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THE FARM COOPERATIVE AND THE FEDERAL INCOME TAX

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INTRODUCTION

Farm cooperatives have possessed a favored position from the very dawn of federal income taxation. The Revenue Act of 1913 exempted from taxation all "labor, agricultural or horticultural organizations."[1] Later Revenue Acts continued this policy, with modifications, and the current statute exempts certain farm cooperatives from taxation.[2] However, even those cooperatives which do not qualify for total exemption are given substantial advantages not available to a normal corporation.

The State of North Dakota has issued 1690 charters for cooperatives as of November 30, 1967, of which 566 remain active.[3] There would seem to be little doubt that the wide-spread use of the cooperative as a marketing and purchasing organization has been encouraged by favorable tax treatment, although several other motives may well be more important.

Recently with the amendment of the anti-corporate farming act,[4] its referral and the resulting suspension of the amending portions, attention has been focused upon the cooperative as a means of accomplishing income and estate tax objectives similar to those enjoyed by a family corporate farm.[5] Later in this article the validity of this proposal will be examined.

The taxation of cooperatives is not itself a difficult subject, but since it has its own vernacular, many practitioners avoid it.

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1. Revenue Act of 1913, Chapter XVI, Sec. 2 G(a), 38 Stat. 172.
2. Internal Revenue Code of 1954, Sec. 521.
3. Letter from Hon. Ben Meier, Secreatary of State, State of North Dakota, November 30, 1967.
4. N.D. CENT. CODE ch. 10-06 (1960).
5. The Forum (Fargo, North Dakota), February 17, 1967, at 3, col. 1, 2; February 26, 1967, § A, at 6, col. 1, 2.

For purposes of this introduction, the writer will hazard an oversimplification of the basic scheme of cooperative taxation.

Cooperatives are either exempt or nonexempt. Exempt cooperatives are not exempt like church or state, but are entitled to broad deductions which may well make them totally exempt for all practical purposes. Nonexempt cooperatives' deductions, though greater than those accorded a normal business corporation, are not as broad as those of the exempt. In all other respects the cooperative will be taxed precisely like an ordinary business corporation. The deductions available only to exempt and nonexempt cooperatives may be summarized as follows:

1. The exempt cooperative can deduct from gross income dividends paid on capital stock, certain patronage dividends and per unit allocations and reasonable additions to reserves.

2. Nonexempt cooperatives can only deduct from gross income certain patronage dividends and per unit allocations.

We shall first turn our attention to the structure of the exempt cooperative, defining it, examining some of its disqualifying features, and inquiring into its tax advantages and disadvantages.

EXEMPT COOPERATIVES

To be exempt, the cooperative must be a "*farmers' cooperative.*" Other cooperatives formed for non-farm purposes are nonexempt regardless of their manner of operation.[6]

As a second requirement the exempt cooperative must be organized and operated on a cooperative basis to either market the products of members or other producers, or for the purpose of purchasing supplies and equipment for the use of members or other persons.[7]

As seen above, the exempt cooperative can sell or purchase products for nonmembers. However, such nonmember transactions are seriously limited. In the case of marketing cooperatives business done with nonmembers must not exceed the business done with members; i. e. membership business must be 50 per cent of total business. For purchasing cooperatives, the value of the purchases made for nonmembers must not exceed 15 per cent of total purchases.[8] In computing both these ratios, business done with the United States is wholly ignored[9].

The administrative definition of "farmers' cooperative" does not

6. Sec. 521(a) IRC 1954.
7. 521 (b) (1) IRC, 1954.
8. 521 (b) (4) IRC, 1954.
9. 521 (b) (5) IRC, 1954.

seem to have been unduly limited. In addition to farmers, fruit growers are mentioned in the statute;[10] the regulations add livestock growers, dairymen and dairy companies;[11] while others are included by case law. In *Long Poultry Farms, Inc. v. Commissioner*[12] poultry growers were found to be farmers, and in other decisions and rulings producers of fruits, vegetables, nuts, eggs, and tobacco have qualified.[13]

Once an organization qualifies as a farmers' organization, can it acquire other related activities and maintain its exemption, or, to put it another way, how much nonfarm business can it perform? Recently the Revenue Service supplied guidelines to its agents indicating that sales of 5 per cent or less of "sideline items" would not jeopardize the exemption, but sums greater than 5 per cent would be scrutinized. If, however, excess sales of "sideline items" were only a necessary supplement to marketing, the essential farmer-related character of the cooperative would seem to be undisturbed.[14]

Whether an item is a sideline or a supplement to agricultural pursuits may be hard to define, and has seldom been presented in litigation. However, in one ruling it was held that a fruitgrowers' cooperative that acquired large tracts of timber and lumbermills for the purpose of fabricating crates to be sold to members was still functioning as a fruitgrowers' cooperative inasmuch as crates were necessary to pack the fruit and the cooperative was furnishing supplies.[15]

Central to the exemption is that the organization operate as a cooperative. This means more than obtaining a charter under a state cooperative statute,[16] for the courts have consistently held that an organization (although organized in the form of a business corporation) that actually operates as a cooperative, will be so treated for federal tax purposes.[17]

The Court of Appeals for the Fifth Circuit put it this way:

> It is immaterial whether the cooperative is organized under a special cooperative — or under general corporation law, the test is the existence of a legally enforceable obligation to pay patronage refunds which existed during the period when such refunds were earned.[18]

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10. 521 (b) (1) IRC, 1954.
11. Treas. Reg. § 1.521-1 (a) (1) (1967).
12. 249 F.2d 726 (4th Cir. 1957).
13. Eugene Fruit Growers Association v. Commissioner, 37 BTA 993; Rev. Rul. 57-358, 1957—CUM. BULL., p. 42.
14. Rev. Rul. 67-37, 1967 INT. REV. BULL. No. 1, at 271.
15. S.M. 2288, III-2 CUM. BULL. 233 (1924).
16. North Dakota's Cooperative law is to be found in N.D. CENT. CODE ch. 10-15.
17. Farmers' Union Coop Co. v. Commissioner, 90 F.2d 488 (8th Cir. 1937).
18. Smith & Wiggins Gin, Inc. v. Commissioner, 341 F.2d 341, 350 (5th Cir. 1965).

Moreover, the principal cuts both ways; an organization that does not seek to be taxed as a cooperative will nevertheless be taxed as such if it operates in that form. Operating as a cooperative simply means that the organization must seek to distribute its earnings or profits to its members and/or patrons in accordance with the amount of business done with the cooperative.[19] All cooperatives, both exempt and nonexempt, operate somewhat on this basis, but the means and methods of allocation are legion.

For the exempt cooperative it is absolutely essential that all the customers of the cooperative, whether members, stockholder, or simply patrons be treated on a fair and equal basis with respect to profits. The Treasury Regulations succinctly state: ". . . in other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned."[20]

The requirement that patronage dividends be paid to all producers on the same basis is compiled with if the cooperative pays patronage dividends to all nonmember producers in cash, property, certain forms of script, or if fit keeps records from which the nonmember's share can be determined, and his share is applied toward the purchase price of a share of stock or a membership in the association.[21]

From an examination of the reported cases it appears that one of the most prevalent reasons an exempt cooperative has lost is exemption is that it has failed to allocate its earning to nonmembers. A typical case was *Farmers' Union Coop. Co. v. Commissioner*.[22] In that case the farmers' cooperative was organized under the cooperative statutes of Nebraska, and ran a grain elevator, a feed and general merchandise store; it bought, sold, shipped grain and other farm products, sold machinery supplies and repairs. Portions of its earning were used to pay dividends on capital stock and no patronage refunds were made to any nonmembers. The Eighth Circuit denied the exemption since the cooperative's by-laws prohibited patronage dividends to nonmembers, requiring profits to be prorated to stockholders in proportion to the amount of the stockholder's business.

This above-discussed rule has but two exceptions. When a cooperative buys or sells because of emergencies, it need not allocate earnings to nonmember customers. Thus, creameries forced to acquire goods from nonmembers when their own supplies failed were not required to distribute patronage on that business.[23] Again, busi-

19. *Id.*
20. Treas. Reg., Sec. 1.521-1(a) (1967).
21. Treas. Reg., Sec. 1.521-1(a)(1) (1967).
22. Note 17, *infra.*
23. IT 1598, II-1 CUM. BULL. 159 (1923).

ness done with the United States requires no patronage payments.[24]

Not all profits need be paid as patronage, however. Cooperatives having capital stock can pay dividends to shareholders, and deduct these payments from gross income.[25] But this offers no wholesale opportunity for the avoidance of the corporate tax, as the deduction is limited specifically by statute. Annual dividends on capital stock cannot exceed the sum of 8 per cent, or in the alternative the maximum legal rate of interest in the state of incorporation, whichever is greater.[26] Moreover, substantially all the stock (except nonvoting preferred stock wherein the owners do not share in the profits of the association upon dissolution or otherwise) must be owned by producers who market their products or purchase their supplies and equipment through the association.[27]

What is "substantially all" of such producers? It has been held that a cooperative retained its exempt status where 91 per cent of its stock was owned by producers,[28] but in an old ruling, the Revenue Service held that where 12 per cent of the shares were held by nonproducers, 9 per cent having been sold voluntarily to nonproducers, the organization did not meet the "substantially all" test.[29] Voluntariness in distribution of stock seems to be an important consideration. A cooperative that mailed corporate stock to various customers without determining whether they qualify as producers, many of whom did not, was held not exempt.[30]

The 8 per cent (or legal rate of interest) seems to be applied against original issuance price, or par value, and this base apparently may not be increased by capitalization of earnings. In a recent district court decision a cooperative's exemption was denied where it paid 8 per cent on a greatly expanded capital structure; the court held that the rate applied to the $100 par value when orignally issued in 1921.[31]

Despite the requirement that all earnings must be paid to patrons the exempt cooperative may maintain a reserve required by law or a reasonable reserve for any necessary purpose.[32] Thus a cooperative can accumulate substantial sums for the purpose of acquiring buildings, equipment, debt retirement, working capital, or for reserves to be employed in the exercise of sound business judgement. Very large reserves have been approved by the courts and

24. Sec. 521(b)(5), IRC 1954.
25. Sec. 521(b)(2), IRC 1954.
26. *Id.*
27. *Id.*
28. Farmers' Coop. Creamery v. Commissioner, 21 BTA 265 (1930).
29. Mim. 3886 X-2 CUM. BULL. 164 (1931).
30. Rev. Rul. 67-204, 1967 INT. REV. BULL. No. 1, at 149.
31. Laura Farmers' Coop. Elev. Co. v. U. S., 20 Am. Fed. Tax R.2d 5693.
32. IRC 1954, Sec. 521(b)(3).

there appears to be little administrative action in recent years testing "reasonableness."[33] However, it is necessary that reserves be allocated to the accounts of patrons by means of qualified written notices of allocation. Enjoyment of the allocation by the patron will be postponed until the reserve is no longer deemed necessary, or if the by-laws so provide, paid at death or retirement or other event which triggers distribution.

The exempt cooperative which meets all of the foregoing tests obtains its exemptions by filing Form 1028 with the District Director for the district where the cooperative has its principal offfce. The regulations make the filing of the application mandatory.[34]

An imaginary tax computation for an exempt cooperative might be as follows:[35]

Gross sales	$1,000,000	
Less:		
Cost of goods sold	750,000	
Gross profit on sales	250,000	
Operating expenses	210,000	
Net profit from operation		$40,000
Distributions from net income:		
Patronage dividends and retained allocations	20,000	
Additions to reserves	10,000	
Dividends to stockholders	10,000	
Total		$40,000
Income subject to tax		0

Prior to calendar 1963, distributions of patronage dividends and per unit retained certificates[36] given in script were deductible, although they were not reportable as income by the recipient. Since

33. Howey v. Commissioner, 1954 P-H Tax Ct. Mem. 54, 125 ($1,507,879); Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957) ($2,098,000).

34. Treas. Reg., Sec. 1.521-1(3) (1967).

35. An exempt cooperative files on form 990-C.

36. A patronage dividend is defined as an amount paid out to the patron according to the net earnings of the cooperative rather than on the basis of units of products marketed for the patron. A per-unit retain certificate is any written notice which discloses to the recipient the stated dollar amount of a portion of the proceeds retained by the cooperative from the marketing of products for the patron. Each are considered as a deferred adjustment on the price to the patron. In 1966, Subchapter T (Cooperatives and Their Patrons) was amended (P.L. 89-809, Nov. 13, 1966) to essentially treat these two forms of distribution alike. For simplicity further references to Patronage Dividends will include per unit retain certificates.

1963 a cooperative has been given choices in determining the form of distribution, but if payment in forms other than cash or property is desired, certain formalities are necessary, which are discussed in detail later. However, it is now possible for the cooperative to pay 20 per cent of its total patronage dividend in cash and issue script in the form of notices of allocation for the balance.[37] Thus the cooperative can retain 80 per cent of the patronage without incurring tax liability.

Problems will arise concerning the allocation of earnings among patrons. In a one-product cooperative, it should be simple to compute the patronage refund by comparing the patron's business with total business, but in more sophisticated cooperatives where a variety of products are both bought and sold, the earnings of the cooperative are determined on quantity, quality, sales price, variable markets and similar such imponderables; allocation will prove complex, but must be reasonable. Moreover, some of the earnings of the cooperative may be capital gains involving an appreciation of property over a substantial period of time. To allocate the earnings from an appreciation in value to the patrons of a given year would be to discriminate against patrons in prior years, so the Regulations require that the gain be allocated to those who were patrons during the taxable year the asset was owned, again on a proportionate basis.[38] This computation can be very difficult and highlights the necessity for maintaining and storing records.

Another allocation problem has arisen with respect to the allocation of patronage received on grain stored as security for Commodity Credit Corporation loans. Farmers storing grains as security for such a loan have the option of repaying the loan and recovering the grain or defaulting and permitting title to pass to the Commodity Credit Corporation. Where the cooperative acts as a warehouseman, storage charges for the time until default and transfer of title to the Commodity Credit Corporation are patronage between the cooperative and farmer, but after default, storage charges are income realized from a governmental agency, and must be allocated to all patrons on the basis of their total patronage. Such nonpatronage income is, of course, tax exempt to the exempt cooperative, a further advantage over the nonexempt cooperative, to which we shall now turn.[39]

NONEXEMPT COOPERATIVES

When one of the requirements for an exempt cooperative is lacking, the cooperative will be treated either as a normal cor-

37. Sec. 1388(c)(1), IRC 1954.
38. Treas. Reg., Sec. 1.1382-3(c)(3) (1967).
39. Sec. 521(b)(5), IRC 1954.

poration or as a nonexempt cooperative. Either way the organization will file a normal corporate income tax return, but if the firm is "nonexempt," it is entitled to certain advantages which are almost as attractive as those of the exempt cooperative, and in some cases, perhaps, more attractive.

The writer has previously discussed the tax differences between the exempt and nonexempt cooperative; basically, the exempt cooperative has additional deductions for dividends, additions to reserves, and certain tax-exempt nonpatronage income. However, the nonexempt cooperative need not pay patronage to nonmembers, and while such earnings may be taxable, they may be applied to the benefit of members and stockholders. The nonexempt cooperative's deduction for patronage dividends and per-unit retain certificates will be computed in the same manner as the exempt cooperative.[40]

Consideration will now be given the deduction for patronage refunds and retain certificates as it applies both to exempt and nonexempt cooperatives. The statute defines both types of payments, and their meanings seem clear today.

A patronage dividend is defined as:

> An amount paid to a patron by a cooperative:
>
> 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 (the cooperative received the amount so paid, and
>
> 3. Which is determined by reference to net earnings of the organization from business done with or for its patrons.[41]

A per unit retain allocation has been defined as,

> Any allocation by an organization (a cooperative) other than by payment in money or other property . . . to a patron with products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.[42]

Essentially the Code now treats patronage dividends and retain allocations alike for years beginning after April 30, 1966.[43] These payments, which are viewed as an adjustment in price, the determination of which is deferred until accounting is complete, are de-

40. Sec. 1382(b), IRC 1954.
41. Sec. 1388(a), IRC 1954.
42. Sec. 1388(f), IRC 1954.
43. Act of Nov. 13, 1966, Pub. L. No. P9-809, 80 Stat. 1539.

ductible if the exacting requirements of law are met.[44]

Where the cooperative has no definite obligation to pay patronage, such payments closely resemble a dividend and are so treated by the courts.[45] Clearly a by-law provision which requires that patronage be paid would qualify, but lesser commands have been extensively litigated. The Regulations provide that the "obligation" be written,[46] but the cases are checkered. In one case allowing a deduction for patronage based upon an oral obligation the Commission has acquiesced.[47]

When the cooperative's by-laws create a pre-existing obligation to distribute patronage, but the directors have discretion to set aside reserves, the courts have often held that the patronage payments are not deductible, at least to the extent of director's discretion.[48] In one case it was found that the director's discretion to establish reserves had lapsed into disuse, and the deduction was saved.[49] However, informal understandings with patrons, even though relied upon in practice, so not create the required legal obligation.[50]

Obviously the greater the income which can be allocated to patronage dividends the lesser will be the federal tax. However, earnings on business with nonmembers, even though paid to members in the form of patronage refunds, will not qualify for the deduction.[51] Since nonmember business will be taxable in any event, and dividends are not deductible by the nonexempt cooperative, the cooperative that pays dividends solely with nonmember business profits frees its other income for patronage refunds. The Revenue Service has, in the past, required that each patron's patronage refund bear a proportionate portion of the nonmember profit,[52] but this position was rejected by the Fifth Circuit which held that a cooperative taxpayer, whose by-laws provided that stock dividends were to be paid from nonpatronage income could double up on its deduction in this manner.[53] The advantages of this method are shown in the following imaginary and simplified illustration, where stock dividends of $30,000 are to be paid:

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44. Sec. 1382(b)(2), IRC 1954.

45. United Cooperatives v. Commissioner, 4 T.C. 93 (1944).

46. Treas. Reg., Sec. 1-1388-1(a)(1) (1967).

47. Southwest Hardwood Company v. Commissioner, 24 T.C. 75 (1955) acq. 1955-2 CUM. BULL. 9.

48. Farmers' Union Cooperative Exchange v. Commissioner, 1944 P-H Tax Ct. Mem. 44, 384.

49. Farmers' Elevator Company of East Grand Forks, Minn. v. Commissioner, 1962 P-H Tax Ct. Mem. 62, 204.

50. American Bar Shook Export Association, Inc. v. Commissioner, 156 F.2d 629 (9th Cir. 1946).

51. Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90 (9th Cir. 1932).

52. A.R.R. 6967, III-1 CUM. BULL. 287 (1924).

53. United States v. Mississippi Chem. Corp., 326 F.2d 569 (5th Cir. 1964).

Government position

Income from operations—patronage sources	$100,000	
Income from operations—nonpatronage sources	50,000	
Total		$150,000
Deductions for patronage dividends (100/150 x $120,000 to be paid):		80,000
Taxable income		$ 70,000

Taxpayer's position (all dividends paid with nonpatronage income)

Income from operations—patronage sources	$100,000	
Income from operations—nonpatronage sources	50,000	
Total		$150,000
Deductions for patronage dividends		100,000
Taxable income		$ 50,000

Perhaps nothing has caused more consternation in the field of cooperative taxation than the payment of patronage dividends by script, certificates, letters of advice, or other noncash form.[54] After many abortive attempts the Commissioner has finally obtained a measure of control over such distributions. Since 1963, the current patronage dividends and per-unit retain allocations, must, to be deductible in the current year, be paid in one of the following ways:[55]

1. In money
2. In other property (except nonqualified written notices of allocation)
3. Qualified written notices of allocation.

Obviously if the patronage refund is paid in money or property, no problem will arise. "Property" as used in the Code, seems to include intangibles except nonqualified notices of allocation, and would certainly include inventory items.

It is with respect to qualified and nonqualified notices of allocation that the going becomes sticky.

54. *See* James K. Logan, *Federal Income Taxation of Farmers' and Other Cooperatives, Part III*, 44 TEXAS L. REV. 1269, 1295.
55. Sec. 1382(b); Sec. 1388(c) and 1388(h), IRC 1954.

A qualified written notice of allocation is defined by the Code.[56] Simply put, it is a written notice which can be redeemed in cash at its stated dollar amount at any time after the date of issue and ending not earlier than 90 days from such date. To be qualified it must be 80 per cent or less than the amount of the patronage dividend, hence, 20 per cent must be paid in money or by qualified check.[57] The patron must consent to the acceptance of such a written notice of allocation and his consent can be in but one of three forms, as follows:[58]

1. By consent in writing.
2. By obtaining or retaining membership in the organization after it has adopted a by-law providing that membership in the organization constitutes consent, and only after the patron has received a written notification and a copy of the by-laws.

Once consent is given, it is effective for the taxable year in which made and all subsequent taxable years of the organization. A group consent to by-law provisions is effective for each individual patron as soon as he has received notification and a copy of the by-law.[59] Consents are revocable by the patron at any time,[60] but it is necessary to terminate membership to revoke a consent in a cooperative with a consent by-law. This consent is important tax-wise to the patron for he further consents to include 100 per cent of the patronage dividends in his income in the year received.[61]

Any notice of allocation meeting the requirements described above would be a nonqualified written notice of allocation. The cooperative is not entitled to patronage refund deduction when paid as nonqualified written notice of allocation, but still can deduct the amount when actually paid or redeemed by the cooperative in money or by the payment of money or other property (except written notices of allocation).[62] Thus, a nonqualified written notice of allocation issued in 1965 would not be deductible in that year but would be deductible in 1967, if redeemed at that time.

Additionally the Code permits the cooperative to take the deduction in the year it would provide the greatest benefit.[63] Using the above example again, the cooperative would compute the effect of redemption on its tax liability for both 1965 and 1967. If the deduction would provide the least tax if made in 1965, such will be the choice; if

56. Sec. 1388(c)(1), IRC 1954.
57. *Id.*
58. Sec. 1388(c)(2), IRC 1954.
59. Sec. 1388(c)(3), IRC 1954.
60. Sec. 1388(c)(3)(B), IRC 1954.
61. Sec. 1385(a)(1), IRC 1954.
62. Sec. 1382(b)(2), IRC 1954.
63. Sec. 1383, IRC 1954.

1967 treatment produces more after-tax dollars, the deduction will be claimed against that year's income.

A patronage dividend will not usually be paid until the prior year's accounting is completed which normally will require several month's time. Accordingly, the Code permits both exempt and nonexempt cooperatives until the 15th day of the ninth month following the cooperative's tax year to file its income tax return and claim the deduction if a proper form of payment is issued by that date.[64]

LIABILITY OF PATRONS

One of the major purposes of the 1962 Act[65] was the coordination of the tax liability between the cooperative and the patron. As noted before, when a cooperative is entitled to a deduction for patronage refund, it necessarily follows that the patron will be taxed upon the full amount of such refund (with the exceptions noted below); the cooperative is not entitled to a deduction when it issues a nonqualified notice of allocation, and it will not be distributing income to its patrons who can ignore the nonqualified notice until redeemed, at which time a deduction will accrue to the cooperative and income to the patron.[66]

However, not all patronage dividends deductible by the cooperative are income to the patron. Since patronage refund is equivalent, in theory, to a rebate in the price, deferred in time until computed, the patron's liability depends on the nature of the original transaction. Where a farmer buys seed for $1,000, he will deduct that sum in the year paid (if on the cash basis) and report a $50 patronage refund received the next year as income; the net effect, albeit disturbed by different tax years, is to net the purchase out at $950.00. However, where the patron expends funds for personal, living or family items he will not be entitled to a deduction; accordingly when he receives a rebate he is not required to include it in income.[67] Similarly where the patron acquires a capital asset or business property subject to depreciation, a patronage refund received thereby is not treated as income but rather serves to lower the basis of the asset. For example, a farmer who acquires farm machinery from a cooperative at a cost of $1,000, and later receives a patronage rebate of $50 will adjust his basis as of the first day of the year the patronage refund is received; his new basis for depreciation is $950.[68]

A business patron who received a qualified written notice of al-

64. Sec. 1382(b), 1382(d), IRC 1954.
65. Revenue Act of 1962, § 17, 76 Stat. 4.
66. Sec. 1385(a), IRC 1954.
67. Sec. 1385(b), IRC 1954.
68. Sec. 1385(b), IRC 1954.

location pays tax on the entire patronage refund despite the fact that he may receive only 20 per cent in cash or property. By including such item in income he acquires a basis for determining gain or loss, and if he later receives a distribution in redemption of the qualified written notice of allocation greater than face value, the excess, beyond reasonable interest should be taxed as capital gain. A sum received less than face value will result in a capital loss.[69] A nonqualified written notice of allocation is not includible in income, has no basis, and gain from its sale is specifically treated as ordinary income.[70]

Similarly nonqualified written notices of allocation will be treated as income in respect of a decedent, reportable by the estate or beneficiary as ordinary income when received, with a credit for any taxes paid by reason of their inclusion in the estate of the decedent.[71] Determining fair market value for estate tax purposes is another matter and the pre-1963 law holding similar certificates or script to have no fair market value may be reborn.[72]

COOPERATIVES AND THE NORTH DAKOTA ANTICORPORATE FARMING ACT

Can the cooperative serve to accomplish the result of avoiding North Dakota's corporate farming act and achieve desired income and estate planning objectives associated only with the corporations? North Dakota law currently contains an express prohibition against corporate farming.[73] However, cooperative farming is permitted under certain limited conditions as follows:[74]

> Cooperative corporations exempted, when.—Nothing in this chapter shall be construed to prohibit co-operative corporations, seventy-five per cent of whose members or stockholders are actual farmers residing on farms or depending principally on farming for their livelihood, from acquiring real estate and engaging in co-operative farming or agriculture.

Opponents of corporate farming have contended that whatever income or estate tax advantages could be gained from the corporation were similarly available through the cooperative associations. Inasmuch as cooperative farm ownership is rare or even unknown

69. Rev. Rul. 55-66, 1955-1 CUM. BULL. 282.
70. Sec. 1385(c)(2)(c), IRC 1954.
71. Treas. Reg., Sec. 1.1385-1(b)(4) (1967).
72. *C.f.* Caswell's Estate v. Commissioner, 211 F.2d 693 (9th Cir. 1954); Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955).
73. N.D. CENT. CODE § 10-06-01 (1960); this statute was repealed by Chapter 97, Sec. 2, 1967 N.D. Session Laws, but the repeal, together with other portions of Chap. 10-06, repealed or added, has been referred to the electorate. By virtue of Sec. 25, North Dakota Constitution, the referral suspends legislative action.
74. N.D. CENT. CODE § 10-06-04 (1960).

and no commentator seems to have discussed the problem, one should proceed in a cautious fashion and examine the matter closely, for there appear to be serious deficiencies in the proposal.

First, one is troubled by the definition of "cooperative." As previously stated a cooperative is simply an entity which serves its patrons without profit, distributing its earnings on a patronage basis. An exempt cooperative must perform either marketing or purchasing functions; a cooperative, in North Dakota, is simply one formed under the provisions of *North Dakota Century Code*, Chapter 10-06. If a cooperative were to own or operate a family farm, title to the land would be transferred to the cooperative and it would presumably carry on farming operations in its own name. It would own the machinery, buy the seed, fertilizer, and supplies, plant the crop, employ such laborers, including members of the family, maintain bank accounts, take out farm and real estate loans and in general perform those acts which would have been performed by members of the family. One may well ask "where is the opportunity for patronage to be paid to the family?" They will not buy or sell to the cooperative but rather, simply work for it as employees and derive profits therefrom as stockholders. Absent patronage dividends, the nonexempt family cooperative would be taxed like any other corporation, and could, presumably, elect to become a so-called corporation.[75] But if it is a corporation for tax purposes, is it still a cooperative exempt from the Anti-Corporate Farming Act? The definition in Section 10-15-01, *North Dakota Century Code*, applies only to that Chapter, and when the stakes involve forced sale of all lands, one must tread cautiously.[76]

Certain other disadvantages to the cooperative are also present. First of all Section 10-15-16, *North Dakota Century Code* provides that each member of a cooperative association, regardless of his stock holdings, shall be entitled to only one vote. The estate planner can well imagine the difficulty in convincing the family patriarch to form a cooperative, and delegate voting control on a per head basis. This cannot be avoided by proxies, for the same section forbids them.

Moreover, Section 10-06-04, *North Dakota Century Code* requires that 75 per cent of the members or stockholders be "actual farmers

75. Sec. 1371, IRC 1954.

76. N.D. CENT. CODE § 10-06-06 provides: "Land of noncomplying corporations sold by county—Proceeds paid to corporation.—In case any corporation, either domestic or foreign, violates any provision of this chapter or fails, within the time fixed by this chapter, to dispose of any real estate to which it has acquired title and which is not reasonably necessary for the conduct of its business, then title to such real estate shall escheat to the county in which such real estate is situated upon an action instituted by the state's attorney of such county, and such county shall dispose of the land within one year at public auction to the highest bidder, and the proceeds of such sale, after all expenses of such proceedings shall have been paid, shall be paid to the corporation which formerly owned the land."

residing on farms or depending principally on farming for their livelihood." One of the objectives of corporate farming is to ease the transfer of the family farms from one generation to the next by maintaining it as a unit, dividing ownership between children by stock certificates rather than the clumsier undivided fee interests. Stockholding permits equitable treatment, although invariably some of the children move off the farm, and herein lies a trap for the unwary, the essential three-fourth's farmer membership or residence can easily slip away. For example, a farm cooperative composed of a father, mother and three children will lose protection from the Anti-Corporate Farming Law when any two no longer depend upon farming principally for their livelihood. For these persons the cooperative appears to be a most speculative vehicle for farm ownership and management.

CONCLUSION

The farm cooperative enjoys definite tax advantages in the functions of purchasing goods and supplies or selling production for its members. Skillful use of available deductions will result in zero tax liability for exempt cooperatives; both exempt and non-exempt cooperatives possess the opportunity to finance growth from earnings represented by script paid as patronage to a great extent, and non-exempts can benefit members by earnings from non-member business. In this regard the cooperative is unique, but its very form, together with federal income requirements, make it an inflexible type or organization that will not serve the needs of the North Dakota farmer seeking the benefits of corporation farming.