

**INCOME TAX TREATMENT OF
COOPERATIVES: Patronage Refunds
and other Income Issues**

Cooperative Information Report 44, Part 2

2005 Edition

Donald A. Frederick

Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Patronage Refunds and other Income Issues
2005 Edition

Donald A. Frederick, Program Leader
Law, Policy & Governance

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

Cooperative Information Report 44, Part 2

April 2005

Preface¹

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

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

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

This report contains three chapters, which are part of a larger project on income taxation of cooperatives. Chapter 4 explains the Internal Revenue Code definition of a patronage refund. Chapter 5 reviews the rules for distinguishing patronage sourced income that can be distributed tax-free to patrons from nonpatronage sourced income that is subject to double taxation. Chapter 6 explores other issues that have arisen in the context of ascertaining the proper tax treatment of distributions from cooperatives to patrons as patronage refunds and patronage-based pass-throughs of deductions and credits.

¹ This report does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. This publication is presented only to provide information to persons interested in the tax treatment of cooperatives.

Highlights

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

Patronage refunds are amounts paid to patrons by a cooperative on the basis of quantity or value of business done with or for such patrons, under a preexisting obligation, based on net earnings from business with or for patrons. Earnings on patronage business are refunded to patrons based on the level of business they do each year with the cooperative. Generally, only earnings on patronage activity qualify for single tax treatment.²

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

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

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

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

Cooperatives with complex organizational structures or financial arrangements confront several technical issues in classifying income for tax purposes. Different groups of patrons may use different services provided by the cooperative, presenting problems of how to allocate funds available for distribution as patronage refunds among those patron groups. Patronage may not always occur in the same year that the resulting income is realized, producing timing differences. And the use of third-party agents has raised questions about whether certain business is really with or for patrons.

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

The American Jobs Creation Act of 2004 created new benefits for cooperatives and their patrons. Cooperatives are allowed to both claim and pass-through to patrons a special deduction for the applicable portion of the cooperative's qualified production activities income. Cooperatives are also given the option to claim at the cooperative level, or pass through to patrons, the small producer ethanol credit and the new low sulfur diesel fuel production credit.

Contents

	Page
Chapter 4. Code Definition of a Patronage Refund	9
An Amount Paid to a Patron	11
By a Cooperative	12
On the Basis of Quantity or Value of Business	
Done With or For Such Patron	12
Under a Preexisting Legal Obligation	12
How Established	14
Preexisting Requirement	16
Board Discretion	17
Patronage or Nonpatronage Allocation	17
Allocations Among Different Groups of Patrons	19
Based on Net Earnings From Business	
With or for Patrons	20
Income Sources	21
Year Patronage Occurred	23
Chapter 5. Patronage and Nonpatronage Business	27
Significance of Classifying Business Sources	27
Tests Applied to Classify Business	29
Regulatory Rules	30
Directly Related/Actually Facilitates Test	32
Nature-of-the-Income Test	35
Taxpayer's Burden of Proof	38

Rental Income	39
Investment Income	40
Interest	41
Dividends	48
Income From Sale of Assets	50
Depreciation Recapture	50
Special Rules	53
Farmland Industries Case	55
Subsequent Rulings	62
Income From Other Events	66
Change in Accounting Method	66
CCC Storage Fees	67
Judicial Settlements	69
Partnership and LLC Earnings	70
Pension Fund Reversions	80
Chapter 6. Other Income Issues	82
Simultaneous Patronage and Nonpatronage Operations	82
Multiple Service Cooperatives	84
Equitable Allocation Among Patron Groups	86
Matching Patronage and Allocation - Tracing	90
Unequal Allocations	94
Use of Third-Party Agents	97
Expenses	99

Export Entity Earnings	104
Domestic International Sales Corporation	104
Foreign Sales Corporation	105
Extraterritorial Income Exclusion	106
Qualified Production Activities Income Deduction	108
Cooperative Pass-through Provision	111
Example	112
Dividend Allocation Rule Repeal	112
Declaratory Judgement Relief	118
Marketing Includes Value-Added Processing Involving Animals	118
Small Ethanol Producer Credit, Co-op Pass-through	119
Small Low Sulfur Diesel Fuel Producer Credit, Co-op Pass-through	120

CHAPTER 4

CODE DEFINITION OF A PATRONAGE REFUND

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

A specific definition of a patronage refund⁴ was added to the Internal Revenue Code (Code) with enactment of the Revenue Act of 1962, as part of the new subchapter T.⁵ Codified at Code section 1388(a), the definition reads as follows:

(a) Patronage Dividend - For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies -

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

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

³ *CF Industries, Inc. v. Commissioner*, 995 F.2d 101 (7th Cir. 1993), *modifying* 62 T.C.M. (CCH) 1249 (1991).

⁴ Patronage dividend in the Code.

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

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

The Code uses the term "patronage dividend" to describe net margins from business done with or for patrons that are allocated to patrons on a patronage basis. "Patronage dividend" was first introduced into the Code by the Revenue Act of 1951.⁶ The term had been used before, however, as a synonym for patronage refund.⁷

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

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

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

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

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

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

AN AMOUNT PAID TO A PATRON

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

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

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

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

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

¹⁰ Treas. Reg. § 1.1388-1(e).

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

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

BY A COOPERATIVE

A payment may only be treated as a patronage refund for purposes of subchapter T if it is paid "by an organization to which part I of this subchapter applies."¹³ Thus, a payment with all the characteristics of a patronage refund will not qualify as a patronage refund unless the paying organization meets subchapter T requirements of operating on a cooperative basis.¹⁴

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

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

The two measures will not necessarily yield identical refunds to individual patrons, but Code section 1388(a)(1) gives cooperatives the option to use either method. And as it is permissible to use either volume or value, it is presumably possible to use a combination of both.

The "with or for" term in Code section 1388(a)(1) provides flexibility, recognizing the variety of relationships a cooperative may have with its patrons.

UNDER A PREEXISTING LEGAL OBLIGATION

The requirement that patronage refunds be made pursuant to a "preexisting legal obligation" to qualify for single tax treatment

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

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

was established long before enactment of subchapter T.¹⁵ The obligation has to have substance. In one case the court said a "moral obligation" to make returns was insufficient to justify the exclusion.¹⁶ In another, an "understanding" that such returns would be made was held deficient.¹⁷

Obligations requiring further action to make them binding upon the cooperative are not sufficient.¹⁸ If the obligation is not established until a declaration is made by the cooperative, the obligation to return net margins is not effective.¹⁹ An "existing legal" obligation is required.²⁰

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

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

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

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

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

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

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

²¹ Treas. Reg. § 1.1388-1(a)(1)(ii).

must be an obligation "of such organization to the patron to pay such amount."²²

How Established

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

A State law, such as the statute under which the cooperative is incorporated, may require refund payments.²³ Mere statutory direction for the directors to allocate net margins annually, however, may not make the margins deductible. An actual allocation and distribution may still be required. In *Fountain City Co-op Creamery Ass'n v. Commissioner*, the patronage refund deduction was disallowed because the directors allocated net margins to reserves rather than making cash or stock distributions to patrons as contemplated by the statute.²⁴

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

A typical bylaw provision creating such an obligation is found in *Sample Legal Documents for Cooperatives*.²⁶

²² *Id.*

²³ Treas. Reg. § 1.1388-1(a)(1).

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

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

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

ARTICLE _ . OPERATION AT COST AND MEMBERS'
CAPITAL

Section 1. Operation at Cost. The association shall at all times be operated on a cooperative service-at-cost basis for the mutual benefit of its member patrons.

Section 2. Margin Allocation. In order to induce patronage and to assure that this association will operate on a service-at-cost basis in all its transactions with its members, the association is obligated to account on a patronage basis to all member patrons on an annual basis for all amounts received from business conducted with members on a patronage basis, over and above the cost of providing such services, making reasonable additions to reserves, and redeeming capital credits. Such allocation shall be on the basis of the volume (dollar value) of product marketed through (purchased from) the association.

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

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

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

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

Preexisting Requirement

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

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

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

²⁸ Treas. Reg. § 1.1388-1(a)(1). A marketing agreement was found to establish the necessary obligation in *Sumner Rhubarb Growers' Ass'n v. Commissioner*, 10 T.C.M. 465, 474 (1951). *See also*, *Western Colorado Producers Corp. v. Commissioner*, 1 T.C.M. 697 (1943).

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

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

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

subsequent tax year, the court held for the cooperative. It found the bylaw created a timely obligation for the following tax years.³²

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

Board Discretion

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

Patronage or Nonpatronage Allocation

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

Although most cooperatives that issue stock do not pay dividends, most are statutorily able to do so within limits.³⁴ For example, the bylaws may permit the board of directors to pay

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

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

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

dividends on capital stock up to a stated percentage, with the remaining earnings allocated to patrons on a patronage basis.

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

Other decisions discussed situations in which, typically by State law, cooperatives could add a certain percentage of each year's net margins to reserves. In those cases involving reserves, the courts generally did not express the same concern as to the effect of such diversions on the legal obligation to pay patronage refunds.³⁶

In a decision involving both issues, the court said discretion to add funds to reserves did not affect the preexisting legal

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

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

obligation, but discretion to pay dividends on stock destroyed the obligation to the extent discretion existed.³⁷

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

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

Allocations Among Different Groups of Patrons

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

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

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

³⁸ Rev. Rul. 69-621, 1969-2 C.B. 167.

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

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

In a 1985 private letter ruling, IRS relied in part on the older decisions on dividend payment discretion to disallow the entire patronage refund deduction claimed by a cooperative that netted gains and losses on patronage business.⁴¹ This ruling was reversed by enactment of section 13210 of the Budget Reconciliation Act of 1985.⁴²

BASED ON NET EARNINGS FROM BUSINESS WITH OR FOR PATRONS

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

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

The Code sets out two further limitations. First, a patronage refund may not include "any amount paid to a patron to the extent that...such amount is out of earnings other than from business done with or for patrons...."⁴⁵

Second, a payment will not be recognized as a patronage refund to the extent such amount is paid "out of earnings from business done with or for other patrons to whom no amounts are

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

⁴² Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13210, 100 Stat. 82 (1985). This legislation will be discussed in detail in Chapter 13 of these reports on how cooperatives treat losses for tax purposes.

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

⁴⁴ Treas. Reg. § 1.1388-1(a)(1).

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

paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."⁴⁶

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

Income Sources

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

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

Most cooperatives also have other kinds of income. Examples include fees for services provided,⁴⁷ gains from dealings in property (frequently sale of a cooperative asset at a gain), interest income, rentals of real property or equipment, royalties, and dividend income. These sources can, under appropriate circumstances, be an integral part of the cooperative's operation

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

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

depending on what the cooperative does for patrons and how its business is conducted.

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

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

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

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

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

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

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

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

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

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

Year Patronage Occurred

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

This is a common occurrence among manufacturing and processing cooperatives and cooperatives that operate in a federated system. For example, a cooperative that processes fruits into juices might take delivery of a crop and process it into a

⁵² *Id.* at 640.

canned or frozen product in one year, and then store it before selling the product well into the subsequent year.

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

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

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

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

In other words, section 1382(f) provides that where a cooperative has earnings from patron business in a year subsequent to the year the underlying business took place, the patronage shall be considered to have occurred in the same year

⁵³ I.R.C. § 1382(f).

⁵⁴ Treas. Reg. § 1.1382-6.

the earnings are included in income. This permits the cooperative to distribute the earnings to patrons as patronage refunds and claim the appropriate tax treatment.

The ability of a local cooperative to treat patronage refunds from a federated cooperative as patronage-sourced income in the year the refund is received was established in *Kingfisher Cooperative Elevator Association v. Commissioner*.⁵⁵

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

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

IRS has also applied Section 1382(f) when a cooperative managed a loss by redeeming nonqualified written notices of allocation during the 8½-month period following the tax year. In a 1979 private letter ruling,⁶¹ the cooperative suffered a loss during the taxable year. It placed each patron's share of the loss in an account receivable. During the 8½ month payment period that

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

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

⁵⁷ Rev. Rul. 74-84, 1974-1 C.B. 244.

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

⁵⁹ I.R.C. § 631(a).

⁶⁰ Rev. Rul. 71-439, 1971-2 C.B. 321, and Rev. Rul. 74-24, 1974-1 C.B. 244, describe workers' cooperatives owning standing timber from which the cooperative manufactured wood products.

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

followed the tax year, the cooperative canceled the accounts receivable due from patrons by redeeming the nonqualified equities at less than face value. The transaction was held to relate to patronage during the taxable year in which the loss occurred.

In contrast, when the applicable tax law provides that an adjustment increases income in the years the underlying transactions took place, IRS may refuse to apply section 1382(f). If the 8½ month payment period has expired, patronage refund tax treatment may be denied.

Revenue Ruling 74-327⁶² held income resulting from the adjustments to depreciation was includible in the cooperative's gross income for the years the incorrect amount of depreciation was claimed. IRS said the fact the amount of depreciation claimed in the prior years was overstated and the overstatement was not discovered until after the returns had been filed for those years did not result in income includible in a later year. Thus, section 1382(f) was not applicable to assign the added income from adjustment to the year the error was discovered and corrected.

⁶² Rev. Rul. 74-327, 1974-2 C.B. 173.

CHAPTER 5

PATRONAGE AND NONPATRONAGE BUSINESS

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

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

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

SIGNIFICANCE OF CLASSIFYING BUSINESS SOURCES

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

⁶³ I.R.C. § 521. Under § 521, farmer cooperatives that meet certain organizational and operational tests may, in addition to patronage refunds, also deduct dividends paid on stock and nonpatronage income distributed to patrons on a patronage basis. Section 521 is discussed in detail in Part 4 of these reports.

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

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

For cooperatives without section 521 status, only patronage-sourced income qualifies for single tax treatment. Nonpatronage income is subject to regular corporate double tax treatment.⁶⁶

Distinguishing patronage and nonpatronage business is significant for another reason. Cooperatives engaged in both patronage and nonpatronage business must separate both income

⁶⁴ I.R.C. § 521(b)(1) requires a qualifying cooperative to return earnings from marketing products to "members or other producers" and providing supplies to "members and other persons." The regulations are more specific, stating: "...patronage dividends must be paid to all producers on the same basis...." Treas. Reg. § 1.521-1(a)(1).

⁶⁵ I.R.C. § 1381(a)(1) and § 1382(c)(2)(A). Treas. Reg. § 1.1382-3(c).

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

and expenses related to each type of business.⁶⁷ This requires the cooperative to maintain adequate records in order to properly allocate income and expense items between patronage business and nonpatronage business. This complicates the cooperative's accounting system and the computation of its tax liability.

Revenue Ruling 63-58⁶⁸ provides an example of how this requirement works. The ruling discusses a cooperative that both stores and markets grain, and that only pays patronage refunds to its members. The ruling states that where cooperatives distribute earnings:

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

TESTS APPLIED TO CLASSIFY BUSINESS

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

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

⁶⁸ 1963-1 C.B. 109.

⁶⁹ *Id.*

⁷⁰ I.R.C. § 1388(a)(3).

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

The phrase "done with or for patrons" provides the basis for tests applied to classify specific business practices or sources of income as patronage sourced or nonpatronage sourced. The Code gives no further explanation of patronage or nonpatronage business, and "the legislative history of the subchapter T provisions is not helpful."⁷²

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

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

Regulatory Rules

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

...incidental income derived from sources not directly related to marketing, purchasing, or service activities of the cooperative association. For example, income derived

⁷¹ I.R.C. § 1388(a).

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

from the lease of premises, from investment in securities, and from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

The two sentences quoted above may be somewhat self-contradictory. The first sentence presents a "directly related" test, which suggests looking at the nature of the transaction and the economic reality of the situation. If income is generated by transactions directly related to marketing, purchasing, or service activities of a cooperative for its patrons, then it is patronage income.

The second sentence lists three specific examples of income--rent, returns on investments, and gains from the sale of assets--as nonpatronage income. For a considerable period of time, the Service read the second sentence as conclusively establishing that income from these three sources is *per se* nonpatronage income. Cooperatives countered that the "directly related" test should be applied to determine the patronage or nonpatronage nature of all income. After numerous court battles led to a series of decisions adopting the cooperative position, the Service has agreed to accept the "directly related" test as the proper standard for determining whether cooperative income is from patronage or nonpatronage sources.⁷³

The regulation language in question was adopted in 1953,⁷⁴ in response to 1951 legislation which required section 521 farmer cooperatives for the first time to allocate income set aside in reserves to avoid corporate tax.⁷⁵ The fundamental requirement

⁷³ Action on Decision 2001-03 (2001), *acquiescing in* Farmland Industries v. Commissioner, T.C. Memo 1999-388.

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

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

for section 521 status is nondiscrimination between member and nonmember patrons. Prior to 1951, in a number of court cases the Commissioner challenged the allocation practices of tax exempt cooperatives as inconsistent with this nondiscrimination requirement for exemption.⁷⁶ Subsection (3) of the current regulation⁷⁷, which follows the definition in subsection (2), indicates this regulation was adopted to deal primarily with allocation of nonoperating income.

The historical background of the regulation suggests that the primary intent was to deal with nondiscriminatory allocations by exempt cooperatives. However, as the Tax Court has said, "it appears to be generally accepted that this definitional attempt is of equal application to both exempt and nonexempt cooperatives."⁷⁸

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

Directly Related/Actually Facilitates Test

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

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

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

⁷⁷ Treas. Reg. § 1.1382-3(c)(3).

⁷⁸ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 451 (1986).

of the cooperative association." Conversely, income directly related to the cooperative's activities is patronage-sourced income.⁷⁹

The directly related test first identifies the cooperative's activities with respect to marketing, purchasing, or services performed for patrons. "The same activities that may be directly related to the cooperative enterprise in one case may not be so directly related in another case."⁸⁰ For example, a workers' cooperative lease of a plywood plant for its own use is directly related to the cooperative's business.⁸¹ Such a plant, however, may not be directly related to another cooperative's marketing, purchasing, or service activities. The activity meets the directly related test if it relates to business done with or for patrons.

The "actually facilitates" language is credited to Revenue Ruling 69-576.⁸² This ruling concerned a cooperative that borrowed money from a Bank for Cooperatives to finance the acquisition of supplies for resale to its members. After the close of its fiscal year, the Bank for Cooperatives determined its net margin and paid the borrower/cooperative a patronage refund based on its ratable share of the bank's margin. In holding the patronage refund paid by the Bank for Cooperatives was patronage sourced income to the cooperative, the Service stated:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the

⁷⁹ Rev. Rul. 74-160, 1974-1 C.B. 246; Rev. Rul. 75-228, 1975-1 C.B. 278; *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

⁸⁰ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 463 (1986).

⁸¹ *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

⁸² Rev. Rul. 69-576, 1969-2 C.B. 166.

cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative operations, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.⁸³

The "actually facilitates" concept enunciated in Revenue Ruling 69-576 has been called the "touchstone or common thread" running through cases and rulings "which enables them to be reconciled" with the regulations, at times facially inconsistent.⁸⁴

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

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

⁸³ *Id.* at 167.

⁸⁴ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 452 (1986).

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.⁸⁵

Patronage sourced income results from activities integrally intertwined with the cooperative's functions in a business context, as opposed to activities that merely produce incidental profits.⁸⁶ Analysis should focus on the "totality of the circumstances" to determine how the activity is related to the cooperative's principle business.⁸⁷ This includes the facts surrounding the generation of income. For example, income generated from temporary excess cash is judged in the context of the cooperative's cash needs and the fluctuation of those needs as it conducts business on behalf of patrons. Excess cash and its temporary use to generate income may be part of the business in which the cooperative is engaged.⁸⁸

Nature-of-the-Income Test

Treas. Reg. § 1.1382-3(c)(2), which provides the directly related test, also gives three specific examples of income derived from sources other than patronage: "Income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets."⁸⁹

⁸⁵ *Id.* at 459.

⁸⁶ *Cotter and Co. v. United States*, 765 F.2d 1102 (Fed. Cir. 1985), 1985-2 U.S.T.C. (CCH) ¶ 9487, *rev'g*, 6 Ct. Cl. 219 (1984), 1984-2 U.S.T.C. (CCH) ¶ 9773.

⁸⁷ 765 F.2d at 1106.

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

⁸⁹ Treas. Reg. § 1.1382-3(c)(2). The list is not without some foundation. A report of the Senate Finance Committee on the 1951

Efforts have sometimes been made to apply these three examples as tests without regard to the underlying facts or the relation to the cooperative's patronage activities. In this approach, if income falls in any of the three categories, it is considered income from a nonpatronage source without considering whether it may meet a "directly related" or "actually facilitates" test.⁹⁰

The approach that any income falling in a category noted in one of the regulatory examples needs no further analysis to determine its patronage or nonpatronage character has not been generally accepted.⁹¹ The Tax Court has said, "in spite of the apparently clear language of the regulation, however, the law, as

amendment to section 101(12) of the 1939 Code gave a somewhat similar list. It stated: "At the present time...nonoperating income such as interest, dividends, rents, and capital gains and also the income from certain business done with the United States Government or its agencies, is taxable to the ordinary cooperative even when allocated to the accounts of patrons, but are tax-free to the exempt cooperative whether or not allocated." S. Rep. No. 781, 82nd Cong., 1st Sess. 20, 21 (1951), *reprinted in* 1951 U.S. Code Cong. & Admin. Serv. 1989.

⁹⁰ "The government contends that all capital gains are not patronage source income and that it is unnecessary to consider whether the lease cancellation payment and [the cooperative's] income from the sale of the machines are otherwise directly related to the cooperative's activities because both are capital gains." *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,348-49 (D. Ore. 1979).

⁹¹ An investigation of the underlying reasons for a transaction was commenced despite the regulations, for example, in *Astoria Plywood Corp. v. United States*, where the court said, "In my view capital gains may be patronage source income. In each instance, it depends on whether the income is 'directly related' to [the cooperative's] activities." 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979). Similarly, *Certified Grocers of California, Ltd. v. Commissioner*, noted "it is clear that interest income earned by cooperatives is, in some circumstances, patronage sourced income," 88 T.C. 238, 243 (1987), citing *Cotter and Co. v. United States*, 765 F.2d 1102, 1107 (Fed. Cir. 1985), and *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459-460 (1986).

it has developed, shows that the language does not always mean what it literally says. Both the [IRS] and the courts have played a hand in this evolution of the law...."⁹²

At times, the courts have been openly hostile to IRS attempts to narrowly interpret this regulation. The Tax Court rejected attempts by IRS to remove income generated by money management practices (interest income) as "any other business enterprise would have done," from patronage-sourced treatment.⁹³ The court quoted another Tax Court decision that said, "We consider [IRS's] position herein not only contrary to the [law], but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives."⁹⁴

The Court of Claims was similarly harsh on IRS's literal interpretation of Treas. Reg. § 1.1382-3(c)(2). In Revenue Ruling 73-497, IRS relied on the regulatory examples to classify interest income earned by a Bank for Cooperatives as nonpatronage-sourced.⁹⁵ The interest income came from temporary investments of surplus funds and on bonds the bank was required to buy to comply with Farm Credit Administration liquidity requirements. In *St. Louis Bank for Cooperatives v. United States*, the Claims Court found Revenue Ruling 73-497 to be "inherently defective....The ruling reiterates the language of the regulation, is conclusory in content, and of little persuasive value."⁹⁶

⁹² *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 451 (1986).

⁹³ 87 T.C. at 463.

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

⁹⁵ Rev. Rul. 73-497, 1973-2 C.B. 314.

⁹⁶ *St. Louis Bank for Cooperatives v. United States*, 624 F.2d 1041, 1050-51 (Cl. Ct. 1980).

TAXPAYER'S BURDEN OF PROOF

Analysis of the patronage- or nonpatronage-sourced nature of a particular business activity is "necessarily fact-intensive."⁹⁷ Cooperatives wishing to establish the patronage nature of a particular activity have the burden of proof to establish the facts necessary to prove IRS's determination incorrect.⁹⁸ Income has been found nonpatronage-sourced when the cooperative fails to show the necessary connection between the activity generating the income and the principal business of the cooperative conducted with or for its patrons.⁹⁹ As the Tax Court has said:

Although we realize that cooperatives such as petitioner need cash to operate, the record in this case does not allow us to determine whether the funds that earned the interest income in issue were needed for use in petitioner's cooperative activity. The record does not disclose, for example, the amount of funds that earned the interest, the term for which the funds were placed, petitioner's needs for the funds, and when those needs were expected to occur. [footnote omitted] Lacking such facts, we must hold that petitioner has failed to prove that respondent erred in determining that the remaining interest income was nonpatronage-sourced.¹⁰⁰

⁹⁷ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459 (1986); *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238, 244 (1987).

⁹⁸ *Certified Grocers*, 88 T.C. at 244 (1987).

⁹⁹ *See*, for example, *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979); *Washington-Oregon Shippers Cooperative, Inc. v. Commissioner*, 52 T.C.M. (CCH) 1406 (1987); *Thwaites Terrace Home Owners Corp. v. Commissioner*, 72 T.C.M. (CCH) 578.

¹⁰⁰ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238, 245 (1987).

On the other hand, most situations in which the patronage or nonpatronage nature of the income was disputed and in which the cooperative's position prevailed resulted from careful explanation of the activity and its relation to the cooperative's business. Examples of these situations are found in the following sections on specific items of income or activities.

RENTAL INCOME

The first example of nonpatronage income listed in the regulation is "income derived from the lease of premises."¹⁰¹ Two significant court decisions included a discussion of the status of rental income, and both found it patronage-sourced. Both cases eschewed a literal application of the regulatory example in favor of an analysis weighing the totality of the facts.

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

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

¹⁰¹ Treas. Reg. § 1.1382-3(c)(2).

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.¹⁰²

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

We are satisfied that petitioner's leasing and subleasing of barges to its transportation cooperative was not an 'investment' in such barges, intended to produce merely passive rental income, but was ... clearly linked to petitioner's principal cooperative enterprise, and was not entered into as an independent and unrelated profit-making activity. We accordingly hold that the barge rentals which petitioner derived in the year in issue were patronage sourced income, within the rational of Rev. Rul. 69-576, and consistent with the philosophy expressed in the *Cotter* case.¹⁰³

INVESTMENT INCOME

The second example of income identified as nonpatronage-sourced in Treas. Reg. § 1.1382-3(c)(2) is income "from

¹⁰² *Cotter and Co. v. United States*, 765 F.2d 1102, 1109-1110, (Fed. Cir. 1985), *rev'g*, 6 Ct. Cl. 219 (1984). While the IRS Chief Counsel's Office did not recommend an appeal of the Cotter decision, it did express disagreement with the outcome. Action on Decision 1986-032 (June 23, 1986).

¹⁰³ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 461-462 (1986). IRS accepted the court's decision that the barge rental income was patronage sourced. Action on Decision 1990-027 (Sept. 24, 1990).

investment in securities." This encompasses both interest earned on funds loaned out by cooperatives and dividends received on equity investments held by cooperatives.

Interest

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

As a general rule, if the loan enables the borrower to perform some service for the cooperative, the interest is likely to be characterized as patronage-sourced income. The cooperative has been able to meet its burden of establishing the loan was directly related to its cooperative activity.¹⁰⁴

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

The first decision in this area, Revenue Ruling 73-497,¹⁰⁵ applied Treas. Reg. § 1.1382-3(c)(2) literally to deny patronage sourced income status to interest income earned by a Bank for Cooperatives on temporary placements of surplus funds and on bonds purchased to comply with liquidity requirements imposed by the Farm Credit Administration. This ruling ignored Revenue Ruling 69-576 and the "directly related to" and "actually facilitates" tests.

In Revenue Ruling 74-160,¹⁰⁶ a plywood workers' cooperative made loans to its chief supplier. The supplier needed the loans to finance equipment necessary to carry out its business operations for the cooperative. This time IRS relied on Revenue Ruling 69-576 and held the loans to purchase equipment facilitated the

¹⁰⁴ See, e.g., Tech. Adv. Mem. 9236001 (May 20, 1992).

¹⁰⁵ Rev. Rul. 73-497, 1973-2 C.B. 134.

¹⁰⁶ Rev. Rul. 74-160, 1974-1 C.B. 246.

accomplishment of the cooperative's activities by enabling the cooperative to obtain needed supplies for its operations. Without making the loans, the cooperative would have been unable to procure the necessary supplies. Thus, income generated as a result of the loans was found to be "directly related" to the cooperative's activities.

Court decisions analyzing the patronage/nonpatronage character of interest income have uniformly adopted some form of the directly related test. An early court case dealt with the money management activities of a Farm Credit System institution. In *St. Louis Bank for Cooperatives v. United States*,¹⁰⁷ the bank sometimes generated surplus funds from the sale of bonds that temporarily exceeded the needs of its member-borrowers. These funds were invested first with other Farm Credit System institutions and, if no one in the system needed the funds, with brokerage houses that sold Farm Credit System bonds.

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

The U.S. Court of Claims disavowed the strict literal interpretation of Revenue Ruling 73-497 in favor of the other rulings previously cited. Looking at the totality of the facts, the court found the interest income earned on the investment of the temporary surplus funds and on bonds held to meet the liquidity requirement to be "directly related" to the services the cooperative bank provided its members and "patronage sourced" for tax purposes.¹⁰⁸

¹⁰⁷ *St. Louis Bank for Cooperatives v. United States*, 624 F.2d 1041 (Ct. Cl. 1979), 1980-2 U.S.T.C. (CCH) ¶ 9509, *rev'g in part, aff'g in part*, 1979-2 U.S.T.C. (CCH) ¶ 9576.

¹⁰⁸ 624 F.2d at 1052-53.

In *Twin County Grocers, Inc. v. United States*,¹⁰⁹ the U.S. Court of Claims also applied the "directly related" test. The court rejected the argument that all interest income was "directly related" to a cooperative's business activity because that income reduced the need for the cooperative to borrow other funds. The court found that prudent money management, absent a showing that it was directly tied to the marketing, purchasing, or service activities of the cooperative, was merely an incidental method of enhancing overall profitability. The cooperative's interest income was held to be from nonpatronage sources.

The watershed case on this issue, *Cotter & Company v. United States*,¹¹⁰ involved a wholesale hardware cooperative that had wide seasonal fluctuations in its business. Suppliers often required payment before Cotter could resell merchandise; so Cotter needed temporary cash surpluses available to pay suppliers. Cotter invested its temporary cash surpluses in short-term paper and claimed the interest generated as patronage sourced income.

The Court of Claims had both *St. Louis Bank* and *Twin County Grocers* to consider in deciding this case. Cotter attempted to distinguish *Twin County Grocers* on the basis that that cooperative failed to show any close connection between the accumulation of surplus funds and its business activity. The Claims Court, however, sided with IRS. The court stated that for interest income to be patronage sourced "the cooperative must establish a connection between the *transaction* that produced the income and the *basic* services it rendered."¹¹¹ This decision appeared to limit *St. Louis Bank* to situations involving financial service cooperatives.

¹⁰⁹ *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983).

¹¹⁰ *Cotter and Co. v. United States*, 765 F.2d 1102, (Fed. Cir. 1985), 1985-2 U.S.T.C. (CCH) ¶ 9487, *rev'g*, 6 Cl. Ct. 219 (1984), 1984-2 U.S.T.C. (CCH) ¶ 9773.

¹¹¹ *Cotter and Co. v. United States*, 6 Cl. Ct. 219, 230 (1984).

But on appeal, the U.S. Court of Appeals for the Federal Circuit reversed the Claims Court. Placing substantial reliance on *St. Louis Bank*, the court said that in determining the status of interest income one should not look at the transaction in a vacuum, but rather should consider "the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function...."¹¹² It found the money management activity of Cotter directly related to its overall function and held the interest income in dispute patronage sourced income.

In *Illinois Grain Corp. v. Commissioner*, the Tax Court adopted the approach of the appellate court in *Cotter*. A grain marketing cooperative established that it operated in a volatile market in competition with large worldwide firms and that it needed surplus funds for flexibility to deal with fluctuations in the marketplace. The court found the short-term placement of these surplus funds to be "inseparably intertwined with the overall conduct of its cooperative enterprise, and the interest income which it earned was therefore patronage sourced...."¹¹³

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

¹¹² *Cotter and Co. v. United States*, 765 F.2d 1102, 1110 (Fed. Cir. 1985), *rev'g* 6 Cl. Ct. 219 (1984).

¹¹³ *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 460 (1986). While the Service did not appeal this decision, it later announced its nonacquiescence in the outcome, A.O.D.-1990-027 (Sept. 24, 1990).

add...to its overall profitability."¹¹⁴ The interest was found to be from nonpatronage sources.

In *Certified Grocers of California v. Commissioner*,¹¹⁵ the Tax Court found interest earned on the temporary investment of funds borrowed to finance construction of a warehouse was income from patronage sources. But as in *Washington-Oregon Shippers Cooperative*, interest earned on the investment of general surplus funds was nonpatronage income.

*Dundee Citrus Growers Association v. Commissioner*¹¹⁶ involved a citrus marketing association that used a pooling system to equitably distribute earnings to members from the sale of a crop whose price might fluctuate substantially during the marketing year. Rather than make distributions to members during the season, and risk overpaying some members, the cooperative invested proceeds from sales of product and paid members after a pool was substantially sold and could be closed. Some of the loans were to a federated cooperative in which this cooperative held membership.

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

The court noted, however, the volatile nature of the industry, the difficulty in recovering over-advances, and the benefits of

¹¹⁴ *Washington-Oregon Shippers Cooperative, Inc. v. Commissioner*, 52 T.C.M. (CCH) 1406 (1987). The cooperative had also made loans to encourage construction of a freight terminal used by the cooperative in its business and to encourage expansion into new territory. Income received on these notes was conceded to be patronage-sourced income.

¹¹⁵ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987).

¹¹⁶ *Dundee Citrus Growers Ass'n v. Commissioner*, 62 T.C.M. (CCH) 879 (1991).

lowering the borrowing costs of the federated cooperative. Given these circumstances, the court concluded the cooperative acted prudently, and "maintenance of the temporary excess of incoming funds over outgoing expenses is both integral to and necessary to petitioner's cooperative functions."¹¹⁷

In *CF Industries v. Commissioner*,¹¹⁸ the Tax Court focused on the length of maturity of the investment instrument. Testimony indicated CF operated in a volatile market and was unable to forecast accurately its cash needs for more than 30 days. On this basis, the U.S. Tax Court said only interest on investments with maturities of 30 days or less would qualify as patronage sourced.¹¹⁹

On appeal, the U.S. Court of Appeals for the 7th Circuit first found that the Tax Court's 30-day rule made no sense and discarded the length-of-maturity test.¹²⁰ The appellate court found that CF needed a cash reserve to operate its business and earning interest on that reserve was prudent cash management for the benefit of its member-patrons. It held all of the interest income under review was patronage sourced because "...the earnings on the money in the cash-management account are generated by the bona fide business dealings of the cooperative, as a producer and seller of fertilizers, with or on behalf of its member-customers. CF is not running a mutual fund for its members on the side."¹²¹

These cases suggest that determining whether interest income is patronage-sourced is a fact-intensive process. While the nature of the investment vehicle is not determinative, the longer its maturity the more closely a court is likely to look at the reason for

¹¹⁷ *Id.* at 885.

¹¹⁸ *CF Industries v. Commissioner*, 62 T.C.M. (CCH) 1249 (1991).

¹¹⁹ The court in *Washington-Oregon Shippers Cooperative* said it was "troubled by the rather long term involved" in 90-day T-bills, but didn't decide the case on that basis. 52 T.C.M. (CCH) 1406 (1987).

¹²⁰ *CF Industries v. Commissioner*, 955 F.2d 101 (7th Cir. 1993), *aff'g as modified*, 62 T.C.M. (CCH) 1249 (1991).

¹²¹ *Id.* at 104.

the investment. Cooperatives seeking patronage-sourced status must show that the invested funds are directly related to their overall business operation, and not just surplus money invested to enhance overall firm profitability.

In 1992, between the Tax Court and 7th Circuit opinions in the *CF* case, the Service issued three rulings that referred to the nature of the lender in determining the nature of interest earned. In the first, a wholesale supply cooperative was primarily financed with funds provided by its members. It invested these funds in certificates of deposit and a money market fund. The Service found that while the investments were prudent money management strategies, the interest income realized was nonpatronage sourced. The Service noted that the funds were placed with third-party financial institutions and not with its own patrons. As nothing in the facts demonstrated that the income in question came from the actual sale of goods and services to its patrons or to others on behalf of its patrons, it must be considered nonpatronage sourced income.¹²²

Two rulings issued shortly thereafter involved co-ops that marketed products on behalf of their members. Both sold their members' production to a noncooperative firm for processing and marketing. As part of the overall arrangement, the co-ops loaned money to the noncooperative firm to fund the processing of member product and received interest on those funds from the firm. In both instances, the Service found that the interest resulted from a transaction required to secure a market for members' products and held the interest income realized by the cooperatives was patronage sourced.¹²³

¹²² Tech. Adv. Mem. 9208004 (October 31, 1991).

¹²³ Tech. Adv. Mem. 9211001 (September 23, 1991); Tech. Adv. Mem. 9236001 (May 20, 1992).

IRS has agreed to abandon its position that interest income is per se nonpatronage sourced.¹²⁴ However, it has not issued any rulings concerning interest income since the *CF* decision, so it is not clear whether that opinion has led the Service to a more flexible interpretation of the “directly related” test or not.

Dividends

Dividends received on equity investments, like interest on loaned funds, fall within the general topic of income "from investment in securities" listed as an example of nonpatronage sourced income in the regulation.¹²⁵ Once again, the courts have looked beyond the narrow confines of the regulatory examples and found dividend income is patronage sourced when the equity position is acquired to facilitate the cooperative's business purpose. As with interest income, the cooperative has the burden of showing the direct relationship between the investment activity and cooperative operations.

In *Land O'Lakes, Inc. v. United States*,¹²⁶ a cooperative was required to purchase stock in a Bank for Cooperatives as a condition of borrowing funds from the bank. This is a common provision in the cooperative banking system, analogous to requirements for capital contributions of members to their marketing, supply, or service cooperative. While the cooperative could have obtained loans elsewhere, such loans would have been on less favorable terms.

IRS challenged the cooperative's attempt to treat the dividends received on the Bank for Cooperative's stock as patronage income. The court turned back the challenge, holding "because the

¹²⁴ Action on Decision 2001-03 (2001), *acquiescing in* Farmland Industries v. Commissioner, T.C. Memo 1999-388.

¹²⁵ Treas. Reg. § 1.1382-3(c)(2).

¹²⁶ *Land O'Lakes, Inc. v. United States*, 675 F.2d 988 (8th Cir. 1982), *aff'g in part, rev'g in part*, 470 F.Supp. 238 (D. Minn. 1979).

transactions actually facilitated the cooperative's activities by providing financing on terms favorable to the cooperative, the income from the bank stock was from a patronage source...."¹²⁷

In subsequent administrative rulings, the Service has said that dividends from a bank for cooperatives are patronage sourced,¹²⁸ even when the funds were borrowed to reloan them to a noncooperative partner in a joint venture.¹²⁹

*Land O'Lakes*¹³⁰ also discussed the cooperative's ownership of a chain of convenience stores that marketed both patron and nonpatron products at retail. The cooperative argued that all dividends received from the chain of stores was patronage sourced income as all sales facilitated the movement of patron product. The court, however, required the cooperative to accept IRS's method of allocating dividends received between patronage and nonpatronage status because the cooperative could not prove that all the sales actually facilitated movement of patron products.

Stock dividends have also been held to be patronage sourced income when holding the stock is a requirement for obtaining needed services. In *Linnton Plywood Association v. United States*,¹³¹ two plywood worker cooperatives shared ownership of a glue factory. The cooperatives received dividends on capital stock in the factory. The court said glue is essential to the manufacture of plywood, and the cooperatives' arrangement to

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

¹²⁸ Tech. Adv. Mem.9211001 (September 23, 1991).

¹²⁹ Tech. Adv. Mem. 9236001 (May 20, 1992).

¹³⁰ *Land O'Lakes, Inc. v. United States*, 675 F.2d 988 (8th Cir. 1982), *aff'g in part, rev'g in part*, 470 F.Supp. 238 (D. Minn. 1979).

¹³¹ *Linnton Plywood Association v. United States*, 410 F.Supp. 1100 (D.C. Ore. 1976).

produce glue through a supplier which they owned "is reasonably related to the business done with or for its patrons."¹³²

INCOME FROM SALE OF ASSETS

The final specific example of nonpatronage sourced income given by the regulation is income from the "sale or exchange of capital assets."¹³³ The term "capital asset" is defined quite broadly in the Code to include all property held by a taxpayer (regardless of how long it is held and whether or not it is connected with a trade or business) unless it falls within four specific exceptions.¹³⁴

While I.R.C. section 1221(a)(2) expressly excludes depreciable business property and real estate used in a trade or business from the definition of capital assets, I.R.C. section 1231 provides that if depreciable business property and real estate used in the trade or business are held for more than one year and the net result from the disposition of these items in a year is a gain, that gain is a capital gain for tax purposes.¹³⁵

Depreciation Recapture

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

¹³² *Id.* at 1108.

¹³³ Treas. Reg. § 1.1382-3(c)(2).

¹³⁴ I.R.C. § 1221. With certain limitations, the four exceptions listed in § 1221 are basically (1) inventory, (2) depreciable business property and real estate used in a trade or business, (3) intellectual property in the hands of the creator, and (4) accounts receivable.

¹³⁵ I.R.C. § 1231.

depreciation during the life of a depreciable asset, some income from sale or exchange of the capital asset may be ordinary income and some may be gain from sale or exchange of a capital asset.¹³⁶

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

That portion of the gain from the sale of machinery treated as ordinary income under section 1245 of the Code is considered patronage sourced income because, in effect, the taxpayer is merely recapturing income that otherwise would have been available for distribution as a patronage dividend. That portion of the gain treated under section 1231 as gain from the sale of a capital asset held for more than six months is considered income derived from sources other than patronage and, thus, does not give rise to a deduction to the cooperative when distributed to its patrons.¹³⁷

In *St. Louis Bank for Cooperatives v. United States*,¹³⁸ the Court of Claims (Trial Division) determined the Service had misclassified an automobile used in business as a capital asset. It found the automobile fell under the exclusion for property used in a trade or business subject to depreciation under I.R.C. section 1221(2).¹³⁹ The judge refused the Service's request to mecha-

¹³⁶ I.R.C. § 1245.

¹³⁷ Rev. Rul. 74-84, 1974-1 C.B. 244, 245. *See also*, Priv. Ltr. Rul. 8952019 (September 28, 1989).

¹³⁸ *St. Louis Bank for Cooperatives v. United States*, 1979-2 U.S.T.C. (CCH) ¶ 9576, at 88,098 (Ct. Cl. 1979).

¹³⁹ I.R.C. § 1221(2). Treas. Reg. § 1.1221-1(b) reads, in part, "Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section

nically apply the regulatory example to classify the gain as nonpatronage-sourced income. The judge, however, did find that the sale was an isolated transaction not integrally related to the supplying of credit, and on that basis held the gain was nonpatronage-sourced income.

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

The panel noted the Service, in Revenue Ruling 74-84,¹⁴⁰ held depreciation recapture was patronage-sourced income when the cooperative was merely recapturing income that otherwise would have been available for distribution as a patronage refund. The panel found it "would be anomalous to treat the gain upon the sale of the automobile resulting from the recapture of excess depreciation as nonpatronage sourced when the depreciation itself was treated as patronage sourced."¹⁴¹

In *Lamesa Cooperative Gin v. Commissioner*, the Service conceded that recapture of depreciation on trailers, tractors, and manufacturing equipment was patronage sourced income.¹⁴²

167 and real property used in the trade or business of a taxpayer is excluded from the term 'capital asset.'"

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

¹⁴⁰ Rev. Rul. 74-84, 1974-1 C.B. 244.

¹⁴¹ *St. Louis Bank for Cooperatives v. United States*, 624 F.2d 1041, 1054 (Ct. Cl. 1980), 1980-2 U.S.T.C. (CCH) ¶ 9509, *rev'g in part, aff'g in part*, 1979-2 U.S.T.C. (CCH) ¶ 9576 (Ct. Cl. 1979).

¹⁴² *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894, 900 (1982).

Astoria Plywood Corp. v. United States involved a firm that converted from noncooperative to cooperative status. It was not able to use patronage income treatment for the recapture of depreciation taken before the business became a cooperative. The court said: "This income reflects the appreciation in value of the machines over the costs Astoria had already recovered through depreciation and is not directly related to the activities of the cooperative."¹⁴³

Special Rules

Transactions not formally sales of property may be so treated under the Code in certain circumstances.

For example, Section 631(a) of the Code provides that the owner of standing timber may elect to treat the cutting of that timber as a sale or exchange of the timber. In Revenue Ruling 71-439, a workers' cooperative was engaged in the manufacture and sale of wood products. The cooperative owned the standing timber that served as the raw material for its wood products business. When the cooperative made the election to treat the cutting of timber as a sale or exchange, it realized gain from the sale of a capital asset. The Service sanctioned patronage sourced income treatment of that gain, saying:

The gain recognized by the instant taxpayer pursuant to a section 631(a) election represents the unrealized appreciation in value of timber cut during the year which, in the absence of an election under section 631(a) of the Code, would have been reflected in the taxpayer's ordinary income from the sale of wood products and be included in amounts available for patronage dividend distribution. The election permits an earlier recognition at capital gains rates of an amount that ultimately may be realized by the

¹⁴³ *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979).

taxpayer when the finished products of its timber is sold. The actual realization of the appreciation in value of the standing timber (when the finished product is sold) is brought about through the cooperative efforts of the members. Accordingly...it is held that the gain recognized by the taxpayer pursuant to an election under section 631(a) of the Code is income from a patronage source.¹⁴⁴

A capital asset may also be created by tax law. An example, the Code provides that amounts received from cancellation of a lease shall be considered amounts received in exchange for the lease.¹⁴⁵ If the lease covers capital assets used in the co-op's business, and the co-op accepts a payment to cancel the lease, the income received is treated, for tax purposes, as income from the sale of a capital asset.¹⁴⁶

In Rev. Rul. 74-160, the Service ruled income from the cancellation of a lease on a veneer plant operated by a plywood workers' cooperative was nonpatronage-sourced income. The Service relied on the literal wording of the capital assets example provided in Treas. Reg. 1.1382-3(c)(2).¹⁴⁷

A contrary conclusion was reached by the U.S. District Court in Oregon a few years later on identical facts. The court applied the "directly related" test and found the capital gain was patronage-sourced income "because it is directly related to its cooperative activities."¹⁴⁸

¹⁴⁴ Rev. Rul. 71-439, 1971-2 C.B. 321, 322. Followed in Rev. Rul. 74-24, 1974-1 C.B. 244, and *Stevenson Co-Ply, Inc. v. Commissioner*, 76 T.C. 637 (1981).

¹⁴⁵ I.R.C. § 1241.

¹⁴⁶ The lease was property used in the trade or business under Treas. Reg. § 1.1231-1.

¹⁴⁷ Rev. Rul. 74-160, 1974-1 C.B. 245, 246.

¹⁴⁸ *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197, at 86,349 (D. Ore. 1979). The court had just stated "In my view,

Farmland Industries Case

In late 1987, the IRS focused cooperative attention on the status of the sale of an asset with the issuance of a controversial ruling, Technical Advice Memorandum (TAM) 8815001.¹⁴⁹ This ruling concerned numerous transactions by Farmland Industries, a regional federated farm supply and marketing cooperative that at the time was the largest cooperative in the country.

By far the largest transaction involved the sale by Farmland of all of the stock in a wholly owned subsidiary, Terra Resources. The subsidiary had been formed to supply Farmland with crude oil that Farmland used to manufacture refined petroleum products which were sold primarily to its local cooperative members. In the early 1980s, Farmland suffered substantial operating losses during a downturn in the agricultural economy. In 1983, Farmland, under severe pressure from the Wichita Bank for Cooperatives to reduce its debt load and increase liquidity, sold all the stock in Terra Resources.

Farmland realized a substantial gain on that sale. On its tax return, Farmland treated the gain as patronage-sourced income and sought to offset the gain with operating losses on its patronage operations.

TAM 8815001 said the gain on the Terra Resources stock sale is income from a nonpatronage source. The Service cited both Treas. Reg. § 1.1382-3(c)(2) and Revenue Ruling 69-576¹⁵⁰ and then said:

Under certain circumstances, income producing transactions included in the list of examples of

capital gains may be patronage sourced income. In each instance, it depends on whether the income is 'directly related' to [the cooperative's] activities." *Id.*

¹⁴⁹ Tech. Adv. Mem. 8815001 (Nov. 3, 1987).

¹⁵⁰ Rev. Rul. 69-576, 1969-2 C.B. 166.

nonpatronage source income (in the Treas. Reg.) may still be categorized as income derived from patronage sources by meeting the “directly related” test. However, Taxpayer sold its stock in Subsidiary in order to ease the financial burdens Subsidiary was imposing on Taxpayer....Although Taxpayer may have made a sound business decision in selling Subsidiary's stock, the income resulting from this sale merely enhanced Taxpayer's profitability and therefore is not income derived from sources directly related to Taxpayer's cooperative functions.¹⁵¹

The IRS disallowed Farmland's netting of its patronage-sourced operating losses against the gain on the sale of stock, which it called “nonpatronage.”¹⁵²

The TAM also concerned losses suffered by the cooperative on the disposition of its stock in two other ventures, (1) a corporation organized to make collective purchases of Mexican crude oil in large volume and (2) a crude oil pipeline company. The Service held that the losses on stock in these two companies were patronage-sourced as those activities were directly related to the cooperative's business operations.

A third group of transactions concerned the disposition of so-called section 1231 property, real estate and depreciable property used in Farmland's business operations, which resulted in gains for Farmland. Farmland claimed virtually all of the gains on these transactions were patronage sourced and ordinary income. The Service determined that the depreciation recapture was entitled to be treated as patronage sourced ordinary income under I.R.C. section 1245. Any additional gain was a capital gain under I.R.C.

¹⁵¹ Tech. Adv. Mem. 8815001 at 5 (Nov. 3, 1987).

¹⁵² *See*, the discussion in part 5 of these reports of *Farm Service Cooperative v. Commissioner*, 619 F. 2d 718 (8th Cir. 1980), and related rulings establishing a general prohibition on cooperatives netting nonpatronage earnings with patronage losses.

section 1231 and therefore nonpatronage sourced under Treas. Reg. § 1.1382-3(c)(2).

The issue was complicated by a contemporaneous dispute between the business community as a whole and the Service over the status of the so-called "Corn Products" doctrine. In *Corn Products Refining Co. v. Commissioner*,¹⁵³ the Supreme Court held that assets not within the then five exclusions to the section 1221 definition of "capital asset" were nonetheless to be treated as ordinary assets if they were acquired as an integral and necessary part of the taxpayer's business. As each of the transactions discussed in TAM 8815001 concerned the disposition of stock or property acquired by the cooperative for a business purpose, Farmland had a cogent argument that, under *Corn Products*, they were not "capital assets" and thus not covered by the example in Treas. Reg. § 1.1382-3(c)(2).

At the time TAM 8815001 was released, the Supreme Court had granted certiorari in *Arkansas Best v. Commissioner*,¹⁵⁴ which had rejected the business purpose test of *Corn Products* and taken a literal reading of Code section 1221 to require all capital stock to be treated as a capital asset. Later in 1988, the Supreme Court affirmed the appellate court decision in *Arkansas Best*.¹⁵⁵

In the meantime, Farmland had asked IRS to reconsider its apparently inconsistent finding in TAM 8815001 that gains on the disposition of stock in Terra Resources were patronage-sourced and losses on the disposition of the stock in the Mexican oil purchasing and domestic pipeline ventures were nonpatronage-sourced. In mid-1989, the Service responded with TAM 8941001. Citing *Arkansas Best*, the Service now said that the stock

¹⁵³ *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

¹⁵⁴ *Arkansas Best v. Commissioner*, 800 F.2d 215 (8th Cir. 1986), cert. granted 480 U.S. 930 (1987).

¹⁵⁵ *Arkansas Best v. Commissioner*, 485 U.S. 212 (1988).

Farmland sold in all three transactions were capital assets under I.R.C. section 1221. The Service dismissed arguments by the cooperative that the "directly related" and "actually facilitates" standards called for patronage sourced income treatment. Placing greater emphasis on Treas. Reg. § 1.1382-3(c)(2), the Service now determined both the gains and losses were from sources other than patronage.¹⁵⁶

The cooperative community responded to these rulings by developing draft legislation to permit cooperatives to elect ordinary patronage-sourced treatment for gain or loss from the sale or other disposition of any asset, provided the asset had been used to facilitate the conduct of business done with or for patrons.¹⁵⁷

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

In 1992, a scaled-back version of the industry proposal, prospective only and limited to farmer cooperatives, passed both houses of Congress as part of the proposed Revenue Act of 1992. However, President Bush vetoed the bill.

Legislation based on the provisions in the Revenue Act of 1992 was introduced in the 103rd Congress. The bills applied only to farmer cooperatives and made the election prospective only.¹⁵⁸ However, the steam was running out of the legislative initiative and Farmland was forced to pursue its position in the courts.

¹⁵⁶ Tech. Adv. Mem. 8941001 (June 14, 1989). This eliminated the inconsistent treatment in TAM 8815001 of the gains (nonpatronage) and losses (patronage).

¹⁵⁷ In the 100th Congress, H.R. 4542 (May 5, 1988), and S. 2669 (July 29, 1988); in the 101st Congress, H.R. 2353 (May 16, 1989), and S. 1273 (June 23, 1989); and in the 102nd Congress, H.R. 2360 (May 15, 1991), and S. 1522 (July 22, 1991).

¹⁵⁸ H.R. 1931 (Apr. 29, 1993) and S. 545 (Mar. 10, 1993).

In 1995, the case was tried in the U.S. Tax Court. The primary issue was straightforward.

Farmland argued that the classification of gains or losses as patronage or nonpatronage sourced depends on the factual relationship between the activity producing the gain or loss and the operations of the cooperative. This is true whether the gains and losses are capital or ordinary in nature. The cooperative asserted that if the activity is directly related to, or facilitates the cooperative's marketing, purchasing or service activities on behalf of its patrons, the gains and losses it produces should be treated as patronage sourced. Farmland cited the numerous cases and rulings on the application of that test discussed in the preceding subsections on dividend, rental, and interest income. It asked the Court to reject the *per se* rules espoused by the IRS under which capital gains and losses are always classified as nonpatronage.

The Service countered, with regard to the disposition of stock in the three ventures, that under *Arkansas Best* capital stock is always a capital asset and under Treas. Reg. § 1.1382-3(c)(2) the disposition of a capital asset is always nonpatronage sourced. Concerning the Section 1231 property, the Service relied on Rev. Rul. 74-84¹⁵⁹ to establish that the gain on the sale of a physical assets used in a trade or business, to the extent that it exceeded the recapture of depreciation, is a gain on the sale of a capital asset and, under the same regulation, *per se* nonpatronage sourced. IRS also attacked the "directly related" test as overly simplistic and asserted Farmland ownership interests in various business ventures under review were strictly "investments."

Four years later, a decision was issued favorable to the cooperative on essentially all fronts. The court began its opinion with an exhaustive discussion of the history of Farmland Industries and a thorough review of the earlier cases on the income items mentioned in the regulation. After summarizing the cases, the court said, "Neither this nor any other court has ever held that

¹⁵⁹ Rev. Rul. 74-84, 1974-1 C.B. 244.

rents, dividends or interest income, or capital gains are nonpatronage based upon a per se rule found in section 1.1382-3(c)(2)... (citations omitted).”¹⁶⁰

The court then held:

...we decline to abandon the directly related test that has been used by this and other courts to distinguish patronage from nonpatronage items and to adopt respondent’s per se nonpatronage rule for capital gains and losses. Accordingly, in this case our task is to determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative’s marketing, purchasing, or service activities on behalf of its patrons.¹⁶¹

The Tax Court concluded by applying the directly-related/actually facilitates test to six different kinds of gains and losses, finding in each instance that the gains and losses were patronage, notwithstanding their character as capital:

- A capital gain from the sale of the stock of Terra Resources
- A capital loss on stock in Mex-Am Crude Corp., a company formed by Farmland and eight other refiners to purchase Mexican oil
- A capital loss on the sale of stock in Seaway Pipeline Inc., a corporation formed by Farmland and others to build and operate a pipeline to transport crude oil

¹⁶⁰ Farmland Industries v. Commissioner, T.C. Memo 1999-388 (Nov. 29, 1999), 78 T.C.M. (CCH) 846.

¹⁶¹ *Id.*

- Net Section 1231 gain from the sale of a natural gas products plant in Texas, the proceeds of which were reinvested in other gas plants
- Net Section 1231 gain from the sale of its soybean processing business as part of the formation of Ag Processing Inc.
- Net Section 1231 gain from the sale of approximately 525 miscellaneous assets (including tractors and other vehicles, livestock, buildings, office furniture and office equipment)

For Farmland, the key holding in the case was the treatment of the gain on the sale of its stock in Terra Resources since that issue involved, by far, the most money. But for most cooperatives, the holding that section 1231 gains and losses realized on assets sold in their trade or business may be patronage is probably of greater significance. It is not common for cooperatives to sell stock in companies that are directly related to their patronage business and, when they do, it is usually at a loss as part of a decision to exit from an unprofitable line of business.

In 2000, the IRS chose not to appeal the Tax Court decision.

In March, 2001, the Service announced its acquiescence in the *Farmland* decision. The Service released an action on decision setting out its new position:

...the Service will view the examples of nonpatronage income in the regulations as instructive, but not controlling. It will look at the facts and circumstances to determine if each item of income or loss is patronage or nonpatronage sourced. The nonpatronage or patronage character of every item of income or loss will be determined by the relationship of the activity producing the income or loss to the cooperative's business of serving its patrons. Only where the activity generating the income or loss is directly related to the cooperative business, in the

sense that it is an integral part of that business, will the income or loss be considered patronage sourced.¹⁶²

Then the Service indicates it may take a restrictive view when applying the “directly related” test:

Interest earned on an investment will be considered nonpatronage income, but interest earned on funds retained for a true cooperative business purpose will be considered patronage income. Income produced by property held for rental purposes will be considered nonpatronage income, but income produced by rental property will be considered patronage income in those unusual situations where the property was held to facilitate business conducted for the benefit of patrons. Gains or losses from the sale or exchange of a capital assets will be considered nonpatronage sourced where the asset was not used for a cooperative business purpose, but will be considered patronage sourced where the asset actually facilitated the cooperative business.¹⁶³

Subsequent Rulings

In the period immediately following the *Farmland* decision, the IRS has issued a number of letter rulings favorable to cooperatives involving the patronage/nonpatronage nature of gain on the sale of assets.

Five private letter rulings issued to rural telephone cooperatives approved the treatment of capital gains on the sale of stock as patronage sourced income. In each of these rulings, a rural telephone cooperative (“RTC”) joined with other small

¹⁶² Action on Decision 2001-03 (2001), *acquiescing in Farmland Industries v. Commissioner*, T.C. Memo 1999-388.

¹⁶³ *Id.*

telephone companies to invest in and thus gain access to new technologies that would enable them to provide cutting-edge services to their member-patrons.¹⁶⁴ In each instance, (1) the RTC achieved its purpose of obtaining the new service for its members, (2) the company started by the RTC and other small telephone companies was engulfed in the rapid consolidation that occurred in the tele-communications industry and merged into a large national publicly traded entity, and (3) the RTC wound up with stock in the publicly traded company, which was inconsistent with its mission, so it sold the stock at a gain and used the proceeds to improve services to member-patrons.

¹⁶⁴ Priv. Ltr. Rul. 200152035 (Oct. 2, 2001) and Priv. Ltr. Rul. 200404003 (Oct. 10, 2003), the RTC's purpose was to secure cellular service for its members; Priv. Ltr. Rul. 200206044 (Nov. 9, 2001) and Priv. Ltr. Rul. 200314002 (Dec. 4, 2002), the RTC's purpose was to secure access to calling card services for its members; Priv. Ltr. Rul. 200239029 (June 19, 2002), the RTC's purpose was to secure access to digital PCS cellular service for its members.

In Priv. Ltr. Rul. 200404003 (Oct. 10, 2003), the RTC had also purchased two licenses to provide PCS service to its patrons. However, it later concluded that developing the infrastructure to provide PCS service was not economically feasible. The RTC sold the licenses and the Service permitted the RTC to treat the gain on the sale of the licenses as patronage sourced even though it never placed the assets in service to its patrons.

Code § 501(c)(12) contemplates that rural cooperative telephone companies ("RTC's") may qualify as tax-exempt organizations. However, most RTC's, including the ones in these letter rulings, don't meet the statutory prerequisites for tax exempt status. The rulings describe them as "non-profit, but taxable, cooperative corporations."

Such RTC's are also not governed by Subchapter T because of the exclusion provided in Code § 1382(a)(2)(C). While these RTC's are technically to be treated the same for tax purposes as they were before enactment of Subchapter T, cases and rulings interpreting Subchapter T are usually applied to them. And likewise, rulings dealing with both rural telephone and electric cooperatives may be of direct relevance to Subchapter T cooperatives.

The IRS analysis is similar in all five determinations. First, the Service notes that while neither the Code nor the regulations provide a clear definition of “patronage sourced income,” it cites *Farmland Industries* and other decisions for the proposition that the courts have, in general, held that “...if the income at issue is produced by a transaction which is directly related to the cooperative enterprise, such that the transaction facilitates the cooperative’s marketing, purchasing, or service activities, then the income is deemed to be patronage income.”¹⁶⁵

Next the Service cites its earlier rulings, Rev. Rul. 69-576 and Rev. Rul. 74-160, which first espoused the “directly related” test.¹⁶⁶ Then it cites several cases, again starting with *Farmland Industries*, which held “...that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced.”

It concludes by finding, in each instance, that the investment by the RTC in the original company was made to provide modern telephone service to its patrons and therefore is directly related to the business of a cooperative whose “*raison d’etre* is to provide telephone service to its patrons.”

Another IRS ruling concludes that most of the gain realized by a cooperative in the process of liquidation from the sale of substantially all of its assets was patronage-sourced.¹⁶⁷ The cooperative was a wholesaler and distributor of natural food and related products, which its members (retailers, supermarkets, individual buying clubs, and cooperative retailers) resold to customers. Apparently the venture was in the vanguard of the health food movement and did quite well while it was a niche market. However, the market expanded and large food industry

¹⁶⁵ *Farmland Industries v. Commissioner*, 78 T.C.M. (CCH) 846, 864 (1999), other cites omitted.

¹⁶⁶ Rev. Rul. 69-576, 1962-2 C.B. 166; Rev. Rul. 74-160, 1974-1 C.B. 245.

¹⁶⁷ Priv. Ltr. Rul. 200252027 (undated, but released Dec. 27, 2002).

firms entered it. This resulted in increased availability of products, greater competition, and lower pricing.

The members concluded they simply didn't need the cooperative any more and decided to liquidate through a sale to a publicly held food wholesaler while the cooperative still had value. The assets sold included trade receivables; inventories; land, property and equipment (including a fleet of trucks); customer lists, their trade name, and other intangible assets. All of these assets were used exclusively in the cooperative's wholesale and distribution activities.

Pursuant to a bylaw covering allocation of a substantial gain or loss, the cooperative intended to distribute any gain on the sale of these assets to member and nonmember patrons based on the amount of business each did from the inception of the cooperative through the date of final sale. It asked the Service to rule that such gain was patronage sourced so the funds could be excluded from the cooperative's gross income when distributed to the patrons.

The Service summarized Revenue Ruling 69-576 and the Tax Court opinion in *Farmland Industries*, and concluded the cooperative could treat any gain as patronage sourced.

Three other items in this ruling are of interest. First, the Service cited Treas. Reg. § 1.1382-3(c)(3) for the proposition that the gain must be allocated (as this cooperative intended) "on a patronage basis in proportion, insofar as is practicable, to the business done by or for patrons during the period to which such income is attributable." This regulation concerns distributions of nonpatronage income that a section 521 farmer cooperative wishes to deduct, while the ruling concerns a subchapter T cooperative allocation of patronage-sourced income. Whether it could be used to compel a subchapter T cooperative to allocate patronage sourced capital gains on this basis is unclear.

Second, the cooperative also sold a wholly owned subsidiary that was formed to loan funds to member retail customers for expansion or relocation. The cooperative didn't attempt to have the gain on this sale classified as patronage-sourced. The service just noted in passing that, unlike the other assets being sold, the

subsidiary operations were not directly related to cooperative operations.

Third, the company was originally formed as a not for profit corporation and later converted to a cooperative corporation. No mention is made of the fact that none of the gain would be allocated to customers during this time period.

The *Farmland Industries* decision has gone a long way toward clearing the air over the proper test to determine if the income items listed in Treas. Reg. 1.1382-3(c)(2) are patronage or nonpatronage sourced. In all likelihood, cooperatives and the Service will continue to disagree over whether specific lease payments, interest and dividends received, and gains and losses on the sale of capital assets are directly related to a cooperative's core business operations on behalf of its member-patrons. But cooperatives no longer have to overcome an IRS position that such items are *per se* nonpatronage in nature.

INCOME FROM OTHER EVENTS

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

Change in Accounting Method

A change in accounting method may result in an adjustment to income in the year of change.¹⁶⁸ Revenue Ruling 79-45¹⁶⁹ describes a cooperative changing from the last-in, first-out inventory method to the first-in, first-out method, using lower of cost or market. The change resulted in a positive adjustment to income in the year of change.

¹⁶⁸ See I.R.C. § 481.

¹⁶⁹ Rev. Rul. 79-45, 1979-1 C.B. 284.

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

Section 1382(f) was applied to the income, so that the patronage to which the income related was considered to have occurred in the year of adjustment. The cooperative requested, and was granted, permission to allocate the earnings to patrons of the prior years.¹⁷⁰

CCC Storage Fees

At times in the past, under certain price support programs administered by the USDA Commodity Credit Corporation (CCC), loans were made to producers with the producer's crop serving as collateral for the loan. The producer had the option, for a specified period, to repay the loan and reclaim the crop. If the producer didn't exercise the option, the producer "defaulted" on the loan. The producer kept the loaned funds, and CCC took title to the crop.

Cooperatives frequently stored crops under CCC programs, both for the farmer before default and for CCC after default. CCC customarily paid the storage fees to the cooperative from the time the crop entered the program until it was either reclaimed, or default occurs and CCC subsequently moved or disposed of the crop. While the farmer held title to the crop, the storage fees were deducted from the loan proceeds.

In the 1950's, some cooperatives were claiming that all CCC payments derived from handling and storing grain produced by patrons were patronage-sourced income. IRS agents were disallowing attempts to deduct patronage refunds to the extent they

¹⁷⁰ For further discussion of I.R.C. § 1382(f), *see* the section of chapter 4 titled "Year Patronage Occurred," *supra*, pp. 23-26.

were based on earnings from storage that occurred after the producer defaulted on the loan and title to the grain was transferred to CCC.

The U.S. Tax Court sided with the Service. In *Pomeroy Cooperative Grain Co. v. Commissioner*,¹⁷¹ the court classified Government storage payments to a cooperative as patronage or nonpatronage sourced income depending on whether the grower still owned the grain. Before loan default, the farmer patron held title to the grain, and storage income received by the cooperative was characterized as patronage-sourced. After default, ownership resided in the CCC, and storage income was nonpatronage sourced.

IRS adopted the ownership test in Rev. Rul. 59-107.¹⁷² The validity of the standard was upheld in *Juniata Farmers Cooperative v. Commissioner*.¹⁷³

Revenue Ruling 70-25¹⁷⁴ described cooperative income received from CCC for crop storage under a "reseal" program. Under the reseal program, farmers obtained a CCC price support loan by pledging the crop and storing it with a cooperative during the period of the loan. The program provided for an automatic extension of the loan for 12 months if the farmer did not satisfy the obligation by the original maturity date.

Under the program, CCC was solely liable for handling and storage charges for the 12 month extended period even though title to the grain remained with the farmer-producer. Revenue Ruling 70-25 held that the handling and storage charges paid to the cooperative association under the reseal program by CCC, for

¹⁷¹ *Pomeroy Cooperative Grain Co. v. Commissioner*, 31 T.C. 674 (1958), *rev'd in part, aff'd in part*, 288 F.2d 326 (8th Cir. 1961); *See also*, *Minburn Cooperative Elevator v. Commissioner*, 18 T.C.M. (CCH) 93 (1959).

¹⁷² Rev. Rul. 59-107, 1959-1 C.B. 20.

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

¹⁷⁴ Rev. Rul. 70-25, 1970-1 C.B. 17.

which CCC was solely liable, was income to the cooperative association derived from business done with or for the United States or any of its agencies and was income derived from nonpatronage sources.

The status of storage payments before default under a reseal program was reviewed by a Federal District Court in *Caldwell Sugars Co-op Inc. v. United States*.¹⁷⁵ The court discussed Rev. Rul. 59-107 and Rev. Rul. 70-25 and concluded Rev. Rul. 70-25 was illogical and incorrect. The court viewed the extension of time to redeem the crop under the reseal aspect of the program as irrelevant. The true test was ownership of the crop. The court stated, "...(I)f the property stored belongs to the farmer, the income derived from such storage is income derived from that farmer, and therefore patronage income. Where the property stored is the property of the Government, then the income yielded by such storage is income yielded from doing business with the Government" and nonpatronage sourced.¹⁷⁶

Shortly thereafter IRS issued Revenue Ruling 89-97.¹⁷⁷ While this ruling did not mention *Caldwell Sugars*, it adopted the holding of the case and revoked Revenue Ruling 70-25.

Judicial Settlements

In two private letter rulings concerning amounts received as settlements from a lawsuit filed under Federal antitrust laws, IRS has taken a middle-of-the-road position toward the tax status of the money received. In the first,¹⁷⁸ the cooperative was permitted to treat the portion of the amount received that covered actual damages claimed as patronage sourced. Money received in excess

¹⁷⁵ *Caldwell Sugars Co-op Inc. v. United States*, 692 F. Supp. 659 (E.D. La. 1988), 88-2 U.S.T.C. (CCH) ¶ 9509.

¹⁷⁶ 692 F. Supp. at 662.

¹⁷⁷ Rev. Rul. 89-97, 1989-2 C.B. 217.

¹⁷⁸ Priv. Ltr. Rul. (EIN 75-0235810), Mar. 8, 1976.

of the amount actually claimed was classified as nonpatronage sourced income.

In the second,¹⁷⁹ the cooperative was granted patronage income treatment of the compensatory damages paid as part of the settlement of the case, but had to treat interest paid as part of the settlement as nonpatronage income.

In a Tax Court case, income from a judgment against a party who wrongfully removed the cooperative's property was not patronage sourced income when the event took place before the organization was a cooperative.¹⁸⁰

Partnership and LLC Earnings

Farmers and other business people form cooperatives to provide themselves with goods and services they either can't afford on their own, or can obtain more efficiently through a group effort. Sometimes these cooperatives find themselves in the same position, their members want them to provide goods and services they can't develop on their own or can obtain more efficiently through a group effort with other cooperatives or with noncooperative firms. These collaborative efforts among two or more businesses are commonly referred to by the general term "joint venture."

Historically, if two or more cooperatives wanted to form a joint venture, they usually organized the entity (called a federated cooperative) under a State cooperative law and paid taxes pursuant to Subchapter T. The federated allocates its earnings to its local cooperative member-patrons on the basis of business done with the federated. The locals then combine the patronage refunds they receive from the federated with operating income for the year and allocate the total to their member-patrons as patronage refunds.

¹⁷⁹ Priv. Ltr. Rul. 8340012 (June 24, 1983).

¹⁸⁰ *Astoria Plywood Corp. v. United States*, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

As these federated systems have traditionally consisted entirely of patrons and their cooperatives, and limited their operations to serving the needs on the member-patrons of the local cooperatives, few questions have arisen over the patronage nature of the income passed down through the system.¹⁸¹

If a cooperative entered into a joint venture with a noncooperative firm, it frequently formed a partnership with that firm. For example, a farm supply cooperative owned a plant that processed a raw material into a valuable agricultural input, which the cooperative then sold to its patrons. The cooperative proposed entering into a partnership with a non-cooperative corporation with a reliable supply of the raw product.

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

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

In this situation, Coop is buying the (processed input) from a supplier that it partially owns: the partnership. When Coop sells this product to its patrons, those sales are "with" its patrons within the meaning of section 1388(a) of the Code. Accordingly, any net margin from these sales that is returned to the patrons is eligible for the patronage dividend deduction because the Coop is, in essence, rebating to the patron a portion of the cost of goods purchased. Similarly, when Coop receives its distributive

¹⁸¹ The IRS ruling first recognizing the "directly related" test involved the federated banks for cooperatives system, Rev. Rul. 69-576, 1969-2 C.B. 166.

share of partnership operating income, the portion of that income that is attributable to Coop's sales to its patrons is akin to a rebate of the cost of the (input) purchased by Coop for resale to its patrons and, when ultimately returned to the patrons, is a rebate of the cost of their purchases of the (input).¹⁸²

One of the impacts the Treasury Department's adoption of the "check-the-box" regulations¹⁸³ had on cooperatives was the rapid rise of the limited liability company (LLC) as the preferred vehicle for organizing joint ventures both among cooperatives and between cooperatives and noncooperative firms. Since the LLC was a relatively new business structure and the Internal Revenue Code doesn't contain any rules specifically covering it, cooperatives were concerned about how IRS might treat distributions of LLC earnings to cooperatives who participated in an LLC.

In two sets of letter rulings issued in 1998, IRS said that if the business activity of the LLC "is directly related to" and "actually facilitates" operations conducted on a cooperative basis, earnings distributed to cooperative members of the LLC are patronage-sourced income. While LLC distributions are taxable income to a cooperative, the amount of the distributions can be deducted if passed through to the cooperative members as a patronage refund. Subsequent rulings have also applied the "directly related" test in a manner that is allowing cooperatives to form alliances that help them stay competitive and still serve their members' needs on a patronage basis.

Significant differences existed in the way the LLC's discussed in these rulings are organized and operated. The facts and specific findings of the rulings are discussed below.

¹⁸² Priv. Ltr. Rul. 9033006 (May 14, 1990).

¹⁸³ T.D. 8697 (Dec. 17, 1996); Treas. Reg. § 301.7701-1 to § 301.7701-3.

Nonagricultural Purchasing Cooperatives. The first rulings were issued in response to inquiries from two health care purchasing cooperatives who provided various services to their members, including the negotiation of contracts with suppliers of products and services used by their members.¹⁸⁴ These contracts allow members to obtain products and services that they need in their businesses at less cost and on more favorable terms than each member would likely receive negotiating on its own. Only cooperative members have access to these contracts. Members typically place orders directly with the suppliers, the suppliers ship directly to the co-op members and bill them directly, and the members pay the suppliers directly.

Each co-op's group purchasing program is a separate allocation unit funded by supplier-paid "administrative fees" under the terms of their contracts with the co-op. The fees are related to the amount of purchases the members of each co-op makes with each vendor. These fees have exceeded the related expenses of the co-ops, with the excess being allocated to the co-ops' members as patronage refunds. Both associations have received IRS Private Letter Rulings recognizing their status as cooperatives.

The two cooperatives formed an LLC to negotiate such contracts on behalf of both co-ops and their members. The two co-ops are the LLC's only members. Their objectives are to combine their market power to arrange better contracts for their members and reduce costs by eliminating duplication in their administrative offices. Co-op members will continue to deal directly with suppliers, but now under the terms of contracts negotiated by the LLC rather than the co-ops.

The cooperatives will not pool or otherwise use "administrative fees" to finance the LLC. Rather, the "fees" will continue to be the property of the co-ops based on the respective purchases of their patrons. The flow of "administrative fees" to

¹⁸⁴ Priv. Ltr. Ruls. 9827042 and 9827043 (April 8, 1998).

the co-ops and then to participating patrons as patronage refunds will continue essentially unchanged.

To finance the LLC, each month each member will write a check to the LLC for its share of the previous month's expenses, computed on the basis of their respective patrons' usage of the LLC the previous year.

The two co-ops formed a second LLC to perform group purchasing functions previously conducted by one of them on a nonpatronage basis. This second LLC (LLC-2) is expected to do a considerably smaller volume of business than the first LLC (LLC-1). LLC-1 will provide administrative and management services to LLC-2. All administrative fees collected on purchases made on a nonpatronage basis through LLC-2 will remain the property of LLC-2, and any distributions to the co-ops based on business generated through LLC-2 will be treated as nonpatronage income.

The IRS issued four findings favorable to the cooperatives:

1. Participation in these LLCs will not affect their status as corporations "operating on a cooperative basis."
2. The "administrative fees" they receive from the vendors related to purchases by their patrons will continue to be patronage-sourced income.
3. The payments they make to the first LLC to cover its expenses will be patronage-sourced expenses.
4. When the first LLC realizes income or loss from activities related to the group purchasing contracts accessed by patrons of the cooperatives, it will be patronage-sourced gain or loss when distributed to the cooperatives.

IRS also found, as expected, that any gain or loss passing through to the cooperatives from business conducted through LLC-2 will be nonmember nonpatronage-sourced income.

Local Farm Supply Cooperatives. Later in the year, rulings were issued in response to inquiries from two local agricultural supply cooperatives who provide their patrons with petroleum products, feed, chemicals, seed and fertilizer, all on a cooperative basis.¹⁸⁵ Faced with aging facilities and equipment, the two cooperatives formed an LLC to conduct their agronomy operations. The LLC is located midway between their respective locations. The LLC has leased a new fertilizer plant and purchased modern equipment to apply the product it sells onto patrons' farmland.

At first, the LLC acted as the agent of the cooperatives; all sales to their farmer patrons of products and services provided by the LLC were funneled through the cooperatives.

However, this proved to be administratively burdensome. The co-ops wanted to make the LLC a principal, selling products and service directly to their patrons. In an unusual arrangement, each farmer-member of one of the cooperatives was also made a member of the other cooperative. When a farmer purchased fertilizer from the LLC, half of the purchase was attributed to each of the co-ops. The LLC split its earnings between the two cooperatives on a 50/50 basis.

Each year the cooperatives will receive their respective shares of the LLC's earnings and report such income under partnership rules. Each will allocate this income to its patrons in proportion to the amount of business each patron has conducted during the year with the LLC.

The IRS determined that allocations of LLC earnings to its co-op members would be patronage-sourced income under Subchapter T. IRS agreed to "look through" the LLC to its cooperative owners and their relationships with their patrons. It found a preexisting legal obligation on the part of the cooperatives to allocate LLC earnings as patronage refunds. It also found the LLC operations are directly related to and actually facilitate the co-

¹⁸⁵ Priv. Ltr. Ruls. 9846022 and 9846027 (August 17, 1998).

ops' supply and service functions. Therefore, it concluded the allocations of LLC earnings by the cooperatives to their members are eligible for the patronage refund deduction.

Agricultural Processing and Marketing Venture involving Cooperative and Noncooperative Firms. The next letter ruling was issued to an agricultural processing and marketing cooperative that felt its long term viability was threatened by the consolidation and globalization occurring in the industry in which it operated. The cooperative was offered the opportunity to join an LLC owned by two noncooperative firms in the industry. The LLC had three times the product volume of the cooperative and, according to the letter ruling, was “a very successful processor and marketer” with “an excellent management team and record of financial success.”¹⁸⁶

The cooperative would transfer its physical assets and some cash to the LLC. It would purchase its members' production at market price and sell the product to the LLC for processing and marketing. The cooperative's voting and financial interest in the LLC will be commensurate with the anticipated share of all product delivered to LLC that it will provide (about 28%). The cooperative's share of the LLC earnings will be allocated to its members on the basis of how much product each member delivers to the cooperative each year.

The IRS applied the “directly related” test and found that the cooperative's share of the LLC operating income attributable to the processing and marketing of its members' product is income from patronage sources. This ruling is significant in that it is the first to involve processing and marketing and the first involving an LLC with both cooperative and noncooperative members.

Large, Regional Farm Supply Cooperatives. The next link in the chain strengthening cooperatives through joint ventures was

¹⁸⁶ Priv. Ltr. Rul. 199920034 (Feb. 24, 1999).

a ruling covering an LLC formed by three large, regional farm supply cooperatives to combine their wholesale agronomy (plant food and crop protection) operations.¹⁸⁷ Manufacturing and retail operations are to remain separate. The LLC is to act as a principal, buying agronomy products from the three regionals and others and reselling the products to the local cooperative members of the three regionals and others.

The LLC was structured so that each of its three cooperative members received a fixed percentage of the earnings. To ensure the local cooperative member-owners received their allocation of LLC earnings on the basis of patronage, each local that belonged to any of the three regionals was offered the opportunity to join all three regionals (which most did). Then they receive a patronage refund from all three regionals based on the amount of agronomy products they purchased from the LLC.

After summarizing the rulings and cases establishing the “directly related” test, the Service noted that:

LLC was formed and is and will be operated to allow Coop 1, Coop 2, and Coop 3 to better serve their members and participating patrons by obtaining economies of scale, elimination of duplication, the ability to achieve operational efficiencies by working together, and reducing costs without sacrificing service. (The Co-ops) anticipate significant cost savings and efficiencies. These savings will flow through to members and participating patrons in the form of lower prices for...products or increased patronage dividends. LLC is directly related to and actually facilitates the accomplishment of the cooperative mission of (The Co-ops).¹⁸⁸

¹⁸⁷ Priv. Ltr. Rul. 200123033 (June 8, 2001). The structure of the entire operation is quite detailed and beyond the scope of this report. The Service treated the venture essentially as if it was a single LLC owned by three cooperatives.

¹⁸⁸ *Id.*

The Service then held that each regional's distributive share of the profits and losses of the LLC on sales of agronomy products to local cooperative members and participating patrons of the regionals was patronage sourced. It also said that use of the LLC for wholesale operations would not alter the established patronage-sourced status of earnings each regional generates for itself on its manufacturing and retail operations.

The Service concluded by stating that two potential items of income for the LLC would be nonpatronage sourced, (1) income on LLC sales to persons who were not members or participating patrons of the regionals and (2) income on any business activity of the LLC that would be nonpatronage in nature if conducted by one of the regionals. The regionals had not asked for patronage treatment of either of these income items.

Limited Partnership of Two Large Marketing Cooperatives. While LLC's are often the structure of choice in forming new joint ventures, and some partnerships have reorganized as LLC's, some partnerships still exist. Since LLC's are taxed as partnerships, rulings concerning one should provide guidance to owners of the other.

This ruling concerned a change in the operations of an existing limited partnership (LP) formed by two cooperatives to slaughter and process livestock and to market and sell processed meat.¹⁸⁹ One partner was a smaller, new-generation cooperative that only accepts a fixed number of cows from its farmer-members and transfers them all to LP for processing and marketing. The other partner was a large, regional cooperative that purchased cows from members and nonmembers in sufficient quantity to meet LP's need for livestock beyond that supplied by the first cooperative.

To improve efficiency and reduce costs, the two partners agreed to shift the regional cooperative's cattle-buying function to the LP. Thus the cooperative's members would be selling their

¹⁸⁹ Priv. Ltr. Rul. 200244013 (July 25, 2002).

livestock directly to the LP. The regional's share of LP earnings on the handling of member cattle would be allocated on a patronage basis to those members who sold cattle to LP.

The Service again displayed an understanding of how cooperatives need to function to stay competitive. It said:

Coop is attempting to best serve its members in the changing economic climate. The increased efficiency realized through the transfer of the buying function will increase LP's profitability and, concomitantly, Coop's patronage sourced earnings and patronage dividends. ... Coop's ability to determine and distribute its (livestock) marketing margins to its members will not be adversely affected, since LP will continue to maintain the required records to insure that such margins are properly allocated and distributed to Coop's members.

* * *

Under these circumstances, Coop's activities through LP are directly related to and actually facilitate, the accomplishment of Coop's cooperative mission.

* * *

Coop's profits realized from its (livestock) marketing activities will remain patronage sourced income after Coop has transferred its (livestock) acquisition activities to LP. Coop's profits from its (livestock) marketing activities are to be allocated and distributed on a patronage basis to Coop's members based upon the (livestock) purchased from Coop's members by LP on behalf of Coop. Coop's (processed meat) marketing profits attributable to LP's purchase of (livestock) from nonmembers attributable to

Coop will continue to be taxable as nonmembers income.¹⁹⁰

These letter rulings suggest that cooperatives and the Service have reached a common ground on the status of earnings returned from joint ventures organized as noncooperative firms to their cooperative members and partners. If the venture's operations are directly related to and actually facilitate activities conducted by the cooperative on a patronage basis, then earnings and losses distributed by the venture to the cooperative can qualify as patronage-sourced. But earnings not directly attributable to providing services to cooperative members and nonmember patrons will be treated as nonpatronage income.

Pension Fund Reversions

One of the trends in employee benefit programs is to change from a defined benefit pension plan to a defined contribution plan. If the defined benefit plan is overfunded at the time it is terminated, a cooperative may realize taxable income on any funds that revert to it after other plan termination obligations are satisfied.

The service has consistently compared these transactions to the sale of Code section 1245 depreciable property. Rev. Rul. 74-84¹⁹¹ held that gain on the sale of a piece of machinery that is recapturing depreciation is patronage-sourced income, while additional gain is nonpatronage-sourced. Citing Rev. Rul. 74-84, the Service has said that the portion of the excess funds reverting to the cooperative attributable to excess company contributions deducted in prior years can be treated as patronage-sourced income. However, that part of the excess funds attributable to "superior investment performance" by the plan "...is not patronage

¹⁹⁰ *Id.*

¹⁹¹ Rev. Rul. 74-84, 1974-1 C.B. 245.

source income since it is incidental income not directly related to the marketing, purchasing, or service activities for the benefit of (Cooperative's) members."¹⁹²

¹⁹² Tech. Adv. Mem. 9208004 (Oct. 31, 1991); *see also*, Priv. Ltr. Rul. 8520003 (Jan. 11, 1985); Priv. Ltr. Rul. 8752008 (Dec. 24, 1987); Priv. Ltr. Rul. 8827027 (April 7, 1988).

CHAPTER 6

OTHER INCOME ISSUES

This chapter is something of a catch-all. It discusses several situations that pose challenges in determining the proper accounting and tax treatment of cooperative financial results in the patronage refund area. It also looks at other issues in determining taxable income, including new tax planning options provided by the American Jobs Creation Act of 2004.¹⁹³

SIMULTANEOUS PATRONAGE AND NONPATRONAGE OPERATIONS

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

While "patron" is not defined in the Code, it is defined in the regulations as "any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association."¹⁹⁴

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

It is common for cooperatives to provide like services to members and nonmembers, but only make patronage refund

¹⁹³ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

¹⁹⁴ Treas. Reg. § 1.1388-1(e).

distributions to members. Cooperatives that conduct both patronage and nonpatronage business must be diligent in separating patronage and nonpatronage earnings.

For example, in Revenue Ruling 74-160 the Service ruled interest income from loans made to a supplier, under circumstances permitting it to be classified as patronage-sourced income, cannot be allocated solely as patronage-sourced net margins if part of that income is attributable to business with nonmembers on a nonpatronage basis. The Service said:

...to the extent such income is allocable to the member patrons on the basis of business done with or for those patrons, the income is patronage sourced income that may be distributed as patronage dividends. However, to the extent the interest income is allocable to nonmember business it constitutes nonpatronage sourced income that must be taken into account in computing the Federal income tax of taxpayer (cooperative).¹⁹⁵

In *Caldwell Sugars Co-op Inc. v. United States*,¹⁹⁶ the association did 87.555 percent of its business with member patrons and the remainder with nonpatrons. The cooperative was entitled to claim 87.555 percent of its income as patronage sourced.

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

¹⁹⁵ Rev. Rul. 74-160, 1974-1 C.B. 245, 246.

¹⁹⁶ *Caldwell Sugars Co-op Inc. v. United States*, 692 F. Supp. 659 (E.D. La. 1988), 88-2 U.S.T.C. (CCH) ¶ 9509.

is attributable in part to net earnings from the efforts of the nonmember workers."¹⁹⁷

The cooperative's membership may decide not to conduct some or all of its business with the cooperative on a patronage basis. Access to the patronage refund deduction is an option, not a mandatory step for associations otherwise operating on a cooperative basis. The earnings from nonpatronage business are taxed at the corporate level. If the earnings are distributed at a later date, they are subject to a second income tax at the recipient level.

Individual members also may choose to "waive" their patronage refund. The cooperative "will not be dealing with these producers on a patronage basis, [and] the net earnings from these transactions will not be available for distribution as patronage dividends but must be included in [the cooperative's] taxable income."¹⁹⁸

MULTIPLE SERVICE COOPERATIVES

Cooperatives can face complicated allocation decisions when providing more than one service to patrons. Differences in services range from those that are essentially integral parts of the same service, such as storage in a grain marketing operation,¹⁹⁹ to services that are quite distinct, as in the case of a cooperative that

¹⁹⁷ Rev. Rul. 74-20, 1974-1 C.B. 242, 243.

¹⁹⁸ Priv. Ltr. Rul. 8104118 (Oct. 30, 1980).

¹⁹⁹ See, e.g., *Pomeroy Cooperative Grain Co. v. Commissioner*, 288 F.2d 326 (8th Cir. 1961), 1961-1 U.S.T.C. (CCH) ¶ 9316, *rev'g in part, aff'g in part*, 31 T.C. 674 (1958) (handling, storage, conditioning grain by a grain marketing cooperative); Priv. Ltr. Rul. 7729062 (no date, 1977) (fertilizer supply cooperative dividing its operation into nitrogen products and mixed products); Priv. Ltr. Rul. 7819019 (Feb. 7, 1978) (two types of marketing arrangements for the same commodity); and Priv. Ltr. Rul. 8531002 (Feb. 28, 1985) (different kinds of supplies).

markets farmers' commodities and purchases supplies for farm production input.²⁰⁰ In some instances, the same set of services is provided to essentially the same group of patrons. In others, the cooperative may deal with different, although somewhat overlapping, sets of patrons.

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

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

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

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

²⁰⁰ See, e.g., *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949), 1949-2 U.S.T.C. (CCH) ¶ 9400; *Juniata Farmers Cooperative v. Commissioner*, 43 T.C. 836 (1965), *acq.*, 1966-1 C.B. 1; and *Pomeroy Cooperative Grain Co. v. Commissioner*, 288 F.2d 326 (8th Cir. 1961), 1961-1 U.S.T.C. (CCH) ¶ 9316, *rev'g in part, aff'g in part*, 31 T.C. 674 (1958).

Except for a technical amendment covering the netting of earnings and losses among allocation units,²⁰¹ the Code doesn't specifically address multiple service cooperatives and their methods of calculating and allocating net margins.

EQUITABLE ALLOCATION AMONG PATRON GROUPS

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

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

In *Pomeroy Cooperative Grain Company v. Commissioner*, decided just before subchapter T adoption, the Eighth Circuit Court of Appeals addressed an "equitable allocation" argument involving a grain marketing cooperative that also generated

²⁰¹ The Consolidated Omnibus Budget Reconciliation Act of 1985 added a new Subsection (j) to Section 1388 of the Code. Cooperatives are given the option to offset patronage losses attributable to one or more allocation units (whether such units are functional, divisional, departmental, geographic, or otherwise) against patronage earnings in one or more other allocation units. Pub. L. 99-272, § 13210, 100 Stat. 82 (1985). This provision is discussed in detail in Part 5 of this series, Handling of Losses.

income from storing members' grain.²⁰² IRS argued that allocating grain storage income to grain marketing patrons in proportion to their grain marketing activities violated the equitable allocation principle.

The court said, there "is some doubt whether the Commissioner has sufficient standing to object to the taxpayer's method of allocating what would normally be income excludable to the taxpayer among its member-patrons in a manner apparently acceptable to such members as an equitable distribution of profits."²⁰³

After discussing the close connection between marketing and storage activities, the court rejected IRS's argument that allocating the net margins from the two activities to one allocation unit was inequitable. The court asserted:

...from a revenue standpoint, the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members. As stated in the Birmingham case..."the crucial question involved in determining the taxability of patronage dividends is whether they constitute income to the cooperative, or to the patron, or to both."²⁰⁴

²⁰² *Pomeroy Cooperative Grain Co. v. Commissioner*, 288 F.2d 326 (8th Cir. 1961) *rev'g in part, aff'g in part*, 31 T.C. 674 (1958).

²⁰³ 288 F.2d at 332.

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

In *Lamesa Cooperative Gin v. Commissioner*,²⁰⁵ the cooperative primarily performed marketing services for its patrons but also purchased small quantities of farm supplies that it resold to patrons approximately at cost. The cooperative based its allocation of patronage refunds solely on the patronage of its marketing operation. The Tax Court approved the cooperative's policy of combining the financial results of these distinct activities and making a single distribution based only on marketing patronage, noting that neither the operation-at-cost principle nor the concept of equitable allocation required any particular accounting method.

Recent decisions have addressed the equitable allocation issue when one or more units within a cooperative suffer a loss. While handling of losses is the subject of Part 5 of these reports, a brief discussion of the issue is presented here.

Treatment of losses by multiple service cooperatives can present a difficult situation, especially where different groups of patrons use distinct services of the cooperative that generate vastly different financial results. The Service has argued that combining such divergent results is inequitable.

Courts have not interpreted the equitable allocation rule as strictly prohibiting such combination of margins and losses among different groups of patrons. In *Ford-Iroquois FS, Inc. v. Commissioner*,²⁰⁶ the cooperative carried operating losses on supply and grain marketing functions forward to offset earnings on supply operations in a later year, pursuant to Code section 172. The method of handling losses did not impose losses directly on patrons of the loss units in proportion to their business done with the cooperative.

IRS argued that the operation at cost and equitable allocation concepts require that the losses be charged to the patrons whose

²⁰⁵ *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982).

²⁰⁶ *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213 (1980).

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

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

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

On the other hand, there is evidence of equity in the netting of losses between groups of patrons when the patrons of one department are often the patrons of others, the commodities involved are similar, geographical separation is limited, and the various patrons of the department are adequately informed of the risk sharing arrangement before the loss transaction occurs.²⁰⁷

One factor frequently mentioned in equitable allocation decisions, at least in recent ones, is the role members play in

²⁰⁷ Priv. Ltr. Rul. 8521003 (Jan. 25, 1985). This ruling described an interesting fact situation and applied several rather strict rules to the situation in addition to the equitable allocation principle. In response to this ruling, legislation was enacted permitting cooperatives to net margins and losses among units. The Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, § 13210, 100 Stat. 82 (1985).

deciding what is "equitable." The courts have given great weight to the members choosing, as owners and users, the method for distributing benefits and risks of cooperative operations.²⁰⁸

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

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

MATCHING PATRONAGE AND ALLOCATION - TRACING

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

If any portion of the earnings from business done with or for patrons is includible in the organization's gross

²⁰⁸ Examples include *Juniata Farmers Cooperative v. Commissioner*, 43 T.C. 836, 841 (1965), *acq.*, 1966-1 C.B. 1 (The cooperative's "method of allocation is a fair and equitable one, fully acceptable to its patrons."); and *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213, 1222 (1980) (With respect to losses carried forward to a new set of patrons, "the allocation of losses among a cooperative's past, continuing and future members is properly the concern of the membership and the board of directors"), quoted with approval in *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894, 905 (1982).

income for a taxable year after the taxable year during which the patronage occurred, then...the patronage (income) shall, to the extent provided in the regulations..., be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income.

The applicable regulation, after restating the Code provision, adds: "Thus, if the cooperative organization pays these earnings out as patronage dividends during the payment period for the taxable year for which the earnings are includible in its gross income, it will be allowed a deduction for such payments under section 1382(b)(1)..."²⁰⁹

For some time, both the Service and cooperatives generally interpreted this language to mean income realized in one year from a prior year's patronage was allocable to patrons of the year of receipt on the basis of business done during the year of receipt.²¹⁰

In Revenue Ruling 79-45,²¹¹ the IRS shifted its position. A change in a cooperative's inventory accounting method caused a positive adjustment in the cooperative's income in the year of change. The cooperative requested, and was granted, permission to allocate the gain to patrons of the cooperative during the 3 years in which the old inventory accounting method was used, the patrons whose business with the co-op resulted in the adjustment.

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

The payment of a patronage dividend that is based on income subject to the treatment of section 1382(f) of the

²⁰⁹ Treas. Reg. § 1.1382-6.

²¹⁰ See Rev. Rul. 69-576, 1969-2 C.B. 166; Rev. Rul. 70-249, 1970-1 C.B. 181.

²¹¹ Rev. Rul. 79-45, 1979-1 C.B. 284.

Code necessitates a tracing of the allocation of this income to patrons that may no longer be members of the cooperative because it was their business with the cooperative that resulted in this income. In situations where that income is related to business done with patrons over an extensive period of time, the payment of a patronage dividend with respect to this income should be made in proportion, in so far as practicable, to the amount of business done by or for such patrons during the period to which such income is attributable.²¹²

Following Revenue Ruling 79-45, the Service denied patronage refund treatment to a local cooperative that distributed a refund from a federated cooperative to its patrons of the year of receipt rather than to patrons of the year the underlying business transactions occurred.²¹³

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

*Lamesa Cooperative Gin v. Commissioner*²¹⁴ concerned a cooperative that sold equipment in 1974 on which it had deducted depreciation in prior years. All the gain from the sale of the equipment was reported on Lamesa's 1974 tax return as ordinary income under Code section 1245. In determining the amount to be

²¹² 1979-1 C.B. at 285.

²¹³ Tech. Adv. Mem. 8023023 (Feb. 28, 1980).

²¹⁴ *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982).

paid as patronage refunds, the cooperative allocated all this gain to its patrons during the 1974 taxable year in proportion to their patronage during that year.

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

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

The requirement of 'equitable allocation' should not be seen as a strict accounting requirement but only as a general principle to prevent inequitable treatment to some patrons at the expense of others. As a principle of equity, the overall scheme of allocation should be examined, including the practicalities of making allocations, the democratic nature of cooperatives, and the extent of patronage to the cooperative by nonmembers who have no say over how patronage dividends are distributed.²¹⁵

The Tax Court dealt with the applicability of tracing to federated cooperatives in *Kingfisher Cooperative Elevator Association v. Commissioner*.²¹⁶ Kingfisher, a local cooperative, belonged to four federated marketing, supply, and finance cooperatives. Kingfisher included patronage refunds received from the federated cooperatives in its gross income in the year of receipt. In computing its patronage refunds for its member-patrons, Kingfisher allocated net income to its patrons according to their patronage during that year. Prior year's patronage activi-

²¹⁵ 78 T.C. at 903.

²¹⁶ *Kingfisher Cooperative Elevator Association v. Commissioner*, 84 T.C. 600 (1985).

ties were not taken into account. Kingfisher's allocation was adopted by its board of directors and ratified annually by its members.

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

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

UNEQUAL ALLOCATIONS

The Code states a patronage refund cannot include any amount paid "out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."²¹⁷

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

Some characteristics of a transaction between cooperative and patron may distinguish one patron's dealing with the cooperative from another patron. For example, the product delivered may be subject to variation in quality, justifying differential treatment in calculating and returning patronage refunds. An example is a bonus program giving higher returns in the form of premium payments to producers who deliver higher quality milk to a milk marketing cooperative.²¹⁸

²¹⁷ I.R.C. § 1388(a) and Treas. Reg. § 1.1388-1(a)(2)(ii).

²¹⁸ Rev. Rul. 75-110, 1975-1 C.B. 167, relating to qualification for § 521; *see also* Rev. Rul. 66-98, 1966-1 C.B. 200 in which a cooperative

A marketing cooperative may use its members' product in different ways, and treat patrons according to the use made of the product. For example, a grain marketing cooperative sold debentures to members to finance a feed manufacturing facility. The debentures carried rights to deliver grain to the feed plant. The cooperative was permitted to calculate and allocate margins on grain delivered to the feed mill differently than grain delivered and sold under the regular grain marketing program.²¹⁹

The Service has permitted variations in patron treatment if based on market factors prevailing when product is delivered to or sold by the cooperative. Revenue Ruling 66-98 described a cooperative formed by department stores to purchase their accounts receivable. The discount charged was based on current market discount rates that varied during the year. The ruling held cooperative operation of a finance corporation did not require it to purchase accounts receivable "on a basis different from that on which such receivables would customarily be acquired by a comparable commercial institution."²²⁰

Small allocations can cause considerable bookkeeping expense. In response, the Service has permitted cooperatives to eliminate small allocations, technically resulting in inequitable treatment.²²¹ Likewise, a cooperative with a very small patronage

formed by department stores to purchase accounts receivable required different "hold backs" for losses based on past loss record.

²¹⁹ Rev. Rul. 74-567, 1974-2 C.B. 174.

²²⁰ Rev. Rul. 66-98, 1966-1 C.B. 200, 201-202.

²²¹ Rev. Rul. 55-141, 1955-1 C.B. 337. Allocations of less than \$1 and all cents in excess of whole dollar amounts were set aside in a fund to defray recordkeeping expenses. *See also* Priv. Ltr. Rul. 9049026 (Sept. 10, 1990) (nondistribution of patronage refund below unspecified de minimis level approved).

sideline function may allocate margins earned from the function on the basis of its primary patronage business.²²²

Section 1388(a) and the requirement that patrons be treated equally with respect to substantially identical transactions have caused problems for cooperatives with farm owners as members that also market the production of the tenants of the members. In *Smith & Wiggins Gin, Inc. v. Commissioner*,²²³ the cooperative ginned cotton delivered by both members and tenants of members. When the patronage refunds of the members were computed, each member was credited not only with the cotton which the member grew and brought to the gin but also with that of the member's tenants. The refund was made to the member and not to the tenants. The court denied patronage refund deductions for the amounts based on cotton delivered by the tenants. The court reasoned the tenants, not the member/landlords, were the proper "patrons" for such distributions.

A similar result was reached in *Iberia Sugar Cooperative, Inc. v. United States*.²²⁴ In this case the cooperative contended that because its bylaws and marketing agreements with members required members to deliver all of the crop, including the nonmember tenants' shares of the crop, the business was transacted only with members. The court disagreed stating patronage refunds, to be deductible, cannot be paid out of earnings based on the production of nonmembers to whom no amounts are paid with respect to substantially identical transactions. The court held refunds paid to members based on product grown by tenants were out of nonpatronage income.

²²² *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894, 907-910.

²²³ *Smith & Wiggins Gin, Inc. v. Commissioner*, 341 F.2d 341 (5th Cir. 1965).

²²⁴ *Iberia Sugar Cooperative, Inc. v. United States*, 480 F.2d 548 (5th Cir. 1973), 1973-1 U.S.T.C. (CCH) ¶ 9465, *aff'g*, 360 F. Supp. 967 (W.D. La. 1972).

USE OF THIRD-PARTY AGENTS

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

In *Mississippi Valley Portland Cement Co. v. United States*,²²⁵ a small group of investors formed an alleged cooperative to manufacture cement. The investors purchased stock in the cooperative, which gave them rights to purchase quantities of cement from the cooperative. These rights were assigned to a common sales agent that resold the cement to the general public. Earnings of the manufacturer were returned to its members on the basis of stock ownership. The association claimed a patronage refund deduction on its income tax return.

The court found the distributions were not made out of earnings from "business with or for patrons" and therefore not excludable from the corporation's taxable income. The court cited two factors as particularly important. First, the record showed the business was operated "not to supply its shareholders with cement at a reduced cost but to supply them with a return on their invested capital."²²⁶

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

In *Land O'Lakes, Inc. v. United States*,²²⁷ the cooperative, in an "agent-buyer" arrangement, sold supplies to independent companies, which resold the supplies to farmer members of the cooperative. The agents entered into contracts with the cooperative under which the patronage refunds, normally payable

²²⁵ *Mississippi Valley Portland Cement Co. v. United States*, 408 F.2d 827 (5th Cir. 1969), *cert. denied*, 395 U.S. 944 (1969), *aff'g* 280 F. Supp. 393 (S.D. Miss. 1967).

²²⁶ 408 F.2d at 834.

²²⁷ *Land O'Lakes, Inc. v. United States*, 675 F.2d 988 (8th Cir. 1982), *aff'g in part, rev'g in part*, 470 F. Supp. 238 (D. Minn. 1979).

to the agents, were paid directly to the farmer-customers of the agents.

The court noted that the Land O'Lakes bylaws created the necessary preexisting obligation to make patronage refunds to the members, and the members had consented to include the refunds in their taxable income. The court acknowledged that an argument could be made that the agents, not the farmers, were the patrons of Land O'Lakes. The court observed, however, that the Code section 1388(c)(1)(B) definition of a qualified written notice of allocation provides for consent from the "distributee." The court held "distributee" has a broader meaning than "patron," encompassing the members of Land O'Lakes. Since the members would recognize the tax obligation, the refunds paid to the farmer-customers under the agent-buyer agreements were properly deductible by Land O'Lakes as patronage refunds.

In *Mississippi Chemical Corp. v. Commissioner*,²²⁸ several members of a fertilizer manufacturing cooperative formed a separate corporation to buy and sell fertilizer. The corporation also became a member of the cooperative.

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

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

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

But when the right to purchase fertilizer was assigned to a nonmember, the cooperative could not deduct the payment as a

²²⁸ *Mississippi Chemical Corp. v. Commissioner*, 86 T.C. 627 (1986).

patronage refund. And the payments could not be deducted as an agreed-upon refund of purchase price either.

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

EXPENSES

Two factors jointly determine net margins--gross income and business expenses, including dividends and taxes. Patronage refunds are based on the net earnings of the cooperative, computed only after taking expenses into account.²²⁹

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

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

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

²²⁹ Treas. Reg. § 1.1388-1(a)(1)(iii), and the explanation below subsection (iii).

...expenses must be assigned to the type of income to which they apply and may not be arbitrarily assigned to reduce one type of income or the other.

The first step in determining whether an item of expense is nonpatronage sourced is to establish how the expense arises. If the expense is incurred with respect to business done with or for patrons, it is patronage sourced.²³⁰

The rule is applied in the same way as the rules for determining if income is from patronage or nonpatronage sources. For example, interest expenses paid to patrons for their deposits in the cooperative are patronage sourced expenses, as is interest on commercial borrowing done as a necessary part of the cooperative's business with or for its patrons.²³¹

The Service has held that administrative expenses and interest costs associated with collection of late payment fees from patrons are patronage-sourced expenses and can be offset against income from patronage sources "in accordance with generally acceptable accounting principles."²³²

IRS has also permitted a marketing cooperative to treat payments made to settle a private civil antitrust lawsuit as patronage sourced expenses for purposes of determining net patronage earnings available for allocation as patronage refunds.²³³

But interest expenses associated with funds a cooperative borrows to redeem per-unit retain certificates early, at less than

²³⁰ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238, 246 (1987).

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

²³² Priv. Ltr. Rul. 8531002 at 6 (Feb. 28, 1985).

²³³ Priv. Ltr. Rul. 9238010 (June 16, 1992).

face value, have been characterized as nonpatronage expenses by IRS. The IRS considers the income generated from redemption at less than face value to be nonpatronage sourced; thus any expenses arising from that activity are likewise nonpatronage in nature.²³⁴

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

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

The Tax Court found the argument:

...entirely speculative and unconvincing. There is nothing in this record to show to what extent, if any, [the cooperative] could have used the excess cash which it temporarily had in its hands, from time to time, for the reduction of other indebtedness on which it was obligated, consistent with maintaining the liquidity necessary for the operation of its business. In any event, it was not done. [The cooperative] chose the manner in which it operated its business, and it must abide the tax results flowing from those choices.²³⁵

Subchapter T prohibits the payment of patronage refunds out of income from nonpatronage sources.²³⁶ Reducing nonpatronage

²³⁴ Priv. Ltr. Rul. 8033070 (May 22, 1980).

²³⁵ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238, 247 (1987).

²³⁶ I.R.C. §§ 1382(b) and 1388(a).

sourced income by patronage sourced expenses would evade this principle by increasing net margins available for distribution as patronage refunds under the single tax rule for patronage refunds. This would then decrease the nonpatronage-sourced income otherwise fully taxable at the cooperative level, at least for nonsection 521 cooperatives.²³⁷

A cooperative that operates on a patronage basis with respect to members and on a nonpatronage basis with respect to nonmembers may find some expenses should be assigned to only one group or the other. For instance, a State may impose an income tax on the net margins derived from nonmember, nonpatronage business but not on net margins from the patronage business if returned to members on a patronage basis. In such a case, earnings from business done with members must be segregated from nonmember business earnings. The income tax is then assessed only against nonmember earnings. Member earnings distributed as patronage refunds are not affected by the tax.²³⁸

Similarly, Federal income taxes paid on nonpatronage income are not applied to reduce patronage refunds payable to patrons with whom the cooperative did business on a cooperative basis.²³⁹

²³⁷ This result is noted in *Des Moines County Farm Service Co. v. United States*, 448 F.2d 776 (8th Cir. 1971), 1971-2 U.S.T.C. (CCH) ¶ 9665, *aff'g*, 324 F. Supp. 1216 (S.D. Iowa), 1971-1 U.S.T.C. (CCH) ¶ 9200; *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), 1980-1 U.S.T.C. (CCH) ¶ 9352, *rev'g*, 70 T.C. 145 (1978); and *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987).

²³⁸ Rev. Rul. 74-161, 1974-1 C.B. 247. This is distinguished from a tax imposed on the total net earnings from all operations, which the Service has said must be allocated to both patronage- and nonpatronage-sourced income. Rev. Rul. 82-76, 1982-1 C.B. 118.

²³⁹ An early Board of Tax Appeals decision, *Farmers Union Cooperative Exchange v. Commissioner*, 42 B.T.A. 1200 (1940), noted this position, basing its decision, in part, on A.R.R. 6967, III-1 C.B. 287 (1924), *superseded by* Rev. Rul. 68-228, 1968-1 C.B. 385, *modified by*

Certain presumptions may affect the allocation of expenses, or at least the need to calculate them separately. An early IRS ruling established a presumption that for patronage and nonpatronage business involving the same activity, the patron and nonpatron portions of a cooperative's business were equally profitable.²⁴⁰ While that presumption is rebuttable, the burden of proof falls on the cooperative.²⁴¹

In *Land O'Lakes, Inc. v. United States*,²⁴² a cooperative operated retail outlets that sold both member product and nonmember goods. All income from the store was designated income from patronage sources, with no profit allocated to nonpatronage-sourced income. Reversing a U.S. District Court decision, the Eighth Circuit Court of Appeals disagreed with designating all the income as patronage sourced.

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

Rev. Rul. 72-602, 1972-2 C.B. 510.

²⁴⁰ A.R.R. 6967, III-1 C.B. 287 (1924), *superseded by* Rev. Rul. 68-228, 1968-1 C.B. 385, *modified by* Rev. Rul. 72-602, 1972-2 C.B. 510. *See also* Valparaiso Grain & Lumber Co. v. Commissioner, 44 B.T.A. 125 (1941), for statement of this presumption.

²⁴¹ Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397 (1972), *aff'd*, 481 F.2d 812 (10th Cir. 1973), 1973-2 U.S.T.C. (CCH) ¶ 9534, *cert. denied*, 414 U.S. 1028 (1973).

²⁴² Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982), 1982-1 U.S.T.C. (CCH) ¶ 9326, *aff'g in part, rev'g in part*, 470 F. Supp. 238 (D. Minn. 1979), 1979-1 U.S.T.C. (CCH) ¶ 9380.

Some expenses cannot be assigned solely to patronage or nonpatronage activity. Instead, they are "organization wide" in their impact. These expenses or payments may not be used to selectively reduce patronage or nonpatronage sourced income but must be applied proportionately to reduce both. For example, amortization of a facility is apportioned between patronage and nonpatronage business to apply proper deduction to net margins available for payment as patronage refunds.²⁴³

EXPORT ENTITY EARNINGS

The Federal government has a long history of lending public policy support to efforts of United States companies to increase sales of their products in foreign countries. For many years, tax incentives were one of the tools used to promote exports. The value of these incentives to cooperatives, and other businesses, were limited by their complexity and constant challenges by other nations to their legality under international trade rules. The American Jobs Creation Act of 2004²⁴⁴ reduced U.S. reliance on this approach to stimulate domestic economic activity.

Domestic International Sales Corporation

The Revenue Act of 1971 authorized the creation of tax-favored Domestic International Sales Corporations (DISC).²⁴⁵ A properly organized and operated DISC is a nontaxable entity. DISC earnings, whether distributed as cash or retained by the DISC, are taxable income to the shareholders. The tax advantage

²⁴³ Rev. Rul. 54-297, 1954-2 C.B. 132.

²⁴⁴ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

²⁴⁵ Revenue Act of 1971, Pub. L. No. 92-178, § 501, 85 Stat. 497; 26 U.S.C. §§ 991-999.

is that shareholders can defer some of their tax liability on earnings allocations from the DISC.

While the DISC statute was not cooperative user friendly, IRS took a positive attitude toward cooperative use of DISC's. In a brief ruling, it said that a section 521 farmers' cooperative could organize and operate a DISC as a wholly owned subsidiary without jeopardizing its section 521 status.²⁴⁶

The Service also took a favorable position on the character of DISC income distributed to its cooperative owner. A fruit processing and marketing cooperative organized a wholly owned DISC to handle its export sales. The cooperative paid a commission to the DISC for its sales, and received back a distribution of one-half of any earnings realized by the DISC. Neither the cooperative nor the DISC handled fruit for nonmembers of the cooperative. The Service held the distribution from the DISC to the cooperative was patronage sourced income because it was produced by a transaction directly related to marketing patrons' products.²⁴⁷

Foreign Sales Corporation

DISC's proved difficult to operate and drew constant criticism from other nations as a violation of the prohibition on export subsidies in the General Agreement on Tariffs and Trade. The Deficit Reduction Act of 1984 created the Foreign Sales Corporation ("FSC") as a substitute for the DISC.²⁴⁸

A FSC was a corporation organized and operated in another country that marketed goods produced in the United States in other

²⁴⁶ Rev. Rul. 73-247, 1973-1 C.B. 294.

²⁴⁷ Rev. Rul. 75-228, 1975-1 C.B. 278.

²⁴⁸ Deficit Reduction Act of 1984, Pub. L. 98-369, §§ 801-805, 98 Stat. 494, 985-1003; 26 U.S.C. §§ 921-927. Although DISC's were not abolished by the 1984 Act, their benefits were limited and an interest charge for tax-deferred amounts was imposed on DISC shareholders.

countries. Under this export incentive scheme, a percentage of an FSC's income earned from the sale of qualified export property was exempt from U.S. tax.

Special rules for cooperatives provided that so-called "exempt" foreign trade income could be retained at the cooperative level tax free, while "nonexempt" foreign trade income was taxable to the cooperative but deductible if allocated to patrons on a patronage basis.²⁴⁹ Thus the legislation presupposed that FSC income was patronage-sourced.

Extraterritorial Income Exclusion

In 1999, the World Trade Organization (WTO), at the request of the European Union, ruled that the FSC regime was not in compliance with WTO obligations. Congress responded by repealing the FSC rules found in Code sections 921-927 and replacing them with a general exclusion from the gross income of U.S. companies for "extraterritorial income (ETI)."²⁵⁰

The new scheme eliminated the need for a foreign company to handle the export arrangements. Qualifying foreign trade income was simply excluded from gross income of the exporting entity.

As the tax-favored ETI was excluded from income, sole proprietorships and owners of passthrough entities (partnerships, LLC's, and S corporations) could benefit directly from the exclusion. To make sure cooperatives and their patrons were not disadvantaged under the newest scheme, two special rules were included in the law.

²⁴⁹ 26 U.S.C. § 923(a)(4) and § 925(f), both of which were repealed by § 2 of the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000.

²⁵⁰ Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423-2435, codified at 26 U.S.C. §§ 941-943.

First, similar to the rules for FSC, qualifying ETI could be retained at the cooperative level tax free.²⁵¹ But in a change from FSC, qualifying ETI could be passed through to patrons as either patronage refunds or per-unit capital retains that could also be excluded from the patrons' gross income.²⁵² Thus ETI was even more beneficial than regular patronage-sourced income as it could be distributed directly to patrons free from any Federal income taxation.

The European Union immediately challenged the ETI regime in the WTO. In January 2002, the WTO Appellate Body found the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

The ETI exclusion was repealed, for transactions after December 31, 2004, by the American Jobs Creation Act of 2004.²⁵³ This included the language allowing agricultural and horticultural marketing cooperatives to pass ETI benefits through to their patrons. Transition rules provide cooperatives and other taxpayers with 80 percent of their otherwise-available ETI benefits for transactions during 2005 and 60 percent of their otherwise-available ETI benefits for transactions during 2006.²⁵⁴ Transition relief is also available for income realized under certain contracts in effect on September 17, 2003.²⁵⁵

²⁵¹ 26 U.S.C. § 941(b)(2).

²⁵² 26 U.S.C. § 943(g).

²⁵³ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101, 118 Stat. 1423.

²⁵⁴ *Id.* at § 101(d).

²⁵⁵ *Id.* at § 101(f).

QUALIFIED PRODUCTION ACTIVITIES INCOME DEDUCTION

To compensate United States manufacturing companies for the loss of export tax relief and encourage domestic economic growth, the American Jobs Creation Act of 2004 provides a new, phased-in deduction from taxable income for a portion of "qualified production activities income" (QPAI) generated by businesses, including cooperatives.²⁵⁶ Unlike the ETI regime, the QPAI deduction is available to all taxpayers deriving income from qualified domestic production activities, whether or not they are exporters. The new deduction can be as much as three percent of QPAI for tax years beginning in 2005-2006, six percent for 2007-2009, and nine percent for 2010 and later.²⁵⁷

QPAI generally is equal to the excess (if any) of a taxpayer's *domestic production gross receipts* for the taxable year, over the sum of:

- (1) the cost of goods sold that are allocable to such receipts,
- (2) other deductions, expenses, or losses directly allocable to such receipts, and
- (3) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.²⁵⁸

"Domestic production gross receipts" means the gross receipts of a taxpayer which are derived from any lease, rental, sale, exchange, or other disposition of:

²⁵⁶ *Id.* at § 102. The Qualified Production Activities Income deduction created by this provision is codified as a new § 199 of the Internal Revenue Code, 26 U.S.C. § 199.

²⁵⁷ I.R.C. § 199(a).

²⁵⁸ I.R.C. § 199(c)(1).

- (1) *qualifying production property* which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States,
- (2) any qualifying film produced by the taxpayer, or
- (3) electricity, natural gas, or potable water produced by the taxpayer in the United States.²⁵⁹

The provision defining "domestic production gross income" also includes two specific exceptions--activities that will not produce QPAI--of interest to cooperatives. The first is the sale of food or beverages at retail.²⁶⁰ The second is the transmission or distribution of electricity, natural gas, or potable water.²⁶¹

"Qualifying production property" consists of:

- (1) tangible personal property
- (2) any computer software, and
- (3) certain sound recordings (records, tapes, CD's, etc.).²⁶²

The Conference Report provides further clarification on the intent of Congress in determining QPAI for agricultural and horticultural cooperatives. First, it states that income derived from the manufacturing, production, growth or extraction in whole or significant part of any agricultural or horticultural product by a cooperative, or from the marketing of agricultural or horticultural products by a cooperative, may be included in the co-op's QPAI.²⁶³

²⁵⁹ I.R.C. § 199(c)(4)(A).

²⁶⁰ I.R.C. § 199(c)(4)(B)(i). This exception is discussed at some length in a footnote to the Conference Report on the American Jobs Creation Act of 2004, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 272, n.27.

²⁶¹ I.R.C. § 199(c)(4)(B)(ii). This exception is also discussed in a lengthy footnote to the Conference Report at 272-273, n.28.

²⁶² I.R.C. § 199(c)(5).

²⁶³ H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 274.

A note to the Conference Report says that the term "agricultural or horticultural product" includes "fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown or extracted by the cooperative."²⁶⁴

Second, it discusses how the handling, processing, and marketing of agricultural products are to be treated under this regime, stating:

Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange, or other disposition of agricultural products with respect to which taxpayer performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of qualifying production property (whether or not by the taxpayer).²⁶⁵

In summary, the range of income that can qualify is broad, including most taxable income realized on manufacturing, producing, growing, and extracting goods in the United States. Rules of special interest to cooperatives provide that:

- Income from food processing (but not retail operations) is included,
- Income from storing and handling (but not transporting) agricultural products that are used in manufacturing, producing, or growing other goods is included, and
- Income from the production (but not the transmission or distribution) of electricity, natural gas, or potable water is also included.

²⁶⁴ H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 274, n.33.

²⁶⁵ H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 271, n.25.

Two limitations apply to this deduction. First, the deduction that may be claimed is the lesser of QPAI or taxable income for the year.²⁶⁶ So if a cooperative or other taxpayer loses money on other activities, that could reduce or eliminate this deduction.

Second, the QPAI deduction may not exceed 50 percent of the W-2 wages paid by the taxpayer for the year.²⁶⁷

Cooperative Pass-through Provision

Another provision of Code sec. 199 is particularly helpful to agricultural and horticultural cooperatives. It provides that patrons of agricultural and horticultural cooperatives can take a deduction on their tax returns for QPAI allocated to them as part of a *qualified* patronage refund or *qualified* per-unit retain.²⁶⁸ The amount each patron can deduct must be computed by the cooperative and a written notice must be provided each patron explaining the computation.²⁶⁹

One special rule provides a cooperative may not take a patronage refund deduction for amounts passed through to patrons that can be deducted by those patrons.²⁷⁰ As this amount is already eligible at the cooperative level for the QPAI deduction, this language merely makes it clear cooperatives can't deduct the same amount twice.

A second special rule states that any qualifying activity of patrons who market agricultural or horticultural products through a cooperative may be attributed to that cooperative for purposes of computing its QPAI deduction.²⁷¹

²⁶⁶ I.R.C. § 199(a)(1).

²⁶⁷ I.R.C. § 199(b).

²⁶⁸ I.R.C. § 199(d)(3)(A).

²⁶⁹ *Id.*

²⁷⁰ I.R.C. § 199(d)(3)(B)(i).

²⁷¹ I.R.C. § 199(d)(3)(B)(ii).

Example

This example illustrates how the deduction and the pass-through might work at a typical agricultural or horticultural cooperative. Assume Co-op C has \$100,000 of QPAI. Also assume it is a tax year beginning in 2005 or 2006, so the available deduction is 3 percent of QPAI, or \$3,000.

Co-op C allocates the \$100,000 to its member-patrons as a qualified patronage refund. It is allowed to deduct the \$3,000 in QPAI under the new law and the remaining \$97,000 as a traditional patronage refund. Thus the result is the same for the cooperative as it was before the new law was enacted, the entire \$100,000 is deductible.

Now assume Patron P does 10 percent of the business with Co-op C in the tax year. Patron P receives a patronage refund of \$10,000 in QPAI, all of which is taxable income to Patron P. However, under the new law Patron P can deduct the applicable percentage of QPAI (3 percent in 2006), or \$300. The value of this benefit will increase significantly when the QPAI deduction increases to 6 percent in 2007 and again to 9 percent in 2010.

DIVIDEND ALLOCATION RULE REPEAL

Until repealed by the American Jobs Creation Act of 2004,²⁷² the dividend allocation rule (DAR) acted as an impediment to equity accumulation by cooperatives. The DAR was an administrative interpretation of subchapter T by the Service, enunciated in Revenue Ruling 68-228.²⁷³ A cooperative distributed patronage

²⁷² American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 312, 118 Stat. 1467.

²⁷³ Rev. Rul. 68-228, 1968-1 C.B. 385. Rev. Rul. 68-228 is not so much a new IRS position as it is a modern restatement of A.R.R. 6967, III-1 C.B. 287 (1924), cited with approval in *Valparaiso Grain & Lumber Co. v. Commissioner*, 44 B.T.A. 125 (1941).

refunds to its members but not to nonmembers with whom it did business. Its bylaws provided that payments of capital stock dividends first come out of net earnings from nonmember (nonpatronage) business. Any capital stock dividends that remained unsatisfied were to be paid out of net earnings from member patronage.

The IRS disallowed part of the cooperative's patronage refund deduction. After citing several subsections of the regulatory definition of patronage dividend,²⁷⁴ the Service said:

To qualify as a patronage dividend...an amount paid...to a patron by a cooperative organization must be determined by reference to the net earnings from business done with or for the patrons. The net income of the cooperative organization must be reduced by dividends paid on capital stock or other proprietary interest. Furthermore, the amount paid to members cannot be paid out of earnings derived from nonmember business.

To permit a cooperative to pay dividends on its capital stock solely out of earnings derived from nonmember business would have the effect of permitting a cooperative to deduct amounts distributed to its members out of the earnings from nonmember business under the guise of patronage dividends.

* * *

Accordingly, to the extent that payment of capital stock dividends is charged against net earnings from nonmember business instead of being charged ratably against all net earnings thereby increasing the amount paid to member patrons, such increase does not qualify as a patronage divi-

²⁷⁴ Treas. Reg. §1.1388-1(a).

dend and therefore is not deductible in arriving at taxable income under section 1382(b) of the Code.²⁷⁵

Thus, the DAR provided that if a co-op has both patronage and nonpatronage sourced income, and it pays dividends on its capital stock, then the funds to pay those dividends must come proportionately from both patronage and nonpatronage income. For example, if a cooperative does 80 percent of its business with patrons and 20 percent with nonpatrons, \$.80 of every \$1.00 paid out as dividends on stock must come from patronage income and only \$.20 can come from nonpatronage income.

Cooperatives that generate nonpatronage earnings and pay dividends on stock usually prefer to pay all of their stock dividends out of nonpatronage income (at least to the extent they earn sufficient nonpatronage income to cover their dividend obligation).²⁷⁶ Since these earnings are subject to double taxation regardless of how they are distributed, distributing them on the basis of stock owned has no adverse tax impact on the cooperative. And it leaves a larger pool of patronage earnings to be distributed to patrons as tax-deductible patronage refunds.

Attempts by cooperatives to convince the Service to limit the application of the DAR were unsuccessful.²⁷⁷

Furthermore, the courts consistently held that a nonsection 521 cooperative that deals with nonmember patrons on a noncooperative basis may not reduce the nonpatronage sourced income by the entire amount paid as dividends on capital stock. Such a cooperative must apportion the amount paid as dividends on

²⁷⁵ Rev. Rul. 68-228, 1968-1 C.B. 385.

²⁷⁶ Farmer cooperatives with section 521 tax status can deduct both patronage-based distributions of nonpatronage income and dividends paid on capital stock. Thus, the DAR is primarily a concern of other cooperatives.

²⁷⁷ Priv. Ltr. Rul. 8547039 (August 27, 1985); Priv. Ltr. Rul. 9852012 (September 24, 1998).

capital ratably between earnings on member and nonmember business.²⁷⁸

For a considerable time, the DAR was not an important issue for cooperatives. They tended to do most of their business with member-patrons and frequently did not pay any return on their capital stock. However, recently market forces have driven cooperatives to become larger and more integrated to remain viable in many of the industries where they participate. This has led some cooperatives to solicit more business with or for nonmembers on a nonpatronage basis. And they are also turning to members and nonmembers for direct financing when their needs for equity capital can no longer be met by retained patronage-based earnings.

Persons making a direct investment in a cooperative, especially nonmembers, expect to receive at least a market rate of return on their investment. When a cooperative has both significant earnings on nonpatronage business and a substantial dividend obligation to meet, the DAR could be a serious additional cost of carrying that additional financing.

The following example illustrates the impact of the DAR:

Facts: Cooperative A earns \$1000 in a given year. Eighty-percent (\$800) is patronage-sourced and 20 percent (\$200) is nonpatronage-sourced. The cooperative pays dividends on its capital stock totaling \$125 per year.

Under the DAR: Assuming Cooperative A is in the 34% tax bracket, it would owe a corporate income tax of \$68 on its

²⁷⁸ *Des Moines County Farm Service Co. v. United States*, 448 F.2d 776 (8th Cir. 1971), *aff'g*, 324 F. Supp. 1216 (S.D. Iowa); *Union Equity Cooperative Exchange v. Commissioner*, 481 F.2d 812 (10th Cir. 1973), *cert. denied*, 414 U.S. 1028, *aff'g*, 58 T.C. 397 (1972); *FCX, Inc. v. United States*, 531 F.2d 515 (Ct. Cl. 1976).

nonpatronage sourced income ($\$200 \times .34$), leaving \$132 in tax-paid nonpatronage-sourced earnings.

Under the DAR, \$100 of the stock dividend would have to be paid out of patronage-sourced income ($\$125 \times .8$), reducing the amount that can be allocated to patrons as patronage refunds and excluded from tax at the cooperative level to \$700 ($\$800 - \100).

This \$100 is now subject to corporate income taxation at the cooperative level because it is distributed on the basis of investment rather than patronage. As Cooperative A is in the 34% tax bracket, it would owe an additional corporate income tax of \$34 ($\$100 \times .34$). The cooperative's total tax liability is \$102 ($\68 on its nonpatronage earnings + this \$34 on patronage earnings).

The “triple” tax: Cooperatives described the DAR as imposing an unfair “triple tax” on the relevant part of their income. Using the example above, that triple tax is computed as follows:

1. The cooperative pays \$68.00 ($\$200 \times .34$) in tax on its nonpatronage-sourced earnings.
2. The investors will pay a tax on the dividends they receive at their personal marginal tax rates. Assuming they are in the 25% tax bracket, this tax would total \$31.25 ($\$125 \times .25$).
3. The cooperative pays \$34.00 ($\$100 \times .34$) in tax on its patronage-sourced income distributed on the basis of investment, not patronage.

DAR repeal: Without the DAR, Cooperative A pays the \$125 stock dividend with its \$132 of tax-paid nonpatronage-sourced earnings. This allows the entire \$800 of patronage-sourced earnings to be distributed as patronage refunds and excluded from taxable income at the cooperative level.

Now Cooperative A is taxed the same on its stock dividends as a regular corporation. The co-op owes tax on its nonpatronage earnings used to pay the dividends. The investors will pay a second tax on the dividends they receive, just as they would on

dividends from a non-cooperative corporation. But elimination of the third tax on patronage earnings reduces the cooperative's tax liability from \$102 to \$68, creating a tax savings of \$34 over current law.

In 1998, cooperatives began a concerted effort to enact legislation overturning the DAR. For example, appropriate language was included in the proposed Taxpayer Refund and Relief Act of 1999 that passed both houses of Congress,²⁷⁹ but was vetoed for other reasons by President Clinton.

In 2004, cooperatives secured repeal of the DAR. The American Jobs Creation Act of 2004 adds a new paragraph to Code sec. 1388(a). It states that--to the extent provided in a cooperative's articles, bylaws, or a contract between the cooperative and its patrons--net earnings available for distribution as patronage refunds shall not be reduced by dividends on capital stock or other proprietary capital interests.²⁸⁰

The provision is not self-executing. To take advantage of this change, the new law requires cooperatives to have appropriate language authorizing them to pay stock dividends out of nonpatronage income in their articles of incorporation, bylaws, or marketing contracts with their members and other patrons. Cooperatives that pay dividends on equity capital will want to review their organizational documents to make sure they include such a provision.

²⁷⁹ The Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong., 1st Sess., § 1335.

²⁸⁰ American Jobs Creation Act of 2004, § 312, Pub. L. No. 108-357, 118 Stat. 1467 (codified at 26 U.S.C. § 1388(a)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 318-319.

DECLARATORY JUDGMENT RELIEF

Farmer cooperatives who want access to the special tax deductions permitted under Internal Revenue Code section 521 and other benefits that come with section 521 status, must apply for and receive approval from IRS. In the past, the only ways a cooperative could get a court to review a rejection of its application was claim a deduction IRS said they weren't entitled to, or pay some tax they didn't think they owed and then sue for a refund.

The American Jobs Creation Act of 2004 amends Code sec. 7428(a)(1) to enable a farmer cooperative to seek judicial review of the denial without first creating a tax controversy or being subject to immediate tax liability.²⁸¹

MARKETING INCLUDES VALUE-ADDED PROCESSING INVOLVING ANIMALS

One of the activities that allows a farmer cooperative to qualify for section 521 tax status is to engage in "...marketing the products of members or other producers."²⁸² IRS interpreted this language to include value-added processing involving a mechanical process (converting corn to ethanol) but not a biological process (feeding corn to hens and selling eggs and chickens).²⁸³

The American Jobs Creation Act of 2004 adds a new subsection (k) to Code sec. 1388 to make it clear that under both

²⁸¹ American Jobs Creation Act of 2004, § 317, Pub. L. No. 108-357, 118 Stat. 1470 (codified at 26 U.S.C. § 7428(a)(1)(D)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 363.

²⁸² I.R.C. § 521(b)(1).

²⁸³ This position was not the subject of a published ruling. Rather, it was a position stated by IRS staff at meetings with representatives of cooperatives involved in this type of value-added marketing activity who had hoped to receive a letter of exemption under § 521.

section 521 and regular cooperative tax rules, marketing products of members and other producers includes feeding products of members and other producer to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.²⁸⁴

SMALL ETHANOL PRODUCER CREDIT, CO-OP PASS-THROUGH

Section 40 of the Code provides a 10-cents-per-gallon tax credit for each gallon of ethanol produced and sold by so-called small ethanol producers, including cooperatives.²⁸⁵ These are companies whose production capacity does not exceed 30 million gallons of ethanol per year.²⁸⁶ The credit can be claimed on production of up to 15 million gallons of ethanol per year.²⁸⁷

The American Jobs Creation Act of 2004 allows cooperatives to choose to pass some or all of the small ethanol producer credit through to their patrons. The credit is to be apportioned among patrons on the basis of the quantity or value of business done with or for such patrons during the tax year. Any credit not passed through to patrons is treated as a general business credit by the cooperative.²⁸⁸

²⁸⁴ American Jobs Creation Act of 2004, § 316, Pub. L. No. 108-357, 118 Stat. 1469 (codified at 26 U.S.C. § 1388(k)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 362.

²⁸⁵ I.R.C. § 40(b)(4)(A).

²⁸⁶ I.R.C. § 40(g)(1).

²⁸⁷ I.R.C. § 40(b)(4)(C).

²⁸⁸ American Jobs Creation Act of 2004, § 313, Pub. L. No. 108-357, 118 Stat. 1467 (codified at 26 U.S.C. § 40(g)(6)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 517-518.

SMALL LOW SULFUR DIESEL FUEL PRODUCER CREDIT, CO-OP PASS-THROUGH

The American Jobs Creation Act of 2004 created a new 5-cents-per-gallon tax credit to small petroleum refiners who must incur capital costs complying with the Environmental Protection Agency's rules limiting the sulfur content of diesel fuel.²⁸⁹ Eligible refiners may claim the credit until they have recovered 25 percent of such costs.²⁹⁰

For these purposes a small refiner is one that employs not more than 1,500 persons directly in refining and has less than 205,000 barrels per day (average) of total refining capacity.²⁹¹ The credit is reduced for refiners with a capacity between 155,000 and 205,000 barrels per day.²⁹² The conferee's report states that when capacity "differs substantially" from average daily output of refined product, capacity should be measured by reference to average daily output.²⁹³

Cooperatives may also choose to pass some or all of this credit through to their patrons. As with the small ethanol producer credit, any pass-through is to be apportioned among patrons on the basis of patronage and any credit not passed through to patrons is treated as a general business credit by the cooperative.²⁹⁴

²⁸⁹ American Jobs Creation Act of 2004, § 339, Pub. L. No. 108-357, 118 Stat. 1481 (codified at 26 U.S.C. § 45H). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 538-539.

²⁹⁰ I.R.C. § 45H(b)(1).

²⁹¹ I.R.C. § 45H(c)(1).

²⁹² I.R.C. § 45H(b)(2).

²⁹³ H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 313.

²⁹⁴ I.R.C. § 45H(g).