

## 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

earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the net earnings of A, do not constitute patronage dividends.

*Example 2.* Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1964. On the same day cooperative B pays to X \$1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of \$1.00 and the expenses and other charges attributable to such products. On March 5, 1967, cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool pays to X, in cash, 10 cents per unit pursuant to the participation certificate. Under the provisions of section 1382(e), X's patronage is deemed to occur in 1967, the year in which the pool is closed. The payment made to X during 1967, amounting to 10 cents per unit, is a patronage dividend. Neither the payment to X in 1964 of \$1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend.

*Example 3.* Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1964, and receives in return therefor \$100. On February 1, 1965, cooperative C, having determined the excess of its receipts over its costs and expenses, pays to Y a cash distribution of \$1.00 and a revolving fund certificate with a stated dollar amount of \$1.00. The amount of patronage dividend paid to Y in 1965 is \$2.00, the aggregate of the cash distribution (\$1.00) and the stated dollar amount of the revolving fund certificate (\$1.00).

*Example 4.* Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to cooperative D during 1964 aggregating \$75 for service rendered him by cooperative D during that year. On May 15, 1965, cooperative D, having determined the excess of its receipts over its costs and expenses, pays to Z a cash distribution of \$2.00. Such amount is a patronage dividend paid by cooperative D during 1965.

(b) *Written notice of allocation.* The term *written notice of allocation* means any capital stock, revolving fund certificate, retain certificate, certificate

of indebtedness, letter of advice, or other written notice, which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative organization, and the portion thereof, if any, which constitutes a patronage dividend. Thus, 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. A written notice of allocation may disclose to the patron the amount of the allocation which constitutes a patronage dividend either as a dollar amount or as a percentage of the stated dollar amount of the written notice of allocation.

(c) *Qualified written notice of allocation*—(1) *In general.* The term *qualified written notice of allocation* means a written notice of allocation:

(i) Which meets the requirements of subparagraphs (2) or (3) of this paragraph, and

(ii) Which is paid as part of a patronage dividend, or as part of a payment by a cooperative association organized and operated in compliance with the provisions of section 521 and § 1.521-1 to patrons on a patronage basis with respect to earnings derived from business done with or for the United States or any of its agencies or from sources other than patronage, that also includes a payment in money or by qualified check equal to at least 20 percent of such patronage dividend or such payment.

In determining, for purposes of subdivision (ii) of this subparagraph, whether 20 percent of a patronage dividend or a payment with respect to nonpatronage earnings is paid in money or by qualified check, any portion of such dividend or payment which is paid in nonqualified written notices of allocation may be disregarded. Thus, if a cooperative pays a patronage dividend of \$100 in the form of a nonqualified written notice of allocation with a stated dollar amount of \$50, a written notice of allocation with a stated dollar amount of \$40, and money in the amount of \$10, the written notice of allocation with a stated dollar amount of \$40 will constitute a qualified written notice of allocation if it meets the requirements of subparagraph (2) or (3) of this paragraph. A *payment in money*, as that

term is used in subdivision (ii) of this subparagraph, includes a payment by a check drawn on a bank but does not include a credit against amounts owed by the patron to the cooperative organization, a credit against the purchase price of a share of stock or of a membership in such organization, nor does it include a payment by means of a document redeemable by such organization for money.

(2) *Written notice of allocation redeemable in cash.* The term *qualified written notice of allocation* includes a written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and 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. The written notice of the right of redemption referred to in the preceding sentence shall be given separately to each patron. Thus, a written notice of the right of redemption which is published in a newspaper or posted at the cooperative's place of business would not be sufficient to qualify a written notice of allocation which is otherwise described in this subparagraph.

(3) *Consent of patron.* The term *qualified written notice of allocation* also includes written notice of allocation which meets the requirement of subparagraph (1)(ii) of this paragraph and which the distributee has consented, in a manner provided in this subparagraph, to take into account at its stated dollar amount as provided in section 1385 and § 1.1385-1.

(i) *Consent in writing.* A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by signing and furnishing a written consent to the cooperative organization. No special form is required for the written consent so long as the document on which it is made clearly discloses the terms of the consent. Thus, the written consent may be made on a signed invoice, sales slip, delivery ticket, marketing agreement, or other doc-

ument, on which appears the appropriate consent. Unless the written consent specifically provides to the contrary, it shall be effective with respect to all patronage occurring during the taxable year of the cooperative organization in which such consent is received by such organization and, unless revoked under section 1388(c)(3)(B), for all subsequent taxable years. Section 1388(c)(3)(B)(i) provides that a written consent may be revoked by the patron at any time. Thus, any written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation. A revocation, to be effective, must be in writing, signed by the patron, and furnished to the cooperative organization. Such a revocation shall be effective only with respect to patronage occurring after the close of the taxable year of the cooperative organization during which the revocation is filed with it. In the case of a pooling arrangement described in section 1382(e) and § 1.1382-5, a written consent which is made at any time before the close of the taxable year of the cooperative organization during which the pool closes shall be effective with respect to all patronage under that pool. In addition, any subsequent revocation of such consent by the patron will not be effective for that pool or any other pool with respect to which he has been a patron before such revocation.

(ii) *Consent by membership.* (a) A distributee may consent to take the stated dollar amount of written notices of allocation into account under section 1385 by obtaining or retaining membership in the cooperative organization after such organization has adopted a valid bylaw providing that membership in such cooperative organization constitutes such consent, but such consent shall take effect only after the distributee has received a written notification of the adoption of the bylaw provision and a copy of such bylaw. The bylaw must have been adopted by the cooperative organization after October 16, 1962, and must contain a clear statement that membership in the cooperative organization constitutes the prescribed consent. The written notification from the cooperative organization must inform the patron that this

bylaw has been adopted and of its significance. The notification and copy of the bylaw shall be given separately to each member (or prospective member); thus, a written notice and copy of the bylaw which are published in a newspaper or posted at the cooperative's place of business are not sufficient to qualify a written notice of allocation under this subdivision. A member (or prospective member) is presumed to have received the notification and copy of the bylaw if they were sent to his last known address by ordinary mail. A prospective member must receive the notification and copy of the bylaw before he becomes a member of the organization in order to have his membership in the organization constitute consent. A consent made in the manner described in this subdivision 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. Thus, any such consent shall not be effective with respect to any patronage occurring after the patron ceases to be a member of the cooperative organization or after the bylaw provision is repealed by such organization. In the case of a pooling arrangement described in section 1382(e) and § 1.1382-5, a consent made under this subdivision will be effective only with respect to the patron's actual patronage occurring after he receives the notification and copy of the bylaw and while he is a member of the cooperative organization. Thus such a consent shall not be 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 provisions is repealed by the organization.

(b) The following is an example of a bylaw provision which would meet the requirements prescribed in (a) of this subdivision.

*Example:* 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 re-

ceived 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.

(c) For purposes of this subdivision the term *member* means a person who is entitled to participate in the management of the cooperative organization.

(iii) *Consent by qualified check.* (a) A distributee may consent to take the stated dollar amount of a written notice of allocation into account under section 1385 by endorsing and cashing a qualified check which is paid as a part of the same patronage dividend or payment described in subparagraph (1)(ii) of this paragraph of which the written notice of allocation is also a part. In order to constitute an effective consent under this subdivision, however, the qualified check must be endorsed and cashed by the payee on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization with respect to which the patronage dividend or payment is paid (or on or before such earlier day as may be prescribed by the cooperative organization). The endorsing and cashing of a qualified check shall be considered a consent only with respect to written notices of allocation which are part of the same patronage dividend or payment as the qualified check and for which a consent under subdivision (i) or (ii) of this subparagraph is not in effect. A qualified check is presumed to be endorsed and cashed within the 90-day period if the earliest bank endorsement which appears thereon bears a date no later than 3 days after the end of such 90-day period (excluding Saturdays, Sundays, and legal holidays).

(b) The term *qualified check* means a check, or other instrument redeemable in money, which is paid as a part of a patronage dividend or payment described in subparagraph (1)(ii) of this paragraph, on which there is clearly imprinted a statement that the endorsement and cashing of the check or other instrument constitutes the consent of the payee to take into account, as provided in the Federal income tax laws, the stated dollar amount of any written notices of allocation which are

paid as a part of the patronage dividend or payment of which such check or other instrument is also a part. A qualified check need not be in the form of an ordinary check which is payable through the banking system. It may, for example, be in the form of an instrument which is redeemable in money by the cooperative organization. The term *qualified check* does not include a check or other instrument paid as part of a patronage dividend or payment with respect to which a consent under subdivision (i) or (ii) of this subparagraph is in effect. In addition, the term *qualified check* does not include a check or other instrument which is paid as part of a patronage dividend or payment, if such patronage dividend or payment does not also include a written notice of allocation (other than a written notice of allocation that may be redeemed in cash at its stated dollar amount which meets the requirements of section 1388(c)(1)(A) and subparagraph (2) of this paragraph). Thus, a check which is paid as part of a patronage dividend is not a qualified check (even though it has the required statement imprinted on it) if the remaining portion of such patronage dividend is paid in cash or if the only written notices of allocation included in the payment are qualified under section 1388(c)(1)(A) and subparagraph (2) of this paragraph (relating to certain written notices of allocation which are redeemable by the patron within a period of at least 90 days).

(c) The provisions of this subdivision may be illustrated by the following example.

*Example:* (1) The A Cooperative is a cooperative organization filing its income tax returns on a calendar year basis. None of its patrons have consented in the manner prescribed in section 1388(c)(2) (A) or (B). On August 1, 1964, the A Cooperative pays patronage dividends to its patrons with respect to their 1963 patronage, and the payment to each such patron is partly by a qualified check and partly in the form of a written notice of allocation which is not redeemable for cash. Each patron who endorses and cashes his qualified check on or before December 14, 1964 (the ninetieth day following the close of the 1963 payment period) shall be considered to have consented with respect to the accompanying written notice of allocation and the amount of such check is treated

as a patronage dividend paid in money on August 1, 1964.

(2) As to any patron who has not endorsed and cashed his qualified check by December 14, 1964, there is no consent and both the written notice of allocation and the qualified check constitute nonqualified written notices of allocation within the meaning of section 1388(d) and paragraph (d) of this section. If such a patron then cashes his check on January 2, 1965, he shall treat the amount received as an amount received on January 2, 1965, in redemption of a nonqualified written notice of allocation. Likewise, the cooperative shall treat the amount of the check as an amount paid on January 2, 1965, in redemption of a nonqualified written notice of allocation.

(d) *Nonqualified written notice of allocation.* The term *nonqualified written notice of allocation* means a written notice of allocation which is not a qualified written notice of allocation described in section 1388(c) and paragraph (c) of this section, or a qualified check which is not cashed on or before the ninetieth day after the close of the payment period for the taxable year of the cooperative organization for which the payment of which it is a part is paid.

(e) *Patron.* The term *patron* includes 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.

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