refunds can't be distributed until the pool is closed and the related margins determined, so per-unit retains give the association a method of making a cash payment to the members, related to use, and eligible for single tax treatment.

Comparison with Patronage Refunds

It is important to recognize the similarities and differences between per-unit retains and patronage refunds.[188]

First, the similarities. Per-unit retains, like patronage refunds, base a patron's capital investment in the cooperative on the extent each patron uses the cooperative's services. Assuming Code requirements are followed, both payment forms are eligible for single tax treatment--tax liability at either the cooperative or patron level, but not both. And both methods generally are used in conjunction with capital financing plans such as a revolving fund or base capital plan.

Several key distinctions should also be noted. The calculation of per-unit retains is not tied to the cooperative's net earnings from business done with or for its patrons as is the case with patronage refunds. Instead, per-unit retains are based on the physical volume or dollar value of product marketed for each patron without regard to net earnings. This non-linkage with

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[188] The term "patronage refund" rather than the Code term "patronage dividend" is used in this series of reports in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

earnings gives cooperatives the ability to raise equity in years with low earnings or even losses and the flexibility to make per-unit retain allocations before the end of the fiscal year.

Single tax treatment of per-unit retain allocations is only available for transactions made as part of a cooperative's marketing operations. In contrast, subchapter T tax treatment is available for patronage refunds based on any marketing, supply, or service activity of a cooperative.

Another difference is that single tax treatment of per-unit retains issued as qualified certificates doesn't require that some portion of the allocation be paid in money. At least 20 percent of a qualified patronage refund distribution must be paid in cash or qualified check.[189]

The contentious issue of whether a refund is from patronage- or nonpatronage-sourced earnings doesn't arise when considering per-unit retains. A per-unit retain allocation, by definition, can only involve funds derived from marketing a patron's products.[190] This activity is generally accepted as patronage in nature.

HISTORICAL BACKGROUND

Little is known of the exact origin of per-unit retain financing by cooperatives. Experienced cooperative advisers indicated that the system just evolved as a natural method of financing a cooperative marketing operation.

A review of some of the earlier court decisions involving cooperative finance indicates per-unit retains were used early in the development of the marketing cooperative system.[191] In *Rei-*

[189] I.R.C. 1388(c)(1).

[190] I.R.C. § 1388(f).

[191] Silveria v. Associated Milk Producers, 219 P. 461, 63 Cal. App. 572 (1923). Members successfully sued their cooperative to secure refunds of per-unit retains collected for capital accumulation because the marketing agreement between the cooperative and its members only authorized deductions to cover transportation and other marketing expenses.

nert v. California Almond *Growers Exchange,* the court described an early per-unit retain similar to those in use today:

> In view of the fact that the Exchange was a nonprofit, nonstock corporation it did not have funds available from the sale of capital stock to be used for working capital and to acquire a plant in which to conduct its operations. To provide working capital from which to make advances to growers before sale of their nuts and for supplies, the reserve for working capital, also known as the suspense account, was established some time prior to 1919. From the amount described as net proceeds to the grower on the annual pool closing statements a further deduction was made, representing a stated percentage of the grower's net proceeds, usually 5 per cent., and held out by the Exchange, and credited to its reserve for working capital. This reserve was placed on the revolving fund basis, the amounts held out in future years being used in part to repay to growers the contributions of prior years to the account.[192]

Per-unit retains (frequently called "deductions" in the earlier years) were authorized by the historically important Bingham Act[193] and other State cooperative laws.[194]

[192] Reinert v. California Almond Growers Exchange, 63 P.2d 1114, 1117 (Cal. App. 1936)(unreported in California); *rev'd,* 70 P.2d 190, 9 C.2d 181 (1937). The California Almond Growers Exchange is currently called Blue Diamond Growers.

[193] Burley Tobacco Growers' Co-op Ass'n v. Tipton, 11 S.W.2d 119, 227 Ky. 297 (1928); Burley Tobacco Growers' Co-op Ass'n et al. v. Brown, 17 S.W. 2d 1002,229 Ky. 696 (1929).

The Bingham Co-operative Marketing Act, adopted in Kentucky in 1922, is sometimes referred to as the "Standard Act" because it served as the model for similar laws adopted in many other States. Baarda, State *Incorporation Statutes for Farmer Cooperatives,* ACS Cooperative Information Report 30 (USDA 1982), p. 3.

[194] See, e.g., Boyle et al. v. Pasco Growers' Ass'n, 17 P.2d 6,170 Wash. 516 (1932).

A detailed study by USDA's Farmer Cooperative Service[195] of financial data for association fiscal years ending in 1954 revealed per-unit retain financing was widely used well before Subchapter T was enacted in 1962. Of the $847 million in equity capital reported by the 1,157 farmer cooperatives supplying data to the study, 10 percent had been acquired through per-unit retains. For marketing associations only, the figure was 18 percent.[196]

A follow-up report disclosed the responding cooperatives reported $489 million of their equity, or 58 percent, was revolving fund capital.“' For all cooperatives, 17 percent of revolving fund capital was acquired through per-unit retains. The percentage increased to 23 percent for local marketing associations and 26 percent for marketing regionals.[198]

Per-unit retains were used extensively in California. The questionnaires from a 1952 survey of California cooperatives by the Department of Agricultural Economics of the University of California (Davis) were made available to USDA for tabulation, using the same methods as USDA's 1954 survey. Of the 157 California cooperatives providing data that had an equity redemption program, 68.4 percent of their revolving fund capital had been acquired by per-unit retains.[199]

USDA studies conducted after enactment of Subchapter T document the continued importance of per-unit retain financing. For 1970, marketing cooperatives reported that 35.9 percent of their allocated equity had been acquired by per-unit retains. This amounted to nearly $460 million.‘@'

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[195] A predecessor to the Rural Business\ Cooperative Service.

[196] H. Hulbert, Griffin, and Gardner, *Methods of Financing Farmer Cooperatives,* FCS General Report 32 (USDA 1957) pp. 14-16. The study found this method of acquiring capital was insignificant for farm supply cooperatives.

[197] H. Hulbert, Griffin, and Gardner, *Revolving Fund Method of Financing Farmer Cooperatives,* FCS General Report 41 (USDA 1958) p. 8.

[198] Id. at p. 19.

[199] Id. at p. 37. Of these 157 cooperatives, 152 were marketing.

[200] Griffin, *A Financial Profile of Farmer Cooperatives in the United States,* FCS Research Report 23 (USDA 1972) at p. 23 (Table 14).

Reliance on per-unit retains varied among commodity groups. Two out of every 3 dollars of patronage-sourced equity in fruit and vegetable cooperatives came from per-unit retains. The percentages for other crops included rice (nearly 50 percent), poultry (38 percent), dairy (26 percent), cotton (13 percent), and grain and soybeans (1 percent).[201]

The latest USDA study, covering 1987, found that while the number of marketing cooperatives using per-unit retains fell from 229 in 1976 to 190 in 1987, the amount of new financing provided from per-unit retains increased from $125 million in 1976 to $190 million in 1987.[202] Thus, for many marketing associations per-unit retains are an integral part of their capital accumulation program.

LEGISLATIVE AND REGULATORY BACKGROUND

In view of the extensive regulatory, judicial, and legislative history of the tax treatment of patronage refunds, it seems difficult to believe that little consideration was given to per-unit retains until the 1960s. The Revenue Act of 1951 made no mention of them.[203]

In 1954, the U.S. Treasury Department (Treasury) issued two administrative rulings that acknowledged per-unit type retains. Rev. Rul. 54-10 set out the IRS's policy regarding the tax treatment of patrons who received noncash allocations from cooperatives. The Service noted that while the term patronage refund "does not include amounts without reference to earnings of the association," the rules in the regulation applied "to all allocations made by a cooperative association in document form."[204]

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[201] Id. at p. 24 (Table 15).

[202] Royer, Wissman and Kraenzle, *Farmer Cooperatives Financial Profile, 1987*, ACS Research Report *91* (USDA 1990) at p. 17 (Table 9).

[203] Revenue Act of 1951, ch. 521, §314, 65 Stat. 452, 491-493 (1951). This law is discussed in Chapter 3 of this series of reports, Frederick and Reilly, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, part 1 (USDA 1993) pp. 85-88.

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

In a one-paragraph decision, Rev. Rul. 54-244, a cooperative had retained a portion of sales proceeds due patrons and issued stock with a par value equal to the amount of funds retained. The patrons had reported the face amount of the stock received as part of their income in each year the stock was distributed. The Service held the value of the stock did not represent "earnings and profits of the association."[205]

In 1958, Treasury issued new regulations to implement the cooperative provisions of the Code as recodified by the Revenue Act of 1954.[206] The definition of "patronage dividends, rebates, and refunds" specifically excluded "Amounts allocated...by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association."[207]

The 1958 version of USDA's *Legal* Phases *of Farmer* Cooperatives only briefly describes the nature of "deductions" from sales proceeds returned to producers and the legal authority for cooperatives to use them to raise capital.[208] In discussing tax law, the statement is made that the only difference between the tax treatment of noncooperative and cooperative corporations is that cooperatives may exclude from gross income "true patronage refunds,"[209] ignoring deductions used as retains.

The 1958 USDA report's one paragraph on the tax treatment of retains states:

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[205] Rev. Rul. 54-244,1954-l C.B. 104. For a thorough discussion of whether payments from patrons to a cooperative are taxable payments for goods and services received or nontaxable contributions to capital, see United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962), *aff'g* 186 F. Supp. 724 (N.D. Calif. 1960).

[206] Internal Revenue Code of 1954, 68A Stat. 3, 177-178 (1954).

[207] Treas. Reg. §1.522-1(b)(4)(ii), published us T.D. 6301, 1958-2 C.B. 197, 247. See *also* Example 1 of this regulation, which immediately follows the quoted definition.

[208] Hulbert and Mischler, *Legal Phases of Farmer Cooperatives*, FCS Bulletin 10 (USDA 1958) at pp. 120-123.

[209] Id. at p. 209.

> Amounts authorized by members to be deducted from sales proceeds in the case of a marketing cooperative or to be added to the cost of purchases made for the express purpose of being used by the cooperative as capital also are not taxable to the cooperative. This is because money furnished to any corporation for capital purposes is not income to the corporation (cites omitted).[210]

The Revenue Act of 1962,[211] which introduced subchapter T and the present system of cooperative taxation, also didn't mention per-unit retain allocations. It focused on written notices of allocation without, however, casting any particular hindrances in the way of per-unit retain type distributions to patrons.

Some knowledgeable cooperative tax practitioners have suggested in informal conversations that this was an inadvertent omission in the original version of Subchapter T. When Subchapter T was drafted, the Treasury Department was only concerned about making sure a current tax was paid on patronage refunds.[212]

The new provisions were, by their terms, only applicable to patronage refunds. Cooperative tax experts recall certain cooperative advisers at the time suggesting that because per-unit retains were not covered by subchapter T, patrons receiving "qualified" retains could still avoid tax on the theory the retains had no fair market value when issued and thus were not taxable income.[213]

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[210] Id. at p. 214.

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

[212] The judicial and administrative decisions that defeated the intent of Congress to create a single current tax in the Revenue Act of 1951 are discussed in "Judicial Decisions" subsection of Chapter 3 of this series of reports. Frederick and Reilly, Income *Tax Treatment of Cooperatives: Background,* ACS CIR 44, part 1 (USDA 1993) at pp. 88-91.

[213] These recollections are supported by language in the Senate Report accompanying the Foreign Investors Tax Act of 1966, which included statutory language on tax treatment of per-unit retains. The report states, ". ..because the per-unit retain certificates issued by cooperatives may have a fair market value considerably less than their face amount...some have raised questions as to whether they may be consid-

Because of this gap in coverage, Treasury amended Treas. Reg. section 1.615 to include rules for the deductibility of per-unit retain certificates by cooperative associations as well as their treatment as income by patrons. Proposed rules were published in May 1965.[214]

Cooperatives found several deficiencies in these proposed rules, notably the lack of recognition of bylaw consent to "qualify" per-unit retain certificates and unmanageable effective dates.[215] Treasury published its final rule that October.[216] The final rule included most of the changes suggested by cooperatives, but the test for distinguishing qualified and nonqualified per-unit retains was still considered unclear.[217]

In 1966, subchapter T was revised to include comprehensive coverage of per-unit retain distributions. These changes, appearing in the Foreign Investors Tax Act of 1966, amended Code sections 1382, 1383, 1385, and 1388 of subchapter T and the information reporting rules for cooperatives in Code section 6044.[218]

The Senate report accompanying this act noted that Treasury's 1965 regulations "provided for the income tax treatment of per-unit retain certificates in a manner that is substantially parallel to the treatment prescribed in the Revenue Act of 1962 with respect to patronage (refunds)."[219]

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ered as paid out by the cooperatives and whether the patrons can be required to include them in their gross income." S. Rep. No. 1707, 89th Cong., 2d Sess., reprinted *in* 1966 U.S. Cong. & Admin. News 4446, 4515.

[214] 30 FR 6349-50 (May 6, 1965).

[215] XIV Legal-Tax Memorandum No. 5, National Council of Farmer Cooperatives (May 6, 1965).

[216] Treas. Reg. §1.61-5(d)-(h), *published as* T.D. 6855, 30 FR 13134-36 (Oct. 15, 1965).

[217] XIV Legal-Tax Memorandum No. 11, National Council of Farmer Cooperatives (Oct. 15, 1965).

[218] Pub. L. No. 89-809, tit. II, § 211(a)-(f), 80 Stat. 1539, 1580-1584 (1966).

[219] S. Rep. No. 1707, 89th Cong., 2d Sess., *reprinted in 1966* U.S. Cong. & Admin. News 4446, 4515.

Treasury's authority to tax per-unit retains at the patron level was still being questioned, even after the 1965 regulations were promulgated.[220] The 1966 amendments clarified both the authority of Treasury to collect a single current tax on per-unit retains and answered cooperative questions about the treatment of qualified and nonqualified retains.

The Senate report to the Foreign Investors Tax Act of 1966 summarized the amendments to subchapter T as follows:

> The bill amends present law to provide tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends. Providing essentially the same treatment for per-unit retain certificates means, generally, that they are to be treated as income to the patron in the year in which the certificates are issued, if the patrons give their consent in writing to the inclusion of the face amount of these certificates in their income or if there is a provision in the bylaws or charter of the cooperative indicating that membership in the cooperative represents consent to such treatment. Under the amendment, the cooperative is permitted to take a deduction in arriving at gross income for a per-unit retain certificate when issued, only when the certificate qualifies for the treatment specified above at that time in the hands of the patron. Otherwise, the amount involved is deductible by the cooperative only at the time the certificate is redeemed.[221]

The 1966 amendments to the Code brought per-unit retain financing within subchapter T coverage by providing for the imposition of income taxes at either the cooperative or patron level. And per-unit retains were to be taxable at face value, even

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[220] *Id.*

[221] *S.* Rep. No. 1707, 89th Cong. 2d Sess. 70, *reprinted in 1966* U.S. Code Cong. & Admin. News 4446, 4515-4516.

if the fair market value was considerably less." The 1966 changes also required cooperatives to provide return information on per-unit retain allocations comparable to that already required for patronage refunds.[223]

Just as amendments were enacted to correct an oversight during the original drafting of subchapter T in 1966, a further amendment was needed in 1969 to remedy a deficiency in the 1966 amendments. The 1962 Act authorized cooperatives to deduct patronage refunds paid in "money, qualified written notices of allocation...or other property...."[224] However, the 1966 amendment only permitted the deduction of per-unit retain allocations paid in "qualified per-unit retain certificates...."[225]

The Senate report accompanying the 1969 amendment explained that cooperatives that marketed products on a pooling basis were having trouble making cash payments to patrons during the 8 ½ month payment period following the end of their taxable year. As the pool might not be closed during that period, and net earnings on a pool can't be determined until it is closed, patronage refunds couldn't be made.

While per-unit retain payments could be made during this time, the Code only authorized the deduction of such retains paid in qualified noncash form. Congress saw "no reason why a cooperative should be able to deduct per unit retain allocations paid as qualified certificates during the 8½ month period following the close of the taxable year, but not per unit retain allocations paid in money during the same period."[226]

The 1969 amendment of subchapter T made it clear cooperatives could deduct cash per-unit retain allocations under

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[222] S. Rep. No. 1707, 89 Cong., 2d Sess. 70, *reprinted in* 1966 U.S. Code Cong. & Admin. News 4446, 4515.

[223] Pub. L. No. 89-809, tit. II, § 211(d), 80 Stat. 1584, codified at I.R.C. § 6044.

[224] I.R.C. § 1382(b)(l).

[225] Pub. L. No. 89-809, 80 Stat. 1539, at tit. II, § 211(a)(2) (1966), codified at I.R.C. § 1382(b)(3).

[226] S. Rep. No. 552, 91st Cong., 1st Sess. (1969), reprinted in 1969 U.S. Code Cong. & Admin. News 2027, 2331-2332.

the same rules as qualified per-unit retain certificates.[227]

The regulations pertaining to subchapter T haven't been rewritten to reflect the 1966 and 1969 Code changes relating to per-unit retains, so per-unit retains are not expressly covered in Treas. Reg. §§ 1.1381-l through 1.1388-L However, where the Code provides parallel treatment for patronage refunds and per-unit retains, the subchapter T regulations should be one source of guidance even though per-unit retains are not specifically referenced. And Treas. Reg. § 1.61-5 with its coverage of per-unit retain certificates, while predating official Code recognition of per-unit retains in 1966, has never been revoked or superseded.[228]

CODE DEFINITION OF A PER-UNIT RETAIN

Code section 1388(f) defines "per-unit retain allocation" as any allocation by a cooperative "to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron."[229]

This definition contains several parts. First, an association making per-unit retain allocations must meet the Code's requirements as a subchapter T cooperative organization.[230]

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[227] Tax Reform Act of 1969, Pub. L. 91-172, § 911, 83 Stat. 487,722 (1969), reprinted *in* 1969-3 C.B. 10,154.

[228] In amending the Code in 1966 to include per-unit retain tax treatment, the Senate Finance Committee acknowledged Treas. Reg. § 1.61-5 (as amended by T.D. 6855, 30 FR 13134, Oct. 15, 1965) and noted on p. 4515 of its report:

> By adopting this amendment, your committee does not intend to reflect on the validity of the regulations recently issued by the Treasury Department with respect to per-unit retain certificates..." S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d Sess. 70, *reprinted in* 1966 U.S. Code Cong. & Admin. News 4446, 4515.

[229] I.R.C. § 1388(f).

[230] I.R.C. § 1388(f). I.R.C. § 1381(a) provides that section 521 farmers' cooperatives and other corporations "operating on a cooperative basis" are eligible for tax treatment under subchapter T. Chapter 2 of this series of reports discusses what it means to be

Second, the allocation must be made to patrons[231] pursuant to an agreement between the cooperative and the patron.[232]

Third, the calculation of the per-unit retain is not tied to the cooperative's net earnings. This requirement distinguishes per-unit retain allocations from written notices of allocation. The basis for computing per-unit retains is apparently left to agreement between the patron and the cooperative. Normally, a per-unit retain is based on the quantity or value of products "marketed"[233] for the patron.

Per-unit retains usually take the form of a deduction of money from a payment to the patron for products sold (in raw or processed form) by the cooperative. The "per-unit" designation often refers to cents or dollars per bushel of grain, per hundred-weight of milk, per box of fruit or some other unit of quantity of

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"operating on a cooperative basis." Frederick and Reilly, Income *Tax Treatment of Cooperatives: Background,* Cooperative Information Report 44, part 1 (USDA 1993) pp. 22-28.

[231] Treas. Reg. § 1.1388-1(e) defines "patron" 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."

The issue of distinguishing a patron from a member is discussed in Chapter 1 of these reports. Frederick and Reilly, Income *Tax Treatment of Cooperatives: Background,* Cooperative Information Report 44, part 1 (USDA 1993) pp. 4-5.

[232] I.R.C.§ 1388(f). By "agreement," the Code means some form of agreement among the members of a cooperative generally, such as a bylaw provision, as to the measure or formula to be used. This concept should be distinguished from "obtaining agreement" from patrons to take into account as income the stated value of qualified per-unit retain certificates required under I.R.C. § 1388(h)(2).

[233] I.R.C. § 1388(f). The Code's specific use of the word "marketed" indicates per-unit retain allocations made with reference to nonmarketing activities of a cooperative don't qualify for single tax treatment.

product marketed by the cooperative. Whether a per-unit retain meets the Code requirements is a question of fact.[234]

Despite various distinctions, the parallelism in the tax treatment of patronage refunds and per-unit retains has been characterized as "striking."[235] Principles that apply to patronage refunds generally also apply to per-unit retains.[236] However, the statutory provisions for per-unit retains and patronage refunds are distinct and do reflect the differences in their character.[237]

Subchapter T tax treatment of per-unit retain allocations follows the same basic principles first established for written notices of allocation, taking into account the differences in form between the two equity instruments and the option to make cash per-unit retain allocations prior to pool closing.[238]

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[234] Rev. Rul. 68-236, 1968-1 C.B. 382. This revenue ruling was prepared for the guidance of cooperative organizations and their patrons in the treatment of per-unit retains for Federal income tax purposes.

[235] Farm Service Cooperative v. Commissioner, 619 F.2d 718,725, n. 17 (8th Cir. 1980), 1980-l U.S.T.C. ¶ 9352, rev'g, 70 T.C. 145 (1978). The court in *Farm Service* noted the similarity of patronage refunds to per-unit retains in supporting its refusal to allow patronage sourced losses to offset nonpatronage sourced income when payments were made in per-unit retain allocations rather than patronage refund allocations.

[236] See Priv. Ltr. Rul. 8447038 (Aug. 20, 1984) where the Service approved the issuance of both qualified and nonqualified per-unit retain certificates.

[237] Farm Service Cooperative v. Commissioner, 619 F.2d 718 at 726 (8th Cir. 1980), 1980-l U.S.T.C. 9352, *rev'g*, 70 T.C. 145 (1978); noting H. Rept. 91-413, 91st Cong., 1st Sess. (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1821.

[238] See Senate Finance Committee Technical Explanation, Pub. L. 89-809 (1966). The Committee, in adopting the 1966 changes, noted that the new law provided "tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends." S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d Sess. 70, 1966 U.S. Code Cong. & Admin. News 4446, 4515-4516.

The tax treatment of per-unit retains to cooperatives is set out in Code section 1382(b). Section 1382 authorizes cooperatives to treat "as a deduction in arriving at gross income"[239] per-unit retains distributed in money, qualified certificates, or other property.[240] Treatment similar to that accorded patronage refunds also applies to cooperative payments used to redeem nonqualified per-unit retain certificates.[241]

ADVANCES AND PER-UNIT RETAINS PAID IN CASH

Marketing cooperatives frequently make an initial cash payment to their producers when product is delivered. This is especially true of pooling cooperatives. A final payment or patronage refund may not be made for some time. The accounting and tax consequences of this payment, and any periodic payments that may be made before the final payment, depend on whether the preliminary payments are considered a cash advance or a cash per-unit retain.

Prior to the 1969 amendment to subchapter T authorizing cash per-unit retains,[242] the Service issued two rulings that involved the treatment of cash advances paid by pooling cooperatives. In Rev. Rul. 67-333, the Service concluded that cash advances are deductible by the cooperative as a cost of products sold in the same year they are considered income to the members.[243]

In Rev. Rul. 69-67, the Service modified Rev. Rul. 67-333 to make it clear that cash advances must be capitalized as part of inventory (cost of goods sold). Cash advances were only deductible to the extent that inventory in the pool was sold by the

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[239] I.R.C. § 1382(b).

[240] I.R.C. § 1382(b)(3).

[241] I.R.C. § 1382(b)(4). Redemptions can be in the form of money or other property (except per-unit retain certificates).

[242] Tax Reform Act of 1969, Pub. L. 91-172, § 911, 83 Stat. 487,722 (1969), *reprinted in* 1969-3 C.B. 10,154.

[243] Rev. Rul. 67-633, 1967-2 C.B. 299.

end of the tax year.[244] For example, if 70 percent of the inventory from the pool was sold by the end of the year, then 70 percent of the cash advances were deductible in that year. Additional deductions were permitted in subsequent years in proportion to the extent that pool inventory was sold off.

Subchapter T was amended in 1969 so that per-unit retains allocated to patrons in cash or other property could receive the same single tax treatment as per-unit retains issued as qualified certificates.[245] Section 1382 of the Code provides, in part:

> (b) In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--
>
> . ..(3) as per-unit retain allocations..., to the extent paid in money, qualified per-unit retain certificates..., or other property...with respect to marketing occurring during such taxable year....[246]

The Service has taken the position that cash payments made during the 8 ½ months of the payment period after the close of the tax year are fully deductible per-unit retains paid in money[247], but such payments during the tax year are cash advances that must be capitalized under Rev. Rul. 69-67.[248]

Another interpretation of this Code language is that it clearly states a cooperative shall not include per-unit retains paid in money in determining taxable income. Thus, a marketing

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[244] Rev. Rul. 69-67,1969-l C.B. 142.

[245] S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969), ***reprinted in 1969*** U.S. Code Cong. & Admin. News 2027, 2331-2332. The effective date for this provision is October 9, 1969.

[246] I.R.C. §1382(b)(3).

[247] Tech. Adv. Mem. 8005012 (Oct. 29, 1979); Priv. Ltr. Rul. 8540056 (July 8, 1985); Priv. Ltr. Rul. 8838018 (June 23, 1988).

[248] Tech. Adv. Mem. 8005012 (Oct. 29, 1979); Priv. Ltr. Rul. 8838018 (June 23, 1988).

cooperative that makes an initial payment to a patron for product delivered appears to have some flexibility in how it treats that payment for tax purposes. If it chooses cash advance treatment, the payments are capitalized as cost of goods sold. If it chooses cash per-unit retain treatment, the entire amount is deductible if paid anytime during the payment period.

In some situations, flexibility may also exist as to the year that the deduction may be taken. For example, it appears that cash payments for product delivered in one year, but made during the first 8 ½ months of the following year, may be considered (1) advances in the second year, (2) per-unit retains paid in money relating back to the first year, or (3) per-unit retains paid during the second year, depending on how the cooperative chooses to characterize them.

PER-UNIT RETAIN CERTIFICATES

Most per-unit retains collected by cooperatives are treated as equity or debt. The funds are retained by the cooperative and the patrons receive written certificates as evidence of their individual capital contributions.

Code Section 1388(g) defines a retain certificate as "any written notice which discloses to the recipient the stated dollar amount of a per-unit retain allocation to him by the organization."[249]

The regulations to Code section 61 are more specific, providing:

> . ..the term "per-unit retain certificate" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice--
>
> (1) Which is issued to a patron with respect to products marketed for such patron;

[249] I.R.C. § 1388(g).

(2) Which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative association; and

(3) The stated dollar amount of which is fixed without reference to net earnings.[250]

A per-unit retain certificate must be a "written notice" issued to the patron.[251] No particular form of written statement is required.[252] Written notices found adequate have included certificates of retain,[253] common stock,[254] revolving fund certificates,[255] and equity capital retain certificates.[256]

The Code and regulations also require that the certificate disclose to the recipient "the stated dollar amount" of the allocation to the patron by the cooperative.[257]

In Revenue Ruling 68-236,[258] IRS described how some cooperatives issue a preliminary statement which indicates the amount of the per-unit retain for that particular transaction. It

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[250] Treas. Reg. §1.61-5(g).

[251] I.R.C. § 1388(g) and Treas. Reg. § 1.61-5(g).

[252] *Id.*

[253] *In* Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001 (1981), the court notes a cooperative issued what it simply called "certificate of retains."

[254] Priv.Ltr Rul. 8846030 (Aug. 22, 1988), describes a cooperative issuing one class of common stock for qualified per-unit retain certificates and another class of common stock for nonqualified per-unit retain certificates.

[255] Riverfront Groves, Inc. v. Commissioner, 60 T.C. 435 (1973).

[256] Tech. Adv. Mem. 8023018 (Feb. 27, 1980). The bylaws in this ruling also permitted the issuance of debt certificates.

[257] I.R.C. § 1388(g) and Treas. Reg. 1.61-5(g). The regulations for Subchapter T, in discussing what is required for disclosing the stated dollar amount of written notices of allocation, note that "a mere credit to the account of a patron on the books of the organization without disclosure to the patron, is not a written notice of allocation." Treas. Reg. §1.1388-1(b). This rule is also applicable to per-unit retain certificates.

[258] Rev. Rul. 68-236,1968-l C.B. 382.

might be issued on a receipt at the time the goods are delivered, or it might appear on the voucher accompanying a check given as initial payment for goods delivered. A more formal statement is issued later showing the total amount of per-unit retains for a specific time period.

The Service said both sets of documents meet the technical definition of a per-unit retain certificate. The written statement uniformly treated by the parties as the per-unit retain certificate will be treated as the certificate for tax purposes.[259] While some degree of informality is tolerated, in *Seiner Association v. Commissioner* the Tax Court made it clear that any notice, whether a per-unit retain certificate or a written notice of allocation, must disclose the amount of the allocation.[260]

Because both written notice of allocation and per-unit retain certificates are issued under a variety of names, it is important to look beyond the specific name of the instrument to establish its true character. For example, a "retain certificate" could be a patronage refund in the form of a written notice of allocation rather than a per-unit retain certificate.[261]

Cooperatives differ in the timing of the distribution of per-unit retain certificates. Certificates may be issued when patrons deliver their product; or might not be issued until the cooperative sells the product. In pooling arrangements, some time may elapse before the cooperative issues the certificates.[262]

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[259] *Id.*

[260] Seiners Ass'n v. Commissioner, 58 T.C. 949, 957-958 (1972). Although this case dealt with written notices of allocation, it referred to Rev. Rul. 68-236 to support the finding of a need for specific disclosure of the amount retained.

[261] See I.R C. § 1388(b), which defines written notice of allocation as "any capital stock, revolving fund certificate, *retain certificate,* certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend." (emphasis added)

[262] See discussion under "Pooling and Statutory Payment Period" in this chapter.

Qualified Per-Unit Retain Certificates

Once a per-unit retain certificate has been established, the next question is whether the certificate is qualified or nonqualified. As is the case with written notices of allocation, the qualified / nonqualified characterization is important because it determines when a cooperative can deduct the allocated amount of the certificate from income.

The Code defines a “qualified per-unit retain certificate” as a certificate which the distributee agrees, through prescribed methods, to include in taxable income “at its stated dollar amount."[263]

Patron agreement is obtained by one of two methods: (1) individual written agreement or (2) an appropriate bylaw provision.‘” Issues in obtaining agreement are discussed later in this subsection.

As with any per-unit retain certificate, the Code requires that qualified certificates be accounted for at their “stated dollar amount."[265] This is true even if the certificates are worth considerably less than face value.

In *Riverfront* Groves, Inc. *v. Commissioner*,*” the U.S. Tax Court ruled that certain per-unit retain certificates be appraised at their face value even though their worth in real terms was much less. The court explained:

> These per-unit retain certificates have no fair market value outside of the citrus industry. They cannot be

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[263] I.R.C. § 1388(h)(l), referring to the I.R.C. § 1385(a) rule on amounts includible in patron’s gross income.

[264] I.R.C. § 1388(h)(2). This provision refers to “obtaining agreement” for a qualified per-unit retain certificate. I.R.C. § 1388(c)(2) uses the term “obtaining consent” for qualifying written notices of allocation. While the Code language varies slightly, the procedures outlined under both Code sections are nearly identical except for inclusion of the qualified check option as a form of consent for qualified written notices of allocation [see I.R.C. § 1388(c)(2)(C)].

[265] I.R.C. §§ 1388(h)(l) and 1388(e)(2).

[266] 60 T.C. 435 (1973).

> utilized as security for normal commercial, or banking transactions, or loans, and they are redeemable by the issuing cooperative solely at the discretion of the board of directors. Petitioner has never received any cash payments from [the cooperative] in redemption of the certificates. In fact, redemptions of similar certificates have not been made by the cooperative for at least 10 years.[267]

The court based its decision on the following rationale:

> . ..this deduction is premised on the consent of the patron to include in his income at their face amount the qualified allocations distributed by the cooperative. It is this voluntary consent of the patron which Congress in enacting subchapter T believed to be sufficient to establish the necessary elements to tax the patron on the noncash distributions.[268]

No Cash Payment Required

One distinction between qualified per-unit retain certificates and qualified written notices of allocation is that no minimum cash payment has to accompany the distribution of qualified per-unit retain certificates.[269] The money or qualified check requirement for qualified written notices of allocation was imposed in part to assist the patron in paying the income tax on the allocation. This requirement was not considered necessary or practical for qualified per-unit retain certificates. As noted in the House Report accompanying the Tax Reform Act of 1969:

> With respect to per-unit retains, this requirement is not imposed since retains are not determined with

[267] Riverfront Groves, Inc. v. Commissioner, 60 T.C. *435,437 (1973).*

[268] *Id.* at 441.

[269] A written notice of allocation is not "qualified" unless it is distributed as part of a patronage refund with *20* percent or more of the patronage refund paid in money or by qualified check. I.R.C. § 1388(c)(l).

respect to profits, and if the requirement were imposed, many cooperatives would merely increase by 20 percent the amount of the retain, and return the increase as a cash payment in satisfaction of the requirement.[270]

Tax Treatment

The tax consequences that arise from distribution of qualified per-unit retain certificates parallel those for qualified written notices of allocation. The cooperative can deduct from gross income in the taxable year of issuance payments made in the form of qualified per-unit retain certificates[271] while patrons must include the stated certificate amount in gross income.[272]

Qualification Based On Written Agreement

As mentioned previously, a qualified per-unit retain certificate requires that the patron agree to include as income the certificate's stated dollar amount.[273] Code section 1388(h)(2) specifies two methods for satisfying this requirement.

One method is to have the patron agree in writing to include the certificate's stated dollar amount in gross income for income tax purposes.[274] A common practice among marketing cooperatives that obtain agreement by written consent is to include the patron agreement provision in their membership or marketing agreement with each patron. Obtaining written agreement from the patron in this manner parallels the Code's written consent procedures for qualifying written notices of allocation.[275]

The written agreement with the patron doesn't have to follow any special form so long as there is adequate disclosure to the

[270] H.R. Rep. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1821.

[271] I.R.C. § 1382(b)(3).

[272] I.R.C. § 1385(a)(3).

[273] I.R.C. § 1388(h)(l).

[274] I.R.C. § 1388(h)(2)(A) and Treas. Reg. § 1.61-5(d)(2).

[275] For an explanation of the requirements for obtaining "consent in writing" for qualified written notices of allocation, see I.R.C. § 1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3).

patron about treating the certificate's stated dollar amount as income. The regulations provide the following example:

> I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any [qualified] per-unit retain certificates issued to me on or after ____ as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.[276] [bracketed language added].

A cooperative can obtain the written agreement from the patron any time during the taxable year. Once obtained, the agreement applies to all products marketed by the patron during the taxable year in which the agreement was made unless another period is specifically provided for.[277] This includes products marketed by the cooperative during the taxable year but before the agreement was executed. Once signed, a written agreement remains in effect, unless revoked, for "all subsequent taxable years of the organization."[278]

Cooperatives which solely rely on individual written agreements to qualify per-unit retain certificates run the risk of not obtaining agreements from all their patrons. If this should happen, the cooperative is limited to deducting only those amounts evidenced by certificates distributed to patrons who did sign such agreements.

Patrons can revoke at any time their written agreements to treat their per-unit retain certificates as income in the year received.[279] Such a revocation must be in writing.[280] A revocation is not necessarily effective immediately. Once filed with the cooperative, a revocation becomes effective on the first day of the

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[276] Treas. Reg. §1.61-5(d)(2)(ii).

[277] I.R.C. § 1388(h)(3)(A)(i).

[278] *Id.*

[279] I.R.C. § 1388(h)(3)(B)(i).

[280] *Id.*

following taxable year.[281] In pooling arrangements, the revocation does not apply "to any products which were delivered to the organization by the distributee before such revocation."[282]

Qualification Based On Bylaw Provision

The other method specified in the Code for obtaining patron agreement is through a bylaw provision that says "membership in the organization constitutes such agreement."[283]

For the bylaw consent to take effect, the member must receive written notification of the particular provision and a copy of the bylaw.[284] Note that consent through bylaw is operative only for members of the cooperative, and not nonmember patrons.[285]

The bylaw language should clearly identify the applicable instrument(s) to which the patron's consent applies.[286] This is particularly important for cooperatives that distribute more than one type of instrument.

The regulations don't include a sample bylaw provision for qualified per-unit retain certificates as is done for qualified written notices of allocation.[287] Such a provision might read:

> Each person who hereafter applies for and is accepted as a member in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any per-unit retain allocations with respect to his patronage occurring after __________, which are made in qualified per-unit retain

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[281] *Id.*

[282] *Id.*

[283] I.R.C. § 1388(h)(2)(B)(i).

[284] I.R.C. § 1388(h)(2)(B)(ii).

[285] I.R.C. § 1388(h)(2)(B).

[286] In one ruling, IRS took a somewhat lenient position. In Tech. Adv. Mem. 8023018 (Feb. 27, 1980), the Service said "certificate of equity" in the bylaws was broad enough to include certificates that were issued as "equity capital retain certificates."

[287] Treas. Reg. § 1.1388-1(c)(3)(ii)(b).

> certificates (as defined in 26 U.S.C. 1388(h)) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such per-unit retain certificates are received by him.
>
> Written notification of the adoption of this bylaw, a statement of its significance, and a copy of the provision shall be given separately to each member and prospective member before becoming a member of the association.

For a bylaw consent to be effective, the Code requires that the cooperative provide members with both written notification and a copy of the bylaw.[288] While the regulations don't contain specific notification instructions for qualifying per-unit retain certificates, the procedures for qualifying written notices of allocation[289] are considered applicable to qualified per-unit retain certificates. The cooperative's written communication should make the member aware of the bylaw and the significance of the consent. Each member should be notified individually and not through a notice posted at the association or published in a newspaper.[290]

Patron consent through a bylaw provision doesn't qualify certificates relating to products delivered after the recipient ceases to be a member of the association.[291] In addition, it doesn't apply to products delivered after the requisite language is stricken from the bylaw.[292]

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288 I.R.C. § 1388(h)(2)(B)(ii).

289 Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

290 *Id.*

291 I.R.C. § 1388(h)(3)(B)(ii).

292 ***Id.***

Nonqualified Per-Unit Retain Certificates

The Code defines a nonqualified per-unit retain certificate as "a per-unit retain certificate which is not" a qualified certificate.[293] Nonqualified certificates have many of the characteristics of qualified ones. Like a qualified per-unit retain certificate, a nonqualified certificate is a written notice which discloses to the patron the stated dollar amount of a noncash allocation. It is based on products marketed without reference to net earnings.

The key distinction is that a nonqualified certificate doesn't include the requisite patron agreement to account for the certificate's stated dollar amount as income when issued.

The tax treatment of nonqualified per-unit retain certificates is comparable to the treatment of nonqualified written notices of allocation. In the taxable year of issue, the cooperative doesn't exclude the stated dollar amount of the nonqualified per-unit retain certificate from income.[294] And the patron doesn't include the stated dollar amount of the certificate as income at the time of receipt.[295]

Only in the taxable year in which nonqualified per-unit certificates are redeemed, can a cooperative reduce its gross income by the amount of the redemption payout to certificate holders.[296] Amounts paid in redemption of nonqualified per-unit retain certificates are "treated as a deduction in arriving at gross income" by the cooperative.[297] The patron recipient must include the redemption amount paid by the cooperative as income in the taxable year received.[298] This finalizes the incidence of taxation for both.

The Service has concluded that a cooperative may issue both qualified and nonqualified per-unit retain certificates in the same

[293] I.R.C. § 1388(i).

[294] I.R.C. § 1382(b).

[295] I.R.C. § 1385(a).

[296] I.R.C. § 1382(b)(4).

[297] I.R.C. § 1382(b).

[298] I.R.C. § 1385(c).

year.[299] Due to the dissimilar tax treatment between qualified and nonqualified per-unit retain certificates, a cooperative issuing both types of allocations should make it clear to patrons that consent applies only to certificates designated as "qualified per-unit retain certificates" by the board of directors.

PAYMENT OF PER-UNIT RETAINS

Per-unit retain allocations, regardless of the form in which distributed, must be "paid" to patrons.[300] And to be deductible from a cooperative's gross income, per-unit retains distributed in money, qualified per-unit retain certificates, or other property must be paid "during the payment period for the taxable year during which the marketing occurred."[301] Similarly, nonqualified per-unit retain certificates must be issued "during the payment period for the taxable year during which the marketing occurred."[302]

Payment Period

The "payment period" is the time interval in which per-unit retains must be allocated to receive single tax treatment. Like that for patronage refunds, the "payment period" for per-unit retains begins on the first day of the taxable year and extends for 20 ½ months, ending on the 15th day of the 9th month following the close of the taxable year.[303] For example, if a cooperative operates on a calendar tax year, the "payment period" extends from January 1 of the taxable year through September 15 of the following year.

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[299] Priv. Ltr. Rul. M-47038 (Aug. 20, 1984).

[300] I.R.C. § 1382(b). The payment also affects the liability of a recipient to take the per-unit retain allocation into account for tax purposes. Riverfront Groves, Inc. v. Commissioner, 60 T.C. 435 (1973).

[301] I.R.C. § 1382(b)(3).

[302] I.R.C. § 1382(b)(4).

[303] I.R.C. § 1382(d) and Treas. Reg. § 1.1382-4.

Cooperatives may use more of the payment period in making allocations as per-unit retains than as patronage refunds. Per-unit retains can be paid anytime during the 12 month taxable year as well as during the M-month interval following the taxable year.[304] Patronage refunds can't be paid until after the cooperative's tax year closes because they are based upon earnings for the year from patronage business.

Prior to statutory recognition of cash per-unit retains in the Tax Reform Act of 1969,[305] it was questionable whether cash payments made after the taxable year could relate back and affect gross income for that taxable year. With the 1969 change to the Code, however, cash payments made during the M-month period following the taxable year can relate back to the taxable year's marketing and are deductible as per-unit retains in the taxable year.[306]

Pooling and Statutory Payment Period

The marketing of products pooled on a seasonal or crop year basis will not always coincide with a particular tax year or the 8½-month period that follows. Pools may stay open for longer than one year because the delivered crops need more time for processing or marketing, or because storage might be desired until the market is more favorable.[307] Growers, who contribute to

[304] Farm Service Cooperative v. Commissioner, 619 F.2d 718 (8th Cir. 1980), 1980-l U.S.T.C. ¶ 9352, *rev'g*, 70 T.C. 145 (1978). Cash per-unit retains were paid when the grower delivered the product.

[305] Pub. L. No. 91-172, 83 Stat. 487, (1969), reprinted *in* 1969-3 C.B. 10.

[306] See Priv. Ltr. Rul. 8838018 (June 23, 1988).

[307] See Wile, *Taxation of Farmers' Cooperatives and their Patrons,* 18 University of Southern California School of Law Tax Institute 449 (1966). The author notes:

> The pooling system is frequently combined with the use of capital or per unit retains. Where commodities require a longer period of time for processing and sale or are to be stored and sold at higher prices when the product supply is lower, the pool may close long after the growers' delivery of their products to the cooperative. *Id.* at 457-458.

pools, need funds in the interim to pay expenses and finance new crops.

The Code recognizes the potential timing problems if multi-year marketing wasn't given appropriate treatment. Section 1382(e)(2) provides that "the marketing of products shall be treated as occurring during any of the taxable years in which the pool is open."[308]

This gives cooperatives some flexibility in timing per-unit retain allocations under a multi-year pooling arrangement. Under section 1382(e)(2), "marketing" must occur in just one of the years the pool is open. This marketing activity is then attributed to all other open pool years, resulting in a payment period for per-unit retains extending for the life of the pool and the 8½ months immediately following the taxable year that the pool closes.[309]

For example, if a pool is open for 2 years, the cooperative can distribute per-unit retains at any time within the 2-year period as well as during the 8 %-month period that immediately follows the taxable year in which the pool closes.

Assigning per-unit retains paid in subsequent years to the earliest taxable year of the pool may create a pool loss for the first year which is carried over and offsets pool profits in subsequent years in which the pool is open. When such a loss occurs, it must be segregated from nonpatronage gains and carried back or forward separately as the case may be.[310]

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[308] I.R.C. § 1382(e)(2).

[309] Code § 1382(e)(l) provides "patronage" shall be treated as occurring in the taxable year the pool closes. Thus patronage refunds for longstanding pools can only be paid during the payment period for the year the pool closes.

[310] Farm Service Cooperative v. Commissioner, 619 F.2d 718 (8th cir. 1980), *rev'g*, 70 T.C. 145 (1978). As stated by the U.S. Court of Appeals for the Eighth Circuit:

> We hold, then, that subchapter T requires a nonexempt cooperative to segregate its patronage and nonpatronage accounts in calculating its gross income, at least in those cases where grower payments or per-unit retain allocations contribute to net operating losses in patronage activities. Id. at 726-727.

The flexibility provided under section 1382(e)(2) for pooling arrangements involving per-unit retains contrasts with section 1382(e)(l) covering pooling that relates to patronage refunds. Under section 1382(e)(l), the patronage is treated as occurring in the taxable year in which the pool closes.[311] For example, if a pool closes 2 years after delivery of the product, the patronage is considered to have taken place in the second year. This is true even if the patron's business with the cooperative took place during the first year.[312]

Sometimes an important issue in pooling situations is determining the year in which the pool, for tax purposes, closes. The regulations provide that "The determination of when a pool is closed will be made on the basis of the facts and circumstances in each case, but generally the practices and operations of the cooperative organization shall control."[313]

This regulation was written before the Code was amended to cover per-unit retains, but appears generally applicable to per-unit retains because it is designed to cover products "marketed under pooling arrangements" pursuant to I.R.C. § 1382(b).

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[311] See Priv. Ltr. Rul. 8005012 (Oct. 29, 1979). Here, the Service determined that cash payments made during the 8 ½ month period after the taxable year ended were not patronage refunds because the pool was still open. The Service then held that these cash proceeds, which were distributed within four to six weeks after the close of the taxable year, qualified as per-unit retains.

[312] Treas. Reg. § 1.1382-5 provides another example where patronage is considered to have occurred in the taxable year in which the pool closes:

> *Example.* Farmer A delivers to the X Cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a 'per bushel' advance. (Both farmer A and the X Cooperative file returns on a calendar year basis.) On October 15, 1963 farmer A receives an additional "per bushel" payment. The pool sells some of its wheat in 1963 and the remainder in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

[313] Treas. Reg. § 1.1382-5.

To avoid keeping a pool open into the next fiscal year, cooperatives sometimes close a pool just prior to the end of the first fiscal year, and sell the remaining inventory to the next year's pool. However, in at least one instance the Service refused to recognize a cooperative's closing of a pool and selling forward of the remaining inventory. The Service looked to Treas. Reg. § 1.1382-5 and determined that a pool was not closed based on the facts that the marketing cooperative retained title and risk of loss of a substantial amount of the goods in the pool.[314]

[314] Priv. Ltr. Rul. 8005012 (Oct. 29, 1979).

CHAPTER 9
REDEMPTION OF PATRONAGE EQUITY

Several preceding chapters have focused on tax issues raised by the distribution of written notices of allocation and per-unit retain certificates. This chapter looks at the consequences of the subsequent redemption of patronage equity. The financial and legal underpinnings of equity redemption are explained. Then key tax considerations and options are discussed.

The primary factor in analyzing the tax implications of a redemption of patronage equity is whether the written notice of allocation or per-unit retain certificate is qualified or nonqualified. Another factor is whether the redemption payout equals the equity's stated value when issued. For example, the redemption of a qualified written notice of allocation for less than face value may require special tax computations by both the cooperative and the holder of the notice to reflect changed circumstances from the time the equity was issued.

ROLE OF EQUITY REDEMPTION IN COOPERATIVE FINANCE

The regular redemption of patron equity is unique to cooperatives. While other corporations occasionally "buy-back" shares, only cooperatives return equity to investors on a systematic basis. This is somewhat ironic, in view of the difficulty cooperatives have attracting equity. But it is consistent with the equitable concept that since current patrons benefit from service provided by the cooperative, they should also be responsible for capitalizing it.

Equity redemption is defined as returning equity to members and other patrons who have previously invested it, in the form of cash or other property. Over the years, patrons build up allocated equity from retained patronage refunds and per-unit capital retains. Equity redemption programs provide cooperatives with a mechanism to keep a balance between each member's use of the cooperative's services and that member's share of the responsibility to provide equity capital.

While several methods are used to redeem equity,[315] the most common plan is to redeem oldest equity outstanding first and work forward toward more current equities. If, each year, a cooperative redeems the equity issued in the earliest year it has equity outstanding, it is said to have a "systematic" redemption program.

For example, if a cooperative is on a 7-year revolving cycle, patronage equities issued in 1989 would be redeemed for cash in 1996. Current patrons would be furnishing equity on the basis of a 7-year moving average of the use they made of the cooperative. Former members would be relieved of their burden of financing the association 7 years after they ceased patronizing it.

Some cooperatives redeem equity on a base capital method. Each member is assigned responsibility for providing a specific amount of equity capital, based on use of the cooperative's services. While more equity is collected from under-invested members, equity is redeemed for over-invested members.

A cooperative that retains patronage refunds and/or collects per-unit retains and also redeems allocated patronage equity on a systematic basis has a way to continually acquire equity while placing the primary responsibility for financing the association on current patrons, in proportion to the extent of their patronage.[316]

TAX TREATMENT OF EQUITY REDEMPTION

The term "redemption" is not defined in subchapter T of the Code or the Treasury Regulations (regulations). One private letter ruling characterized redemption as "the act of buying back

[315] Some equity redemption plans are briefly discussed in chapter 2 of these reports. For a thorough explanation of cooperative equity redemption, see D. Cobia, et al., *Equity Redemption: Issues and Alternatives for Farmer Cooperatives,* ACS Research Report No. 23 (USDA 1982).

[316] For a report of current cooperative equity redemption practices, see Rathbone and Wissman, *Equity Redemption and Member Equity Allocution Practices of Agricultural Cooperatives,* ACS Research Report No. 124 (USDA 1993).

or repurchasing"[317] something which may be accomplished in a number of different ways, including "repurchase, cancellation, repayment, or any other action otherwise satisfying one's obligations."[318]

Redemption of patronage equity, like its issuance, signifies a form of payment by the cooperative to the patron. However, it is important to view the issuance and redemption acts as separate and distinct events for purposes of tax treatment.

As indicated in earlier chapters on patronage refunds and per-unit retains, tax consequences at the time of redemption, for both the cooperative and its patrons, depends on whether the equity was originally issued in qualified or nonqualified form.

Redemption of Qualified Patronage Equity

When qualified written notices of allocation or qualified per-unit retain certificates are redeemed, the cooperative and the patron recipients generally do not make any adjustments to income in the taxable year of redemption.[319]

The cooperative deducted the stated value of qualified written notices of allocation[320] or qualified per-unit retain certificates[321] from gross income in the taxable year of issue.

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[317] Priv. Ltr. Rul. 7926068 (March 29, 1979), quoting Marker v. Scotts Bluff County, 289 N.W. 534,537 (1939).

[318] Priv. Ltr. Rul. 7926068 (March 29, 1979), *citing* Stoller v. State, 105 N.W.2d 852 (1960).

[319] This statement assumes redemption payment is for the full face amount of the equity.

[320] I.R.C. § 1382(b)(l) and Treas. Reg. § 1.1382-2(b)(1). Qualified written notices of allocation are treated "as an item of gross income and as a deduction therefrom." I.R.C. § 1382(b). See also I.R.C. § 1382(c)(2)(A), specifically permitting § 521 farmer cooperatives to deduct qualified written notices of allocation representing nonpatronage earnings distributed to patrons on a patronage basis.

[321] I.R.C. § 1382(b)(3) and Treas. Reg. § 1.61-5(d). Qualified per-unit retain certificates are treated "as a deduction in arriving at gross income." I.R.C. § 1382(b).

Patron recipients include the face value of the qualified equity in gross income in the taxable year received.[322] As a result, single tax treatment for the cooperative and patrons was finalized at the time the qualified equity was issued.

Redemption of Nonqualified Patronage Equity

The tax treatment of nonqualified written notices of allocation[323] and nonqualified per-unit retain certificates[324] is not finalized at the time of initial distribution. In the year of issue, cooperatives must include the stated value of the nonqualified written notices or nonqualified per-unit retain certificates in gross income. Patrons don't account for the stated value of the nonqualified equity at the time of issue for tax purposes.[325]

In the year of redemption, however, the cooperative can deduct from income the value of payments in money or other property to patron recipients to redeem nonqualified allocations.[326] Payments to redeem nonqualified written notices of allocation are treated by the cooperative "in the same manner

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[322] I.R.C. § 1385(a).

[323] I.R.C. § 1388(d) defines "nonqualified written notice of allocation" as "...a written notice of allocation which is not described in subsection (c) [i.e., a qualified written notice of allocation] or a qualified check which is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is a part is paid."

[324] A per-unit retain certificate is nonqualified if the cooperative fails to meet the necessary requirements for obtaining patron agreement. See I.R.C. § 1388(i).

[325] For financial accounting purposes it may be appropriate for patrons to account for the value of the certificates as a receivable in the year issued. This matter may be relevant for corporate patrons who report on audited financial statements and it indicates that the book treatment and tax treatment of accounting for patronage equity certificates are not necessarily the same.

[326] I.R.C. § 1382(b)(2) for redemption of nonqualified written notices of allocation; I.R.C. § 1382(b)(4) for redemption of nonqualified per-unit retain certificates.

as an item of gross income and as a deduction therefrom," while amounts paid in redemption of nonqualified per-tit retain certificates are "treated as a deduction in arriving at gross income."[327]

Patrons must recognize as ordinary income the amount of the redemption payment in the tax year the funds or property are received.[328] Single tax treatment is thus finalized at the time of redemption, with the tax obligation placed on the patron.

To be deductible by a cooperative, payments in redemption of nonqualified equity must be made "in money or other property."[329] Payment in "other property" is accounted for at fair market value.[330]

While "other property" is not defined by the Code,[331] issuance of new written notices of allocation to redeem outstanding nonqualified written notices of allocation is not permitted.[332] Similarly, new per-unit retain certificates may not be issued to redeem other nonqualified per-unit retain certificates.[333]

If all or part of the redemption payment is in a noncash form, cooperative records should reflect the payment and patrons should receive tangible evidence of the redemption.= No specific form of notification is mandated, although some written notice is

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[327] I.R.C. §1382(b).

[328] I.R.C. § 1385(c)(2)(C).

[329] I.R.C. §§ 1382(b)(2), 1382(b)(4), and 1382(c)(2)(B).

[330] I.R.C.§ 1388(e). See also Treas. Reg. § 1.1382-2(c) which states in part: "In determining the amount paid which is allowable as a deduction under this paragraph, property...shall be taken into account at its fair market value when paid."

[331] See Priv. Ltr. Rul. 7926068 (March 29, 1979), wherein IRS interpreted "amounts paid...in other property" to include the cancellation of accounts receivable, issued to patrons to recover an operating loss. This letter ruling was substantiated by Rev. Rul. 81-103, 1981-l C.B. 447.

[332] I.R.C. §§ 1382(b)(2) and 1382(c)(2)(B).

[333] I.R.C. § 1382(b)(4).

[334] In Rev. Rul. 81-103,1981-l C.B. 447, the redemption of nonqualified written notices by crediting account receivables was evidenced by "clearly identified book entries and notification to its patrons."

probably required.[335]

The issuance of new nonqualified written notices of allocation in the same year that outstanding nonqualified notices are redeemed doesn't affect the tax treatment of either issue. In determining total tax liability, a cooperative must account for both transactions.[336] This concept should apply as well to nonqualified per-unit retain certificates issued in the same year that other nonqualified per-unit retain certificates are redeemed.

A cooperative's ability to use Code section 1383 is not affected by subsequent adjustments to its underlying net margins which were the basis for the original issue of nonqualified written notices of allocation.[337]

Corporate reorganizations may also take place without impacting the tax status of nonqualified equity. In one instance, a cooperative issued nonqualified written notices of allocation to patrons of a particular division. When the division was spun off as a separate cooperative, the nonqualified allocations were transferred to the new cooperative as part of a tax-free reorganization under Code section 368(a)(l)(D). IRS held the nonqualifieds would be deductible when redeemed by the new cooperative, just as they would have been had the reorganization not occurred.[338]

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[335] In Priv. Ltr. Rul. 7926068 (Mar. 29, 1979), the cooperative had "properly notified its patrons at each of the steps involved in the transaction" including "the redemption of previously issued nonqualified written notices of allocation." See also Rev. Rul. 70-407, 1970-2 C.B. 52, wherein IRS emphasized the use of written notices to patrons in approving cancellation of equity credits representing qualified written notice of allocation to recover an operating loss.

[336] Priv. Ltr. Rul. 7925101 (March 23, 1979). Recall, however, a cooperative will not receive a deduction if the new issue of written notices are used to redeem previously issued nonqualified written notices. I.R.C. § 1382(b)(2).

[337] Priv. Ltr. Rul. 8540051 (July 3, 1985), and Priv. Ltr. Rul. 8540056 (July 8, 1985). Nonqualified written notices of allocation issued without regard to a I.R.C. § 481 adjustment caused by change in pool accounting methods.

[338] Priv. Ltr. Rul. 8613017 (Dec. 23, 1985).

And in a tax-free reorganization in which nonqualified per-unit retain certificates were exchanged for a class of stock, a cooperative was allowed to treat redemption of the stock as redemption of the original nonqualified per-unit retain certificates.[339]

Typically, nonqualified written notices of allocation or nonqualified per-unit retain certificates are issued some time prior to the taxable year of redemption. However, redemption may quickly follow the time of issue, even within the payment period of the same taxable year.

For example, a cooperative with a taxable year ending on June 30, can take a deduction based on redemption of nonqualified written notices of allocation and per-unit retain certificates so long as the issue and redemption take place by March 15 of the following year.[340] Or, a cooperative may simply distribute cash patronage refunds[341] or per-unit retains.[342] Cooperatives may choose to do this if the objective is to return income to patrons instead of providing equity capital to the cooperative.

One technical rule must be followed. Both nonqualified written notices of allocation and nonqualified per-unit retain certificates may be redeemed within the payment period of 2 different tax years. The payment period extension of one tax year 8 ½ months into the following tax year causes the overlap.

If this occurs, a cooperative must take the redemption-based deduction in the first taxable year. The regulation includes this example: "[I]f a cooperative which reports its income on a calendar year basis pays an amount in redemption of a nonqualified written notice of allocation on January 15, 1966, it will be allowed a deduction for such amount only for its 1965 taxable year."[343]

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[339] Priv. Ltr. Rul. 8846030 (Aug. 22, 1988).

[340] Priv. Ltr. Rul. 7728030 (no date), 1977.

[341] I.R.C. § 1381(b)(l).

[342] I.R.C. § 1382(b)(3).

[343] Treas. Reg. § 1.1382-2(c). A separate regulation, § 1.1382-3(d), pertaining specifically to section 521 cooperatives, contains the same

Tax Computation Upon Redemption of Nonqualified Equity

Nonqualified written notices of allocation and per-unit retain certificates may be redeemed years after original issue. Yet, the single tax principle cannot be finalized in the redemption year by a simple "reversal" of the tax burden between the recipient and cooperative. It wouldn't be feasible to reopen the tax returns of all the patron recipients for the year in which the nonqualified paper was issued.

Cooperatives and patron recipients recognize all tax adjustments brought about by redemption of nonqualified paper in the year of redemption. The applicable rules are found in Code section 1383. It deals exclusively with the tax computations where a cooperative redeems nonqualified written notices of allocation and nonqualified per-unit retain certificates.[344]

Section 1383(a) contains a general statement that allows cooperatives to deduct redemptions of nonqualified patronage equities in the year of redemption. It then provides two methods for a cooperative to use in computing the deductible amount and specifically states the tax due is the lesser of the two amounts. The following analysis discusses the two methods and provides examples to illustrate when each is advantageous.

Patrons include payments in redemption of nonqualified equities in taxable income in the year of receipt, regardless of the method the cooperative uses to determine its tax adjustment.[345]

Redemption Year Alternative

Under the first method, the cooperative takes a regular deduction for amounts "paid in redemption" of nonqualified

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rule. Although these regulations only mention nonqualified written notices of allocation, the same rule would appear applicable to the redemption of nonqualified per-unit retain certificates.

[344] I.R.C. § 1383.

[345] I.R.C. § 1385(c). The tax treatment of patrons is discussed in chapter 10.

equities.[346] The redemption amount is treated as a deduction under the relevant Code section 1382 provision: section 1382(b)(2) for regular nonqualified written notices of allocation, section 1382(b)(4) for nonqualified per-unit retain certificates, or 1382(c)(2)(B) for nonqualified written notices of allocation representing patronage-based distributions of nonpatronage income by a section-521 farmer cooperative.

Prior Year Alternative

The alternative method for calculating tax on redemption of nonqualified equity involves redoing certain calculations for the year(s) the nonqualifieds were issued and using the results to adjust the cooperative's tax deemed paid in the year of redemption.

Under the prior years alternative, a cooperative first recalculates the amount of tax for the prior year or years.[347]

The regulations provide that the first step in determining the change in tax for the prior taxable year is to determine the amount of tax paid in that prior year. As the base figure, take the tax reported on the cooperative's applicable tax return, add any tax assessed (or collected without assessment) as deficiencies, and then subtract the amount of any rebates paid by IRS to the cooperative.[348] This step produces the actual tax liability of the cooperative for the year the nonqualified equities were issued.

The cooperative next computes the aggregate decrease in tax for the prior taxable year that results from treating the nonqualified written notices of allocation and/or nonqualified per-unit retain certificates issued during that year as if they had been issued in qualified form.[349] In calculating the decrease in tax

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[346] I.R.C. § 1383(a)(l); Treas. Reg. § 1.1383-l(a)(l)(i).

[347] I.R.C. § 1383(a)(2) and Treas. Reg. § 1.1383-1(b)(1). The phrase "year or years" is used because a cooperative may, in its current taxable year, redeem nonqualified equities issued in more than one previous year. The singular term "year" is used in this section to simplify the explanation.

[348] Treas. Reg. § 1.1383-1(b)(3).

[349] I.R.C. § 1383(a)(2)(B); Treas. Reg. § 1.1383-1(a)(1)(ii).

for the prior taxable year, appropriate adjustment is made to "any item which is dependent upon the amount of gross income or taxable income (such as charitable contributions, net operating losses, the foreign tax credit, and dividends received credit)."[350]

Finally, the cooperative subtracts any decrease in taxes caused by treating the nonqualified notices as qualified in the year of allocation from otherwise taxable income in the year of redemption.[351]

Examples of Nonqualified Redemptions

A numerical model will illustrate how the various computations work and how a cooperative determines which of the two methods results in the least tax.

General Model

As illustrated in Example 1, assume that in 1988 Cooperative A had $20,000 in margins and the entire amount was distributed to member-patrons as nonqualified written notices of allocation.[352] The $20,000 is reported as taxable income in 1988 by Cooperative A. Cooperative A was in the 15-percent tax bracket in 1988, so the total tax due was $3,000.

In 1994, Cooperative A has margins of $30,000. This amount is also distributed entirely to patrons as nonqualified notices. In addition, Cooperative A redeems the nonpatronage notices distributed in 1988.

Under the redemption year alternative, Cooperative A starts its tax computation by first recognizing the $30,000 in margins distributed an nonqualified notices as taxable income. Then, it deducts the $20,000 paid in redemption of the 1988 nonqualified notices, leaving net taxable income for 1994 of $10,000. At the 15 percent tax rate, the tax due is $1,500.

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[350] Treas. Reg. § 1.1383-1(b)(3).

[351] I.R.C. § 1383(a)(Z), Treas. Reg. §1.1383-1(a)(ii).

[352] The same analysis would be valid if the cooperative had issued nonqualified per-unit retain certificates, either exclusively or in combination with nonqualified written notices of allocation.

EXAMPLE 1: GENERAL MODEL

a) Redemption Year Alternative

1988

Net Margin	20,000
Nonqualified Allocations	20,000
Taxable Income	20,000
Tax Due (15% x 20,000)	3,000

1994

Net Margin	30,000
Nonqualified Allocations	30,000
Redemption of Nonqualifieds from 1988	(20,000'
Taxable Income	10,000
Tax Due (15% x 10,000)	1,500

b) Prior Year Alternative

1988 (recomputed)

Net Margin	20,000
Assume Payment as Qualified Allocations	(20,000)
Taxable Income	0
Tax with Recomputation	0
Tax Paid in 1988	3,000
Tax Savings from Recomputation	3,000

1994

Net Margin	30,000
Nonqualified Allocations	30,000
Taxable Income	30,000
Unadjusted Tax (15% x 30,000)	4,500
Tax Savings from Recomputation	(3,000)
Tax Due	1,500

Under the prior year alternative, Cooperative A recomputes its taxable income for 1988 assuming it had distributed the $20,000 margin for that year as qualified written notices of allocation. The entire $20,000 patronage refund is now deductible and the tax savings for 1988 is $3,000.[353] Cooperative A next figures the tax on its $30,000 in taxable income for 1994. At the 15-percent rate, the tax is $4,500. Finally, it subtracts the tax it would have saved using qualified notices in 1988 ($3,000) from the tax otherwise due in 1994 ($4,500), and arrives at tax due in 1994 of $1,500.

Under these or similar facts (no change in the applicable tax rate and margins in the year of redemption at least equal to those in the year of issuance), both methods produce the same result. The regulations provide that when this happens, the tax shall be computed under the simpler redemption year method and other parts of section 1383 shall be disregarded.[354]

Change in the Applicable Tax Rate

Assume the same facts in Example 1, except that in 1994 a change in tax rates became effective so that the minimum corporate rate was increased from 15 percent to 20 percent.

As reflected in Example 2, under the redemption year alternative, the 20 percent rate would be applied to Cooperative A's otherwise taxable income for 1994 ($30,000) less the deduction for redemption of the 1988 nonqualified notices ($20,000). The tax due would be $2,000 ($10,000 x .20).

Under the prior year alternative, the recomputation of the 1988 tax would reflect the tax rate in effect in that year. The deduction would still be $3,000 ($20,000 x .15). However, now the cooperative's unadjusted tax for 1994 is $6,000 ($30,000 x .20). The tax due under this method is $3,000 ($6,000 - $3,000).

Thus, other things being comparable, if the applicable tax rate in the year of redemption is higher than in the year of distribution

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[353] To keep the example simple, the assumption is made that there are no adjustments to other items dependent on the amount of gross or taxable income.

[354] Treas. Reg. § 1.1383-1(a)(3).

EXAMPLE 2: INCREASE IN TAX RATE FROM 15% TO 20% IN 1994

a) Redemption Year Alternative

1988	
Net Margin	20,000
Nonqualified Allocations	20,000
Taxable Income	20,000
Tax Due (15% x 20,000)	3,000

1994	
Net Margin	30,000
Nonqualified Allocations	30,000
Redemption of Nonqualifieds from 1988	(20,000)
Taxable Income	10,000
Tax Due (20% x 10,000)	2,000

b) Prior Year Alternative

1988 (recomputed)	
Net Margin	20,000
Assume Payment as Qualified Allocations	(20,000)
Taxable Income	0
Tax with Recomputation	0
Tax Paid in 1988	3,000
Tax Savings from Recomputation	3,000

1994	
Net Margin	30,000
Nonqualified Allocations	30,000
Taxable Income	30,000
Unadjusted Tax (20% x 30,000)	6,000
Tax Savings from Recomputation	(3,0001
Tax Due	3,000

the redemption year method will be more favorable to the cooperative. If the applicable rate is lower in the year of redemption, then the prior year method will be more favorable.

Higher Marginal Tax Rate in Redemption Year

With the progressive nature of the income tax rate structure, a similar result to Example 2 occurs if the cooperative's margins are such that it is in a higher marginal tax bracket in the year of redemption.

Example 3 assumes the same facts as in Example 1, including the actual tax rates, except that in 1994 Cooperative A has margins of $100,000. Again, all of the margin is distributed to patrons as nonqualified written notices of allocation.

Under the redemption year alternative, Cooperative A would deduct the $20,000 paid in redemption of the 1988 nonqualified notices from its otherwise taxable income of $100,000. The tax due on the resulting $80,000 in taxable income would be $15,450 [($50,000 x .15) + ($25,000 x .25) + ($5,000 x .34)].[355]

Under the prior year method, the adjustment for redemption of the 1988 nonqualified notices is still the amount of tax that would have been saved had qualified notices been issued in 1988, or $3,000 ($20,000 x .15). When this is subtracted from the cooperative's unadjusted tax obligation of $22,250 [($50,000 x .15) + ($25,000 x .25) + ($25,000 x .34)], the tax due is $19,250.

Thus, the result of the cooperative being in a higher tax bracket because of higher earnings in the year of redemption is the same as a tax rate increase. Other things being comparable, the redemption year method will be more favorable to the cooperative.

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[355] This example reflects the corporate income tax rates in effect for 1994: 15 percent on the first $50,000 of taxable income; 25 percent on taxable income from $50,001 to $75,000; and 34 percent on taxable income above $75,000. I.R.C. § 11.

EXAMPLE 3: HIGHER MARGINS IN 1994

a) Redemption Year Alternative

1988

Net Margin		20,000
Nonqualified Allocations		20,000
Taxable Income		20,000
Tax Due (15% x 20,000)		3,000

1994

Net Margin			100,000
Nonqualified Allocations			100,000
Redemption of Nonqualifieds from 1988			(20,000)
Taxable Income			80,000
Tax Due			
(15% on first 50,000)	7,500		
(25% on next 25,000)	6,250		
(34% on final 5,000)		1,700	15,450

b) Prior Year Alternative

1988

Net Margin	20,000
Assume Payment as Qualified Allocations	(20,000)
Taxable Income	0
Tax with Recomputation	0
Tax Paid in 1988	3,000
Tax Savings from Recomputation	3,000

1994

Net Margin	100,000
Nonqualified Allocations	100,000
Taxable Income	100,000

Unadjusted Tax		
(15% on first 50,000)	7,500	
(25% on next 25,000)	6,250	
(34% on final 25,000)	8,500	22,250
Tax Savings from Recomputation		(3,000)
Tax Due		19,250

Lower Margins or Loss in Redemption Year

As shown in Example 4, if margins in the year of redemption are substantially lower than in the year nonqualified notices being redeemed were issued and thus the cooperative is subject to a lower marginal tax rate, the prior year method is more favorable. This advantage might be made even more significant by a special rule permitting cooperatives to recapture tax paid in the year of issuance that might otherwise be lost under the computation methods.

Assume the same basic facts as in Example 3, only reverse the margins so that Cooperative A earned $100,000 in 1988 and only $20,000 in 1994. All margins are again distributed as nonqualified allocations.

Under the redemption year method, deduction of the $100,000 paid in redemption of 1988 nonqualified notices from the $20,000 in otherwise taxable income for 1994 would yield a tax loss of ($80,000). The only benefit would be a savings of the $3,000 in taxes otherwise due on the $20,000 in 1994 margins ($20,000 x .15).

Under the prior year method, the cooperative would have a potential deduction of $22,250, the savings by treating the nonqualified notices issued in 1988 as qualified notices for that year. The tax obligation, without adjustment, for 1994 would be only $3,000 ($20,000 x .15).

Access to the tax loss carryback or carryover provided in Code section 172 to use the ($80,000) loss generated under the redemption year method is apparently precluded. The regulations provide that the prior year alternative in Code section

1383(a)(2) must be used "when a credit or refund would be allowable for the taxable year under section 1383(b)(1)."[356]

If a cooperative uses the prior year alternative in section 1383(a)(2), then redemption deductions available under sections 1382(b) or 1382(c)cannot be used in calculating taxable income or loss for that year, "including the computation of any net operating loss carryback or carryover."[357]

The tax calculated under the prior year alternative relates back to the year the nonqualified paper was first issued. The tax impact triggered by redemption, however, is confined to the taxable year in which redemption takes place. The Code emphasizes the relation back concept and the limited use of the prior year method when it states that a deduction based on section 1383(a)(2) "shall not be taken into account for any purposes of (subchapter T) other than for purposes of this section."[358]

EXAMPLE 4: LOWER MARGINS OR A LOSS IN YEAR OF REDEMPTION

a) Redemption Year Alternative

1988

Net Margin		100,000
Nonqualified Allocations		100,000
Taxable Income		100,000
Tax Due		
(15% on first 50,000)	7,500	
(25% on next 25,000)	6,250	
(34% on final 5,000	8,500	22,250

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[356] Treas. Reg. § 1.1383-1(a)(3).

[357] Treas. Reg. § 1.1383-1(a)(2).

[358] I.R.C.§1383(b)(3). This does not prevent a cooperative from deducting, in the year of redemption, the value of nonqualified distributions made in a year a refund or credit is claimed under § 1383(b)(l). Priv. Ltr. Rul. 7925101 (March 23, 1979).

1994

Net Margin	20,000
Nonqualified Allocations	20,000
Redemption of Nonqualifieds from 1988	(100,000)
Taxable Income	(80,000)
Tax Due	0

b) Prior Year Alternative

1988

Net Margin	100,000
Assume Payment as Qualified Allocations	(100,000)
Taxable Income	0
Tax with Recomputation	0
Actual Tax Paid	22,250
Tax Savings from Recomputation	22,250

1994

Net Margin	20,000
Nonqualified Allocations	20,000
Taxable Income	20,000
Unadjusted Tax (15% x 20,000)	3,000
Tax Savings from Recomputation	(22,250)
Tax Credit	19,250

Here is where the special rule applies. Code section 1383(b)(l) provides that if the decrease in tax determined under the prior year alternative exceeds the redemption year tax computed without the deduction, then the excess amount "shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year."[359] The excess is then "refunded or credited in the same manner as if it were an overpayment for such taxable year...."[360]

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[359] I.R.C. § 1383(b)(l). See *also* Treas. Reg. § 1.1383-l(c).

[360] *Id.*

In the example, Cooperative A would be entitled to a refund or credit for 1994 of $19,250, the difference between the recovery of 1988 taxes ($22,250) and the tax otherwise due on margins for 1994 ($3,000). The tax adjustment for using the prior year alternative is returned to the taxpayer as if it were a tax deposited in the year the return is filed for the year of redemption and no interest is recovered, regardless of how old the certificates are.

An additional, more complex example of the application of Code section 1383 is provided in the regulations.[361]

REDEMPTION AT LESS THAN FACE VALUE

While cooperatives normally redeem written notices of allocation and per-unit retain certificates at face value, this is not always the case. Cooperatives may redeem outstanding patronage-based equities at less than face value for several reasons, two of which are most common. A cooperative may pay off outstanding patronage equity at a discount as part of a plan to redeem the equity prior to its normal time of redemption. Redemption at less than face value may also be a part of a program to pass an operating loss on to patrons.

At the time of distribution, the face value of patronage equity determines the extent to which taxable income of both cooperatives and patrons is impacted. If qualified, the equity's face value represents the income amount deducted by the cooperative and recognized by the patron in the taxable year of issue. If nonqualified, it is the amount of income recognized by the cooperative.

Because these adjustments in the issue year are based on face value, subsequent redemption payouts for less than the equity's stated value may lead to income readjustments by the cooperative and patron in the taxable year of redemption.

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[361] Treas. Reg. § **1.1383-1(d).**

Discounts for Out-of-Order Redemptions

Generally, a cooperative redeems written notices of allocation or per-unit retain certificates in the same order as issued. There are times, however, when a cooperative may wish to redeem equities out of sequence. Early redemption may be implemented to sever financial relations with an inactive or terminated member,[362] as part of a financial restructuring,[363] or to convey some cash to the members as rapidly as possible.[364]

When a cooperative redeems certain patronage equity early, those holding unredeemed equity with the same issue date, in effect, are financing the cooperative. To reflect this unequal burden, and perhaps for other reasons, a cooperative redeeming equities out of sequence may do so at a discount.

The discount will vary, but usually it relates in some way to the cost of capital. For example, in one private letter ruling, equities with a normal 8-year revolving period could be redeemed beforehand upon patron request, at 50 percent of the equity's face value (excluding the 20 percent paid in cash when issued).[365] A more complex formula involving actuarial tables and interest rates may also be used.[366]

Cooperative Loss Allocation

Cooperatives sometimes redeem written notices of allocation and per-unit retain certificates for less than face value to offset a loss previously allocated among patrons.

In Revenue Ruling 81-103,[367] a cooperative allocated a loss among its patrons by establishing accounts receivable in their

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[362] Priv. Ltr. Rul. 8015048 (Dec. 31, 1979); Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

[363] Priv. Ltr. Rul. 8225100 (Mar. 25, 1982).

[364] Priv. Ltr. Rul. 7840010 (June 22, 1978), Priv. Ltr. Rul. 8031041 (May 8, 1980), Priv. Ltr. Rul. 8033070 (May 22, 1980), among others.

[365] Priv. Ltr. Rul. 7840010 (June 22, 1978).

[366] Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

[367] Rev. Rul. 81-103,1981-l C.B. 447.

names. In a later year, the cooperative redeemed certain nonqualified written notices of allocation. For patrons with both accounts receivable and nonqualified notices, the cooperative offset the receivable against the redemption payment. Any remaining amount was then distributed as cash.

The Service allowed the cooperative to deduct both the cash payment and the amount applied to the outstanding accounts receivable. IRS noted that Code section 1382(b)(2) permits a deduction for "amounts paid...in money or other property...in redemption of nonqualified written notices of allocation."[368] The Service also noted that satisfaction of the accounts receivable does not result in any additional taxable income to the cooperative because, as an accrual basis taxpayer, the cooperative had already taken the accounts receivable into income.[369]

This rationale also applies to writedowns of equity accounts which lead to redemption at less than the original face value.[370]

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[368] Id. An earlier private letter ruling involving essentially identical facts notes, "Accounts receivable may be bought, sold, and otherwise be disposed of. They are generally considered to constitute 'property' as that term is used in a legal context." Priv. Ltr. Rul. 7926068 (March 29, 1979) *citing* State ex. rel. Globe-Democrat Pub. Co. v. Gehner, 294 S.W. 1017 (1927).

[369] Rev. Rul. 81-103, 1981-1 C.B. 447. The ruling includes an example wherein the cooperative had issued a nonqualified written notice of allocation representing a patronage refund of $15. At redemption, the cooperative paid $11 in cash to the patron and notified the patron an account receivable of $4 was satisfied. The cooperative was allowed a $15 deduction for redemption.

[370] Priv. Ltr. Rul. 8248048 (Aug. 30, 1982) states:

> The assessment of losses attributable to member business to the members by the establishment of an account receivable due the Taxpayer from each member does not generate any federal income tax consequences to the Taxpayer either when the account receivable is established, collected, or forgiven except for a reduction of the Taxpayer's losses otherwise reportable on its tax returns by an amount equal to the amount assessed and the deduction allowable to the Taxpayer for redemption of nonqualified written notices of allocation (apportioned equities).

See also, Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

Tax Consequences

If a cooperative redeems written notices of allocation or per-unit retain certificates for less than the original face value, it may be necessary to make certain income tax adjustments. This depends largely on whether the notice or certificate is qualified or nonqualified.

In the case of nonqualified equity, a cooperative can't deduct the equity's stated value from gross income when issued. The cooperative takes the deduction only upon redemption of the nonqualified equity. If the redemption is for less than the stated value, a cooperative deducts the actual amount paid at redemption. No new taxable income is created for the cooperative to recognize. As with other nonqualified distributions, patrons include only the money actually received as a redemption in taxable income for the year the funds are received.

In the case of qualified equity, however, redemption for less than face value raises a controversial issue as to whether a cooperative must reconcile its earlier deduction of the full face amount when issued.

The first rulings on redemption of qualified equity at less than face value concerned the tax treatment of the patron while ignoring the impact on the cooperative.[371] They held the patron taxpayers sustained an ordinary loss equal to the difference between the stated dollar amount of the qualified allocations (reported as taxable income in the year they received notice of the allocation) and the amount received on redemption, under Code section 165(a). This treatment has *been* consistently applied.[372]

In its first examination of the impact on taxes at the cooperative level, IRS held the cooperative could not recognize a gain as a result of a proposed redemption of qualified equity

[371] Rev. Rul 70-64, 1970-1 C.B. 36, *suspended by* Notice 87-68, 1987-2 C.B. 378; and Rev. Rul. 70-407, 1970-2 C.B. 52.

[372] Priv. Ltr. Rul. 8031041 (May 8, 1980); Priv. Ltr. Rul. 8225100 (March 25, 1982); Tech. Adv. Mem. 8952019 (Sept. 28, 1989).

revolving funds for about 20 cents per $1 of face value.[373] The Service found the redemption of qualified equity was governed by Code section 311(a). It provides a corporation, subject to certain exceptions not important here, doesn't recognize gain or loss on a distribution, based on current stock holdings, of other stock (or rights to acquire its stock) or of property that hasn't increased in value.[374]

Although not developed in the ruling, the rationale for this approach is as follows. The term "property," as used in this part of the Code, includes money.[375] The term "distribution with respect to its stock' includes distributions made in redemption of stock (other than distributions in complete or partial liquidation).[376] Finally, the term "stock" as used in the Code is considered broad enough to include equity interests not specifically called stock, such as the many terms cooperatives use to refer to retained patronage allocations. Thus, under Code section 311(a), money paid by a cooperative in redemption of patronage-based equities is a distribution of property with respect to its stock that doesn't produce a gain or loss to a cooperative for tax purposes.

In a short time, IRS reversed its position. It continued to recognize the application of Code section 311. However, it asserted that the "tax benefit rule," a tool of judicial interpretation not found in the Code, prevailed over section 311.[377]

The tax benefit rule provides that recovery of an item which produced an income tax benefit in a prior year must be added to income in the year of recovery.[378] Where a cooperative redeems qualified patronage equity at less than face value, the tax benefit

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[373] Priv. Ltr. Rul. 7410291300A (Oct. 29, 1974).

[374] I.R.C. § 311(a).

[375] I.R.C. § 317(a).

[376] Treas. Reg. § 1.311-l(a).

[377] Priv. Ltr. Rul. 7743054 (July 28, 1977); Priv. Ltr. Rul. 8225100 (March 25, 1982).

[378] See, e.g., Twitchco Inc. v. United States, 348 F. Supp. 330 (M.D. Ala. 1972); Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

rule would hold the cooperative obtains an income tax benefit because the deduction for full value in the year of issue is not offset by the same amount of payment at redemption.[379]

IRS's position applying the tax benefit rule to a cooperative's cash redemption of qualified equity credits was developed in a 1977 private letter ruling. The Service stated redemption for less than face value:

> ...is distinguishable from the situation in which a corporation redeems its stock as described in section 311 of the Code...[For patronage based equities the] full face amount of the equity credits was either excluded from income or deducted from income in accordance with the provisions of Subchapter T of the Code when they were issued. The cooperative now plans to distribute only a fraction of the face value of these equity credits to its patrons.
>
> In this situation the tax benefit rule prevails over the provisions of section 311 of the Code. The tax benefit rule is of judicial origin, and is not expressly stated in the Code. The rule requires that if an amount is deducted from gross income in one taxable year and provides a tax benefit to the taxpayer in that year, and the amount is recovered in a later year, the recovery must be included in income in the later year.[380]

In 1992, IRS issued a technical advise memorandum (TAM) again applying the tax benefit rule. It said a cooperative must recognize as taxable income the difference between the stated dollar amount of qualified written notices of allocation and a lesser amount paid to redeem the notices.[381]

According to the TAM, the cooperative vigorously contested the finding during the administrative process. It argued that the

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[379] Priv. Ltr. Rul. 7743054 (July 28, 1977); Tech. Adv. Mem. 7840010 (June 22, 1978); Priv. Ltr. Rul. 8225100 (March 25, 1982).

[380] Priv. Ltr. Rul. 7743054 (July 28, 1977).

[381] Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

tax benefit rule doesn't apply to the redemption of qualified equities for less than their stated dollar amount and that it was not required to recognize income by reason of Code section 311. The cooperative has petitioned the U.S. Tax Court challenging the Service's position.[382] Protracted litigation is possible unless the parties can settle their differences.

The Service has taken other positions that may complicate redeeming patronage-sourced equities at less than face value. For one thing, it considers such income to be nonpatronage-sourced income to the cooperative.[383]

For another, IRS asserts that a section 521 cooperative may not deduct the allocation of such nonpatronage-sourced income to patrons on a patronage basis. Code section 1382(c)(2)(A) permits a section 521 cooperative to deduct amounts paid on a patronage basis with respect to nonpatronage sourced "earnings." The Service has said amounts realized as a result of a discounting procedure are not "earnings" and therefore are not deductible.[384] Instead of section 1382(c) earnings, IRS characterized the income as "amounts recovered which were previously deducted against 'earnings' of another taxable year."[385]

[382] Gold Kist Inc., Tax Court Docket No. 10768-93.

[383] Tech. Adv. Mem. 7840010 (June 22, 1978) dealt with qualified written notices of allocation; Priv. Ltr. Rul. 8033070 (May 22, 1980) covered qualified per-unit retain certificates.

[384] Tech. Adv. Mem. 7840010, (June 22, 1978). The Service relied, in part, on I.R.C. § 911(b) definition of "earned income" as well as definition of "earnings" appearing in *Black's Law Dictionary*.

[385] Priv. Ltr. Rul. 7840010 (June 22, 1978).

CHAPTER 10
TAXATION OF PATRONS

While most administrative and judicial law on taxation focuses on the cooperative, the patron is an equally important element of the equation. A patron is usually perceived as an individual dealing with his or her local cooperative. However, if that local cooperative is part of a federated system, the local is a patron of the federated cooperative and must deal with the tax laws as they apply to both cooperatives and patrons.[386]

Patrons, if they are also members,[387] not only share in the earnings of a cooperative but also have ultimate control, as the user-owners, of the method used by their cooperative to allocate those earnings (and losses). Thus, any analysis of cooperative taxation must also consider the taxation of patrons.

Subchapter T generally imposes a single current tax obligation on cooperative margins. Whether the cooperative or the patrons assumes this tax obligation for a given payment generally depends on a mutual arrangement on how to recognize the income for tax purposes. This gives cooperative members valuable flexibility in planning the tax consequences of their business transactions.

Before rules clarifying cooperative and patron taxation were established in subchapter T in 1962,[388] patron treatment of refunds or other payments from the cooperative was not always

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[386] See, *e.g.*, Rev. Rul. 70-249, 1970-1 C.B. 181 (concerns proper year to include certain per-unit retains from the regional to the local in the local's taxable income).

[387] While the terms "member" and "patron" are sometimes used interchangeably, there is an important distinction between them for tax purposes. A member is allowed to vote on issues presented to the membership. A patron is any person, member or nonmember, with whom the cooperative does business on a cooperative basis. Treas. Reg. § 1.1388-1(e).

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

consistent with the tax treatment of these distributions taken by the cooperative. Code section 1385, titled “Amounts Includible in Patron’s Gross Income,” was added to the Code as part of subchapter T. Section 1385 provides specific rules on the taxation of income received by patrons based on the cooperative-patron relationship.[389]

Generally, when patrons receive taxable distributions of earnings from a cooperative, they are included in the patrons’ gross income along with other income received in the course of farming or other business operations.[390] Patrons recognize the income in the tax year it is received from the cooperative.

Cooperative distributions to patrons may be in the form of money, property, or noncash allocations of equity or debt in the cooperative, evidenced by written notices of allocation or per-unit retain certificates. The tax consequences to the patron of any distribution of written notices of allocation and retain certificates when received, and later when redeemed, depends primarily upon whether the notices or certificates are “qualified” or “nonqualified” distributions.

Written notices of allocation and per-unit retain certificates may be redeemed by the cooperative for less than or more than face value. Holders may be able to sell or exchange them, although this isn’t common.

Patrons may incur losses in connection with patronage distributions from a cooperative. Such losses are recognized for tax purposes in a number of situations.

In addition to receiving distributions from it, members and patrons sometimes make payments to their cooperative. The potential tax effects of patron payments to a cooperative depends on the nature and purpose of the payment.

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[389] Treas. Reg. § 1.1385-1 provides explanation and examples.

[390] An exception for consumer goods is discussed beginning on the next page.

INCLUSIONS IN GROSS INCOME

Code section 1385 begins with a general rule that for tax purposes patrons must include in gross income:

(1) patronage refunds[391] paid in money, qualified written notices of allocation, and other property (but not nonqualified written notices of allocation),[392]

(2) patronage-based distributions of nonpatronage income from a section 521 cooperative paid in money, qualified written notices of allocation, or other property (but not nonqualified written notices),[393] and

(3) per-unit retains paid in qualified per-unit retain certificates.[394]

Subchapter T only covers amounts received from the cooperative based on the cooperative-patron relationship. Other kinds of income are covered by rules not specific to cooperatives.

Exclusion for Personal, Living, and Family Items

Code section 1385(b) provides that in two instances the amount of any patronage refund and any amount received on redemption, sale, or other disposition of a nonqualified written notice of allocation isn't included in a patron's gross income.[395]

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

[392] I.R.C. § 1385(a)(l) and Treas. Reg. § 1.1385-1(a)(1).

[393] I.R.C. § 1385(a)(2) and Treas. Reg. § 1.1385-1(a)(2).

[394] I.R.C. § 1385(a)(3). While § 1385 doesn't mention per-unit retains paid in cash, they undoubtedly are also taxable income to the recipient in the tax year received. While the regulations for section 1385 don't mention per-unit retains, their inclusion in patrons' gross income is supported by Treas. Reg. § 1.61-5(a).

[395] As the Code doesn't mention per-unit retains in this section, no exclusions are available for per-unit retain distributions.

One is when the distribution is "attributable to personal, living, or family items."[396] The regulations describe personal, living, or family items in terms of the tax status of the item purchased. A patron doesn't include as income patronage refunds "received with respect to the purchase of supplies, equipment, or services, which are not used in the trade or business and the cost of which is not deductible under section 212."[397]

Similarly excluded are amounts received in redemption of nonqualified written notices of allocation which were received as a patronage refund with respect to the purchase of supplies, equipment, or services not used in a trade or business and the cost of which was not deductible under Code section 212.[398]

Code section 212 allows individuals to deduct expenses incurred in the "production of income."[399] If a patron can't deduct the expense of supplies, equipment, or services obtained from a cooperative under section 212, then patronage refunds received from a cooperative "with respect to" such purchases are not income to the patron.[400]

Exclusion for Adjustment to Basis of Depreciable Property

Patrons may also exclude from gross income patronage refunds and amounts received in redemption of nonqualified written notices of allocation "properly taken into account as an adjustment to basis of property."[401] Regulations say this exclusion

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[396] I.R.C. § 1385(b)(2).

[397] Treas. Reg. § 1.1385-l(c)(l)(i).

[398] Treas. Reg. § 1.1385-1(c)(1)(ii).

[399] I.R.C. § 212. "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income . . .." Id.

[400] Treas. Reg. § 1.1385-1(c)(1)(ii).

[401] I.R.C. § 1385(b)(l).

covers patronage refunds distributed with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or business property depreciable for tax purposes under Code section 167.[402]

In this case, the patronage refund or payment in redemption of a nonqualified allocation should be treated as an adjustment to the basis of the property or asset rather than as ordinary income by the patron.[403] The adjustment is effective as of the first day of the taxable year in which the distribution is received.[404] To the extent that the amount received exceeds the adjusted basis of the property, it shall be considered ordinary income.[405]

The primary beneficiaries of the "adjustment to basis" rule are patrons who purchase from their cooperative property used in their business and depreciable under Code section 167. The principal kind of depreciable property is permanent and tangible such as buildings (but not the land), office furniture and machines, and farm machinery. Normally, a taxpayer can't deduct the total cost of such items in the year of purchase, but rather must depreciate the cost over a number of years.

The regulations provide that Code section 167 property includes all farm buildings (except the residence of the owner), machinery, and physical property (except land). Livestock acquired for work, breeding, and dairy purposes may, under certain conditions, also be section 167 property.[406]

Related Patronage Refunds

Amounts received by patrons which are excludible from gross income if used as basis adjustment are (1) cash and qualified noncash patronage refunds[407] and (2) amounts received upon

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[402] Treas. Reg. §1.1385-1(c)(1).

[403] Treas. Reg. §1.1385-1(c)(2).

[404] Treas. Reg. §1.1385-1(c)(2)(i).

[405] *Id.*

*Treas. Reg. §1.167(a)(6)(b).

[407] Treas. Reg. § 1.1385-l(c)(l)(i).

redemption, sale, or other disposition of a nonqualified written notice of allocation to the extent treated as ordinary income.[408]

The portion of a patronage refund or redemption amount that a patron can apply to basis and exclude from gross income is limited to amounts "received with respect to the marketing or purchasing" of the property whose basis is adjusted.[409]

The refund portion must qualify as a "patronage dividend" as defined in the Code.[410] It cannot include any portion of a section 521 cooperative refund or redemption amount that was derived from U.S. Government or nonpatronage sourced income.[411]

Patrons need to establish what portion of the amount received from the cooperative relates to the eligible property. The determination may be based on the patron's own records or the notices received from the cooperative. These examples illustrate how to make the proper calculation.

Example 1. Patron A receives a qualified written notice of allocation totaling $100 from a cooperative. Patron A's only business with the cooperative during the cooperative's taxable year was the purchase of property eligible for basis adjustment. The entire $100 received by Patron A can be applied to basis adjustment if otherwise qualified.

Example 2. Assume a similar situation to Example 1, except the cooperative notifies patron A that $80 of the payment qualifies as a refund from patronage sources, while $20 is from nonpatronage sources. Patron A has $80 available for basis adjustment and exclusion. The remainder must be included in gross income and cannot be used to adjust eligible property basis.

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[408] Treas. Reg. § 1.1385-1(c)(1)(ii).

[409] Treas. Reg. §§ 1.1385-l(c)(l)(i) and (c)(1)(ii).

[410] Treas. Reg. § 1.1385-l(c)(l)(i). The Code definition of "patronage dividend" appears at I.R.C. § 1388(a).

[411] Treas. Reg. § 1.1385-l(c)(l)(i) only applies to patronage refunds described in Treas. Reg. § 1.1385-1(a)(1). Refund or redemption amounts paid by I.R.C. § 521 cooperatives and derived from U.S. Government or nonpatronage sourced income are described in Treas. Reg. § 1.1385-1(a)(2).

Example 3. Patron B receives $100 in patronage refunds from the cooperative, all of which is from patronage sources. During the cooperative's taxable year, patron B purchased $1,000 in supplies and equipment from the cooperative, $200 of which was properly eligible for basis adjustment. Patron B applies only the allocable portion of the refund, which is $20 (200/1000 x 100), to the eligible property basis adjustment.

Basis Adjustment

The regulations provide that if a patron purchases eligible assets or property from the cooperative and owns the asset or property any time during the taxable year in which the amount is received, the adjustment to the property's basis occurs "as of the first day of the taxable year in which such amount is received."[412] This important rule frees patrons, who purchase a covered item in one year and receive the related patronage refund the following year, from having to file an amended return for the previous year to adjust their depreciation deduction.

The following example, based on the regulations, illustrates this timing issue. More complex examples, including some dealing with redemptions of nonqualified written notices of allocation and other aspects of basis adjustment, are found in the regulations.[413]

Example 4. On July 1, 1994, a cooperative patron purchases an implement for use in her farming business for $2,900. The implement has an estimated useful life of 3 years and an estimated salvage value of $200, which the patron chooses to take into account in computing depreciation. She files her income tax returns on a calendar-year basis. For 1994, she claims depreciation of $450 pursuant to her use of the straight-line method of depreciation at the rate of $900 per year.

On July 1, 1995, the cooperative pays a patronage refund to the patron of $300 in cash regarding her purchase of the farm implement. She will adjust the basis of the implement and compute

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[412] Treas. Reg. §1.1385-1(c)(2)(i).

[413] Treas. Reg. §1.1385-1(c)(3).

her depreciation deduction for 1995 (and subsequent taxable years) as follows:

Cost of farm implement, July 1, 1994		2,900
Less:		
Salvage value	200	
Depreciation for 1994 (6 months)	450	
Adjustment as of Jan. 1, 1995 for cash patronage dividend	300	950
Basis for depreciation for remaining 2 ½ years of estimated life		1,950
Depreciation deduction for 1995 ($1,950 divided by the 2 ½ years of remaining life)		700

When Exclusion Not Available

A patron's application of patronage refunds or redemption amounts to property basis is a substitute for recognizing it as gross income. This exclusion isn't available in all circumstances.

For example, the distribution from the cooperative may exceed the property's adjusted basis. In this case, the amount of the distribution is first applied to basis. To the extent the distribution exceeds the adjusted basis, it is ordinary income to the patron.[414]

Another example is when a patron has sold or otherwise disposed of the property before the taxable year in which the patron receives the distribution. This usually occurs where the distribution is in redemption of a nonqualified written notice of allocation. In such cases, the basis adjustment is not used and the amounts received are "included in gross income as ordinary income."[415]

[414] Treas. Reg. §1.1385-1(c)(2)(i).

[415] Treas. Reg. §1.1385-1(c)(2)(ii).

The regulations also describe special rules for situations involving losses deductible under Code section 165 on long-term capital assets no longer owned by the taxpayer.[416]

A patron, who markets eligible property through a cooperative, may receive patronage refunds based on that sale in the same taxable year as the property was sold. In that case, the distribution is treated as additional proceeds from the sale of that property.[417]

Finally, if a patron receiving a patronage refund or proceeds from the disposition of nonqualified written notices of allocation is unable to identify the related property, basis adjustment isn't available and the patron must treat the distribution as ordinary income.[418]

Taxable Year

Code section 1385 designates the taxable year in which a patron must include patronage refunds,[419] amounts received as nonpatronage distributions from a section-521 cooperative,[420] and per-unit retain&n gross income. Generally, such amounts are included in patron income in the taxable year received.[422]

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[416] Treas. Reg. §§1.1385-1(c)(2)(ii)(a) and (b).

[417] Treas. Reg. §1.1385-1(c)(2)(iii).

[418] Treas. Reg. §1.1385-1(c)(2)(iv).

[419] I.R.C. § 1385(a)(l).

[420] I.R.C. § 1385(a)(2).

[421] I.R.C. § 1385(a)(3).

[422] I.R.C. § 1385(a). At one time, IRS said cooperatives had to "trace" margins back to the specific transactions that generated them and allocate the margin to the patrons of that year. Rev. Rul. 79-45,1971-l C.B. 284. The IRS position was rejected in Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982) and Kingfisher Cooperative Elevator Association v. Commissioner, 84 T.C. 600 (1985). For a discussion of "tracing" see Frederick and Reilly, Income *Tax* Treatment of Cooperatives: *Patronage Refunds,* ACS Cooperative Information Report 44, Part 2 (USDA 1993), 62-66.

Patrons frequently receive taxable distributions from cooperatives in a tax year subsequent to the time the related transactions took place. These four examples illustrate how this may occur:

1. The cooperative and patron have different tax years, resulting in different years for income recognition.[423]

2. Cooperatives usually distribute patronage refunds or per-unit retain allocations during the eight and one-half month period after the cooperative's tax year, as provided in Code section 1382(d). The year payment is received by patrons, which may follow the tax year in which the cooperative took its deduction, is the year the patron recognizes the distribution for tax purposes.[424]

If the cooperative fails to make payments within the payment period and thereby loses its deduction, patrons must still include the amount received in gross income in the year of receipt.[425]

3. Cooperatives frequently redeem nonqualified written notices of allocation and nonqualified per-unit retain certificates several year after issuance. These payments are taxable income to patrons in the year of receipt.[426]

4. Cooperative payments may also be treated as occurring in a subsequent tax year when they are from a local cooperative belonging to a federated system. Because each cooperative in the system has its own tax year and payment period, the actual income from the patron's initial transaction with its local cooperative may not be recognized for some time.

For example, a local marketing cooperative might receive product from a patron in year one. In that same year, the local cooperative delivers the product to a federated cooperative for further processing and sale. The local receives a patronage refund or per-unit retain from the federated in year two, based on business done with or for its patrons in year one.[427]

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[423] See, e.g., Tech. Adv. Mem. 7936017 (May 31, 1979).

[424] Treas. Reg. § 1.1385-1(a).

[425] Id.

[426] I.R.C. § 1385(c).

[427] In this situation the local association is a "cooperative" for tax purposes when dealing with its patrons and a "patron" itself when dealing with the federated cooperative. The local cooperative includes

The Code provides that the local can make patronage refunds during the payment period of year two based on the amounts received from the federated.“’ Local patrons will likely receive their appropriate share of the federated cooperative’s earnings in patrons’ tax year three.

IRS has said that patrons who receive such payments in a year subsequent to the year the underlying transaction took place may not “accelerate” the recognition of an expected distribution. A patron may not “accrue an estimated patronage refund” in order to recognize it as income in a tax year prior to the time the cooperative issues the refund.[429]

Patrons receive other kinds of payments from their cooperative for which subchapter T provides no special timing rules. In these instances, general tax principles apply.

Marketing cooperatives frequently make partial payments to producers for product delivered at or shortly after delivery. After the end of the its fiscal year, the cooperative determines net margins allocable to each patron and pays them during the cooperative’s payment period. Questions have arisen as to the correct year for the patron to include the advance payment in taxable income.

As a general rule, the advance is considered a partial payment for product delivered and must be treated by patrons as income from the sale of product in the year received. “The grower is not to defer the accounting for the payments until the year in which the final settlement is made with him by the association for his entire crop...."[430]

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cash payments and qualified patronage refunds and per-unit retains received from the federated cooperative in gross income in the year of receipt. These amounts are then deductible by the local if passed on to its patrons as cash or qualified distributions within the payment period for the year of receipt of the local.

[428] Rev. Rul. 70-249,1970-l C.B. 181, applying I.R.C. § 1382(f) and Treas. Reg. § 1.1382-6.

[429] Tech. Adv. Mem. 7936017 (May 31, 1979).

[430] Rev. Rul. 71-430, 1971-2 C.B. 219.

Similarly, a patron can't postpone the tax liability on an advance to a subsequent tax year by simply having the cooperative postpone payment. If the patron could have received the advance in the first year, IRS has applied the doctrine of constructive receipt to require the patron to include it in income for the first year.[431] This is consistent with the cash receipts and disbursements method of accounting that requires amounts to be included in gross income when actually or constructively received.@*

If the patron hasn't met all the conditions for securing a right to payment, no income has been received for tax purposes. In a letter ruling, one of several options under the cooperative's marketing program permitted patrons to defer making a pricing decision until the year following harvest and delivery of grain to the cooperative. No advance was payable until the patron made the pricing decision. IRS said constructive receipt did not apply and no current tax liability resulted for deferring payment until the second year.[433]

The regulations discuss one other issue concerning the year patrons include amounts received from cooperatives in income. Patrons must recognize payments by qualified check in the taxable year received, if the check is endorsed and cashed on or before the 90th day following the close of the payment period for the cooperative's taxable year in which the relevant patronage occurred.[434]

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[431] Priv. Ltr. Rul. 8004074 (Oct. 31, 1979).

[432] Treas. Reg. § 1.451-l(a).

[433] Priv. Ltr. Rul. 8004074 (Oct. 31, 1979).

[434] Treas. Reg. § 1.1385-1(d)(3). Thus, if a patron on a calendar tax year receives a qualified check in November of one year and cashed it in January of the following year, for tax purposes the amount received is income to the patron in the first year.

PAYMENT FORM

Section 1385 of subchapter T lists specific forms of cooperative payments that must be included in gross income by patrons. These include patronage refunds[435] and patronage-based distributions of nonpatronage income by section-521 cooperatives& paid in money, qualified written notices of allocation, or other property, and per-unit retain allocations paid as qualified per-unit retain certificates.[437]

Patrons must also recognize as income all amounts received in redemption of nonqualified written notices of allocation and nonqualified per-unit retain certificates."'

For other kinds of income received by the patron from the cooperative, subchapter T provides no special rules and general tax principles therefore apply.

Money or Other Property

The term "money" includes cash, negotiable bank checks, and qualified checks.[439]

The term "other property" includes payments of merchandise or other property in kind. Payments made in property are accounted for by the patron at the property's fair market value when received.[440]

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[435] I.R.C. § 1385(a)(l) and Treas. Reg. § 1.1385-1(a)(l).

[436] I.R.C. § 1385(a)(2) and Treas. Reg. § 1.1385-1(a)(2).

[437] I.R.C. § 1385(a)(3). See also Treas. Reg. § 1.61-5(f)(l)(i). Although the Code doesn't specifically mention cash per-unit retain distributions, the same rules undoubtedly apply.

[438] I.R.C. § 1385(c)(l), Treas. Reg. § 1.1385-1(b) (nonqualified written notices of allocation), and Treas. Reg. § 1.61-5(f)(1)(ii) (nonqualified per-unit retain certificates).

[439] Treas. Reg. §§ 1382-2(b)(1), 1.1388-1(c)(1)(ii).

[440] Treas. Reg. § 1.1385-1(d)(l). For an example involving the stock of a successor noncooperative company being issued as a patronage refund allocation to the patrons of a predecessor cooperative and its valuation, see Priv. Ltr. Rul. 8617040 (Jan. 24, 1986) and Priv. Ltr. Rul.

Qualified Written Notices and Per-Unit Retains

Code section 1385(a) provides that patrons must include the amount of any patronage refunds distributed in cash or as qualified written notices of allocation[441] and qualified per-unit retain certificates[442] in gross income in the taxable year received. Qualified notices and certificates are valued by patrons at their "stated dollar amount."[443]

Patrons recognize the income in the tax year they receive the qualified allocation(s). Subsequent redemption of the notice or certificate is not a taxable event for the patron as long as the redemption payment is for the face amount. Redemptions for less than, or in excess of, the face value are discussed later in this chapter.

Nonqualified Written Notices and Per-Unit Retains

Patrons who receive nonqualified written notices of allocation or nonqualified per-unit retain certificates recognize no income at the time of issuance. The single tax obligation is transferred from the cooperative to the patron when the nonqualified equity is redeemed by the cooperative.[444]

If the redemption payment is applied against a debt owed by the patron to the cooperative, the patron receives property (and thus income) to the extent of debt satisfaction.[445]

8638054 (June 24, 1986).

[441] I.R.C. § 1385(a)(l).

[442] I.R.C. § 1385(a)(3).

[443] I.R.C. § 1388(c)(l) and Treas. Reg. § 1.1385-1(d)(2) for qualified written notices of allocation, I.R.C. § 1388(h)(l) for qualified per-unit retain certificates. Similarly for "certificates of indebtedness," James W. Salley, Inc. v. United States, 1976-1 U.S.T.C. ¶ 9443 (W.D. La. 1976).

[444] I.R.C. § 1385(c)(2) and Treas. Reg. § 1.1385-1(b).

[445] See Priv. Ltr. Rul. 7926068 (Mar. 29, 1979) where IRS permitted a cooperative to offset accounts receivable, established to allocate a loss, against outstanding nonqualified written notices of allocation.

Code section 1385(c) includes basis and gain rules by which patrons determine the income they must recognize from the redemption of nonqualified written notices of allocation paid as patronage refunds,[446] patronage-based distributions of nonpatronage earnings by a section-521 farmer cooperative,[447] and nonqualified per-unit retain certificates.[448]

The first step in determining a patron's taxable income when nonqualified written notices of allocation and nonqualified per-unit retain certificates are redeemed is to establish the patron's basis in that property. The basis of these equities in the hands of the patron is zero.[449] The assignment of basis is statutory and the equity's fair market value has no tax effect at either issuance or redemption. The Code also provides that if such equities are acquired from a decedent, the basis of the heir shall be the basis in the hands of the decedent.[450]

Second, the amount of taxable income must be determined. The realized gain upon redemption is the amount received which exceeds basis.[451] In most situations, the basis of a nonqualified written notice of allocation or nonqualified per-unit retain certificate is zero; so patrons will realize taxable income for the full amount paid in redemption.

Third, the nature of the income must be established. The Code states the amount received by the patron, up to the stated dollar amount of the nonqualified written notice or per-unit retains being redeemed, shall "be considered as ordinary income,"[452] that is, "gain from the sale or exchange of property which is not a capital asset."[453] Treatment as ordinary income

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[446] I.R.C. § 1385(c)(l)(A)(i).

[447] I.R.C. § 1385(c)(1)(A)(ii).

[448] I.R.C. § 1385(c)(l)(B).

[449] I.R.C. § 1385(c)(Z)(A) and Treas. Reg. § 1.1385-1(b)(3).

[450] I.R.C. § 1385(c)(2)(B) and Treas. Reg. § 1.1385-1(b)(3). The basis is not increased to the fair market value as of the date of death.

[451] I.R.C. § 1385(c)(2)(C).

[452] *Id.*

[453] Treas. Reg. § 1.1385-1(b)(1).

applies to the original patron recipient and subsequent holders.*

The redemption, sale, or other disposition of nonqualified written notices of allocation or nonqualified per-unit retain certificates may result in a gain that exceeds their stated face value. Excess amounts "will be treated under the applicable provisions of the Code."[455] For instance, the regulations say amounts received in excess of a nonqualified written notice's stated dollar amount should be treated as interest by the recipient if the amounts "in effect, constitute interest."[456]

The following example from the regulations illustrates the tax treatment of nonqualified allocations by patrons.

> Example. A, a farmer, receives a patronage dividend from the X Cooperative, in the form of a nonqualified written notice of allocation, which is attributable to the sale of his crop to that cooperative organization. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition, as ordinary income. If A gives the written notice of allocation to his son B, B takes A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Such gain is income in respect of a decedent within the meaning of section 691(a) and section 1.691(a)-1.[457]

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[454] *Id.*

[455] *Id.*

[456] *Id.*

[457] Treas. Reg. §1.1385-1(b)(4). Examples from the regulations were written only for written notices of allocation and don't specifically

REDEMPTION AT LESS THAN FACE VALUE

Cooperatives may redeem written notices of allocation or per-unit retain certificates for less than their face value.[458]

Cooperatives redeem equity for less than face value for a variety of reasons. The cooperative may have an operating loss, and the patrons may absorb the loss by taking a reduction in the amount they will receive in cash or other property upon redemption.[459]

A patron may voluntarily agreed to take less than face value for his or her equity as part of a program that redeems equity for cash at an earlier date than under the cooperative's normal equity redemption plan.[460]

The cooperative and patron may also have an arrangement calling for early redemption on the occurrence of some agreed-upon event such as termination of the patron's membership in the cooperative.

Providing for early redemption, but at less than face value, recognizes that those patrons whose equity is not redeemed early bear the burden of providing the cooperative its capital, an obligation no longer being met by those "cashing out" early.

Redemption at less than face value may be handled in several ways. Commonly, the cooperative will: (1) notify patrons that some or all of the equity will not be redeemed[461] or (2) notify

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include per-unit retain certificates. However, principles involved are the same, as should be the results.

[458] This is not the same as so-called "partial redemption." In a partial redemption, some of a patron's retains are redeemed. The patron still has an equity or debt interest in the cooperative to the extent of written notices of allocation or per-unit retains subject to future redemption.

[459] For examples, see Priv. Ltr. Rul. 7804083 (Oct. 28, 1977), Priv. Ltr. Rul. 7950064 (Sept. 14, 1979), and Priv. Ltr. Rul. 8624019 (Mar. 10, 1986).

[460] Priv. Let. Rul. 8031041 (May 8, 1980), Priv. Ltr. Rul. 8033070 (May 22, 1980).

[461] Rev. Rul. 70-407, 1970-2 C.B. 52.

patrons that a payment for only a portion of the face value represents complete redemption of the equity interest.[462]

The way holders are notified of a cancellation or redemption at less than face value partly depends on how the cooperative allocates the loss among patrons.[463] If some or all of the equity will not be redeemed, the cooperative notifies holders that their written notices of allocation or per-unit retain certificates are canceled, in whole or in part.[464] If patrons are to receive any payment, the cooperative should send the payment plus notification that it represents full redemption.

Tax Consequences, Qualified Equity

The tax consequences for a patron, whose equity is redeemed at less than face value, depend primarily on whether the written notice of allocation or per-unit retain certificate is qualified.

When a qualified written notice or per-unit retain certificate is redeemed at less than face value or is canceled altogether, patron holders can claim an ordinary loss to the extent they had previously recognized the qualified allocations as income.[465] The amount of the loss is the difference between the equity's stated value and the amount received.

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[462] Rev. Rul. 70-64,1970-l C.B. 36. Although Rev. Rul. 70-64 was suspended by Notice 87-68, 1987-2 C.B. 378, it was relied on by the Service in Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

[463] Patrons of different departments may receive differing notices. For example, see Priv. Ltr. Rul. 7804083 (Oct. 28, 1977).

[464] In Revenue Ruling 70-407, 1970-2 C.B. 52, the cooperative offset the amount determined to be due from marketing patrons because of a cooperative loss against their outstanding marketing credits in the order issued until the full amount of the indebtedness due from each patron was offset. The cooperative accomplished the offset by notifying each patron, in writing, that specific marketing credits had been canceled to the extent necessary to recoup excessive cash advances received by that patron in the loss year.

[465] Rev. Rul. 70-407, 1970-2 C.B. 52; Priv. Ltr. Rul. 8624019 (Mar. 10, 1986); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

The loss is recognized in the tax year the redemption occurs. This offsets the patron's previous recognition of the face amount of the qualified equity as ordinary income in the year received.[466]

Tax Consequences, Nonqualified Equity

From a tax standpoint, holders of nonqualified written notices of allocation or nonqualified per-unit retain certificates lose nothing if redemption is for less than face value. The patron's basis in nonqualified notices or certificates is zero, so gain is realized only for amounts received at redemption. Because the patron recognized no income when the nonqualified equity was issued, the patron has no loss for tax purposes if the equity is redeemed for less than the face amount.

REDEMPTION AT GREATER THAN FACE VALUE

Cooperative payments in redemption of retained patronage refunds or per-unit retain certificates may exceed the face value of the notice or certificate.[467] Although the whole payment to patrons may be termed "redemption" and paid simultaneously, any amount in excess of the notice or certificate redeemed is not a true redemption. Rather, it is a payment that falls into some other category for tax purposes.

The regulations provide that if a patron receives an excess payment, the distribution is divided into two parts. Amounts received up to the notice or certificate's face value are ordinary income. The excess is then treated "under applicable provisions of the Code."[468]

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[466] Rev. Rul. 70-407, 1970-2 C.B. 52; Priv. Ltr. Rul. 8225100 (Mar. 25, 1982); Priv. Ltr. Rul. 8624019 (Mar. 10, 1986).

[467] See Agway, Inc. v. United States, 524 F.2d 1194 (Ct. Cl. 1975), and Agway, Inc. v. United States, 1981-2 U.S.T.C. ¶ 9700 (Ct. Cl. 1981), *aff'd* 696 F.2d 1367 (Fed. Cir. 1982).

[468] Treas. Reg. § 1.1385-1(b)(1). For example, this regulation states "amounts received in redemption of a nonqualified written notice of

The tax classification of excess paid at the time of redemption can turn on the facts of the situation. In *Agway, Inc. v. United States*,[469] the federated cooperative issued preferred stock to a member cooperative as part of a patronage refund in one year and redeemed it in a later year for an amount greater than its face value. IRS argued the amount received above face value was essentially a dividend and should be taxable to the patron-recipient as ordinary income. The cooperative asserted that the premium was a long-term capital gain.

The court said the hallmarks of a dividend are pro rata distribution of earnings and profits and no change in basic shareholder relationships. The cooperative's bylaws provided retained equities were to be "retired in the order in which they have been received." The court found the premium payments, based on the amount of the underlying equity redemption, did not meet the "pro rata distribution" test.

As the members of the federated cooperative received different distributions of preferred stock each year depending on the proportion of business each did with the federated that year, a redemption of that stock issued in a prior year would not be in the same proportion as the total equity investment of each member in the federated.

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allocation which are in excess of the stated dollar amount of such written notice of allocation and which, in effect, constitute interest shall be treated by the recipient as interest."

[469] In this protracted litigation, the Service actually raised the same issue twice. The first case involved stock a cooperative, that was subsequently merged into Agway, received from being a member of yet another cooperative in 1957. This stock was redeemed for a premium in 1960. Agway, Inc. v. United States, 524 F.2d 1194 (Ct. Cl. 1975), 1975-2 U.S.T.C. ¶ 9777. The second case involved stock the predecessor cooperative received in 1960 that was redeemed in 1962. Agway, Inc. v. United States, 1981-2 U.S.T.C. ¶ 9700 (Ct. Cl. 1981), *aff'd* 696 F.2d 1367 (Fed. Cir. 1982). IRS justified the repeat litigation of the grounds that a regulation issued in 1959 supported its position and if not controlling in the first case because it could not be applied retroactively, it was controlling in the second case. The courts held the regulation wasn't applicable to this situation and decided both cases on other grounds for the cooperative.

The only way a distribution could be "pro rata" would be if every stockholder received the same number of shares in each year at issue. Consequently, the court ruled the excess over face value was not a dividend on capital stock, but rather a long-term capital gain for the recipient.[470]

Good accounting practice would suggest cooperatives clearly identify payment in redemption and payment in excess of redemption so patron recipients can treat each portion appropriately for tax purposes. This is particularly true when part of the payment is a redemption of a qualified written notice of allocation or a qualified per-unit retain certificate upon which patrons had previously been taxed.

The Service has said no gain or loss need be recognized if the payment is part of a tax-free reorganization. In a letter ruling, a cooperative proposed to restructure its capital to allocate accumulated nonpatronage income to its members. The cooperative would issue various classes of capital stock in exchange for members' current holding of common voting stock, per-unit retain certificates, and a proportionate share of the surplus built from nonpatronage sourced income.

Even though the members received additional value in the form of a more direct interest in the nonpatronage earnings retained by their cooperative, the ruling held "no gain or loss will be recognized by the members" as the transactions were a "recapitalization" under Code section 368(a)(l)(E), a reorganization that does not trigger a gain or loss under Code section 354(a)(1).[471]

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[470] The court in *Agway* relied on other decisions that addressed the basic character of patronage refunds paid during that time, such as Tomlinson v. Massey, 308 F.2d 168 (5th Cir. 1962), 1962-2 U.S.T.C. ¶ 9730; and Raley v. United States, 491 F.2d 136 (5th Cir. 1974), 1974-1 U.S.T.C. ¶ 9300.

[471] Priv. Ltr. Rul. 8846030 (Aug. 22, 1988).

SALE OR EXCHANGE OF EQUITY INTERESTS

Under some circumstances a member or patron may have an interest in a cooperative that can be sold or exchanged to others. The tax issues to be considered when a holder sells or exchanges a written notice of allocation or per-unit retain certificate are: (1) the effect on the seller when the sale or exchange is made, and (2) the effect on the purchaser when the cooperative redeems the notice or certificate.

IRS dealt with both issues in a letter ruling.[472] Shortly after issuance, cooperative members sold qualified written notices of allocation to an unrelated third party at less than face value. Soon thereafter the members purchased similar certificates from another patron, also for less than face value. The members reported their loss on the sale of their written notices as an ordinary loss. When the certificates purchased by the members were redeemed by the cooperative, the members treated these certificates as a capital asset eligible for long-term capital gain treatment.

The Service disallowed the members' loss deduction for the sale of their written notices of allocation on the ground that no actual loss was incurred. The mere exchange of one interest for a similar interest was not sufficient to generate a tax loss as the members had exactly what they had before the transactions, qualified allocation certificates from the same cooperative issued in the same year.

IRS determined that the gain on the sale of the written notices by a third party subsequent holder (the difference between the discounted purchase price and the amount paid to the holder by the cooperative at the time of redemption) was a capital gain. This was true regardless of whether the holder was a member of the cooperative, because the certificates were not acquired in the ordinary course of a trade or business, but rather as an investment.[473]

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[472] Tech. Adv. Mem. 8432010 (April 27, 1984).

[473] Id. The U.S. Tax Court, in dealing with transactions that occurred before the enactment of subchapter T, reached the same

TRANSFER OF RIGHTS TO PATRONIZE A COOPERATIVE

In some situations, the right to patronize a cooperative is a valued asset in itself. When patronage rights are limited, the right to patronize is often tied to some equity ownership or capital contribution. An example of limited patronage rights is the issuance of milk bases by dairy cooperatives.

A milk base has been described in one revenue ruling as "an intangible right permitting the [patron] the opportunity to sell a designated amount of milk at a premium price pursuant to a program designed to alleviate the ill effects of seasonal fluctuations on the supply of milk."[474] A milk base is an intangible property right that qualifies as a capital asset[475] if held by a taxpayer who is not a dealer in milk bases.[476]

Revenue Ruling 77-168[477] addressed the issue of determining the cost of a milk base when it had been allocated to or purchased by patrons over time. Patrons received their initial milk base allocations according to their past supply record.

In subsequent years, patrons could purchase additional milk base in varying quantities and prices, normally from other dairy farmers who no longer had a need for some or all of the milk base they owned. When patrons transferred bases, the cooperative updated its records to reflect the total number of pounds each patron was entitled to deliver. Certificates issued by the cooperative to the base purchaser didn't identify the specific base acquired.

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conclusion in Greenvine Corp. v. Commissioner, 40 T.C. 926 (1963).

[474] Rev. Rul. 77-168, 1977-1 C.B. 248. Holding period and termination of base under the California Agric. Code are discussed in Rev. Rul. 73-416, 1973-2 C.B. 304. See also Rev. Rul. 72-384, 1972-2 C.B. 479, *modifying* Rev. Rul. 70-644, 1970-2 C.B. 167; and Rev. Rul. 73-429, 1973-2 C.B. 205, clarifying Rev. Rul. 70-644, 1970-2 C.B. 167.

[475] I.R.C. § 1221.

[476] I.R.C. § 1221. See Rev. Rul. 70-644, 1970-2 C.B. 167 and Rev. Rul. 65-228, 1965-2 C.B. 43.

[477] Rev. Rul. 77-168, 1977-1 C.B. 248.

A patron sold some milk base when the price of the base was deflated. The patron computed the tax basis of the milk base sold by assigning to it the weighted average cost of the total milk base acquired over the years.

The Service likened the sale of milk base to the sale of some stock shares from a larger lot of shares which had been purchased at different times and prices. In stock transactions, if the particular shares sold cannot be linked to the purchase of the same shares, the stock sold or transferred must be charged against the earliest of such shares purchased to determine the cost or other basis of the stock.“’

Relying on this analogy to stock transactions, the Service ruled the patron could not use the weighted average method in determining gain or loss from the sale of the milk base. Instead, the patron had to use the “first in, first out” method as described in the regulations for stock sales.[479]

TAXATION OF DIRECT INVESTMENTS

When a member makes a direct purchase of a share of common voting membership stock in a cooperative (or purchases a membership in a nonstock cooperative), IRS treats that transaction as it would any direct investment in a noncooperative firm. The purchase has no immediate tax effect.

For example, in Revenue Ruling 65-241, a farmers' cooperative was denied a deduction for the cost of the Class C stock it was required to buy to borrow from a bank for cooperatives. The cooperative had attempted to treat the purchase as either a business expense under Code section 162 or as interest under Code section 163. IRS also stated that whether such stock would

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[478] Treas. Reg. §1.1012-1(c)(1).

[479] Rev. Rul. 77-168, 1977-1 C.B. 248, discussing Treas. Reg. § 1.1012-1(c)(1). One other comment on milk bases. In Revenue Ruling 65-228, the Service ruled that since a milk base has a life of indefinite duration, payments are capitalized and not subject to amortization or depreciation under Code section 167. Rev. Rul. 65-228, 1965-2 C.B. 43.

be considered a capital asset if disposed of by the cooperative for a gain or loss would depend upon the facts of each case.[480]

INCOME NOT BASED ON PATRONAGE

In analyzing the taxation of cooperative patrons, the primary focus is on payments resulting from patronage business: advances, patronage refunds, and per-unit retain allocations. Members and other patrons, however, may receive payments from a cooperative which are not based on patronage-related business.

For the most part, any payment a member or patron receives from a cooperative which is not based on patronage is treated the same as a payment from a noncooperative source. The single tax principle of subchapter T applies only to the distribution of income from the patronage relationship.[481]

There are several ways a patron may receive a payment from a cooperative that is outside the patronage relationship. They may receive payments that, although paid to them in proportion to their business with the cooperative, don't qualify as patronage refunds because the underlying income wasn't directly related to that business. Payments to patrons may be in proportions not related to their patronage business with the cooperative. Or patrons may collect dividends based on capital stock ownership in the cooperative or other dividend-like distributions.

Income From Nonpatronage Sources

Income from nonpatronage sources is sometimes distributed to patrons in proportion to the amount of patronage business conducted with the cooperative.[482]

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[480] Rev. Rul. 65-241, 1965-2 C.B. 44.

[481] The exception is the nonpatronage sourced income passed to patrons by an I.R.C. § 521 cooperative. Section 521 will be discussed in detail in a subsequent report in this series.

[482] The issue of distinguishing patronage and nonpatronage income and their tax treatment at the cooperative level is the subject of Chapter

Frequently, each patron receives a single payment consisting of two parts--a true patronage refund and a distribution of nonpatronage sourced income. It is important that the supporting documentation properly distinguish the two types of payments. Otherwise, the failure to provide the patrons with a proper written notice of allocation or per-unit retain certificate may jeopardize the subchapter T tax status of the patronage-sourced distribution.

Section 521 cooperatives are allowed to deduct distributions of nonpatronage income to patrons that are made on a patronage basis.[483] Patrons must include such distributions in their gross income in the taxable year received in the same manner as their patronage refund.[484]

The Service has looked at the correct way for patrons of non-section 521 cooperatives to treat patronage-based distributions of nonpatronage income on two occasions and reached apparently conflicting conclusions.

Letter ruling 8031057 concerned a federated cooperative without section 521 status and a member cooperative with it.[485] The federated cooperative distributed nonpatronage earnings (after taxes) to its members on the basis of the patronage purchases for the prior 3 years. The member cooperative claimed the distribution was a dividend and therefore eligible for the 85 percent dividends received deduction under Code section 243(a)(1).

However, IRS determined that a dividend had to be a distribution in accordance with the equity interests of the members in a cooperative. A distribution based on patronage, not total equity investment, could not be a dividend and therefore didn't qualify for the 85 percent dividends received deduction. IRS decided the distribution was "other income" and noted that

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5 of these reports. See Frederick and Reilly, *Income* Tax Treatment of *Cooperatives: Patronage Refunds,* ACS Cooperative Information Report 44, Part 2 (USDA 1993).

483 I.R.C. § 1352(c)(2).

484 I.R.C. § 1355(a)(2) and Treas. Reg. § 1.1355-1(a)(2).

485 Tech. Adv. Mem. 8031057 (April 29, 1980).

the local cooperative with section 521 status could have avoided taxation by including the distribution in total income refunded to members as a patronage refund.

Letter ruling 8547039 appears to have been drafted to correct a perceived error in the previous ruling.[486] It began by citing the definition of a dividend in Code section 316 as "any distribution of property made by a corporation to its stockholders out of its earnings and profits." It then noted several cases that held a dividend may be distributed to stockholders on some basis other than equity holdings. IRS stated that such distributions out of earnings on nonpatronage business were dividends. If the recipients were corporations, they were entitled to claim the 85 percent dividends received deduction under Code section 243.

One additional point is worth noting. If the Service successfully establishes that Code section 277 applies to cooperatives, access to the dividends received deduction for corporations under Code section 243 will be precluded.[487]

Not Paid on Patronage Basis

Members and patrons may receive payments from a cooperative which are not based on the amount of business they transacted with the cooperative. Examples would be a cooperative making an interest payment on a loan provided by a patron or director fees paid a patron-director as compensation for time spent on cooperative business. These payments don't qualify for Subchapter T treatment because they are made without regard to the amount of cooperative business done with or for patrons.

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[486] Priv. Ltr. Rul. 8547039 (August 27, 1985).

[487] I.R.C. § 277(a). The applicability of § 277 to cooperatives is, at the time this is written, a matter of ongoing controversy between IRS and cooperatives. One court has held § 277 doesn't apply, Landmark, Inc. v. United States, 25 Cl.Ct. 100 (1992), 92-1 U.S.T.C. ¶ 50,058. As it won the case on other grounds, the Service didn't appeal but neither has it accepted this decision. The § 277 issue will be discussed in a subsequent report in this series.

Dividends on Capital Stock

Cooperatives may pay dividends on capital stock.[488] No Code provision specifically addresses patron receipt of dividends on capital stock from cooperatives. They are treated by the patron the same as a dividend distribution from any other corporation.

Amounts Not Deductible by Cooperative

The single tax principle ultimately places the tax incidence of patronage refunds and per-unit retains on the final recipient and not the cooperative. But this applies only if payments are distributed according to subchapter T rules. Just because a distribution to a patron is taxable to the cooperative doesn't make it automatically deductible by the patron-recipient.

For example, if a cooperative fails to make a distribution within the proper payment period outlined in subchapter T, then the payment must be included in gross income by the cooperative and the patron recipient.[489]

LOSSES

Because members and other patrons use and finance a cooperative, any loss incurred by a cooperative is ultimately borne by them. The financial impact on patrons will depend on the character of the cooperative loss as well as the method for handling the loss.[490] Some recurring issues in the treatment of cooperative losses at the patron level are if and when the loss is to be recognized, for how much, and whether it is an ordinary or capital loss.

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[488] This ability to pay dividends is subject to rate of return restrictions found in various laws affecting cooperatives. These include state incorporation statutes for cooperatives, the Capper-Volstead Act (7 U.S.C. § 291), and § 521(b)(2) of the Internal Revenue Code.

[489] Treas. Reg. § 1.1385-1(a).

[490] The handling of losses will be covered in detail in a subsequent report in this series.

A cooperative loss is not assumed by its patrons until there is a transaction between the cooperative and patron that passes the loss on to the patrons. If the loss is absorbed at the cooperative level-usually by carrying the loss back or forward to reduce the amount of otherwise taxable income in other years--patrons notice little direct effect and generally have no tax consequences to worry about.

However, if a cooperative reduces a patron's equity interest in the cooperative, thereby passing the loss through to the patrons, the patrons may be able to take the loss into account for tax purposes.

In Revenue Ruling 70-64,[491] the Service determined that losses incurred by members of an agricultural cooperative upon redemption of qualified written notices of allocation at less than face value were ordinary losses deductible in the year of redemption. Like most cases dealing with this issue, a key determinant in whether the loss was capital or ordinary was the purpose behind acquiring the asset.

The Service noted the patron:

> ...joined the cooperative to facilitate his business and to make it more profitable. The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of [the patron's] trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified written notice of allocation is an ordinary loss deductible for 1968 under the provisions of section 165 of the Code.[492] The loss is measured by the difference between the stated amount

[491] Rev. Rul. 70-64, 1970-1 C.B. 36, ***suspended by Notice** 87-68, 1987-2* C.B. ***378 in*** response to the Arkansas Best decision (see note 109 below), but relied on by the Service in Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

[492] Citing Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), Ct. D. 1787, C.B. 1955-2, 511; Bumet v. Harmel, 287 U.S. 103 (1932), Ct. D. 611, C.B. XI-2, 210; and Western Wine and Liquor Co. v. Commissioner, 18 T.C. 1090 (1952), *acq.*, C.B. 1958-1, 6.

included in income in 1963 and the amount received upon redemption.[493]

Traditional methods for classifying assets as either capital or ordinary became less clear following the 1988 Supreme Court decision in *Arkansas Best Corp. v. United States*.[494] In this case, the Supreme Court ruled a taxpayer[495] realized a capital loss, not an ordinary loss, when it sold stock in a bank subsidiary even though the stock had been acquired and held for a valid business purpose. The Court viewed the taxpayer's motivation in purchasing an asset as irrelevant to the question of whether the asset is within the definition of a capital asset.[496] The Service suspended Revenue Ruling 70-64 during the *Arkansas Best* litigation.[497]

In a U.S. Tax Court case, IRS cited *Arkansas Best* to support its position that commodity hedges produced capital gain or loss treatment. In *Federal National Mortgage Association v. Commissioner* (FNMA),[498] the taxpayer hedged debentures and mortgages with short sales of U.S. Treasury securities. IRS claimed the losses generated were capital in nature. The Tax Court disagreed and held that these hedges resulted in ordinary gains and losses. The

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493 Rev. Rul. 70-64,1970-l C.B. 36, *suspended by* Notice 87-68, 1987-2 C.B. 378. Similarly, Rev. Rul. 70-407, 1970-2 C.B. 52; Priv. Ltr. Rul. 7950064 (Sept. 14, 1979); Priv. Ltr. Rul. 8248048 (Aug. 30, 1982); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

494 Arkansas Best Corp. v. United States, 485 U.S. 212 (1988), 1988-l U.S.T.C. ¶ 9210, overturning Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

495 The taxpayer is not a cooperative, but a diversified holding company.

496 This decision significantly limits the Supreme Court's earlier holding in Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), which had been interpreted as excluding from the definition of a capital asset property acquired for a business purpose.

497 Notice 87-68, 1987-2 C.B. 378, issued when Arkansas Best was on appeal from the Eighth Circuit Court of Appeals.

498 Federal National Mortgage Ass'n v. Commissioner, 100 T.C. No. 36 (1993).

Tax Court noted the hedging transactions must be integrally related to the purchasing and holding of the assets hedged (not necessarily in the same asset) in order to be eligible for ordinary gain or loss treatment.

After the FNMA case, the Treasury Department, in temporary and proposed regulations, modified its interpretation of the Arkansas Best decision and agreed that gains and losses from many hedging transactions should be considered ordinary gains and losses.[499]

The FNMA decision and the subsequent regulations pertained solely to hedging arrangements. In light of ***Arkansas Best,*** it is still not clear how much weight should be given to a taxpayer's motivation in purchasing an asset in determining a patron's ability to claim an ordinary loss on equities issued by a cooperative. However, in one subsequent letter ruling, IRS denied a cooperative's attempt to avoid recognizing income upon the redemption of qualified notices for less than face value partly on the grounds that the patrons were entitled to an ordinary loss deduction. IRS reasoned that it would amount to avoidance of the single tax principle underpinning subchapter T if the cooperative could also escape taxation on the earnings.[500]

IRS has contended that a loss from nonpatronage sources cannot be used to reduce a cooperative's patronage-sourced income.[501] Under this theory, a cooperative may not "transfer" a

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[499] T.D. 8493, Prop. Treas. Reg. §1.1221-2T.

[500] Tech Adv. Mem. 9249005 (August 21, 1992). See also Tech. Adv. Mem. 9128007 (March 28, 1991), wherein IRS held an assessment to cover a loss was deductible by the members as a necessary business expense under Code § 162. If a cooperative could redeem some old qualified retained equities at face value and then assess the members for their share of a loss and have the members deduct the amount recouped, it would seem logical the cooperative could simply cancel old equities of equal value and have the members be eligible for the same tax treatment.

[501] Rev. Rul 74-377, 1974-2 C.B. 274. However, the Eighth Circuit Court of Appeals suggested in a footnote that a cooperative could offset current patronage income with nonpatronage losses. See Farm Service Cooperative v. Commissioner, 70 T.C. 145 (1978), *rev'd*, 619 F.2d 718,725

loss from nonpatronage business to a patron by simply reducing patronage refunds.

PATRON PAYMENTS TO A COOPERATIVE

Cooperative taxation from the patron's perspective usually focuses on income passing from cooperative to patron. However, members and other patrons may make payments to the cooperative as well. Generally, patron payments to cooperatives are for (1) payment for products or services received from the cooperative or (2) contributions to capital. A patron payment to the cooperative may or may not be deductible.

Patrons can generally deduct ordinary and necessary business expenses incurred in the conduct of their business.[502] On the other hand, Code section 263 disallows deductions for amounts paid for the acquisition or creation of a capital asset. For a cost to be capitalized under section 263, the payment must create or enhance what is essentially a separate and distinct property interest.

Contributions to Capital

Members and other patrons contribute to their cooperative's capital by payment of membership fees or dues, purchase of membership or other classes of stock, and patronage-based capitalization.

An example of a capital investment in a cooperative that is an acquisition of capital rather than an ordinary and necessary business expense is a one time membership fee. IRS has said that such a fee, used to capitalize the cooperative, creates a "separate and distinct capital asset" and the payor/member may not deduct any part of the fee under Code section 162.[503]

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n.16 (8th Cir. 1980).

[502] I.R.C. § 162.

[503] Priv. Ltr. Rul. 8723018 (March 5, 1987).

Contributions to cooperative capital by members and other patrons often serve as a pre-condition for using the cooperative. The compulsory nature of these contributions has been used to support the view that such payments should be expenses rather than contributions to capital for tax purposes. The courts have dealt with this issue on several occasions, not always with consistent results.

In United Grocers *v. United States,*[504] a case predating subchapter T, a grocery supply cooperative argued that various monthly payments required from its members for them to do business with the cooperative were nontaxable contributions to capital. IRS claimed the payments were for goods and services rendered and should be taxed as ordinary income to the cooperative.

The Ninth Circuit Court of Appeals held that the determinant as to whether a payment to a cooperative was a contribution to capital or ordinary income was the intent of the patron making the payment. The court found that the only reason members paid the fees was because the fees were required to obtain merchandise and services at the lowest possible price; the members had no true investment motive. Therefore the cooperative had to treat the payments as ordinary income.

While United *Grocers* didn't deal specifically with the tax impact on patrons, the district court noted that evidence offered by the government indicated that members deducted the payments to the cooperative as business expenses on their own income tax returns. The district court, however, struck that evidence from the record and disregarded it as not properly admissible on the issue of the cooperative's claims.[505]

In a letter ruling issued after United *Grocers,* the Service held that periodic payments may be considered contributions to capital. The ruling described a taxi cooperative whose members purchased one share of stock at a fixed price and made periodic payments based on use of the cooperative. IRS ruled these

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

[505] United Grocers v. United States, 186 F. Supp. at 737.

periodic payments were contributions to capital, stating "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."[506] This ruling didn't address the tax consequences to members making such payments.

An interesting line of cases developed in the late 1960's concerning the proper treatment by member-patrons of payments made to banks for cooperatives for class C stock. At the time, member-borrowers from the banks were required to purchase class C stock in an amount equal to 15 percent of the interest payable on the loan each quarter.[507]

In Revenue Ruling 65-241, IRS stated that:

> . ..costs incurred by cooperatives in purchasing class C stock are not deductible either as a business expense under section 162 or as interest under section 163 of the Internal Revenue Code of 1954. Whether such stock will be considered a capital asset upon subsequent disposition by a farmers' cooperative will depend upon the facts in the particular case.[508]

In M.F.A. Central Cooperative v. Bookwalter[509], a Federal district court determined that the stock was of no use or benefit to the member-cooperative. It paid no dividend and conveyed no rights to the cooperative. The court found that interest was a term of art meaning an amount one contracted to pay for the use of borrowed funds. These payments weren't deductible as interest

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

[507] The banks for cooperatives have replaced this interest-override method of financing with a loan-based capital plan. However, the same factors are Likely to apply in determining the tax consequences to patrons of capitalizing the banks.

[508] Rev. Rul. 65-241, 1965-2 C.B. 44, 45.

[509] M.F.A. Central Cooperative v. Bookwalter, 286 F. Supp. 956 (E.D. MO. 1968).

payments because they didn't meet the court's strict interpretation of interest. However, the stock was purchased only because it was a precondition to borrowing from the bank. So the cost was deductible as an ordinary and necessary business expense.

In *Mississippi Chemical Corp. v. United States,*[510] decided in February 1969, a U.S. District Court in Mississippi reasoned that any charge required as a precedent to a loan of money is interest. The court held that although the Class C stock cost $100 a share, it had only a nominal value of $1 per share. The $99 difference was deductible as interest by the purchasing cooperative member.

In Penn *Yan Agway Cooperative v. United States,*[511] decided in November 1969, the United States Court of Claims noted *M.F.A. Central Cooperative v. Bookzuulter,* but reached the same conclusion as the court in *Mississippi Chemical.* This court held the interest override payments were deductible on the grounds that they were measured as a percentage of the interest payable on the outstanding loan obligation to the bank.

After Penn *Yan Agwuy,* the U.S. Court of Appeals for the Eighth Circuit reviewed the earlier decision in *M.F.A. Central Cooperative v. Bookzuulter.* In June 1970, the appellate court affirmed the finding of the district court that the payments for the class C stock weren't deductible as interest but reversed the original finding that the payments were deductible as necessary and ordinary business expenses.[512] The Eighth Circuit found the class C stock had substantial value and must be treated as a capital asset by the purchaser-cooperative.

In September 1970, the U.S. Court of Appeals for the Fifth Circuit reviewed of the district court holding in *Mississippi*

[510] Mississippi Chemical Corp. v. United States, 69-l U.S.T.C. ¶ 9266 (S.D. Miss. 1969).

[511] Penn Yan Agway Cooperative v. United States, 417 F.2d 1372 (Ct. Cl. 1969). The U.S. Court of Claims opinion in Penn Yan Agway Cooperative v. United States is dated November 14, 1969. The U.S. Court of Appeals (Eighth Circuit) decision in M.F.A. Central Cooperative v. Bookwalter followed shortly thereafter on June 8, 1970.

[512] M.F.A. Central Cooperative v. Bookwalter, 427 F.2d 1341 (1970), *aff'g in* part, *rev'g in part,* M.F.A. Central Cooperative v. Bookwalter, 286 F. Supp. 956 (E.D. MO. 1968).

Chemical Corp. The Fifth Circuit affirmed the district court's determination that most payments for class C stock were deductible as interest expense.[513]

In a rare venture into cooperative taxation, the U.S. Supreme Court decided to review the Fifth Circuit opinion in United States v. *Mississippi Chemical Corp.*[514] *In* an opinion long on history of the Farm Credit System and short on analysis of tax law, a unanimous Supreme Court accepted the IRS position that the class C stock acquired by cooperatives to borrow from banks for cooperatives is a capital asset under Code section 1221.[515] The Court held the class C stock had substantial valued derived from attributes other than marketability.

The Court also noted that Congress, in the Farm Credit Act of 1955, required cooperative borrowers to purchase "stock' on a quarterly basis[516] as part of a scheme to retire government investments in the Farm Credit System.[517] If Congress had meant for the quarterly payments to be interest, it could have called them interest.[518]

Other Payments

Patron payments to cooperatives may take the form of a loan instead of a contribution to equity capital. In such cases, the member or patron making the loan will realize the same tax consequences as it would in making a loan to any other party.

Members and patrons may make other types of payments to cooperatives that are not contributions to capital. For instance, annual payments by patrons to a cooperative to cover annual op-

[513] Mississippi Chemical Corp. v. United States, 70-2 U.S.T.C. ¶ 9601 (5th Cir. 1970), *aff'g* 69-l U.S.T.C. ¶ 9266 (S.D. Miss. 1969).

[514] United States v. Mississippi Chemical Corp., 401 U.S. 908 (1971).

[515] United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972).

[516] 69 Stat. 655, 12 U.S.C. § 1134.

[517] 405 U.S. at 305, 312.

[518] Id. at 312.

erating deficits are deductible as an ordinary and necessary business expense under section 162 of the Code.[519]

[519] Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).

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Rural Business-Cooperative Service (RBS) provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The cooperative segment of RBS (1) helps farmers and other rural residents develop cooperatives to obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs. RBS also publishes research and educational materials and issues ***Rural Cooperatives*** magazine.