A Study of the Tax Treatment of Cooperative Organizations and their Patrons

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A STUDY OF THE TAX TREATMENT OF COOPERATIVE ORGANIZATIONS AND THEIR PATRONS

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CHAPTER I

INTRODUCTION

Purpose and Objectives of the Study

Today cooperatively-owned enterprises in which people have pooled their needs for a specific service or type of goods can be found all across this country. Such organizations have been expanding in their scope of usefulness. The modern cooperative might be found running a consumer-owned supermarket or urban shopping center as well as functioning in the more traditional area of agriculture. Certainly the cooperatively-owned enterprise is an entrenched form of business in our economy.

The purpose of this independent study is to impart an understanding of the Internal Revenue Code, specifically Sections 521 and 1381 through 1388, as it applies to the cooperative organization. These sections of the Internal Revenue Code apply to any cooperative corporation except the following cooperatives:[1]

1. Organizations which furnish electrical energy or provide telephone service to people in rural areas.

2. Organizations which are taxed as mutual savings banks.

3. Organizations which are taxed as insurance companies.

4. Organizations which have been specifically exempted.

Although these corporations may be cooperative in nature, they are dealt with in other sections of the tax law and consequently are outside the scope of this study. A partial list of exceptions would include rural electrification cooperatives, credit unions, cooperative insurance companies, farm credit associations, building and loan associations, and cooperative hospital service organizations.

In line with the above purpose, the study will set forth:

1. The nature of the cooperative organizational structure.

2. The reasons for the development of the cooperative enterprise.

3. The general attitude of the Federal Government toward its tax status.

4. The unique tax treatment applicable to the cooperative enterprise.

5. The taxation perspective of the cooperative patron.

The Nature of the Cooperative Enterprise

It was said above that a cooperative is a form of business. As such it assumes the risks and uncertainties of any other business form. Yet fundamentally, it differs from other forms of business in that it is owned and controlled by patrons whose chief intention is to obtain the goods and services from the organization for themselves on the most advantageous basis possible. This is not to say that the cooperative transacts business with its members only. But nonmember business must not be in such excessive amounts as to violate restrictions applying thereto or ramifications concerning tax status will result. The restrictions on nonmember business and the consequences of violation are more appropriately discussed below. At this point, it is emphasized that the owners invest in the organization primarily for the purpose of availing themselves of the lowest economically practicable net cost of the desired goods and services, and only secondarily, if at all, for economic gain from dividends on invested capital.[2] The term 'lowest practicable net cost' is replete in the literature expounding on the cooperative nature. The only way the purpose is achieved is for the customers or users of the services to be also the owners. It is in this way that the pooled needs of the patrons are fulfilled.

In the term 'cooperative organization' the word 'organization' generally refers to a corporation. This is the dominant type of cooperative structure, although there seems to be nothing in any state statute requiring incorporation for cooperatives. The Internal Revenue Code has no such requirement either. But from the members' point of view, a corporate charter from the Secretary of State is highly desirable to preclude any possible contentions that the cooperative is a partnership for tax purposes. However, a charter of incorporation is not the controlling factor for determining the tax existence of a corporation. Thus, unincorporated cooperatives may be treated as corporations for federal tax purposes if operations are truly on a cooperative basis. The corporate status is additionally desirable to limit members' legal liability. For the practical reasons of relieving the incorporators from spelling out organizational characteristics in bylaws and contracts with members, all states have statutes adapted to the incorporation of agricultural cooperatives.[3] For the most part, separate incorporation laws have not been enacted by the states for incorporating non-agricultural cooperatives primarily because the diversity of cooperative business purposes makes it impractical.[4] Instead, use of the general corporation acts has been made.

The enabling state statutes authorizing the formation and operation of cooperatives are designed to facilitate the non-profit or limited-profit operation with control vested in member-users, and the distribution of residual income to patrons in proportion to patronage, all of which are implied in the cooperative form of business. In order to accomplish these ends, the statutes generally embody the following principles of cooperative organization:

1. Membership is open to people regardless of class, creed or color.

2. Earnings on stock are limited to not more than the usury rate of interest which in most states is not in excess of 8 percent. (Section 521 of the Internal Revenue Code has a similar stipulation regarding the relationship between cooperative tax status and earnings on capital stock.)

3. Voting control is restricted usually to one vote per member, regardless of the number of shares held, or made proportionate to patronage. The former voting method is the more common.

4. The excess of receipts over expenditures and reserve provisions is returned to the patrons in proportion to patronage.

5. In the case of dissolution, net assets are to be distributed to patrons in proportion to volume of patronage.[5]

Thus in its organizational structure, the cooperative closely resembles the corporate form of business. Cooperatives own property, enter into contracts and incur debt. Their charter is in perpetuity. Their members, like ordinary stockholders, have limited liability. Yet the relationship between the cooperative corporation and the patron-owner is somewhat analagous to that between a partnership and the partner-owner, in the sense of the one vote per member principle, since all partners in a partnership have equal rights in management regardless of the extent of contribution, that is in the absence of a contrary agreement. Insofar as the perspective of the Internal Revenue Code is concerned, there are vague considerations of both business forms present in the cooperatives' tax status. On the one hand, the Internal Revenue Code applies corporate tax rates to cooperatives. On the other hand, the legitimacy of the cooperative deductions for distributions of earnings requires the member-patrons to be taxed on those distributions, which resemble a sharing of profits (albeit from one's own patronage) more than a dividend. It would seem the most accurate to say that a new economic form of business has been evolved to meet the needs of various people in society. Therefore, at this point, let us consider those needs in the light of the development of the cooperative enterprise.

Reasons for the Development of the Cooperative Enterprise

The cooperative enterprise has developed mainly for the reasons of business efficiency and economic relief. The economic cooperative movement got its generally accepted start in Rochdale, England in 1844 among the oppressive circumstances of the Industrial Revolution. Essentially the movement was a reaction against the early abuses, or, at least, rigors of the capitalistic industrial system.

Caught in a situation of low wages and high prices for goods, twenty-eight weavers each saved one pound sterling and then all invested in a consumer-owned nonprofit store, to establish for themselves a measure of financial relief.[6] From this model, the Rochdalian principles were derived and are today embodied in state statutes adapted to incorporating agricultural organizations. These were enumerated above.

In the United States, cooperative organization matured in a different setting, that of agriculture, but for the same reasons--commercial efficiency and economic relief. After the Civil War, a significant transformation started from what might be called personal farming, which is reliance on one's own agricultural products for satisfaction of family needs, to commercial and capitalistic farming. By the turn of the century, the transformation was essentially complete. With the closing of the frontier, officially recognized by the Census in 1890, there was a shift toward more intensive farming, because to be successful in farming, one had to improve farming efficiency. It was no longer easy to pull up stakes and go West.[7] With land limited, the application of capital, in the form of expenditures for machinery and supplies, increased. As a result, farm output increased with the mechanization of farms and this increased supply exerted a downward pressure on farm prices in the period 1873 to 1896. Farmers depended upon distant markets for their raw products and drew finished products from the same distant markets. The farmer blamed much of his woes on this system of interchange whereby he was pinched in marketing his crops and also in purchasing his supplies.[8] Viewing himself in this plight, the farmer turned to economic cooperation for relief. In the cooperative organization, farmers found a way to integrate marketing and purchasing activities with their production activities without surrendering the autonomy of the family farm, an institution entrenched from colonial days in this society.[9] Also, cooperative financing institutions helped to alleviate the poor credit position which farmers found themselves in. The fact that farm prices began a quarter century upward climb in 1897 did not discourage cooperative organization in the least. On the contrary, the ever increasing capital requirements, the growth of urban markets, and the realization among farmers that they needed to develop counter forms of organization to neutralize large business combinations, all promoted continued cooperation. Indeed, these reasons for cooperative development are still the motivating factors behind agricultural cooperative existence today.

> The modern farmer finds himself involved in a productive process, which, if efficiency is to be secured, demands a variety and frequently a size of capital equipment in excess of the carrying capacity of the one-man farm and a labor specialization quite outside the scope of the individual farm personnel.[10]

After the turn of the century, not only did the agricultural cooperative amplify its scope of services to include such activities as breeding and seed improvement, to name a few, but the idea of cooperative enterprise caught on in non-agricultural businesses. Thus, for example, the first retail merchandising associations were formed to pool merchandising experience and meet competition from mail-order firms and chain stores. Other examples would include the reorganization of the Associated Press in 1900 to provide an efficient, comprehensive news gathering service and the development of commercial bank clearing house associations to facilitate the settlement of inter-bank claims, prior to the establishment of the Federal Reserve System in 1913.[11] Again the recurrent reason underlying the development of these cooperative enterprises was business efficiency.

General Attitude of the Federal Government

Up to this point, nothing has been said about the attitude of the Federal Government toward the cooperative movement. It might be helpful to survey, in a general way, that attitude before beginning the discussion of how cooperatives are taxed. Of course, the taxation structure applicable to the cooperative organization will reflect Congressional and Treasury Department attitudes.

Liberal may be the most suitable adjective for describing the Federal Government's tax attitude toward cooperative enterprise. It is easier to describe the variety of federal aids reflecting that attitude than to endeavor to expose the rationale behind the aids. Certainly the cooperative attributes of independence, self-help, and business efficiency, besides being the reasons for cooperative development, are highly acceptable qualities in this society and were recognized and fostered by the Federal Government insofar as they are manifested in the cooperative organization. But probably the primary reason for the express favoritism shown to cooperative enterprise stems from fear of centralized commercial and financial power and the anathema which monopoly represents in this economy.[12]

Today one of the dominant cooperative privileges is the exemption, by way of legislative grace, from most of the burden of the corporation income tax. The mechanics of this privilege will be set forth in Chapter 2. Suffice it to say here that cooperatives may deduct from their income qualifying distributions of cooperative earnings to members or patrons. Clearly, taxable income can be reduced substantially or eliminated completely by such a privilege.

In the past the exemption from paying income tax has been a 'complete' exemption for certain cooperative organizations. The first federal statute to give tax exemption to farmer cooperatives was the War Revenue Act of 1898, which, in levying a stamp tax, excluded the "farmers' purely local cooperative company or association."[13] The Revenue Act of 1913, the first income tax law enacted after the adoption of the 16th Amendment (which conferred the authority that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."), in Section G (a), exempted certain types of nonprofit concerns in providing that, "nothing in this section shall apply to labor, agricultural, or horticultural organizations."[14] Despite the absence of a specific reference to "cooperatives" in the 1913 Act, the precedent for lenient tax treatment was started. The Income Tax Statute of 1916 was more specific in its reference to "Farmers', fruit growers', or like associations, organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them."[15] The Revenue Act of 1918 repeated this provision.[16] The Revenue Act of 1921 broadened the provisions to include farmer cooperatives acting as purchasing agents for members.[17] The Revenue Act of 1924 continued the combined provisions.[18] The 1926 Revenue Act elaborated significantly on the provisions for total tax exemption by reference that

> exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the state of incorporation or 8 percent per annum, whichever is greater . . . and if substantially all such stock . . . is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve . . . for any necessary purpose.[19]

This same Act allowed dealings with nonmembers of the cooperative and retention of a tax exempt status provided the value of nonmember purchases did not exceed 15 percent of the value of all purchases. These same provisions appear in the Revenue Acts of 1928 and 1932. Except for the addition in the Revenue Act of 1934 of provisions permitting business done with the United States to be disregarded in determining the right to exemption, no change in the language of the 1926 Revenue Act was put into the Revenue Acts of 1936 and 1938. Section 101 of the Internal Revenue Act of 1939 set forth these summarized requirements for tax exempt status:[20]

1. The association was to be for either marketing or purchasing.

2. It was to be operated by farmers on a cooperative basis.

3. Dividends on its capital stock were not to exceed either 8%, or the legal rate of interest of the state where incorporated, whichever was higher.

4. Business done with nonmembers was not to exceed that done with members, and purchases by nonmembers who were not farmers could not exceed 15% of the total volume, business done with the United States Government being disregarded.

5. Only farmer patrons of the cooperative might own its voting stock, although anyone could own nonvoting, nonparticipating preferred stock.

6. Nonmembers and members were to be treated alike with respect to allocated reserves and patronage dividends.

7. Reserves were limited to the amount required by state law or any amount reasonably required for any necessary purpose, such as buildings, machinery and the like.

The enactment of Section 314 of the Revenue Act of 1951 was a step in the opposite direction to the prior liberal tax treatments. That Section repealed none of the existing law, but it added a special tax treatment for all cooperatives qualifying under existing law for exemption. For taxable years beginning after December 31, 1951, compliance with the exemption requirements no longer conferred fully tax exempt status but it did authorize a complying organization to make certain additional deductions in computing its taxable income. Thus, even before the Revenue Act of 1951, there had developed two categories of cooperatives for tax purposes: those that were the so-called "exempt" coops because they complied with statutory requirements and those termed "nonexempt" for the contrary reason. Now after the 1951 law, there were still the two categories but the "exempt" status was a technical status, not automatically providing a zero tax liability. Passage of the Revenue Act of 1951 was a marked change in Treasury Department and Congressional attitude. In effect, the Act was a clarification that Congress may constitutionally tax cooperatives under the Sixteenth Amendment. In other words, the net margins of cooperatives are income to them within the meaning of that amendment. Net margin, sometimes called residual income, is defined as the excess of cooperative receipts in a fiscal year over cost of labor, management, materials, depreciation, and borrowing. Prior to this change in perspective, the prevailing attitude of the Treasury Department tended to consider patronage dividends as adjustments in the prices of products the cooperative sold to or bought from members, since the cooperative tries to transact its business at cost. The patronage dividends were thus in the nature of price rebates and would not be considered income within the meaning of the Sixteenth Amendment. Or alternatively, it was advanced that the marketing cooperative was merely the agent of its patrons, and when there was an excess after the cooperative, as bailee for the patrons, had paid expenses, that excess was returned to the patrons. It supposedly acted as trustee when it took legal title to products in order to facilitate sales. Of course, these theories were based on the underlying assumption that the cooperative had a contractual obligation to distribute its net margin to the members as patronage dividends.[21]

The complete revision of the Internal Revenue Code in 1954 made no substantive changes in the law as it stood after the 1951 Revenue Act became effective. Section 314 of the Revenue Act of 1951 subsequently became Section 522 of the Internal Revenue Code of 1954. For purposes of this Introduction, neither were substantive changes initiated by the Revenue Act of 1962 nor by the Tax Reform Act of 1969.

Liberal tax treatment is not the only reflection of Federal Government attitude toward cooperatives. Obviously, when many producers join together to market their products collectively, one of their priorities is to obtain the highest possible prices. Soon after the enactment of the Sherman Antitrust Act, it was evident that the agricultural marketing cooperatives were on untenable grounds as far as "combinations in restraint of trade" were concerned. The remedy was Section 6 of the Clayton Act of 1914, which exempted from the antitrust laws agricultural associations which had no capital stock. Soon after the Clayton Act, it was evident that this protection was inadequate, since increased capital requirements necessitated incorporation and the sale of stock. Again Congress obligingly passed remedial legislation, the Capper-Volstead Act in 1922.

Under its provisions most cooperatives received the desired protection. For an association to qualify under the Capper-Volstead Act, the value of products handled by it for non-members could not exceed the value of products handled for members. Secondly, each member was allowed only one vote. That dividends could not exceed 8 percent was a third requirement. Lastly, the price of any agricultural product could not be "unduly enhanced" by the restraint of trade. Whether prices were raised unduly was to depend on the opinion of the Secretary of Agriculture, who was empowered to order the cooperative to cease and desist from its monopolistic activity.[22] As a practical matter, the Secretary is unlikely to view high farm prices with excessive disfavor.

Several credit facilities, enacted by Congress, also have been an aid to agricultural cooperatives. The War Finance Corporation Act of 1918, the Federal Reserve Act of 1913, the Agricultural Marketing Act enacted in 1929, the Farm Credit Act of 1933, and the Rural Electrification Act of 1936, all allowed for loans to cooperatives under varying statutory requirements.

Especially with regard to agricultural cooperatives, it seems fair to summarily say that the attitude of the Federal Government has been liberal toward the cooperative form of business. Basically this liberal attitude has taken the form of lenient tax treatment, antitrust law exemption, and provision for credit facilities insofar as agricultural cooperatives are concerned. Even the nonagricultural or the so-called nonexempt cooperatives have been the recipients of a favorable tax status from Congress, when compared to the tax treatment of for-profit corporations. The concern of this study will now be focused on the technical application of the cooperative tax status.

ENDNOTES

[1] Internal Revenue Code of 1954, sec. 1381.

[2] John Davis, An Economic Analysis of the Tax Status of Farmer Cooperatives (Washington, D.C.: American Institute of Cooperation, 1950), p. 3.

[3] Farmer Cooperative Service, United States Department of Agriculture, Legal Phases of Farmer Cooperatives, by L.S. Hulbert, extended and revised by Raymond J. Mischler (Washington, D.C.: U.S. Government Printing Office, 1958), p. 10.

[4] Davis, Economic Analysis, p. 21.

[5] List compiled from: Philip J, Dodge, People Help Themselves Through Cooperatives (New York: Public Affairs Committee, Inc., 1964), pp. 6-7.
Jerry Voorhis, American Cooperatives (New York: Harper and Brothers, 1961), pp. 11-22.
Davis, Economic Analysis, p. 20.

[6] Martin A. Abrahamsen and Claud Scroggs, editors, Agricultural Cooperation, Selected Readings (Minneapolis: University of Minnesota Press, 1957), pp. 187-196.

[7] Joseph G. Knapp, The Rise of the American Cooperative Enterprise: 1620 - 1920 (Danville, Illinois: The Interstate Printers and Publishers, Inc., 1969), pp. 99-105.

[8] Ibid., pp. 46-57.

[9] Frank Robotka, "A Theory of Cooperation," Journal of Farm Economics (February 1947), pp. 94-114.

[10] Abrahamsen and Scroggs, Agricultural Cooperation, Readings, p. 166.

[11] Knapp, Rise of American Cooperative, pp. 428-431.

[12]Robert T. Patterson, _The Tax Exemption of Cooperatives_ (New York: University Publishers, 1961), pp. 50-66.

[13]30 Stat. 448, 461.

[14]38 Stat. 114, 172.

[15]39 Stat. 756, 767.

[16]40 Stat. 1057, 1076.

[17]42 Stat. 227, 253.

[18]43 Stat. 253, 283.

[19]44 Stat. Part 2: 9, 40-41.

[20]Internal Revenue Code of 1939, sec. 101(12).

[21]Patterson, _Tax Exemption_, pp. 67-80.

[22]Hulbert, _Legal Phases_, pp. 166-177.

CHAPTER 2

TAX TREATMENT OF COOPERATIVES

Cooperative Tax Classifications

From the discussion of the general attitude of the Federal Government toward the cooperative enterprise in the Introduction Chapter, it will be recalled that there are two broad classifications of cooperatives for taxation purposes. The terms "exempt" and "nonexempt" label the two classifications. In terms of actual tax treatment, the exempt cooperative category may be subdivided into two classifications, with the result that there are (1) "genuinely" exempt cooperatives and (2) "technically" exempt cooperatives. A summary of Section 1381 of the Internal Revenue Code will clarify this situation. It in effect says that the cooperative tax provisions, which follow Section 1381, apply to all cooperatives including the so-called "exempt" farmer cooperatives described in Section 521, and then Section 1381 goes on to exclude from its purview exempt organizations operating on a cooperative basis, and the other types of cooperatives (e.g., mutual savings banks, cooperative insurance companies, and cooperatives engaged in furnishing electric energy or telephone service to rural people) mentioned on page one. A clarifying example of a cooperative organization "genuinely" exempt from the application of Section 1381 and thus outside the scope of this paper would be a hospital service cooperative, providing computer or purchasing services to member hospitals.

Since the "exempt" farmer cooperatives described in Section 521 are taxed (Section 1381 states that the corporate income tax rates shall apply to all cooperatives under the scope of Section 1381), their status as an "exempt" organization is here described as being a "technical" status. To the Section 521 exempt farmer cooperative, this means two things. They are entitled to special deductions in arriving at their taxable income. Secondly, they are considered as organizations exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes. The latter reference may or may not involve a tax benefit. For instance, if a tax law were to impose a special excess profits tax on all organizations except those "exempt from income taxes," the Section 521 farmers' cooperatives would be exempt from that hypothetical tax. By the same token they are not entitled to be treated as taxable associations, despite their actually being subject to the corporate normal tax and surtax. For example, the 85% deduction for dividends received from a taxable domestic corporation does not apply to distributions of exempt cooperatives.

Requirements for Exemption of Farmers' Cooperatives

In order to qualify as a Section 521 exempt cooperative, several conditions must be met. The exemption in Section 521 is available only to organizations of producers of farm products which market or purchase for their patrons. The definition of a patron is an encompassing one, i.e., all persons with whom or for whom the cooperative does business, and includes members and nonmembers, whether an individual, trust, estate, partnership, corporation, or another cooperative.[1] Associations of fruit growers, livestock growers and dairymen can obviously qualify, too. The Internal Revenue Service has held that an association organized and operated on a cooperative basis for marketing "farm-raised fish" qualifies.[2] But an association purchasing supplies for fishermen or oyster growers is not exempt when the fish and oysters are not produced on a farm.[3] A cooperative association which served a marketing function for independent lumber companies was not exempt either.[4]

Of course, the association must operate on a cooperative basis. To satisfy Section 521, this means, for a marketing cooperative, that the proceeds from sales of products, less the necessary operating expenses, must be returned on a proportionate patronage basis of either quantity or value to the persons who furnished the products. In this connection, purchasing life insurance for members is not a necessary marketing expense.[5] The requirement that operations be on a cooperative basis may be rephrased to say that members and nonmembers must be treated alike. "Anyone who shares in the profits of a farmers' cooperative marketing association, and (emphasis added) is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of Section 521."[6] Profits cannot be diverted from nonmembers to members. All patrons must receive patronage dividends in proportion to their patronage. Yet this is not to say that a member's patronage dividend must be based on the profit made on his particular transaction. However, a marketing cooperative cannot sell more in value of products for nonmembers than it does for members, if it wishes to be exempt.

If the cooperative purchases supplies and equipment for producers of farm products, it also must treat members and nonmembers alike.

> The term 'supplies and equipment' as used in Section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household.[7]

Again, a purchasing cooperative may not purchase more for nonmembers than the value of purchases for members. Further, the value of purchases made for nonmembers who are not producers cannot exceed 15% of the value of total purchases, although business done with the United States or any of its agencies is disregarded in computing total purchases. The Service considers a producer to be an owner or tenant who "bears the risks of production, cultivates, operates, or manages a farm for gain or profit," including a person who receives a rental based upon farm production.[8] A stockholder of a producer corporation must qualify as a producer on a basis independent of his stock ownership.[9] For purposes of this 15% limitation, supplies and equipment, which are used by a member for non-agricultural or nonfarm purposes, are considered to be purchases made for nonmembers-nonproducers.[10] For example, the purchases of gasoline for a member's use in a nonfarming business are nonmember-non-producer purchases. If an exempt cooperative is proposing to exchange any of its surplus products for unlike products processed by a nonmember-nonproducer in order to have an increased stock, the consequences of so doing should be checked beforehand. The Service will consider the exchange transaction to be a sale to a nonmember-nonproducer and a subsequent purchase of the product using the "sale" proceeds. Thus the original purchases when combined with other nonmember-nonproducer purchases may exceed the 15% limit and cause termination of the exempt status. The exchanging nonmember-nonproducer becomes a patron as well and is entitled to a proportionate share of net margin.[11]

If a cooperative engages both in marketing farm products and purchasing supplies and equipment, it must meet the requirements of Section 521 as to each function in order to deserve the exemption.[12] Obviously, business records must be of such a sufficient and permanent nature as to prove compliance.

Section 521 also requires that if a cooperative issues capital stock, the dividend rate must be fixed not to exceed 8% or the legal rate of the state of incorporation, if that is higher, on the stock purchase price. A stock dividend to shareholders is not considered to increase the purchase price of their stock.[13] Further, substantially all of the voting common stock must be owned by producers. "Substantially all" means at least 85 percent.[14] Additional capital may be raised by issuing preferred stock or bonds without exemption consequences, provided the holders of those securities cannot vote and are entitled to no profits other than a fixed return on their investment.[15]

Exemption status requires that the cooperative be able to establish that it has no net income for its own account other than that reflected in an authorized reserve. Authorized reserves are of two kinds. The first is a reserve required (not merely permitted) by state statute. The second kind refers to reasonable reserves for any necessary purpose, the two descriptive adjectives being of great importance. Examples of necessary reserves include those for capital expenditures and amounts to retire indebtedness incurred for those expenditures. Capitalization of a part of a reserve in the form of a stock dividend may be indicative of lack of need and result in denial of exemption.[16]

At times, farmers' cooperatives have joined together, for reasons of business efficiency, to form a federated cooperative which then operates on behalf of the member cooperatives. Since a federated coop really serves the interests of the patrons of its member cooperatives, the Service has held that it is necessary to look through to those patrons to determine whether the federated cooperative meets the exemption requirements.[17] Thus, the federated coop is considered to be dealing directly with the patrons of its member cooperatives for purposes of determining its tax status.

Distributions Treated Similarly By Exempt and Nonexempt Cooperatives

Although cooperatives which do not meet the exemption requirements set forth above are termed nonexempt coops, the distinction will not be crucial in this section. This is so because both kinds of cooperatives receive similar tax treatment in some areas. The additional tax advantages accruing to an exempt cooperative are deferred until a later subchapter heading.

Both exempt and nonexempt cooperatives treat qualifying patronage dividends and per-unit retain allocations alike. The distinction between patronage dividends and per-unit retain allocations is best made by defining the terms. Patronage dividends are amounts paid out to the patron with reference to his patronage and to the net earnings of the cooperative. A per-unit retain allocation is a patron's share of the proceeds from products marketed for him during the tax year that the cooperative retains at a specified amount per-unit sold. Thus they are computed with reference to units of product marketed and without reference to net earnings. The actual written notice informing the patron of the amount which the cooperative retained is called a per-unit retain certificate. It should be noted at this point that Section 1382 (b) considers patronage dividends as an item of gross income and a subsequent deduction therefrom while per-unit retains are exclusions from gross income. This is so because per-unit retains are considered as contributions to capital by patrons.[18]

The initial requirement for deductibility of a patronage dividend is that the cooperative must have a preexisting and enforceable written obligation to distribute a patronage dividend on the basis of quantity or value of business done with the patron. That obligation may be imposed by state law, by-law provisions, articles of incorporation, or any written contract.[19] The deduction will be disallowed any time discretionary action by a board of directors is required to initiate the patronage dividend. The extent to which the Tax Court had in the past required a firm pre-existing obligation is illustrated in the following case decided in 1944. The Tax Court determined that if a board of directors had the discretion of paying a percentage of par value on common stock or of refraining from paying it as a dividend and instead paying it as a patronage dividend, then, to the extent of the percentage on par, there was no pre-existing patronage dividend obligation or deduction.[20] The Service took a more lenient position in a 1969 Revenue Ruling. Therein it was held that if a board of directors is permitted to pay dividends out of net profits up to 8% on the amount paid for the stock, but only pays out the equivalent of 2%, the entire amount in excess can qualify as a patronage dividend.[21] A patronage dividend deduction was disallowed in a situation where it was possible for the board of directors to have absorbed the entire amount of patronage dividends in setting up a surplus fund, which was to be credited until it equaled 20% of the paid-in capital. The surplus fund was to be used for "conducting the business," according to the cooperative by-laws. The Tax Court concluded that the patronage dividend "depended upon some corporate action subsequent to its receipt of the money later so distributed."[22] Yet the Tax Court recognizes the legitimacy of a cooperative's patronage dividend distribution after setting aside necessary reserves and the payment of dividends on capital stock as required by by-laws.[23]

The requirement that a cooperative have this pre-existing obligation to pay a patronage dividend in order for it to be deductible or excludable has an interesting history to it. Prior to the enactment of Section 314 of the Revenue Act of 1951, there was no statutory authority for exempt or nonexempt cooperatives to "deduct" patronage dividends. Instead, the concept that patronage dividends operates to reduce a cooperative's (exempt or nonexempt) taxable income was advanced by the Treasury Department through administrative rules and recognized by the courts upon the theory that such dividends were in reality rebates or refunds on business transacted by the cooperatives with its stockholders or members where the cooperative was committed to make such refunds. Thus, this concept excluded the amounts from the scope of the word "income" in the 16th amendment with regard to the cooperative. The courts, prior to 1951, did not attempt to deny the taxpayer an advantage which the Treasury Department was willing to grant.[24] As stated in the Introduction, the 1951 legislation took away a categorical tax exempt status from exempt cooperatives and subjected them to income tax to the same extent as the nonexempt cooperatives, except that the law allowed exempt cooperatives additional deductions. In doing that, the 1951 Revenue Act was really an assertion that the amounts were income to the cooperative within the meaning of the 16th Amendment; and a subsequent provision out of legislative grace for an exempt cooperative's patronage dividend deduction. This assertion underlying the law may be best exposed by quoting the study prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, prior to passage of the Revenue Act of 1951. The study opens with the following statement:

> The fact that cooperatives are corporations and that Congress has the constitutional power to tax them as corporations may appear so obvious that discussion of the proposition is unnecessary. However, general statements have been made to the effect that the cooperatives are only agents, partnerships, or trusts, with the implication that they are not entities in their own right capable of having income subject to tax. For this reason it is necessary to establish beyond question the fact that the cooperatives are separate corporate entities which are taxable as such.[25]

Now the 1951 Revenue Act did not deal in any way with nonexempt cooperatives. The statute did make it clear that the patronage dividends of both exempt and nonexempt cooperatives should be treated alike, i.e., as deductions from income. It did so, rather oddly, by reference to the prevailing nontaxable condition of the patronage dividends of the nonexempt cooperatives, which had come about by means of administrative determinations upheld by the courts. These determinations had always required a pre-existing obligation for deductibility of patronage dividends based upon the rebate theory. As a result, the deduction of patronage dividends by nonexempt cooperatives continued until 1963 to be a matter of administrative rather than legislative grace. It was the Revenue Act of 1962 which provided the statutory basis for the tax treatment of non-exempt cooperatives, and exempt cooperatives as well by repealing Code Section 522, which was the equivalent expression in the 1954 Code to Section 314 of the Revenue Act of 1951. The 1962 Revenue Act enacted Code Sections 1381 through 1388. Thus, up until 1963 and with regard to non-exempt cooperatives, the courts were ordinarily limited to determining whether, or to what extent, the cooperative had complied with all the conditions under which the Treasury had expressed its willingness to forgo the tax on the cooperative level.

Deductions for Patronage Dividends;
Exclusion of Per-Unit Retains

The patronage dividends and per-unit retain allocations which may be deducted or excluded in determining the cooperative's taxable income are only those that are paid in the payment period and fall into one of the four following categories: (the payment period for any taxable year consists of the taxable year plus the following 8½ months[26] --the last day of this period is the due date for the tax return.)

1. patronage dividends to the extent paid in money, property, or encompassed within a qualified written notice of allocation, with respect to patronage occurring during the taxable year, or

2. money or property paid in redemption of a previously distributed nonqualified written notice of allocation paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred, or

3. per-unit retain allocations to the extent paid in money, property, or qualified per-unit retain certificates with respect to the coop's marketing during its tax year, or

4. money or property paid in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred.

From a practical standpoint, patronage dividends are usually not paid out in cash immediately after the close of the accounting period. Rather the distributions are made by written instruments of various types. A few examples are certificates of interest, or preferred stock redeemable at a fixed date or at the coop's discretion. These instruments are not patronage dividends as such but they may contain a patronage dividend _if_ the stated dollar amount is fixed with reference to the cooperatives net patronage earnings and they "qualify." To qualify for a patronage dividend deduction (under the first category above with reference to a qualified written notice of allocation), these instruments must meet _all_ three of the following tests:

1. The instrument must be in writing, disclosing to the recipient the dollar amount allocated to him and the portion constituting a patronage dividend,

2. The notice must be redeemable in cash at its stated dollar amount at any time within 90 days after the date of payment and the patron must be advised simultaneously with the instrument of his redemption right; <u>or</u> the patron must have consented in advance to the inclusion of the amount in his income (discussed in Chapter 3),

3. 20% of the distribution must be in cash or paid by "qualified" check, although any nondeductible written allocations are disregarded in accumulating a total to which the 20% is applied.[27]

Basically, a qualified check is any instrument redeemable in cash by the cooperative and accompanied by a consent statement notifying the patron that he consents to be taxed on the full stated dollar amount of the written notice of allocation by endorsing and cashing the qualified check. In practice, the qualified check is used chiefly for non-members. The qualified written notice of allocation is treated as the equivalent of money at its stated dollar amount for purposes of deduction by the cooperative.

The various written instruments which do not meet these three requirements when issued in the payment period as a patronage dividend may be correctively paid during the payment period, thus qualifying for the patronage deduction.[28] However, if the payment period lapses and such instruments are still unqualified, later redemption will not result in a deductible patronage dividend.[29]

Like the various written instruments which may contain a patronage dividend, a per-unit retain certificate is either qualified or unqualified for tax purposes. It is emphasized again that per-unit retain allocations are patrons' shares of proceeds from products marketed for them that the cooperative retains at a specified amount per unit sold. The informative written notice sent to the patron is the per-unit retain certificate. Whether they are qualified or not depends on whether the patron has consented to include the amount in his income. The manner of the patron's consent is more appropriately discussed in Chapter 3. When the per-unit retain certificate is nonqualifying, the amount involved is deductible by the cooperative only at the time the certificate is redeemed.

The legitimate extent of the patronage dividend deduction also depends on how the cooperative treats nonmember patronage. Frequently, a cooperative will have nonmember sales which provide a portion of net patronage earnings. If a cooperative does not pay any patronage dividends to nonmembers, any portion of the amount paid to members that is out of net earnings from patronage with nonmembers is not deductible as a patronage dividend.[30] In the discussion of the requirements for attaining exempt status under Section 521, it was said that one necessary condition was equal treatment of all patrons. This statement must now be appropriately modified for certain exceptions, which will not cause loss of the exempt status but will affect the amount of the deduction for patronage dividends. These exceptions are discussed now rather than earlier for two reasons. The reader should now have an understanding of qualified written notices of allocation. Secondly, it is here emphasized that these exceptions to the equal treatment requirement have an impact on the amount of the patronage dividend deduction. The otherwise qualifying Section 521 farmers' cooperatives can distribute non-qualifying written notices of allocation to patrons who have not consented to including the amount in their income and at the same time make payments of 20% in cash and the rest in qualified written notices of allocation to consenting patrons. Also, there are no exempt status consequences when the cooperative makes payments of less than $5 in nonqualified written notices of allocation while payments of $5 or more are made in the form of 20% cash and the rest in qualified written notices. Thirdly, the cooperative can pay less interest or dividends on nonqualified written notices of allocation to nonconsenting patrons than it pays on deductible written notices of allocation to consenting patrons. But unequal treatment is present in a stipulation that a patron, who does not cash the qualified check accompanying the written notice, will forfeit his patronage dividend.[31]

In order to compute the amount of the patronage dividend deduction in cases where nonexempt cooperatives make distributions to members only, the Service has set forth an accounting format as follows:

$$\text{Net earnings from patronage less fixed dividends paid or payable on outstanding capital stock} \times \frac{\text{Total member's business}}{\text{Total business}}$$ [32]

For both exempt and non-exempt cooperatives, the term "net earnings from patronage" means the gross patronage income less the total of all business expenses and "includes the excess of amounts retained by the organization to cover expenses or other items over the amount of such expenses or other items."[33] The patronage dividend must come from all patronage business earnings included in the cooperative's gross income for its taxable year, even though the patronage may have occurred in the previous taxable year.[34] A patronage dividend deduction cannot be claimed if the distributions come from sources other than patronage. For example, investment income, rental income, and income from business done with the government are nonpatronage business earnings. However, exempt cooperatives are allowed special treatment with regard to government business income as will be shown later.

The Internal Revenue Service's formula above obviously assumes that member and nonmember business is equally profitable. When there is no evidence to the contrary, the use of the formula has been validated by the courts. Though it is an administratively formulated rule, the 5th Circuit, in United States v. Mississippi Chemical Co., said in regard to its applicability that "As a matter of fact and law, administrative practice has no effect upon the determination of what constitutes gross income, except insofar as the practice is in accord with the rules of law governing that determination." The use of the formula has been sustained in the following cases:

The Trego County Cooperative Association, 6 B.T.A. 1275

Farmers Union Cooperative Exchange, 42 B.T.A. 1200

Valparaiso Grain and Lumber Co., 44 B.T.A. 125

The Tax Court has held that where there is definite evidence that sales to nonmembers were not profitable, those sales cannot be included in total sales for purposes of calculating patronage business income available for deductible patronage dividends.[35] In this case, there was testimony that sales were classified into retail sales which were to members and wholesale sales which were to nonmembers.

The "fixed dividends paid or payable on outstanding capital stock" must be subtracted from net patronage earnings and not charged solely to income from business done with nonmember patrons (i.e., in the absence of any contrary evidence). At times, cooperatives have attempted to deduct the entire dividend paid on capital stock from nonmember-generated income, thus modifying the amount to which the ratio of member business to total business is applied. Such calculation would result in a larger patronage dividend deduction. The Tax Court has uniformly disallowed such a move in the absence of any proof that nonmember business is not equally profitable. An eloquent opinion of the Tax Court on this matter follows:

> On the one hand the stockholder-patron receives a distribution from its cooperative solely in respect of its status as stockholder. This is a normal dividend from net earnings which is not deductible at the cooperative level in the same manner that a distribution of earnings and profits by an ordinary corporation is not deductible at the corporate level. The distributions are based on the stockholder's investment in the cooperative and represent a return on that investment--the greater the investment, the greater the dividend on capital stock.
>
> On the other hand, the stockholder-patron also receives a distribution solely in respect of its status as patron. This latter distribution is based on patronage with the cooperative during the year--the greater the patronage, the greater the patronage dividend.
>
> In attributing the entire dividend paid on capital stock to nonmember business, petitioner is saying, in effect, that its stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business. Such attribution ignores the dual nature of the stockholder-patron's interest in its non-exempt cooperative. We are unable to find any indication that the stockholders have invested in anything but the undivided totality of petitioner's operations and assets. By following a computational path that fails to reflect the reality underlying its mode of operation, petitioner has substituted accounting fiction for taxable fact.[36]

Up to this point, this study has demonstrated what is technical compliance with two out of the three basic principles recognized by the courts[37] under which an allocation of a cooperative's earnings qualifies as a patronage dividend deduction. The first of the three requirements was that the allocation must be made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative. The second requirement is that the allocation must have been made out of profits or income realized from transactions with the particular patrons for whose benefit the allocations were made, and not out of profits realized from transactions with other persons who are not entitled to participate in such allocations. This was discussed in the portion of the paper dealing with the extent of the patronage dividend deduction when members receive distributions out of net earning from nonmember patronage. Yet to be discussed is the third qualifying principle which requires that the allocation of earnings be made ratably to the particular patrons whose patronage created the income from which the allocation refund was made.

The basis of the patronage dividend must be the amount of the patron's business with the cooperative during <u>its</u> taxable year. But the Code specifies that patronage in one year, which results in earnings includible in the cooperative's gross income in a succeeding taxable year, be treated as patronage occurring in that succeeding taxable year.[38] Accordingly, the deduction will be disallowed if the patronage dividend is paid on the basis of salaries received as employees of the cooperative.[39] But if the cooperative is a worker's association and it distributes its net earnings to its member stockholders based upon the number of man-hours worked by them for the association, both the Tax Court and the Service consider the distributions to be patronage dividends.[40]

The Additional Deductions of the Exempt Cooperatives

If a farmer's cooperative is able to comply with the requirements mentioned above for exempt status, two additional advantages accrue to it from a tax perspective. First of all, the Code provides statutory authority for these cooperatives to deduct amounts paid as dividends on capital stock during their taxable year. The Regulations specify that the term capital stock encompasses "common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association."[41] In order to secure the deduction, the dividend must be paid actually or constructively in the taxable year. Thus, it is the payment date rather than the declaration date that is important. The Service has held that a dividend declared in a year in which a cooperative was nonexempt but paid the following year when the cooperative was exempt is deductible in the later year.[42] From a practical standpoint, the dividend check is presumed to be paid in the taxable year when mailed early enough to be received through the mail within the taxable year of the cooperative. Further, the coop's method of accounting has no role to play in the determination of time of deductibility.

It was recognized by the courts from the beginning of tax law that a dividend paid on capital stock of a nonexempt cooperative was not deductible and had, in fact, the same character as a dividend paid on a noncooperative corporation's stock.[43]

The second advantage accruing to the exempt cooperatives is the authority to deduct distributions from nonpatronage business earnings. Such income may result from investing and renting activities and from doing business with the government. To be deductible, these requirements must be met:

1. The distributions must be paid on a patronage basis.

2. They must be paid in money or qualified written notices of allocation.

3. They must be paid within the payment period.[44]

If the written notices of allocation were unqualified at their time of issuance, a subsequent redemption in the payment period will legitimize the deduction, provided there was a patronage basis for distribution originally.

It is these additional types of deductions which make the attainment of the exempt status described in Section

521 desirable from the cooperative's point of view. Attention will now be turned to the point of view of the patron.

ENDNOTES

[1]Reg. 1.1388-1(e).

[2]Rev. Rul. 64-246, 1964-2 CB 154.

[3]Rev. Rul. 55-611, 1955-2 CB 270.

[4]Income Tax Unit Ruling 1312, CB June 1922, 263.

[5]Rev. Rul. 55-558, 1955-2 CB 270.

[6]Reg. 1.521-1(a)(3).

[7]Reg. 1.521-1(b).

[8]Rev. Rul. 67-422, 1967-2 CB 217.

[9]Rev. Rul. 72-589, 1972-2 CB 282.

[10]Rev. Rul. 67-223, 1967-2 CB 214.

[11]Rev. Rul. 67-346, 1967-2 CB 216.

[12]Reg. 1.521-1(c).

[13]Rev. Rul. 68-169, 1968-1 CB 286.

[14]Rev. Rul. 73-248, IRB 1973-23, 9.

[15]Published Mimeograph 3886, CB Dec. 1931, 164.

[16]Farmers Mutual Cooperative Creamery, 33 BTA 117.

[17]Rev. Rul. 69-651, 1969-2 CB 135.

[18]Senate Finance Committee Report for P.L. 89-809, November 13, 1966.

[19]Reg. 1.1388-1(a).

[20]United Cooperatives, Inc., 4 TC 93.

[21]Rev. Rul. 69-621, 1969-2 CB 167.

[22]Farmers Union Cooperative Elevator Assn., 45,157 P-H Memo TC.

[23]The Farmers Elevator Co. of East Grand Forks, Minn., 62, 204 P-H Memo TC.

[24]Midland Cooperative Wholesale, 44 BTA 824.

[25]Robert T. Patterson, The Tax Exemption of Cooperatives (New York: University Publishers, 1961), p. 74.

[26]Reg. 1.1382-4.

[27]Internal Revenue Code of 1954, sec. 1388(b),(c); Reg. 1.1388-1(c).

[28]Reg. 1.1382-2(c).

[29]Reg. 1.1388-1(a)(2)(iii).

[30]Smith and Wiggins Gin, Inc. v. Comm., (5 Cir; 1965) 15 AFTR 2d 354;
United States v. Mississippi Chemical Co., (5 Cir; 1964) 13 AFTR 2d 442;
Rev. Rul. 63-58, 1963-1 CB 109.

[31]Reg. 1.521-1(f).

[32]Appeals and Review Recommendation 6967, CB June 1924, 287.

[33]Reg. 1.1388-1(a)(1).

[34]Internal Revenue Code of 1954, sec. 1382(f).

[35]Producers Crop Improvement Association, 7 TC 562.

[36]Union Equity Cooperative Exchange v. Comm., 58 TC 397.

[37]Petaluma Cooperative Creamery, 52 TC 457;
United States v. Mississippi Chemical Co., (5 Cir; 1964) 13 AFTR 2d 442;
Pomeroy Cooperative Grain Co. v. Comm., (8 Cir; 1961) 7 AFTR 2d 891.

[38]Internal Revenue Code of 1954, sec. 1382(f);
Reg. 1.1382-6.

[39]Farmers Cooperative Co., 60,043 P-H Memo TC.

[40]Puget Sound Plywood, Inc. v. Comm., 44 TC 305.

[41]Reg. 1.1382-3(b).

[42]Rev. Rul. 70-233, 1970-1 CB 180.

[43]Sacred Heart Cooperative Merchantile Co., 2 BTA 24;
Farmers Cooperative Association, 5 BTA 61;
The Trego County Cooperative Assn., 6 BTA 1275;
Cloquet Cooperative Society, 21 BTA 744;
Riverdale Cooperative Creamery Association, (9 Cir; 1931) 9 AFTR 1186.

[44]Internal Revenue Code of 1954, sec. 1382(c)(2).

CHAPTER 3

TAX PERSPECTIVE OF COOPERATIVE PATRONS

Additions to Patrons' Incomes-Qualified Distributions

From the tax perspective of the cooperative, Chapter Two presented the basic structure that patronage dividends and per-unit retain allocations are transient dollar amounts which, in effect, do not alter the cooperative's taxable income if their outflow follows their intake within the form and time requirements prescribed by law. As a result of the distribution of qualifying per-unit retain allocations and patronage dividends, the tax paying entity is shifted from the cooperative to the patron. The present chapter is concerned with this shift.

It is an aid to the understanding of this chapter to recognize the underlying objective of the Internal Revenue Code in dealing with cooperatives and their patrons. That objective is simply to insure that a current single tax be paid at either the cooperative or patron level.[1] Thus, as a general rule, the patron is not taxed on income from a cooperative unless the distribution is deductible by the cooperative. Recalling that deductibility by the cooperative for patronage dividends within written notices of allocation and for per-unit retain allocations hinged around the patron's consent to inclusion of the amount in his income, it is obvious that the determination of what constitutes consent becomes very important. In effect, consent becomes constructive receipt.

Proper consent by the patron to include in his income the amount of a per-unit retain certificate makes the allocation deductible by the cooperative because the patron's consent "qualifies" the per-unit retain allocation. Consent is indicated by a written agreement between the patron and the cooperative. This is one way. This agreement is to apply to all products delivered by the patron during the taxable year of the cooperative in which the agreement is made, and all subsequent years. The agreement may be revoked at any time by a written document. A second way of consenting is by the patron obtaining or retaining membership in the cooperative after the organization has adopted a bylaw providing that membership in the cooperative constitutes such consent and the patron has received a written notification to that effect and a copy of the bylaw.[2] This kind of consent ceases to be effective with respect to products delivered after the patron ceases to be a member of the cooperative or after the bylaw containing the provision that membership constitutes consent is repealed. This second manner of expressing consent to include the per-unit retain allocation in the patron's income was provided in 1966 by Public Law 89-809. That legislation amended prior law to treat per-unit retain certificates in a parallel manner to the tax treatment of patronage dividends within written notices of allocation, which tax treatment had been codified by the Revenue Act of 1962.

Consent by a patron to report the stated dollar amount of a written notice of allocation occurs in one of the following ways. The first way of expressing consent is by signed written notice from the patron to the cooperative. The notice need not take any special form and the Regulations mention signed invoices, sales slips, delivery tickets, or marketing agreements as possible documents. Section 1388(c)(3)(B)(i) provides that a written consent may be revoked by a patron at any time. As a result, a document purporting to be irrevocable is not consent. If a revocation is executed, it will not be effective until the beginning of the next taxable year of the cooperative.[3] Another possible expression of consent to report written notices of allocation in income is by membership. If membership is acquired or retained after the cooperative has adopted a bylaw, which constitutes membership as an expression of consent and has sent to the patron a written notice to that effect and a copy of the bylaw, then consent is present. Such consent is deemed to cover all patronage with the cooperative that occurs after receipt of the notice and bylaw copy. It terminates along with the patron's membership or upon a change in bylaws repealing the consent provision.[4]

A third form of consent by cooperative patrons is designed chiefly for nonmembers. A patron who has not consented through either of the two forms mentioned above is deemed to have consented to include the full stated dollar amount of a written notice of allocation if and when he endorses and cashes a qualified check, which is paid as part of a patronage dividend together with the allocation notice, on or before the 90th day after the close of the cooperative's payment period for its taxable year for which the dividend is paid.[5] In order to qualify, the check must be accompanied by the allocation notice and inform the payee in a clearly imprinted statement that by endorsing and cashing the check, the patron consents to the inclusion of the full amount in his gross income.[6] These indications of consent were codified by the Revenue Act of 1962, which provided in detail for the tax treatment in this area. Prior to January 1,1963, there was no statute dealing specifically with a patron's income from cooperative distributions. Rather the distributions issued after 1957 as patronage dividends were taxed under Section 61, clarified by Reg. 1.61-5. This Regulation, effective after 1957, did not differentiate between cash or accrual basis taxpayers. It required that amounts allocated to the patron by the cooperative (exempt or nonexempt) on the basis of patronage in cash, merchandise, capital stock, revolving fund certificates or in whatever manner, be included in income in the taxable year when received to the extent of fair market value of the merchandise or document at the time of receipt.[7] If any previous allocation document was later redeemed, the patron picked up as ordinary income in the year of redemption, the excess of the amount realized over the previously included amount of income.[8] Under these regulations, measurement problems as to fair market value abounded. Further complicating the system prior to the Revenue Act of 1962 was the tendency of the courts not to find fair market values in noncash allocations of patronage dividends, but at the same time holding that the patronage dividends were deductible by the cooperative. Thus, the intent of the Congress since the Revenue Act of 1951 that "earnings of cooperatives would be currently taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons,"[9] was frustrated by this judicial position. In 1955, the 5th Circuit affirmed the Tax Court's decision that revolving fund certificates, which were issued to patrons under an agreement that the cooperative could keep a part of the proceeds from marketing patron's produce in order to maintain adequate reserves, had no fair market value and did not constitute taxable income to the patron. In the case, the agreement between the cooperative and the patron allowed the cooperative the sole discretion as to redemption of the certificates. The Commissioner argued that the respondent should be treated as if he had actually received the cash in the amount evidenced by the certificate and then reinvested the cash in the cooperative. Both the Court of Appeals and Tax Court rejected that argument, asserting that the respondent never actually or constructively received or had any right to receive anything but the certificates. And the certificates were not the equivalent of cash.[10]

The 4th Circuit Court of Appeals in 1957, held that even an accrual basis taxpayer could not be taxed on a patronage refund credit on the cooperative's books. The bylaws of this cooperative provided that its members and patrons would furnish money for its capital through their patronage. The Commissioner's argument of constructive receipt or assignment of income was refuted by the fact that the petitioner taxpayer never had any dominion or control over the funds represented by the certificates. The Court said, "To require the inclusion in income of contingent credits such as are here involved, would be to require the patrons of cooperatives to pay tax upon income which they have not received, over which they have been given no control and which they may never receive. It is a safe assumption that Congress never intended to impose upon the patrons of cooperatives the hardship and burden which the taxability of these contingent credits would involve."[11]

About five years later, that safe assumption was proven partially invalid with the passage of the Revenue Act of 1962, which provided Sections 1381 through 1388 or Subchapter T to the Internal Revenue Code. (Correctly speaking, the range of Subchapter T from section 1381 through 1388 is not all inclusive, since possible Sections 1384, 1386, and 1387 do not exist.) The Revenue Act of 1962 spelled out the qualifying requirements elucidated in Chapter 2. It is interesting to note the sympathetic reason underlying the 20% cash payment requirement from the perspective of the patron. The reason can be gleaned from the law's accompanying Senate Report:

> Your Committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons enough cash to pay at least the first bracket income tax. To give assurance that the cooperative provides the patron with at least enough money to pay this first bracket tax, your committee has provided that cooperatives must pay at least 20% of their patronage dividends (and in the case of tax exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to be required to include any such amounts in their income).[12]

Qualified written notices of allocation paid as a patronage dividend and qualified per-unit retain certificates are includible in the recipient's gross income for the taxable year in which received, even though the organization was allowed a deduction for those amounts for its preceding taxable year because they were paid during the payment period for that preceding taxable year.[13]

Additions To Patrons' Incomes-Unqualified Distributions

When a cooperative issues unqualified written notices of allocations as a patronage dividend or nonqualifying per-unit retain certificates, it must pay the tax on the dollars represented by those documents. They do not become deductible until they are redeemed, at which time the patron does become taxable upon receipt of money or property in redemption. Even if the patron should sell the unqualified notice or certificate, he still is taxable as the result of a sale. His gain in both cases is considered as a gain from the sale or exchange of property which is not a capital asset. His basis for determining the gain is zero in both redemption or sale. However if the notice or certificate was acquired from a decedent, the basis is the same as the basis it had in the decedent's hands.[14]

Special Consequences to the Patron

For certain patronage dividends or amounts received in the redemption of nonqualified written notices of allocation which were paid as patronage dividends, exceptional tax treatment is warranted to the patron. When a distribution to the patron is in one of the forms above <u>and</u> is received either (a) with reference to the patron's purchase of personal, living, or family items, which would be supplies, equipment or services not used in the patron's trade or business and the cost of which items is not deductible under Section 212 as a nonbusiness expense, or (b) with reference to the marketing or purchasing of a capital asset or depreciable property used in the trade or business, then these distributions are excluded from the patron-recipient's gross income.[15] But they then become subject to the following special rules. First, if the distribution has reference to the purchase by the patron through the cooperative of a capital asset or depreciable asset and the patron has owned that asset any time during the taxable year in which the distribution was received, then the distribution reduces the asset's basis as of the first day of the taxable year. If there is an excess of the distribution over the basis of the asset, that excess is then ordinary income to the patron.[16] Secondly, if a patron receives patronage dividends or amounts in redemption of nonqualified written notices of allocation based on the patron's sale of a capital asset or depreciable asset in the same taxable year in which he sold the asset, the amounts are added to the sale proceeds he realized.[17] Thirdly, when a patron purchases or sells a capital asset or depreciable asset through the cooperative and did not own the asset at any time during the taxable year of receipt of the distribution, then the amount is included in the patron-recipient's gross income.[18] The fourth special rule requires the patron to treat the distribution as ordinary income if he cannot identify the transaction or item to which the distribution relates.[19]

An example out of the Regulations illustrates the application of the first special rule.[20] "On July 1, 1964, P, a patron of a cooperative association, purchases an implement for use in his farming business from such association for $2,900. The implement has an estimated useful life of three years and has an estimated salvage value of $200 which P chooses to take into account in the computation of depreciation. P files his income tax returns on a calendar year basis. For 1964 P claims depreciation of $450 with respect to the implement pursuant to his use of the straight-line method at the rate of $900 per year. On July 1, 1965 the cooperative association pays a patronage dividend to P of $300 in cash with respect to his purchase of the farm implement. P will adjust the basis of the implement and will compute his depreciation deduction for 1965 (and subsequent taxable years) as follows:

Cost of farm implement, July 1, 1964	$2,900
Less:	
Salvage value	200
Depreciation for 1964 (6 mos.)	450
Adjustment as of Jan. 1, 1965 for cash patronage dividend	300
Total	950
Basis for depreciation for the remaining 2½ years of estimated life	1,950
Depreciation deduction for 1965 ($1,950 divided by the 2½ years of remaining life)	780

ENDNOTES

[1]Senate Finance Committee Report for P.L. 89-809, November 13, 1966.

[2]Internal Revenue Code of 1954, sec. 1388(h).

[3]Reg. 1.1388-1(c)(3)(i).

[4]Reg. 1.1388-1(c)(3)(ii)(a).

[5]Internal Revenue Code of 1954, sec. 1388(c)(2)(C).

[6]Ibid., sec. 1388(c)(4).

[7]Reg. 1.61-5(a) and (b).

[8]Reg. 1.61-5(b)(2).

[9]Senate Report No. 1881, 87th Congress, 2nd Session, p. 111.

[10]Comm. v. B.A. Carpenter, (5 Cir; 1955) 46 AFTR 1743, affirming 20 TC 603.

[11]Long Poultry Farms v. Comm., (4 Cir; 1957) 52 AFTR 912.

[12]Senate Report No. 1881, 87th Congress,2nd Session, pp. 112-113.

[13]Reg. 1.1385-1(a)(2).

[14]Reg. 1.1385-1(b).

[15]Reg. 1.1385-1(c).

[16]Reg. 1.1385-1(c)(2)(ii).

[17]Reg. 1.1385-1(c)(2)(iii).

[18]Reg. 1.1385-1(c)(2)(ii).

[19]Reg. 1.1385-1(c)(2)(iv).

[20]Reg. 1.1385-1(c)(3).

CHAPTER 4

CONCLUDING REMARKS

In the two preceding chapters of this independent study, the interrelationship of the application of the Internal Revenue Code to the cooperative organization and its patrons was exposed. The codification of this interrelationship has been the result of a relatively recent legislative enactment, essentially coming from the Revenue Act of 1962. Prior to 1963, cooperative and patron tax treatment stemmed largely from rulings of the Treasury Department and precedent from court decisions, although between 1951 and 1963 the tax treatment of the exempt cooperative was based upon statutory authority. Under the pre-1963 applications, this interrelationship between cooperative and patron for purposes of tax policy was never effectively established. Thus, dollars of cooperative's net incomes were not being taxed to the cooperative because they were allocated to patron's accounts as patronage dividends and those same dollars were not taxable to the patron because they were not distributed in the form of cash or property with a fair market value. Under present law, such a situation, frustrating to the objective intent of the tax law, cannot exist. Today the intent of Congress that either the cooperative or the patron be subjected to a single tax on the amounts involved is a legal reality.

Certainly the intent of the tax law is a recognition by Congress of the unique nature of cooperative business, different from that of other forms of business. It is a recognition that patronage dividends are not dividends in the sense of the normal signification of the word. Lastly, it is recognition that the function of this institution is a beneficial one, with a useful role to play in our commercial economy.

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