APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE PAPER

INDUSTRY: Farmers Cooperatives

ISSUE: Income from Excess Capacity

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UIL NO: 1382.07-00 (1)

FACTUAL/LEGAL ISSUE: Factual

APPROVED:

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EFFECTIVE DATE: 10/14/92

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(1) This number has been proposed but not approved. When the number is approved it will be included in the IRM and the Uniform Issue List.

SETTLEMENT GUIDELINES

STATEMENT OF ISSUE

Whether rental income is patronage sourced income to a nonexempt cooperative.

Also, whether income earned by a nonexempt cooperative backhauling goods for nonpatrons following the delivery of patrons' products is patronage sourced income.

EMPLOYEE PLANS/EXEMPT ORGANIZATIONS DIVISION'S POSITION

The position of Exempt Organizations is that, as a general rule, rental income and income derived from backhauling goods for nonpatrons are nonpatronage income to a nonexempt cooperative.

DISCUSSION

IRC 1388(a) defines the term "patronage dividend" as an amount paid to a patron of the cooperative on the basis of business done "with or for" the patron, pursuant to a preexisting obligation to pay that amount, and determined by reference to the net earnings of the cooperative from business done "with or for" its patrons.

IRC 1388(a) also provides that a "patronage dividend" does not include any amount paid to a patron to the extent that either (A) it is out of earnings other than from business done "with or for" patrons, or (B) it is out of earnings from business done "with or for" other patrons to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.

The Regulation 1.1382-3(c)(2) defines the term "income from sources other than patronage" as follows:

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

This definition appears in a section of the regulations pertaining only to exempt cooperatives but generally has been accepted as applicable to exempt and nonexempt cooperatives alike. See Illinois Grain Corporation v. Commissioner, 87 T.C. 435 (1986).

The most significant factor in distinguishing between patronage and nonpatronage income of nonexempt cooperatives has been Revenue Ruling 69-576, 1969-2 C.B. 166. The test from Revenue Ruling 69-576 that is always applied in the characterization of cooperative income is, as follows:

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

In Cotter and Company v. United States, 765 F.2d 1102 (Fed. Cir. 1985), rev'g and rem'g, 84-2 USTC ¶ 9773 (Cl. Ct. 1984), the Court considered the patronage or nonpatronage character of three types of income: interest income, warehouse rental income, and income from the use of a sprinkler system.

Cotter was the nonexempt cooperative supplying goods to True Value hardware stores throughout the United States. Its business was seasonal, so Cotter had deficits and surpluses at different times of the year. It invested the surpluses in short-term commercial paper for periods of 43 days or less. It had warehouse space in which to store goods between their purchase and resale, and from which it distributed goods to its patron stores. Furthermore, its rapid growth indicated that its need for warehouse space would increase in the future. To plan for this growth, Cotter built excess warehouse space and leased it out on a temporary basis. When Cotter purchased its Chicago warehouse facility, it was served by a loop sprinkler system to which certain nearby buildings owned by unrelated parties were connected. Water entered the system at Cotter's warehouse and the water tanks and pumping equipment were there. Cotter collected a fee for supplying the water and maintaining the equipment.

The Claims Court decided Cotter consistent with the standard it established in Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983). That is, quoting the test in Rev. Rul. 69-576, 1969-2 C.B. 166, and distinguishing St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Ct. Cl. 1980), the Court stated the question was whether the transactions facilitated basic functions of the cooperative in some way other than simple money management or by enhancing overall profitability. The warehouse rental income was held to be nonpatronage sourced.

With respect to that rental income the Court stated,

> [T]he dispositive question with respect to the rental income is whether the transaction which produced such income, i.e., the rental of excess warehouse space facilitated the basic purchasing and marketing activities of the plaintiff.
>
> *   *   *   *
>
> Plaintiff here was able to show that the purchase or construction of warehouse facilities larger than necessary for its present needs facilitated the operation of its growing business. It made a thoroughly insufficient showing, however, that the rental of excess space contributed in any significant way to the accomplishment of its principal functions, aside from enhancing the cooperative's overall profitability.

Cotter appealed the Claims Court decision to the Federal Circuit. The Federal Circuit reversed the Claims Court and held that the rental income was patronage income. The Federal Circuit summarized its conclusion as follows:

> We agree with the Claims Court that Congress did not intend the term "with or for patrons" to be "of unlimited scope, [so that] all

> income produced by cooperatives that is passed through to patrons would be, in essence, income obtained for patrons, and would, therefore, be considered patronage sourced". Cotter, 6 Cl. Ct. at 227. A cooperative cannot merely "clothe its shareholders as patrons and its corporate dividends as patronage payments" and retain the benefits of Subchapter T. Mississippi Valley, 408 F.2d at 835. But Subchapter T was also not enacted to require that a cooperative acting for its patrons function in an economically unreasonable manner or penalize it for acting reasonably. Considering the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function will allow courts to distinguish from cooperative activity transactions which merely enhance overall profitability in a manner incidental to cooperative function. Such activity is not to receive the benefit of Subchapter T, but other activity, which does directly relate to cooperative function when considered in its actual business environment, cannot properly be considered outside "business done with or for patrons". Cotter's transactions here were not merely to gain incidental profits; they resulted from activities integrally intertwined with the cooperative's functions.

In reaching this conclusion, the Federal Circuit criticized the "narrow analytical focus" of the Claims Court, saying that it had the effect of imposing a penalty upon Cotter for doing what they had to do in the business environment in which they functioned. The Federal Circuit stated that they might reach a different result were they writing on a clean slate, but concluded the Claims Court misapplied the analysis set forth in St. Louis Bank for Cooperatives. Citing Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), the Federal Circuit concluded St. Louis Bank cannot be so narrowly read as to limit its conclusion to banking cooperatives.

The following additional grounds were given for the rental income being held to be patronage sourced:

> The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space. Architects do not as yet provide warehouses with accordion pleated walls that may be expanded or contracted in strict conformity to the owner's needs.... It is clear from the undisputed facts that Cotter did not go into the warehouse rental business seeking to

> enhance its corporate profits while hiding behind its label as a cooperative. Indeed, Cotter occasionally must lease space from others as well. Rather, Cotter implemented a reasonable plan to secure the warehousing of its goods at the lowest cost to its patrons; the result is a primary function of Cotter's.

In Cotter and Company and Subsidiaries v. United States, AOD-CC-1986-032, the Office of Chief Counsel recommended no certiorari. This AOD states, in part, that:

> We disagree with the decision of the Federal Circuit. The opinion purports to apply the "directly related" test of Treas. Reg. § 1.1382-3(c)(2), but does so in a way that cuts the heart out of the test... Applicable law requires that the cooperative establish a connection between the transaction that produced the income and the basic services it rendered. The Federal Circuit has gone beyond existing law and established an unprecedented rule under which all cooperative income would qualify as patronage sourced, even if the transaction producing it did not facilitate the basic functions the cooperative was established to perform for its patrons.

In Illinois Grain Corporation v. Commissioner, 87 T.C. 435 (1986) the Tax Court considered the characterization of both interest and rental income. Illinois Grain was a nonexempt grain marketing cooperative. Most of its product was carried to market by barge on the Mississippi River. In order to assure itself of barges, Illinois Grain joined a barging cooperative that satisfied approximately half of its barging needs. It also leased two barges, then subleased them to the barging cooperative, which added those two barges to the fleet serving Illinois Grain. The rental income in issue was the income from the sublease of those two barges.

In deciding this case, the Tax Court first analyzed the various court decisions and rulings to see if they have a touchstone or a common thread. The Court concluded that it found such commonality in the test enunciated in Rev. Rul. 69-576. As a general conclusion, prior to considering the facts pertaining to the interest income and the rental income, the Court said:

> A review of the statutory provisions, the decided cases in the area and, indeed, respondent's announced position on the subject as embodied in Rev. Rul. 69-576, leads us to the conclusion that in this case, the petitioner must prevail as to both types of income here in issue. As the cases make clear, such a determination is necessarily

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

As for the barge rental income, the Tax Court concluded it was not the result of an investment intended to produce merely passive rental income, but the result of its overall efforts to move its patrons' grain to market. The Court admitted the barge rental may not have been a significant factor in that effort, as only two barges were subleased, but neither did the Court believe the subleases were entered into as an independent and unrelated profit making activity. Accordingly, the barge rental income was held to be patronage income "within the rationale of Rev. Rul. 69-576 and consistent with the philosophy expressed in the Cotter case."

Finally, the Court added this cautionary note to its opinion:

> We repeat that every case of this nature must necessarily turn upon its own facts. The same activities which may be directly related to the cooperative enterprise in one case may not be so directly related in another case. It all depends upon the nature of the cooperative effort, and the way the cooperative conducts its business. In the instant case, we do not think petitioner did anything different with respect to managing its short-term funds than any other business enterprise would have done, consistent with skilled professional money management. Respondent would appear to require that petitioner do something less than this in order to secure the benefits of subchapter T. We do not think the law requires this, and commonsense indeed dictates otherwise.

In Illinois Grain Corporation v. United States, AOD-CC-1990-027 (Sept. 24, 1990), the Office of Chief Counsel acquiesced in the holding that the barge rental income was patronage sourced, but nonacquiesced as to the holding concerning the interest income.

The AOD notes that the rental transaction can be considered to actually facilitate Illinois Grain's marketing activity in that it placed the barges with a lessee that was already carrying Illinois Grain's products to market.

Nonexempt cooperatives frequently earn additional income by backhauling goods for nonpatrons following the delivery of patrons products. There are no decided cases on the question of whether such backhauling income is patronage versus nonpatronage sourced. Taxpayers argue that the backhauling income reduces the operating expenses incurred to produce the patronage income. All backhauling issues have an inherent hazard of litigation to the Government in that the primary purpose of the initial trip was the delivery of patrons products.