

by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates which have previously been made. The amount shown as the tax by the taxpayer on his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting under this section. In determining the decrease in tax for the prior taxable year (or years), appropriate adjustment shall be 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 the dividends received credit).

(c) *Refunds.* If the decrease in tax for the prior taxable year (or years) determined under section 1383(a)(2)(B) and paragraph (a)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction under section 1382 (b) or (c)(2)(B), the excess shall be considered to be a payment of tax for the taxable year of the deduction. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year. See section 6151 and the regulations thereunder, for rules relating to time and place for paying tax shown on returns.

(d) *Example.* The application of section 1383 may be illustrated by the following example:

Example: The X Cooperative (which reports its income on a calendar year basis) pays patronage dividends of \$100,000 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends of \$100,000 were paid in nonqualified written notices of allocation the X Cooperative is not allowed a deduction for that amount for 1963. On December 1, 1966, the X Cooperative redeems these nonqualified written notices of allocation for \$50,000. Under section 1382(b)(2), a deduction of \$50,000 is allowable

in computing its taxable income for 1966. However, the X Cooperative has a loss for 1966 determined without regard to this deduction. The X Cooperative, therefore, makes the computation under the alternative method provided in section 1383(a)(2). Under this alternative method, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1963 and for such other years prior to 1966 as are affected which results from recomputing its tax for 1963 and such other years affected) as if patronage dividends of \$50,000 had been paid on February 1, 1964, in qualified written notices of allocation. In addition, under this alternative method the X Cooperative cannot use the \$50,000 as a deduction for 1966 so as to increase its net operating loss for such year for purposes of computing a net operating loss carryback or carryover. If the X Cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it will claim a credit or refund (as an overpayment of tax for 1966) of the decrease in tax for 1964 and for such other years prior to 1966 as are affected. It shall not, however, apply one method for computing the tax with respect to the redemptions in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

[T.D. 6643, 28 FR 3156, Apr. 2, 1963]

TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

§ 1.1385-1 Amounts includible in patron's gross income.

(a) *General rules.* Section 1385(a) requires every person to include in gross income the following amounts received by him during the taxable year, to the extent paid by the organization in money, a qualified written notice of allocation, or other property (other than a nonqualified written notice of allocation):

(1) The amount of any patronage dividend received from an organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, unless such amount is excludable from gross income under the provisions of section 1385(b) and paragraph (c) of this section, and

(2) The amount of any distribution received from a farmers', fruit growers', or like association, organized and

operated in compliance with the requirements of section 521 and §1.521-1, which is paid on a patronage basis with respect to earnings derived by such association either from business done with or for the United States or any of its agencies or from sources other than patronage.

The amounts described in subparagraphs (1) and (2) of this paragraph are includible in gross income for the taxable year in which they are received even though the cooperative organization was allowed a deduction for such amounts for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Similarly, such amounts are includible in gross income even though the cooperative organization is not permitted any deduction for such amounts under the provisions of section 1382 because such amounts were not paid within the time prescribed by such section.

(b) *Treatment of certain nonqualified written notices of allocation.* (1) Except as provided in paragraph (c) of this section, any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subparagraph (2) of this paragraph shall, to the extent that the stated dollar amount of such written notice of allocation exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset, whether such gain is realized by the patron who received the nonqualified written notice of allocation initially or by any subsequent holder. Any amount realized on the redemption, sale, or other disposition of such a nonqualified written notice of allocation in excess of its stated dollar amount will be treated under the applicable provisions of the Code. For example, amounts received in redemption of a nonqualified written notice of 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.

(2) The nonqualified written notices of allocation to which subparagraph (1) of this paragraph applies are the following:

(i) A nonqualified written notice of allocation which was paid as a patronage dividend (within the meaning of section 1388(a) and paragraph (a) of §1.1388-1), by a cooperative organization subject to the provisions of part I of subchapter T, and

(ii) A nonqualified written notice of allocation which was paid by a farmers', fruit growers', or like association, organized and operated in compliance with the requirements of section 521 and §1.521-1, to patrons on a patronage basis with respect to earnings derived either from business done with or for the United States or any of its agencies or from sources other than patronage.

(3) The basis of any nonqualified written notice of allocation described in subparagraph (2) of this paragraph, in the hands of the patron to whom such written notice of allocation was initially paid shall be zero, and the basis of such a written notice of allocation which was acquired from a decedent shall be its basis in the hands of the decedent.

(4) The application of this paragraph may be illustrated by the following example:

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 §1.691(a)-1.

(c) *Treatment of patronage dividends received with respect to certain property—*

(1) *Exclusions from gross income.* Except as provided in subparagraph (2) of this paragraph, gross income shall not include:

(i) Any amount of a patronage dividend described in paragraph (a)(1) of this section which is received with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which is received with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167; and

(ii) Any amount (to the extent treated as ordinary income under paragraph (b) of this section) received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend with respect to the purchase of supplies, equipment, or services, which were not used in the trade or business and the cost of which was not deductible under section 212, or which was received as a patronage dividend with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167.

(2) *Special rules.* (i) If an amount described in subparagraph (1) of this paragraph relates to the purchase of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and the person receiving such amount owned such asset or property at any time during the taxable year in which such amount is received, then such amount shall be taken into account as an adjustment to the basis of such property or asset as of the first day of the taxable year in which such amount is received. To the extent that such amount exceeds the adjusted basis of such property it shall be taken into account as ordinary income.

(ii) If an amount described in subparagraph (1) of this paragraph relates to the marketing or purchasing of a capital asset (as defined in section 1221), or property used in the trade or business of a character which is subject to the allowance for depreciation pro-

vided in section 167, and the person receiving such amount did not own the asset or property at any time during the taxable year in which such amount is received, then such amount shall be included in gross income as ordinary income except that:

(a) If such amount relates to a capital asset (as defined in section 1221) which was held by the recipient for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and with respect to which a loss was or would have been deductible under section 165, such amount shall be taken into account as gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977);

(b) If such amount relates to a capital asset (as defined in section 1221) with respect to which a loss was not or would not have been deductible under section 165, such amount shall not be taken into account.

(iii) If an amount described in subparagraph (1) of this paragraph relates to the marketing of a capital asset (as defined in section 1221) or property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 167, and such amount is received by the patron in the same taxable year during which he marketed the asset to which it relates, such amount shall be treated as an additional amount received on the sale or other disposition of such asset.

(iv) If a person receiving a patronage dividend or an amount on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was received as a patronage dividend is unable to determine the item to which it relates, he shall include such patronage dividend or such amount in gross income as ordinary income in the manner and to the extent provided in paragraph (a) or (b) of this section, whichever is applicable.

(3) The application of this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1964, P, a patron of a cooperative association, purchases an implement for use in his farming business from

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such association for \$2,900. The implement has an estimated useful life of three years and has an estimated salvage value of \$200 which P chooses to take into account in the computation of depreciation. P files his income tax returns on a calendar year basis. For 1964 P claims depreciation of \$450 with respect to the implement pursuant to his use of the straight-line method at the rate of \$900 per year. On July 1, 1965, the cooperative association pays a patronage dividend to P of \$300 in cash with respect to his purchase of the farm implement. P will adjust the basis of the implement and will compute his depreciation deduction for 1965 (and subsequent taxable years) as follows:

Cost of farm implement, July 1, 1964	\$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Adjustment as of January 1, 1965 for cash patronage dividend	300
Total	950
Basis for depreciation for the remaining 2½ years of estimated life	1,950
Depreciation deduction for 1965 (\$1,950 divided by the 2½ years of remaining life)	700

Example 2. Assume the same facts as in example (1), except that on July 1, 1965, the cooperative association paid a patronage dividend to P with respect to his purchase of the implement in the form of a nonqualified written notice of allocation having a stated dollar amount of \$300. Since such written notice of allocation was not qualified, no amount of the patronage dividend was taken into account by P as an adjustment to the basis of the implement, or in computing his depreciation deduction, for the year 1965. In 1968, P receives \$300 cash from the association in full redemption of the written notice of allocation. Prior to 1968, he had recovered through depreciation \$2,700 of the cost of the implement, leaving an adjusted basis of \$200 (the salvage value). For the year 1968, the redemption proceeds of \$300 are applied against the adjusted basis of \$200, reducing the basis of the implement to zero, and the balance of the redemption proceeds, \$100, is includable as ordinary income in P's gross income for the calendar year 1968. If the patronage dividend paid to P on July 1, 1965, had been in the form of \$60 cash (20 percent of \$300) and a qualified written notice of allocation with a stated dollar amount of \$240, then the tax treatment of such patronage dividend would be that illustrated in example (1).

Example 3. Assume the same facts as in example (2), except that the nonqualified written notice of allocation is redeemed in cash on July 1, 1966. The full \$300 received on redemption will reduce the adjusted basis of the implement as of January 1, 1966, and the depreciation allowances for 1966 and 1967 are computed as follows:

Cost of farm implement, July 1, 1964	\$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 months)	450
Depreciation for 1965	900
Adjustment as of January 1, 1966 for proceeds of the redemption	300
Total	1,850
Basis for depreciation on Jan. 1, 1966 ...	1,050
If P uses the implement in his business until fully depreciated, he would be entitled to the following depreciation allowances with respect to such implement:	
For 1966	700
For 1967	350
Total	1,050
Balance to be depreciated	0

Example 4. Assume the same facts as in example (3), except that P sells the implement in 1965. The entire \$300 received in 1966 in redemption of the nonqualified written notice of allocation is includable as ordinary income in P's gross income for the year 1966.

(d) *Determination of amount received.* In determining the amount received for purposes of this section:

(1) Property (other than written notices of allocation) shall be taken into account at its fair market value when received;

(2) A qualified written notice of allocation shall be taken into account at its stated dollar amount; and

(3) The amount of a qualified check shall be considered an amount received in money during the taxable year in which such check is received if the check is endorsed and cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization in which the patronage to which such amount relates occurred.

(e) *Effective date.* This section shall not apply to any distribution or allocation received from a cooperative organization, or to any gain or loss on the redemption, sale, or other disposition of any allocation received from such an organization, if such distribution or allocation was received with respect to patronage occurring in a taxable year of the organization beginning before January 1, 1963. See § 1.61-5 for the tax treatment by patrons of such distributions or allocations.

[T.D. 6643, 28 FR 3157, Apr. 2, 1963, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

DEFINITIONS; SPECIAL RULES

§ 1.1388-1 Definitions and special rules.

(a) *Patronage dividend*—(1) *In general.* The term *patronage dividend* means an amount paid to a patron by a cooperative organization subject to the provisions of part I, subchapter T, chapter 1 of the Code, which is paid:

(i) On the basis of quantity or value of business done with or for such patron,

(ii) Under a valid enforceable written obligation of such organization to the patron to pay such amount, which obligation existed before the cooperative organization received the amount so paid, and

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

For the purpose of subdivision (ii) of this subparagraph, amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment. The term *net earnings*, for purposes of subdivision (iii) of this subparagraph, includes the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items. For purposes of such subdivision (iii), net earnings shall not be reduced by any taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests.

(2) *Exceptions.* The term *patronage dividend* does not include the following:

(i) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings not derived from business done with or for patrons.

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially

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

(iii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents, even if such documents were originally paid as patronage dividends.

(iv) An amount paid to a patron by a cooperative organization to the extent that such amount is fixed without reference to the net earnings of the cooperative organization from business done with or for its patrons.

(3) *Examples.* The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. (i) Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1964. On the same day cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a *retain certificate* having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1964, cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate stated dollar amount calculated at the rate of 2 cents per unit. Under the provisions of section 1382(e), W's patronage is deemed to occur in 1964, the year in which the pool is closed.

(ii) The patronage dividend paid to W during 1964 amounts to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of the cash distribution (3 cents), and the stated dollar amount of the capital stock of A (2 cents), which are fixed with reference to the net