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**INCOME TAX TREATMENT OF
COOPERATIVES: Distributions, Retains,
Redemptions, and Patrons' Taxation**

Cooperative Information Report 44, Part 3

2005 Edition

Donald A. Frederick

Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Distributions, Retains, Redemptions and Patrons' Taxation
2005 Edition

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Cooperative tax rules are a logical combination of the unique attributes of a cooperative and the income tax scheme in the Internal Revenue Code. The single tax principle is applied to earnings from business conducted on a cooperative basis in recognition of the unique relationship between the members and their cooperative associations. Cooperatives have been granted a certain degree of flexibility in their financial and tax planning and should exercise their options effectively to maximize benefits for members.

Key words: Cooperative, equity, income, patronage, per-unit retain, tax

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Preface¹

The correlation between cooperative finance and taxation involves several elements of the cooperative/patron relationship. Earnings are allocated to patrons on the basis of the amount of business they do with the cooperative, not to investors on the basis of equity ownership. Tax law recognizes that cooperative margins are allocated directly to patrons and permits cooperatives to pass through those earnings to patrons much as a partnership passes through its earnings to its partners.

To accommodate the unique association between a cooperative and its patrons, the Internal Revenue Code (Code) has special and sometimes complex rules creating a single tax on cooperative margins. Part II of this series described the patronage refund, the basic vehicle for cooperatives to distribute margins to patrons and for patrons to provide equity capital--through retained patronage refunds--to their cooperative. This report examines the additional elements of the cooperative/patron relationship. It covers how patronage refunds are distributed to patrons, how the per-unit retain operates as another tool of equity accumulation for marketing cooperatives, the operation and tax treatment of methods cooperatives use to redeem outstanding equity, and looks specifically at how various patronage financing developments are taxed at the patron level.

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

Highlights

The linchpin of cooperative equity accumulation is the patronage refund. A patronage refund is a distribution from a cooperative to a patron, based on the amount of business done with or for that patron, out of net earnings from business with or for all patrons. The payment can be made in money or as a distribution of equity or debt capital in the cooperative.

The Internal Revenue Code (Code) provides that if timely payment is made, the underlying earnings of the cooperative are only subject to a single Federal income tax. If the patronage refund is "qualified" according to procedures in the Code, the tax obligation is immediately passed through to the patrons. If the refund is "nonqualified," the tax obligation falls on the cooperative until the equity is redeemed. Then the tax burden passes through to the patron.

Marketing cooperatives have another method of distributing funds and accumulating patronage-based capital that also qualifies for single tax treatment. The per-unit retain is a distribution based on the volume or value of product marketed through the cooperative by the patron. Per-unit retains can be issued as capital certificates, permitting the cooperative to retain the underlying funds as equity and debt financing. Retains are taxed much like patronage refunds, including the option to issue qualified or nonqualified retain certificates.

Although equity accumulation is one of the biggest challenges facing cooperatives, each year many associations redeem part of their patronage-based capital. Equity redemption frequently focuses on the oldest allocations in the cooperative. Redeeming the oldest equities, particularly those of persons no longer patronizing the cooperative, implements the cooperative principle that financing should come from persons currently benefitting from the cooperative's services. Tax consequences for the cooperative and the patron at the time of redemption are determined by the nature of the allocation and whether the redemption is for the full face amount of the original equity distribution.

With few exceptions--notably when members purchase nondepreciable personal and household goods from their cooperative--the earnings on all cooperative business activity are

subject to Federal income taxation. Ultimately, if not immediately, that tax burden falls on the patron. The timing and extent of that tax burden depend on the way those earnings are distributed. Some cooperative distributions from nonpatronage sources and patronage-based funds not distributed according to specific rules in the Code may be taxable to the patron even though a tax was already paid by the cooperative.

The American Jobs Creation Act of 2004 created a new tax pass-through deduction and two pass-through energy-related credits that give cooperatives new flexibility in allocating tax benefits between the cooperative and its patrons.

The characteristics of payments from a patron to a cooperative are important in determining if they are deductible business expenses or nondeductible contributions to capital.

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CHAPTER 7

PATRONAGE REFUND DISTRIBUTIONS

After a cooperative determines its earnings and reviews its capital needs, it must decide the amount and form of patronage refunds² to be distributed to its patrons. Generally, a cooperative pays the patronage refund in two forms--in money or with a document representing an equity or debt interest in the cooperative.

Timely distributions of patronage refunds in money automatically qualify for single taxation. To likewise qualify for single tax treatment, the noncash payment document must comply with the Internal Revenue Code (Code) requirements to be a "written notice of allocation."

Cooperatives can place the tax obligation for refunds issued as written notices of allocation on either the cooperative or the patrons. But whatever method of allocation is chosen, it is subject to the basic public policy underlying the enactment of subchapter T of the Code,³ a single tax is immediately due on the underlying cooperative margins.

Some Code requirements relating to the distribution of patronage refunds are mandatory in whatever form paid. Other constraints apply to specific distribution methods. This chapter describes the forms in which patronage refunds may be paid to qualify for cooperative tax treatment and the tax collection method applicable to each form.

² The term "patronage refund" (rather than "patronage dividend" as used in the Internal Revenue Code) is used in this report in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

³ I.R.C. §§ 1381-1388.

TAX TREATMENT

Alternative tax treatments are often an important factor in determining the form of a patronage refund, so taxation will be discussed before the technical aspects of the refund options.

Code Provisions

Code section 1388(a) defines a patronage refund. Rulings and cases interpreting this definition are covered in Chapter 4 of these reports.⁴ In summary, a patronage refund is an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or for such patron. The payment must be made pursuant to a legal obligation that existed before the transaction occurred that produced the margin being refunded. The payment must also be based on net earnings of the cooperative from business with or for patrons.

The basic rules governing taxation of patronage refunds are in Code sections 1382(a) and 1382(b)(1). Section 1382(a) states single tax treatment of payments from a cooperative to its patrons is only available for distributions described in section 1382(b).

In determining the taxable income of a cooperative, section 1382(b) provides "...there shall not be taken into account amounts paid during the payment period for the taxable year" in four specific circumstances. The first is the subject of this chapter⁵ and is set forth in Code section 1382(b)(1) as follows:

⁴ Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, RBS Cooperative Information Report 44, Part 2 (USDA 2005), pp. 9-26.

⁵ The other three distributions are redemptions of nonqualified written notices of allocation, qualified per-unit retain allocations, and redemptions of nonqualified per-unit retain allocations. Each is discussed in later chapters of this report.

...patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year.

As section 1382(b)(1) suggests, several other Code definitions bear directly on the proper distribution of patronage refunds. These include the payment period,⁶ written notice of allocation,⁷ qualified written notice of allocation,⁸ nonqualified written notice of allocation,⁹ and determining the amount paid or received.¹⁰

Taxation in General

Patronage refunds fall into one of three categories: money or other property, qualified written notices of allocation, and nonqualified written notices of allocation. This section explains an important difference between the tax treatment of nonqualified written notices of allocation and other forms of patronage refunds. This is a key consideration in deciding how the patronage refund allocation should be structured.

Payments in money or other property are deductible by the cooperative in the year the underlying patronage business occurs.¹¹ The payments are included in the gross income of the patron recipients in the year of receipt.¹² Money is valued at face value.

⁶ I.R.C. § 1382(d).

⁷ I.R.C. § 1388(b).

⁸ I.R.C. § 1388(c).

⁹ I.R.C. § 1388(d).

¹⁰ I.R.C. § 1388(e).

¹¹ Treas. Reg. § 1.1382-2(b)(1).

¹² I.R.C. § 1385(a)(1), Treas. Reg. § 1.1385-1(a). The tax treatment of patrons is discussed in chapter 10 of this report.

Property is valued at its fair market value.¹³

Patronage refunds paid in the form of qualified written notices of allocation are taxed essentially as cash. Qualified written notices of allocation are deductible by the cooperative in the taxable year the underlying patronage business occurs.¹⁴ The payments are included in the gross income of the patron recipients in the year of receipt.¹⁵ Qualified written notices of allocation are taken into account at their stated dollar amount.¹⁶

Example A illustrates the tax consequences of a patronage refund paid in cash, other property, or as a qualified written notice

Example A. Patronage Refund Paid in Cash, Other Property, or Qualified Written Notice Of Allocation

| <u>Cooperative</u> | | <u>Patron</u> | |
|-----------------------|--------------|-----------------------|--------------|
| Income | \$1,000 | | |
| Expenses | | Income | |
| Crop | \$600 | Crop | \$600 |
| Other | <u>\$300</u> | | |
| Total | <u>\$900</u> | | |
| Margin | <u>\$100</u> | Refund | <u>\$100</u> |
| Taxable Income | 0 | Taxable Income | \$700 |

¹³ I.R.C. § 1388(e)(1), Treas. Reg. § 1.1382-2(b)(1).

¹⁴ Treas. Reg. § 1.1382-2(b)(1).

¹⁵ I.R.C. § 1385(a)(1), Treas. Reg. § 1.1385-1(a).

¹⁶ I.R.C. § 1388(e)(2), Treas. Reg. § 1.1382-2(b)(1).

of allocation. Assume a marketing cooperative pays one producer \$600 for a crop, incurs \$300 in additional business expenses for processing and marketing the crop, and sells it for \$1,000.

Any business is allowed to deduct the payment to the patron for the crop (\$600) and other expenses (\$300). A cooperative may also deduct the margin earned when it sells the producer's crop (\$100), provided the cooperative returns the margin to the patron as a patronage refund paid in cash, other property, or a qualified written notice of allocation. This leaves the cooperative with no taxable income on its business conducted on a cooperative basis.

The patron includes the \$600 crop payment and the \$100 patronage refund in gross income, for a total taxable income of \$700. The patron must include the entire \$100 patronage refund in gross income, even if part was paid as a qualified written notice of allocation.

Example B illustrates the same situation, only the patronage refund is paid as a nonqualified written notice of allocation.

Example B. Patronage Refund Paid as a Nonqualified Written Notice Of Allocation

| <u>Cooperative</u> | | <u>Patron</u> | |
|-----------------------|--------------|-----------------------|--------------|
| Income | \$1,000 | | |
| Expenses | | Income | |
| Crop | \$600 | Crop | \$600 |
| Other | <u>\$300</u> | | |
| Total | <u>\$900</u> | | |
| Margin | <u>\$100</u> | Refund | <u>\$100</u> |
| Taxable Income | \$100 | Taxable Income | \$600 |

When a noncash patronage refund payment is made using a nonqualified written notice of allocation, the current obligation to pay tax on the underlying margin remains with the cooperative. The cooperative is allowed the \$900 in normal business deductions, including the \$600 deduction for the payment to the patron for the crop. But the \$100 margin is taxable income to the cooperative in the year the patronage occurs.

The patron includes the \$600 payment for the crop in gross income. The patron has no immediate tax liability, however, for the value of the nonqualified allocation.

When the cooperative redeems the nonqualified written notice of allocation, the tax obligation is transferred to the patron. The cooperative is allowed to deduct the value of the money or other property distributed to the patron.¹⁷ And the patron includes the value of the money or property received in gross income in the year of receipt.¹⁸

Therefore, in the year the cooperative redeems the \$100 patronage refund issued as a nonqualified written notice of allocation, the cooperative claims a \$100 deduction from gross income and the patron includes the \$100 payment in gross income.

The use of nonqualified allocations places a temporary tax obligation on the cooperative and postpones any tax obligation for the patron until the patron receives cash or other property to redeem the nonqualified allocation.

REFUND DISTRIBUTION BASICS

This section details the fundamental requirements that must be met to protect access to single tax treatment for patronage refunds. While the rules may seem cumbersome at times, it should be remembered that a series of court decisions had permitted

¹⁷ I.R.C. § 1382(b)(2), Treas. Reg. § 1.1382-2(c).

¹⁸ I.R.C. § 1385(c), Treas. Reg. § 1.1385-1(b).

cooperatives and patrons to avoid the current single tax obligation which Congress had intended to create under the Revenue Act of 1951.¹⁹ Subchapter T of the Code was enacted as part of the Revenue Act of 1962²⁰ to make sure the single tax due was collected on a current basis.²¹

Actual Payment to Patrons

The first rule in establishing tax deductibility at the cooperative level is that an actual payment must be made to the patrons. This requirement is based on the Code definition of a patronage refund as "an amount paid to a patron by (a cooperative)..."²² This requirement has two parts, the first is "actual payment" and the second is the payment must be made to a "patron."

The first condition, actual payment, is addressed in *Seiners Association v. Commissioner*.²³ *Seiners Association* didn't distri-

¹⁹ *Caswell's Estate v. Commissioner*, 211 F.2d 693 (9th Cir. 1954), *rev'g*, 17 T.C. 1190 (1952); *Commissioner v. Carpenter*, 219 F.2d 635 (5th Cir. 1955), *aff'g*, 20 T.C. 603 (1953), *acq.* 1958-1 C.B. 4; *Long Poultry Farms, Inc. v. Commissioner*, 249 F.2d 726 (4th Cir. 1957), *rev'g*, 27 T.C. 985 (1957). These cases are discussed in chapter 3 of these reports, Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) pp. 119-121.

²⁰ Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962), *reprinted in* 1962-3 C.B. III.

²¹ S. Rep. No. 1881, 87th Cong., 2nd Sess. 111 (1962), *reprinted in* 1962-3 C.B. 703, and 1962 U.S. Code Cong. & Admin. News 3304, 3414-3415; S. Rep. No. 1707, 89th Cong., 2nd Sess. (1966), *reprinted in* 1962-2 C.B. 1055, 1108 and 1966 U.S. Code Cong. & Admin. News 4446, 4515.

²² I.R.C. § 1388(a). The provision covering deductibility of patronage refunds also requires that they be "paid." I.R.C. § 1382(b).

²³ *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972).

bute the cash portion of its patronage refunds within the permissible time period for tax deductibility.²⁴ Rather, patrons had the right to withdraw the cash portion of their refund before the expiration of the payment period. The cooperative argued that this constituted constructive receipt sufficient to satisfy the Code requirements. The U.S. Tax Court disagreed, holding an actual payment must occur for a distribution of money to be deductible as a patronage refund.

A cooperative may meet its payment obligation by mailing the money or written notice of allocation to the last known address of the refund recipient. Such refunds are considered paid on the date they normally would be received by the recipients, including any distributions returned when the addressee cannot be located by postal authorities and held by the cooperative subject to the rightful owner's claim.²⁵

The second condition requires that the patronage refunds be paid to "patrons."²⁶ Under most circumstances, a cooperative should have little difficulty determining to whom the patronage refund is paid. Patronage refunds are paid to patrons whose business with the cooperative produced the margin being returned.

Sometimes payment to patrons will be impossible or impractical. This following discussion reviews how cooperatives have handled some of those situations.

Occasionally, a cooperative may find it impossible to locate patrons to whom refunds are owed. Many States have so-called escheat laws that require such unclaimed funds be paid to the State. In Revenue Ruling 68-423,²⁷ a section 521 cooperative, having ceased operations some years before, attempted to make a

²⁴ The time periods within which cooperatives can distribute patronage refunds, called "payment periods," are discussed in a subsequent section of this chapter.

²⁵ Rev. Rul. 55-141, 1955-1 C.B. 337.

²⁶ Treas. Reg. § 1.1382-2(b)(1).

²⁷ 1968-2 C.B. 373.

cash distribution of nonpatronage income in a bank account to former patrons as part of its final liquidation.²⁸ Under the State's escheat law, the cooperative was obligated to turn the funds over to the state at the time of liquidation.

The IRS permitted the cooperative to deduct the payments, even though the funds were paid to the State and not the patrons. IRS noted payment was made to the State within the applicable payment period for such distributions. It said the State's escheat law was "custodial" in nature, meaning the rightful owners of the unclaimed property (cash) paid to the State by the cooperative could obtain this money by presenting evidence of ownership. The same logic appears to apply to unclaimed patronage refunds paid to the State under escheat.

In some circumstances, payment may be made to a patron's successor in interest, such as the estate of a deceased individual patron²⁹ or a successor in interest of a corporate or partnership patron.

Another example of payment to someone other than the patron occurs when an intermediary is imposed between the cooperative and the person whom the cooperative wishes to treat as its patron. In *Land O'Lakes, Inc. v. United States*,³⁰ part of the cooperative's

²⁸ A section 521 cooperative is permitted to deduct patronage-based allocations of nonpatronage income under I.R.C. § 1382(c). Special rules for section 521 cooperatives will be discussed in a later report in this series.

²⁹ Rev. Rul. 73-93, 1973-1 C.B. 292.

³⁰ This dispute first arose over whether Land O'Lakes, Inc., was entitled to section 521 tax status. The first District Court opinion held the cooperative was eligible for section 521 status. *Land O'Lakes, Inc. v. United States*, 362 F. Supp. 1253 (D. Minn. 1973), 1973-2 U.S.T.C. ¶ 9644. This finding was reversed, 514 F.2d 134 (8th Cir. 1975), 1975-1 U.S.T.C. ¶ 9431, *cert. denied*, 423 U.S. 926. The case was remanded to the District Court to determine issues resulting from the cooperative's non-section 521 status. The District Court found the agent-buyer arrangement permissible, and this determination was

business consisted of selling agricultural supplies to agent-buyers who resold the supplies to members and other patrons. The agent-buyer, a nonmember-nonproducer, was used in geographical areas where the cooperative had no member-cooperatives or company stores. The agent-buyer executed a contract with the cooperative to agreeing to provide the cooperative with all invoices based on sales of supplies to producers.

At the end of each year, the cooperative distributed patronage refunds directly to producers who purchased supplies from the agent-buyer as reflected by the invoices. The cooperative treated the agent-buyer as an agent of the farmer producers. The courts ultimately concurred with this treatment. While several decisions emanated from this litigation, the original U.S. District Court opinion addresses this issue most succinctly:

Plaintiff's reliance on agency principles to support its argument that the agent-buyer was acting in a fiduciary capacity on behalf of the producer-customers appears to be a strained legal position, but the Court believes the contract between Land O'Lakes and the agent-buyers was a permissible arrangement and not violative of the statute. The evidence established that the use of the agent-buyer was necessitated by a lack of other facilities to adequately provide for the supply needs of the producer-customers. The government has not made any showing that the agent-buyers breached the contract or acted in any manner contrary to the intended purpose of the arrangement to supplement the lack of supply outlets for the benefit of the producer-customers.³¹

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

³¹ *Land O'Lakes, Inc. v. United States*, 362 F. Supp. 1253, 1261 (D. Minn. 1973).

The final opinion in this case found Code support for Land O'Lakes' position. The court noted that Code section 1388(c)(1) defines a qualified written notice of allocation as a notice which the "distributee" consents to include in his own income. The court interpreted the word "distributee" to be broader than "patron," and concluded that the refunds paid directly to the farmer-customers pursuant to the agent-buyer agreements were properly deductible by Land O'Lakes as patronage refunds.³²

Payment Period

A cooperative's ability to deduct patronage refunds is conditioned not only on actual payment to patrons but also on such payments being made within a certain time period.

The Code requires cooperative payment of patronage refunds to take place "during the payment period for the taxable year."³³ The "payment period" for payment of patronage refunds "is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year."³⁴ This encompasses the cooperative's taxable year plus the following 8½ months. For example, a cooperative on a calendar-year tax year has until September 15th of the following year to distribute its patronage refunds.

Although refunds to patrons may be made before the end of a cooperative's taxable year, in most cases it is impossible to complete the process by the last day of the taxable year. The cooperative's financial results for the year have to be computed before the actual margin available as a patronage refund can be determined. The Code, therefore, allows cooperatives a grace period following their taxable year to complete the payment

³² Land O'Lakes, Inc. v. United States, 675 F.2d 988, 991 (8th Cir. 1982).

³³ I.R.C. § 1382(b).

³⁴ I.R.C. § 1382(d).

process. However, payment may not be delayed beyond the period established by the Code.

The payment period is coordinated with the tax return filing deadline for cooperatives. Generally, qualifying cooperatives have 8½ months following the end of the taxable year to file their income tax returns.³⁵ This provides time for cooperatives to compute, allocate, and distribute their patronage refunds before finalizing their tax return for the year.

If a refund is not paid to patrons during the permitted payment period to which the refund relates, the payment no longer qualifies for cooperative single tax treatment. The U.S. Tax Court held that a refund that met all the other requirements of the Code, but was paid 3 days late, was not deductible.³⁶

If the cooperative's actions regarding patronage refunds during the payment period fail to qualify as a "payment," subsequent actions can't retroactively cause such distributions to become acceptable. In *Seiners Association v. Commissioner*,³⁷ the cooperative provided its patrons with financial statements during the payment period. The statements contained figures from which a patron could calculate the refunds due assuming the patron kept all records of transactions with the cooperative for the year. After the payment period expired, the cooperative distributed cash and written notices of allocation.

The Tax Court held (1) the actions taken during the payment period did not qualify as payment in cash or as written notices of allocation and (2) the cooperative's subsequent actions could not correct deficiencies occurring during the payment period. The court said a cooperative must meet "very definite rules to deduct

³⁵ I.R.C. § 6072(d).

³⁶ *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972). The payment period ended August 15. Payments on August 18 of one year and September 18 the next failed to qualify for cooperative tax treatment.

³⁷ 58 T.C. 949 (1972).

patronage (refunds) from its taxable income."³⁸

A cooperative's patronage refund payments may be made within the payment period and qualify as patronage refunds for the taxable year even though the cooperative lost its cooperative character as of the last day of its taxable year. IRS permitted a cooperative that converted to a noncooperative corporation and terminated its taxable year upon the conversion to deduct patronage refunds paid to former patrons after the conversion, but before the expiration of the payment period.³⁹

Timing Problems

The Code includes the general rule that a patronage refund deduction must be based on patronage occurring during the tax year the deduction is claimed.⁴⁰ In several instances, a cooperative may not be able to make a final determination of its margins until well after the end of the payment period for the year the patron conducted the business that generated the margin. The coop must determine the tax year the patronage occurred because patronage refunds can only be paid in the payment period for that year.

Income Received in a Subsequent Year

Cooperatives may receive income based on patronage which took place in prior years. A patron may deliver product to a marketing cooperative in one year. The cooperative processes and stores the product and doesn't sell the processed product until the following year. While patronage occurred in the tax year delivery was made, the income generated from that patronage is not created until a subsequent year. A similar result may arise when the patron and cooperative have different tax years.⁴¹

³⁸ *Id.* at 955.

³⁹ Priv. Ltr. Rul. 8604011 (October 25, 1985).

⁴⁰ I.R.C. § 1382(b)(1).

⁴¹ For example, Priv. Ltr. Rul. 7936017 (May 31, 1979).

Code section 1382(f) recognizes this timing difference by assigning patronage to the taxable year that income is created. The cooperative recognizes the income for tax purposes in the year of receipt. The margin on that business qualifies for single tax treatment if allocated and distributed in an appropriate manner within the payment period for the year of receipt.⁴²

Federated Cooperatives

A common situation leading to receipt of income by a cooperative in years following its dealings with patrons occurs when the cooperative is part of a federated system. A local cooperative may deliver patrons' products to a federated cooperative for further processing and marketing. A period of one or more years commonly passes before the local receives a patronage refund based on that business from the federated.

The U.S. Tax Court, citing section 1382(f), held that a local cooperative may include a patronage refund from a federated in gross income in the year of receipt and pass the amount received through to patrons of that year as a deductible patronage refund.⁴³

Pooling

If a cooperative markets under a pooling arrangement and the pool isn't closed until a tax year (or several tax years) following the patrons' delivery of product into the pool, the calculation of patronage refunds must await the final accounting for that pool.

The Code has a special provision dealing specifically with products marketed under a pooling arrangement. Section 1382(e) recognizes the timing problem inherent in pooling by assigning all

⁴² I.R.C. § 1382(f) and Treas. Reg. § 1.1382-6. *See, e.g.*, Priv. Ltr. Rul. 7951127 (Sept. 24, 1979) (income realized by a § 521 cooperative from the sale of a capital asset on the installment basis); Priv. Ltr. Rul. 8142166 (July 24, 1981) (raw product delivered in one year is processed and the finished goods sold in a subsequent year).

⁴³ *Kingfisher Cooperative Elevator Ass'n. v. Commissioner*, 84 T.C. 600 (1985).

patronage to "the taxable year in which the pool closes."⁴⁴ The regulations provide that the circumstances of each case will be considered in determining when a pool is closed, but generally the procedures of the cooperative will be followed.⁴⁵

Accounting Method Adjustments

The requirement that patronage refunds be paid during the statutory payment period may cause hardship to cooperatives whose accounting methods are adjusted in years following the taxable year. The determinative factor is the tax year in which income is recognized.

Patronage-sourced income may be created in one tax year, but not refunded to patrons within the payment period for that tax year because the income wasn't recognized in time to make payments. In that case, any subsequent payment of refunds based on that income may not qualify as payment during the payment period.

In Rev. Rul. 74-327⁴⁶ an IRS audit conducted in 1973 resulted in a disallowance of a portion of the depreciation claimed by a cooperative in 1970 and 1971. IRS held the income resulting from adjustments to depreciation was correctly included in the cooperative's gross income for the years under examination. While noting Code section 1382(f), IRS found it inapplicable.

If income relating to a cooperative's patronage during one tax year is recognized as patronage income in a subsequent tax year, the payment period for the subsequent tax year applies.⁴⁷

⁴⁴ I.R.C. § 1382(e)(1) and Treas. Reg. § 1.1382-5. The regulation contains a simple example illustrating this point.

⁴⁵ Treas. Reg. § 1.1382-5.

⁴⁶ Rev. Rul. 74-327, 1974-2 C.B. 173.

⁴⁷ I.R.C. § 1382(f), Treas. Reg. § 1.1382-6.

Qualified Checks

Patronage refunds paid in qualified checks⁴⁸ also raise a timing consideration. The Code says a qualified check issued during the payment period is to be treated as an amount paid in money during that payment period if it is "endorsed and cashed" on or before the 90th day after the period closes.⁴⁹ Tax treatment of a qualified check depends on whether the recipient cashes it, a fact that may not be known until after the payment period ends. A cooperative that issues qualified checks may have to file its income tax return as much as 90 days before it knows whether some payments are qualified or nonqualified.⁵⁰

PAYMENT IN MONEY OR OTHER PROPERTY

Most cooperatives pay at least some of their patronage refunds in "money." The term "money" covers cash, regular bank checks, and "qualified checks."⁵¹ Payment of patronage refunds in money requires more than a right to receive payment from the cooperative. It requires actual payment.⁵²

Patronage refunds may also be paid in the form of property. While this is not a usual form of payment, it may give the cooperative a mechanism to satisfy its patronage refund obligations without a cash drain on the cooperative or requiring patrons to take an equity interest in the cooperative.

When patronage refunds are paid in property, the value of the property determines the amount of the cooperative's deduction and

⁴⁸ Qualified checks are defined at I.R.C. § 1388(c)(4). They are discussed in more detail later in this chapter.

⁴⁹ I.R.C. § 1382(d).

⁵⁰ See Priv. Ltr. Rul. 7728030, (no date), 1977.

⁵¹ Treas. Reg. §§ 1382-2(b)(1), 1.1388-1(c)(1)(ii).

⁵² *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972).

the patron's income. The Code states that property shall be taken into account at its fair market value.⁵³

In one instance, a cooperative was acquired by another corporation. In its last taxable year prior to merger, the co-op became obligated to pay patronage refunds to patrons. It paid the refunds partly in money and partly in shares of stock of the acquiring corporation. The acquiring corporation's stock was valued at par value in computing the patronage refund deduction.⁵⁴

WRITTEN NOTICE OF ALLOCATION

Payment of patronage refunds with a document evidencing an equity or debt interest in the cooperative rather than payment in cash was a recognized practice before the formal definition of a written notice of allocation appeared in Subchapter T in 1962.⁵⁵

Payment through such a written notice was considered payment in money to the patron, followed by either reinvestment in the cooperative's capital or a loan to the cooperative.⁵⁶

Written notices of allocation permit cooperatives to combine the payment of refunds with other financing objectives. Patrons receive these notices as a return based on proportion of business done with their cooperative. They represent the culmination of a patronage relationship between the cooperative and patron. At the same time, written notices of allocation are a means of acquiring patron financing through capital contributions in proportion to use of the cooperative's services.

⁵³ I.R.C. § 1388(e)(1); *see also*, Treas. Reg. § 1.1382-2(b)(1).

⁵⁴ Priv. Ltr. Rul. 7738016 (June 22, 1977).

⁵⁵ For description of such practices, *see* *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949); and *Farmers Cooperative Co. v. Commissioner*, 288 F.2d 315 (8th Cir. 1961), *rev'g*, 33 T.C. 266 (1959).

⁵⁶ Rev. Rul. 55-66, 1955-1 C.B. 282.

These notices are an important determinant in taxable events. They represent payments to patrons by the cooperative, the receipt of income by patrons, the cooperative's receipt of capital contributions, and capital investments by patrons.

The following sections describe the character of written notices of allocation, the form they may or must take, their contents, and how they are distributed.

Character

A written notice of allocation is a disclosure to each patron of that patron's patronage payment. Treasury Department regulations provide that the notice shall report the entire "stated dollar amount allocated [to the patron] on the books of the cooperative."⁵⁷

A written notice of allocation usually evidences a contribution to the cooperative's equity capital. It is not restricted, however, to equity. This notice can represent a loan to the cooperative. The Code definition of a written notice of allocation includes the term "certificate of indebtedness."⁵⁸

Form

These notices of allocation must be in writing. A mere credit to a patron's account on the cooperative's books, without written disclosure to the patron, does not qualify.⁵⁹

The cooperative must issue a written notice of allocation to each patron receiving a patronage refund (unless the patronage refund is to be paid entirely in money). The Code lists documents that may qualify as written notices of allocation including "capital

⁵⁷ Treas. Reg. § 1.1388-1(b).

⁵⁸ I.R.C. § 1388(b).

⁵⁹ Treas. Reg. § 1.1388-1(b).

stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice."⁶⁰

If capital stock is part of a written notice of allocation, it is usually issued as some form of preferred stock.⁶¹ Common stock usually certifies membership. Its issuance is unrelated to the amount of business conducted with the cooperative. Preferred stock issued as a written notice of allocation can have all the attributes of ordinary preferred stock, including transferability, right to dividends on capital stock, and preferences of various kinds.⁶² Cooperatives may use a special class of common stock rather than preferred stock as part of a written notice of allocation.⁶³

The Code doesn't elaborate further on the form of a written notice of allocation. However, certain information must be included in a written notice of allocation regardless of its form.

Contents

The Code states a written notice of allocation must disclose to the recipient "the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage [refund]."⁶⁴ This awkward language is usually applied by cooperatives so that the notice reports: (1) the total patronage refund allocated to the patron, (2) the amount returned at the time

⁶⁰ I.R.C. § 1388(b) and Treas. Reg. § 1.1388-1(b).

⁶¹ Priv. Ltr. Rul. 8138144 (June 26, 1981).

⁶² Preferred stock with these characteristics was described in *Agway Inc. v. United States*, 524 F.2d 1194 (Ct. Cl. 1975), 1975-2 U.S.T.C. ¶ 9777, a pre-subchapter T situation, thus not a "written notice of allocation."

⁶³ *See* Priv. Ltr. Rul. 8505001 (May 15, 1984) where the cooperative issued two classes of common stock. The class issued as a written notice of allocation was nonvoting.

⁶⁴ I.R.C. § 1388(b) and Treas. Reg. § 1.1388-1(b).

of the allocation in the form of money or other property, and (3) the amount retained as a contribution to capital (1 less 2).

The written notice can't be presented in a manner that requires the recipient to compute the payment amount. In *Seiners Association v. Commissioner*,⁶⁵ each member received a receipt or invoice at the time it purchased supplies from the cooperative. The patronage refund due each member could be calculated by multiplying the member's total purchases for the year by a percentage factor set forth in the cooperative's financial statements issued at the annual meeting following the taxable year. The financial statements reported the cooperative's earnings for the year, the total amount available for "members' rebates," and the percentage factor upon which individual rebates could be calculated.

Members, who kept all of their purchase records for the year, could determine their allocable patronage refund by multiplying the percentage figure given in the financial statements by the amount of their purchases. However, the financial statements distributed at the annual meetings did not by themselves contain sufficient information for the members to compute their allocable shares.

The court ruled the combination of financial statements and receipts provided by the cooperative did not constitute a written notice of allocation. The court stated:

Even assuming that the members kept adequate records, they would still have been put to the task of making correct calculations to determine the allocable stated dollar amount. Therefore it is obvious that on their face these documents did not reveal a stated dollar amount. The available documents showed no individual dollar amounts whatsoever. Clearly the type of instrument intended by Congress as sufficient to meet the

⁶⁵ *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972).

requirements of a written notice of allocation is that notice which petitioner sent out after the close of the payment periods.⁶⁶

The written notice of allocation must disclose to the patron the portion of the allocation, if any, which constitutes a patronage refund.⁶⁷ If the notice partly represents an allocation of a patronage refund eligible for single tax treatment and partly a distribution of cooperative income not qualifying for a patronage refund deduction, the patron must be informed of that fact in the notice. The portion constituting a patronage refund may be disclosed either as a stated dollar amount or a percentage of the face amount of the written notice of allocation.⁶⁸

Distribution

Just as the money portion of a patronage refund must be "paid," so written notices of allocation must be distributed to patrons entitled to receive them. Most are distributed by mail. The process must assure that all portions of a written notice of allocation are actually distributed.⁶⁹

QUALIFIED WRITTEN NOTICE OF ALLOCATION

A "qualified" written notice of allocation is a special kind of notice. Notices are qualified in two ways. One way is based on redemption rights assigned to the written notice of allocation by the cooperative when issued.⁷⁰ The other is to have the recipient

⁶⁶ *Id.* at 957.

⁶⁷ I.R.C. § 1388(b) and Treas. Reg. § 1.1388-1(b).

⁶⁸ Treas. Reg. § 1.1388-1(b).

⁶⁹ *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972).

⁷⁰ *See* I.R.C. § 1388(c)(1)(A) and Treas. Reg. § 1.1388-1(c)(2).

consent to include the stated dollar amount of the notice in gross income for tax purposes in the year of receipt.⁷¹ In either case, at least 20 percent of the patronage refund reported by the written notice must be paid in money or by qualified check.⁷²

If a written notice is "qualified," then the portion of the patronage refund retained by the cooperative is taxed essentially the same as a cash distribution. The retained funds are deductible by the cooperative in the taxable year the underlying margin was earned. Both the cash distribution and the retained funds must be included in gross income of the recipient in the year of receipt.

For purposes of determining the dollar amounts paid by the cooperative and received by patrons, a qualified written notice of allocation "shall be taken into account at its stated dollar amount."⁷³ Both the deduction taken by the cooperative and the income received by patrons are based on the stated dollar amount of the notice.

Redeemable Notice

One method of qualifying a written notice of allocation is based on the document's redemption characteristics. The Code defines a qualified written notice in redeemable form as:

(A) written notice of allocation which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation...⁷⁴

⁷¹ See I.R.C. § 1388(c)(1)(B) and Treas. Reg. § 1.1388-1(c)(3).

⁷² I.R.C. § 1388(c)(1).

⁷³ I.R.C. § 1388(e)(2).

⁷⁴ I.R.C. § 1388(c)(1)(A).

A written notice relying on redemption rights for qualification must be redeemable in cash at its stated dollar amount.⁷⁵ The cooperative must stand ready to give the patron full cash payment of the stated dollar amount at any time during the appropriate payment period. That period begins on the date the written notice is "paid" (distributed to the patron) and continues for 90 days.⁷⁶

If a patron chooses not to redeem the notice during the specified time period, the cooperative may redeem the notice as it would any other written notice of allocation. The patron's choice not to redeem does not destroy the notice's qualified status.

The recipient of a redeemable written notice of allocation must also receive written notification of the right to redeem it in cash. The notification and the written notice of allocation must be separate documents but may be given simultaneously to each patron.⁷⁷ Publishing the notification in a newspaper or posting it at the cooperative's place of business is not sufficient.⁷⁸

A cooperative can deduct the full face value of a redeemable qualified written notice of allocation,⁷⁹ provided at least 20 percent of the entire patronage refund was paid in cash when the redeemable notice as distributed.⁸⁰ If the patron does not seek redemption during the given redemption period, the cooperative has no further cash outlay until redeeming the written notice of allocation at some later date.

⁷⁵ I.R.C. § 1388(c)(1)(A) and Treas. Reg. § 1.1388-1(c)(2).

⁷⁶ I.R.C. § 1388(c)(1)(A). The cooperative may, if it wishes, give patrons a longer time period in which to exercise the redemption option.

⁷⁷ I.R.C. § 1388(c)(1)(A) and Treas. Reg. § 1.1388-1(c)(2).

⁷⁸ Treas. Reg. § 1.1388-1(c)(2).

⁷⁹ I.R.C. § 1382(b)(1).

⁸⁰ I.R.C. § 1388(c)(1).

Qualification Based on Patron Consent

A second way to qualify a written notice of allocation requires the distributee to consent to include the stated dollar amount of the allocation in gross income in the year received.⁸¹

The patron consent requirement is satisfied through a written consent agreement,⁸² a bylaw provision,⁸³ or the distributee endorsing and cashing a qualified check.⁸⁴ These are the only permissible means for obtaining patron consent.⁸⁵

Written Consent

One way to obtain patron consent is through a written statement, signed by the distributee, and furnished to the cooperative.⁸⁶ No specific form or words are needed as long as the document "clearly discloses the terms of the consent."⁸⁷

The regulations provide a general consent form for per-unit retains which can be used for written notices of allocation with appropriate changes in the instrument's description.⁸⁸ The sample language reads:

I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any per-unit retain

⁸¹ I.R.C. § 1388(c)(1)(B) and Treas. Reg. § 1.1388-1(c)(3).

⁸² I.R.C. § 1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3)(i).

⁸³ I.R.C. § 1388(c)(2)(B) and Treas. Reg. § 1.1388-1(c)(3)(ii).

⁸⁴ I.R.C. § 1388(c)(2)(C) and Treas. Reg. § 1.1388-1(c)(3)(iii).

⁸⁵ See *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001 (1981).

⁸⁶ I.R.C. § 1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3)(i).

⁸⁷ Treas. Reg. § 1.1388-1(c)(3)(i).

⁸⁸ See Treas. Reg. § 1.61-5(d)(2)(ii) and *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001, 1016, n. 25 (1981).

certificates issued to me on or after _____ as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.⁸⁹

A written consent may refer to written notices of allocation generally without being precise as to the name of the document. The Service approved a consent provision in a membership agreement that said:

The producer agrees the amount of any allocation with respect to his patronage occurring after October 1, 1963, indicated in written notice of allocation received by him from the Association, will be reported by him to the Director of Internal Revenue as income in the taxable year in which the notice of allocation is received.⁹⁰

According to the regulations, written consent may be on "a signed invoice, sales slip, delivery ticket, marketing agreement, or other document, on which appears the appropriate consent."⁹¹ A membership agreement containing a required consent provision in express terms is also effective.⁹²

However, a signed membership agreement in which the member agrees to abide by the cooperative's "rules and regulations" will not make a bylaw provision effective as a written consent.⁹³ Similarly, an endorsed patronage refund check may

⁸⁹ Treas. Reg. § 1.61-5(d)(2)(ii).

⁹⁰ Priv. Ltr. Rul. 8023018 (Feb. 27, 1980). This ruling focused on bylaw provisions whose terminology did not correspond exactly to the names given the written notices of allocation.

⁹¹ Treas. Reg. § 1.1388-1(c)(3)(i).

⁹² Priv. Ltr. Rul. 8023018 (Feb. 27, 1980) and Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).

⁹³ *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001 (1981). The bylaw consent was not effective standing

provide written consent, but only if it contains "express terms by which the signer" gives consent.⁹⁴

Written consent is effective for anyone signing the consent document. It doesn't depend on membership in the cooperative.⁹⁵ The cooperative should choose the most appropriate document based on convenience and its method of operation. In some circumstances, a separate document whose only content is a consent provision may be the only appropriate means.⁹⁶

Bylaw Consent

Another way of obtaining patron consent to qualify a written notice of allocation is through a cooperative bylaw provision.⁹⁷ Bylaw consent⁹⁸ differs from written consent in that bylaws are not documents signed by members. As a result, the formalities for bylaw consent are devised to insure that consent is an informed consent despite the absence of a signature. The bylaw provision must meet certain requirements as to form and applies only to cooperative members who have been properly notified.

A consent provision in the bylaws must provide "that membership in the organization constitutes such consent"⁹⁹ and that the recipient agrees to take the distribution "into account at its stated dollar amount...."¹⁰⁰ The regulations provide an example of an appropriate bylaw consent provision. It states:

alone because a copy of the provision was not provided to members.

⁹⁴ *Id.* at 1014, n.20.

⁹⁵ Compare with bylaw consent which applies only to members.

⁹⁶ Such as when a cooperative deals with nonmembers on a patronage basis (eliminating the membership agreement option).

⁹⁷ I.R.C. § 1388(c)(2)(B) and Treas. Reg. § 1.1388-1(c)(3)(ii).

⁹⁸ Sometimes referred as consent by membership, as in Treas. Reg. § 1.1388-1(c)(3)(ii).

⁹⁹ I.R.C. § 1388(c)(2)(B)(i).

¹⁰⁰ I.R.C. § 1388(c)(1)(B).

Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after....., which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.¹⁰¹

The sample provision doesn't name a particular document to serve as the written notice of allocation. Under this language, any written instrument otherwise conforming to the Code requirements can suffice. If a bylaw consent provision adopts more specific terminology, the instrument issued must conform to the bylaw provision.¹⁰²

Bylaw consent is effective for current members at the time the provision is adopted and for members who join a cooperative with a consent provision in place.¹⁰³ "Member means a person who is entitled to participate in the management of the cooperative organization."¹⁰⁴

A bylaw consent provision applies only to members.¹⁰⁵ Cooperatives must use one of the two other consent methods for qualifying written notices with respect to nonmember patrons.

Being a member of a cooperative with a consent provision in its bylaws does not, by itself, meet the Code requirement for by-

¹⁰¹ Treas. Reg. § 1.1388-1(c)(3)(ii)(b).

¹⁰² Priv. Ltr. Rul. 8023018 (Feb. 27, 1980).

¹⁰³ I.R.C. § 1388(c)(2)(B).

¹⁰⁴ Treas. Reg. § 1.1388-1(c)(3)(ii)(c).

¹⁰⁵ Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

law consent. Members at the time the bylaw is adopted, and persons who become members later, must receive "a written notification and copy of such bylaw...."¹⁰⁶

This notice must inform patrons that the bylaw has been adopted and state its tax significance.¹⁰⁷ Both notification and a copy of the bylaw must be given to each member or prospective member.¹⁰⁸ A written notice and bylaw can't be merely published in a newspaper or posted at the cooperative's place of business.¹⁰⁹

The notice and bylaw can be mailed; and a member or prospective member is "presumed to have received" the notice and bylaw if they are sent to the last known address by "ordinary mail."¹¹⁰ For prospective members, both documents must be received prior to obtaining membership for consent to be effective.¹¹¹

Whether a cooperative uses written or bylaw consent, it must meet all requirements to make the consent effective. In *Independent Cooperative Milk Producers Ass'n v. Commissioner*,¹¹² the Tax Court did not allow one signed document that lacked the express consent provision (marketing agreement) to incorporate another document (bylaws) that contained the necessary consent language. The court believed explicit reference to the patron's consent on the face of the writing "is best suited to achieve the certainty the statute was intended to produce."¹¹³

¹⁰⁶ I.R.C. § 1388(c)(2)(B)(ii); Treas. Reg. 1.1388-1(c)(3)(ii)(a).

¹⁰⁷ Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001 (1981).

¹¹³ *Id.* at 1015.

The Tax Court also looked to the regulations which indicate the signature and consent must appear in the same document¹¹⁴ and concluded that the specificity of all Code consent requirements suggests a strict approach requiring "unambiguous, affirmative acts of consent..."¹¹⁵

Qualified Check

A third means of qualifying written notices of allocation is to issue a "qualified check," defined by the Code as:

...a check (or other instrument which is redeemable in money) which is paid as a part of a patronage [refund]... on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage [refund] or payment of which such qualified check is also a part.¹¹⁶

A check must meet requirements as to its form, the payment it represents, the recipient, and the consent statement to be "qualified." And this type of consent is effective only if the recipient takes specific action.

The instrument must be in the form of a check or "other instrument which is redeemable in money."¹¹⁷ It doesn't have to be an ordinary check payable through the banking system. It can be an instrument redeemable in money by the cooperative.¹¹⁸

¹¹⁴ Citing Treas. Reg. § 1.1388-1(c)(3)(i).

¹¹⁵ *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001, 1017 (1981).

¹¹⁶ I.R.C. § 1388(c)(4).

¹¹⁷ I.R.C. § 1388(c)(4).

¹¹⁸ Treas. Reg. § 1.1388-1(c)(3)(iii)(b).

A qualified check must be paid as part of a patronage refund.¹¹⁹ Section 521 cooperatives may also use qualified checks to distribute nonpatronage sourced income.¹²⁰ Consent obtained by means of a qualified check relates only to those written notices of allocation which are part of the same patronage refund or payment as the qualified check.¹²¹

Finally, the consent language for a qualified check must be "clearly imprinted" on the check itself.¹²² The consent form may not be a loose enclosure mailed or delivered to the patron, nor may the consent be attached to the check.¹²³ The recipient of a qualified check gives consent by "endorsing and cashing" the check.¹²⁴

A qualified check must be endorsed and cashed "on or before the 90th day after the close of the payment period for the taxable year of the organization for which such patronage dividend or payment is paid."¹²⁵ The cooperative may set an earlier deadline for endorsing and cashing the qualified check.¹²⁶

A qualified check is presumed to have been endorsed and cashed within the 90-day period if the earliest bank endorsement is dated no later than 3 days after the end of the 90-day period (excluding Saturdays, Sundays, and legal holidays).¹²⁷

¹¹⁹ I.R.C. § 1388(c)(4).

¹²⁰ I.R.C. § 1388(c)(4); Treas. Reg. §§ 1.1388-1(c)(3)(iii)(a) and (b).

¹²¹ Treas. Reg. § 1.1388-1(c)(3)(iii)(a).

¹²² I.R.C. § 1388(c)(4).

¹²³ *Id.*

¹²⁴ I.R.C. § 1388(c)(2)(C).

¹²⁵ *Id.*

¹²⁶ Treas. Reg. § 1.1388-1(c)(3)(iii)(a). Compare with redeemable written notices of allocation, where the redeemable period must extend for at least 90 days. I.R.C. § 1388(c)(1)(A).

¹²⁷ Treas. Reg. § 1.1388-1(c)(3)(iii)(a).

Effective Consent Period

For qualified written notices of allocation based on consent, qualification applies only to patronage that occurs while the consent is effective. The consent period is different for written consent, bylaw consent, and qualified check consent. For consent based on a writing or a bylaw provision, it is necessary to consider the initial effective date, duration of the consent period, and conditions for revocation.

Written Consent

Written consent is effective for all patronage occurring during the cooperative's taxable year in which the consent is given,¹²⁸ unless it specifically provides to the contrary.¹²⁹ The written consent remains in effect for "all subsequent years of the organization" until revoked.¹³⁰

The applicable tax year in which patronage is considered to have occurred may follow the year in which the patron conducted business with the cooperative. In pooling arrangements, for example, patronage is treated as having occurred during the taxable year in which the pool closes.¹³¹ A written consent made any time before the end of the cooperative's taxable year during which the pool closes "shall be effective with respect to all patronage under that pool."¹³²

¹²⁸ I.R.C. § 1388(c)(3)(A)(i). Thus written consent can apply retroactively to cover patronage that occurred from the beginning of the cooperative's tax year until the consent became effective.

¹²⁹ Treas. Reg. § 1.1388-1(c)(3)(i).

¹³⁰ I.R.C. §§ 1388(c)(3)(A)(i) and 1388(c)(3)(B), and Treas. Reg. § 1.1388-1(c)(3)(i).

¹³¹ I.R.C. § 1382(e), cited in I.R.C. § 1388(c)(3)(A)(i).

¹³² Treas. Reg. § 1.1388-1(c)(3)(i).

Written consent can be revoked only by "the distributee."¹³³ The revocation must be in writing,¹³⁴ signed by the patron,¹³⁵ and is effective only when filed with the cooperative.¹³⁶

Written consent can be revoked at any time. A consent that cannot be revoked will not "qualify" a patronage-based distribution.¹³⁷ Absent revocation, a patron's written consent remains in effect for all taxable years subsequent to the year in which such consent is given.¹³⁸

Revocation of written consent doesn't take effect immediately upon patron signature and delivery to the cooperative. The written consent remains in force for all patronage conducted up to the close of the cooperative's taxable year in which the revocation is filed.¹³⁹ Thus, a cooperative using written consent can predict its tax position regarding patronage refunds for the taxable year.

In a pooling arrangement, revocation of written consent is not effective for any pool "to which the distributee has been a patron before such revocation."¹⁴⁰ Written consent remains in effect for any pools in which the patron participated prior to revocation.¹⁴¹

Bylaw Consent

Unlike written consent, bylaw consent cannot be retroactive to the beginning of the cooperative's tax year. Bylaw consent applies only to patronage occurring after a patron has received written no-

¹³³ I.R.C. § 1388(c)(3)(B)(i).

¹³⁴ *Id.*

¹³⁵ Treas. Reg. § 1.1388-1(c)(3)(i).

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ I.R.C. § 1388(c)(3)(A)(i) and Treas. Reg. § 1.1388-1(c)(3)(i).

¹³⁹ I.R.C. § 1388(c)(3)(B)(i) and Treas. Reg. § 1.1388-1(c)(3)(i).

¹⁴⁰ I.R.C. § 1388(c)(3)(B)(i).

¹⁴¹ Treas. Reg. § 1.1388-1(c)(3)(i).

tification of the adoption of the bylaw provision, a copy of the bylaw, and has attained member status in the cooperative.¹⁴²

The Code provision on pooling arrangements,¹⁴³ which assigns patronage to the year the pool closes, does not apply to bylaw consent situations.¹⁴⁴ In pooling arrangements, bylaw consent applies only to patronage that occurs after notification and bylaw copy are received, even though for income and distribution purposes patronage occurs in the year the pool closes.¹⁴⁵

Bylaw consent remains in force so long as the patron remains a member of the cooperative and the bylaws contain the required consent provision.¹⁴⁶ Bylaw consent ends once the distributee "ceases to be a member" of the cooperative or the cooperative's bylaws "cease to contain" the required consent provision.¹⁴⁷

In pooling situations, bylaw consent no longer is effective "with respect to any patronage under a pool after the patron ceases to be a member of the cooperative organization or after the bylaw provision is repealed by the organization."¹⁴⁸

Qualified Check

Consent by qualified check applies to all patronage represented by the written notice of allocation to which the qualified check relates. Consent is effective upon endorsement and cashing of the

¹⁴² "A consent...shall be effective only with respect to patronage occurring after the patron has received a copy of the bylaw and the prerequisite notice and while he is a member of the organization." Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

¹⁴³ I.R.C. § 1382(e).

¹⁴⁴ I.R.C. § 1388(c)(3)(A)(ii).

¹⁴⁵ Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

¹⁴⁶ I.R.C. § 1388(c)(3)(A)(ii).

¹⁴⁷ I.R.C. § 1388(c)(3)(B)(ii) and Treas. Reg. § 1.1388-1(c)(3)(ii)(a)

¹⁴⁸ Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

check within 90 days after the close of the cooperative's payment period.¹⁴⁹ No opportunity to revoke exists after this occurs.

If an otherwise qualified check is not endorsed and cashed within the permissible period, the distribution becomes a nonqualified written notice of allocation.¹⁵⁰ The regulations provide that if the patron then cashes the check, the action is treated as a redemption of a nonqualified written notice of allocation.¹⁵¹

Deceased Patron's Estate

The death of a patron raises special concerns about the continuing effectiveness of that patron's consent. Written notices of allocation may be distributed to the estate of a deceased patron. In Revenue Ruling 73-93,¹⁵² the Service addressed the issue of whether bylaw consent, applicable to a deceased member while alive, was sufficient to qualify a written notice of allocation paid to the deceased member's estate. IRS found that the member's consent was still effective for business conducted with the cooperative during the part of the year prior to the patron's death, and the portion of the written notice covering that time period was qualified.

However, the member's consent did not cover business conducted on behalf of the estate after the member's death. Written notices of allocation relating to business with the estate itself would only be qualified if the required consent was specifically granted by the estate. If the estate is to qualify under bylaw consent, the estate must follow normal procedures for membership, including receipt of a bylaw consent provision and formal membership in the cooperative.¹⁵³

¹⁴⁹ Treas. Reg. § 1.1388-1(c)(3)(iii)(a).

¹⁵⁰ I.R.C. § 1388(d), and Treas. Reg. § 1.1388-1(d).

¹⁵¹ Treas. Reg. § 1.1388-1(c)(3)(iii)(c)(Example 2).

¹⁵² 1973-1 C.B. 292.

¹⁵³ *Id.*

The 20-Percent in Money Requirement

Another requirement to qualify a written notice of allocation is that at least 20 percent of the total patronage refund must be "paid in money or by qualified check."¹⁵⁴

This requirement was enacted as part of Subchapter T to ensure that cooperatives provided patrons with sufficient cash to pay the first bracket tax bill on qualified allocations immediately taxable to the patrons.¹⁵⁵

"Payment in money" can be made in cash or by a bank check.¹⁵⁶ If the patron has consented to include the entire allocation in taxable income, by either a written agreement or bylaw consent, a regular check is sufficient. However, if consent has not been attained, the 20 percent payment must be by "qualified check" as defined in Code section 1388(c)(4) and discussed previously.

Some cooperatives with a written consent or bylaw consent program nonetheless make the "money" payment by a check that meets the requirements of a qualified check. Then, if other consent methods are found invalid for any reason, they can fall back on the qualified check option to substantiate its patronage refund deductions.

The Service has held that the payment in money must be made at the same time the patron receives the written notice of allocation. IRS reasoned that if the cash payment were made before or after receipt, the patron could face the same problems the

¹⁵⁴ I.R.C. § 1388(c)(1).

¹⁵⁵ Rev. Rul. 65-221, 1965-2 C.B. 320; S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 C.B. 707, 818 and 1962 U.S. Code Cong. & Admin. News 3304, 3415-3416. A minimum tax rate of 20 percent was included in the Internal Revenue Code of 1954, §1, 68A Stat. 5 (1954), and remained unchanged until reduced to 14 percent in 1964.

¹⁵⁶ Treas. Reg. § 1.1388-1(c)(1).

20-percent payment in money requirement was intended to eliminate.¹⁵⁷

Basis of Calculation

The 20 percent calculation is based on the total dollar amount of the written notice of allocation. This includes, in the case of a section 521 cooperative, any nonpatronage-sourced income distributed on a patronage basis.

Any portion paid in nonqualified written notices of allocation "may be disregarded" in determining the 20 percent amount.¹⁵⁸ In an example provided in the regulations,¹⁵⁹ cooperative A paid a patronage refund of \$100 in the form of a nonqualified written notice of allocation with a stated dollar amount of \$50, a written notice with a stated dollar amount of \$40, and money in the amount of \$10. The written notice with a stated dollar amount of \$40 would constitute a qualified written notice if all other requirements under section 1388(c) are met. The \$10 payment in money accompanying the \$40 written notice satisfies the 20-percent-payment-in-money requirement.

Prohibited Payment Forms

The regulations, on their face, prohibit certain noncash payments in lieu of money.

Offsetting a Debt. A credit by a cooperative against amounts a patron owes it, in lieu of payment to the patron, doesn't satisfy the "paid in money" requirement.¹⁶⁰ Revenue Ruling 65-221 states this is because the patron "does not have the opportunity to use the money he is entitled to have made available to him from the cooperative to pay his taxes."¹⁶¹

¹⁵⁷ Priv. Ltr. Rul. 7746080 (August 22, 1977).

¹⁵⁸ Treas. Reg. § 1.1388-1(c)(1).

¹⁵⁹ *Id.*

¹⁶⁰ Treas. Reg. § 1.1388-1(c)(1).

¹⁶¹ Rev. Rul. 65-221, 1965-2 C.B. 320, 320-321.

Paying Membership Fee. Cooperatives and prospective members may find it convenient to apply patronage refunds due nonmember patrons toward the cost of membership stock or a membership certificate. The patron isn't required to make an initial payment for membership, yet gains the benefits of membership in the course of time.

There is no prohibition against this practice. However, amounts applied towards membership costs cannot reduce the money portion paid in connection with written notices of allocation below the 20 percent requirement for qualification. As noted in the regulations, payment in money does not include "a credit against the purchase price of a share of stock or of a membership in such organization."¹⁶²

Documents Redeemable by the Cooperative. The regulations also provide payment in money does not include a document redeemable by the cooperative for money.¹⁶³

Constructive receipt. Although not specifically mentioned in the regulations, the payment in money requirement also is not met through "constructive receipt," whereby a patron has the right to collect the money at any time after its availability is "declared."

In *Seiners Association v. Commissioner*,¹⁶⁴ the U.S. Tax Court found that allowing constructive receipt would completely negate the 20 percent money payment rule. Money not actually received cannot be applied towards the patron's tax liability that results from recognizing the full value of the qualified written notice as taxable income. In addition, the words of the statute calling for payment in the form of "money" (or qualified check) are not compatible with the constructive receipt concept. The court noted that there is "little room for doubt that when a statute requires a

¹⁶² Treas. Reg. § 1.1388-1(c)(1).

¹⁶³ *Id.*

¹⁶⁴ *Seiners Ass'n v. Commissioner*, 58 T.C. 949 (1972).

distribution of money its requirements cannot be met by the application of the constructive receipt doctrine."¹⁶⁵

Patrons' Discretion

The above discussion suggests that a check drawn on a bank is the only acceptable noncash method of meeting the 20 percent-in-money requirement. However, the Service has been more flexible and permitted noncash distributions to satisfy the payment in money requirement where the patron had the option to receive a cash or bank check payment, but voluntarily agreed to direct the funds elsewhere.

In the first ruling in this area,¹⁶⁶ the Service allowed an arrangement where the patron, by contract with the cooperative, agreed to apply the entire patronage refund, including the 25 percent otherwise paid in a qualified check, against an annual minimum payment owed by the patron to the cooperative for equipment purchased under a conditional sales contract.

In a second ruling released in 1965,¹⁶⁷ the IRS discussed the authority of a patron to direct the cooperative to make the payment in money to a third party. Three situations were presented:

(1) The bylaws of cooperative X said it could deduct from patronage refunds otherwise payable to a member an annual amount for dues to a farmers' educational organization. Before the cooperative could deduct the amount for dues, the member had to authorize the "check-off" in writing.

(2) Cooperative Y had a similar bylaw provision except it automatically paid the dues unless the member notified the cooperative in writing that it did not want the funds deducted.

(3) Cooperative Z's bylaws provided simply for check-off of dues to a farmers' education organization. The members

¹⁶⁵ *Id.* at 959.

¹⁶⁶ Rev. Rul. 65-128, 1965-1 C.B. 432.

¹⁶⁷ Rev. Rul. 65-221, 1965-2 C.B. 320.

were not given authorization either to deduct the dues or to discontinue the deduction. If a member did not want dues deducted, the only alternative was withdrawal from membership in the cooperative.

IRS said that in the cases of both cooperative X and cooperative Y, the member makes the election as to the deduction from their patronage refund. Consequently, the amounts applied to the educational organization's dues by both cooperatives would satisfy the 20 percent "paid in money" requirement. The dues check-off by cooperative Z, however, could not be treated as a patronage refund "paid in money" because the payments were not made at the option of the individual member for whom the dues were paid. The Service stated:

...where the disposition of the money the patron is entitled to receive from the cooperative is beyond the control of the cooperative, a payment by the cooperative to a third party at the option of the patron can be treated as a payment in money to the patron. The cooperative, in effect, has made the money available to the patron and is simply following his authorization as to payment.¹⁶⁸

The importance of patron choice also was emphasized in a subsequent letter ruling.¹⁶⁹ Here, a supply cooperative met its payment in money requirement by having the funds credited to each patron's account. The credit could be used by the patron to purchase merchandise within 8½ months after the close of the cooperative's fiscal year. Checks were sent to the patrons for any unused credits before the end of the 8½-month period. The patrons also had the option to request the cooperative to send them

¹⁶⁸ *Id.* at 321.

¹⁶⁹ Priv. Ltr. Rul. 7850073 (Sept. 18, 1978).

the remaining part of their patronage refund in money rather than establish a credit.

The ruling outlines the general rule in the regulation against crediting accounts in lieu of actual cash payment. However, relying on Revenue Ruling 65-221, IRS stated:

...where the patron has the option of receiving the money he is entitled to receive from the cooperative, in cash, rather than as a credit to his account with the cooperative; the cooperative, in effect, has made the money available to the patron and is simply following his authorization in regard to payment, whether such authorization is given either actively or passively.¹⁷⁰

In another instance, a wholesale hardware cooperative had a policy whereby when a membership was terminated and the member was indebted to the cooperative, returns of retained refunds could be applied against the debt. The cooperative proposed a bylaw change in which the cash portion of qualified written notices of allocation could be applied against the debt unless timely request for payment of an amount equal to 20 percent of the total allocation in cash was made by the member.

The Service approved the cooperative's bylaw change. The payment in money requirement was met because the patron could receive cash upon request.¹⁷¹

A more recent letter ruling has reinforced the guidelines set out above.¹⁷² In this instance, members of a cooperative of health care providers paid annual dues to help finance their cooperative. Many of the members also belonged to, and paid dues to, a tax-exempt organization that provided information and educational services to the health care community.

¹⁷⁰ *Id.*

¹⁷¹ Priv. Ltr. Rul. 8006112 (Nov. 20, 1979).

¹⁷² Priv. Ltr. Rul. 200226037 (March 28, 2002).

The cooperative wished to amend its bylaws to provide that (1) it could apply the entire cash portion of the patronage refunds owed to the members against the dues owed by that member and (2) if any cash patronage refund was still owed to a member who was also a member of the exempt organization, that amount could be transferred from the cooperative to the exempt organization in payment of the member's dues to the exempt organization. However, the bylaw amendment will also provide that cooperative members may request that 20 percent of their total patronage refund be paid in cash and the cooperative will honor that request.

IRS summarized previous decisions on the issues and concluded:

The rulings applying the "20% cash requirement" in set-off and assignment situations involving patronage dividends focus on whether money has been "made available" to the patron. If the patron has the option to receive cash, but does not exercise that option and rather allows its patronage dividends to be applied to amounts that the patron owes the cooperative or to a third party, the patron will be treated as having received a "payment in money" as that term is used in Section 1388(c)(1) of the code [citations omitted]. If the patron does not have the option to receive the 20% cash, and the patronage dividend is automatically applied to amounts the patron owes the cooperative or to a third party, then the 20% cash requirement is not met [citations omitted].¹⁷³

NONQUALIFIED WRITTEN NOTICE OF ALLOCATION

The Code uses the term "nonqualified written notice of allocation" to cover two documents, a written notice of allocation

¹⁷³ *Id.*

that does not meet the requirements for qualified status set out in Code section 1388(c) and a qualified check that is not cashed within 90 days after the close of the payment period.¹⁷⁴

A nonqualified written notice of allocation can be in any form allowable for a written notice of allocation. For example, a cooperative may pay all its patronage refunds as nonqualified written notices of allocation in the form of preferred stock.¹⁷⁵

Nonqualified notices must comply with the general requirements covering all written notices of allocation, or else single tax treatment is forfeited. The unique aspect of nonqualified notices is the method by which single tax treatment is achieved.

When a nonqualified notice is issued, the cooperative is not entitled to an immediate deduction from gross income and the patron recipient is not required to include as income in the year received the stated dollar amount of the allocation. Instead, deduction by the cooperative and income recognition by the patron take place in the taxable year in which the nonqualified notice is redeemed.¹⁷⁶ Therefore, single tax treatment for both the cooperative and patron is finalized in the taxable year of redemption.

A written notice of allocation will acquire nonqualified status if the payment in money is not included with the notice at the time of distribution,¹⁷⁷ the payment is less than 20 percent of the amount of the patronage refund, or the proper patron consent is not attained.¹⁷⁸

¹⁷⁴ I.R.C. § 1388(d) and Treas. Reg. § 1.1388-1(d).

¹⁷⁵ Priv. Ltr. Rul. 8138144 (June 26, 1981).

¹⁷⁶ I.R.C. §§ 1382(b)(2) and 1385(c). Redemption of patronage equity is discussed in another chapter.

¹⁷⁷ Priv. Ltr. Rul. 7728030, (no date), 1977.

¹⁷⁸ Priv. Ltr. Rul. 7825095 (March 27, 1978). The Service approved the cooperative's proposal to retroactively reclassify the written notices of allocation from qualified to nonqualified status and to deduct

Sometimes written notices of allocation inadvertently attain nonqualified status. But issuing a nonqualified notice might also reflect the members' preference for the cooperative to assume the tax liability attributable to the allocation in the year of issue, while deferring the patron's tax burden until the time of redemption.

Cooperatives have considerable flexibility to issue patronage refunds as a combination of cash, qualified written notices of allocation, and nonqualified written notices of allocation. The only limit is that at least 20 percent of a qualified allocation package be paid in money.

The regulations include an example in which a cooperative pays a patronage refund of \$100 consisting of a \$50 nonqualified written notice of allocation, a \$40 qualified written notice of allocation, and \$10 in money. The \$40 written notice of allocation was qualified because the \$10 payment in money is at least 20 percent of the total allocation package comprised of the qualified notice and the payment in money.¹⁷⁹

The Service has also approved a patronage refund distribution scheme using only cash and nonqualified written notices of allocation.¹⁸⁰

payments to patrons in redemption of the notices.

¹⁷⁹ Treas. Reg. § 1.1388-1(c)(1).

¹⁸⁰ Priv. Ltr. Rul. 8142166 (July 24, 1981).

CHAPTER 8

PER-UNIT RETAIN ALLOCATIONS

The traditional tool of cooperative finance, both to return earnings to members and to acquire equity capital, is the patronage refund. However, a second patronage-based financing mechanism, the per-unit retain allocation, is an important source of capital for certain marketing cooperatives.

WHAT IS A PER-UNIT RETAIN?

A per-unit retain allocation¹⁸¹ is a distribution by a cooperative to a patron based on the quantity of products, measured by physical volume or dollar value, marketed through the cooperative by the patron.

Per-unit retains can be distributed in money, certificates, or other property¹⁸² and receive single tax treatment as long as payment or allocation occurs during the cooperative's taxable year or within 8½ months after the close of the taxable year.¹⁸³

A cooperative's authority to issue per-unit retains usually appears in the association's bylaws, the member marketing agreement, or both.

¹⁸¹ The formal Code term "per-unit retain allocation" is often shortened to "per-unit retain" or "per-unit retains."

¹⁸² I.R.C. §§ 1382(b)(3)-(4).

¹⁸³ The payment period may last longer in situations where the cooperative has a pool remaining open over more than one taxable year. *See* discussion under "Pooling and Statutory Payment Period" in this chapter.

How Per-Unit Retains Are Used

The primary role of per-unit retains is to generate member-contributed capital. In a typical transaction, a cooperative markets a certain number of units of a patron's product resulting in a given price per-unit. Under the marketing agreement between the cooperative and the patron, the cooperative deducts a fixed amount of money per-unit of product marketed from the check it sends the patron for sales proceeds as a patron equity or debt interest in the cooperative. The patron receives a per-unit retain certificate evidencing the particular interest. The certificate's stated value is the amount invested in the cooperative.¹⁸⁴

Capital generated from per-unit retain certificates might be used to replenish a cooperative's working capital,¹⁸⁵ targeted for general capitalization uses,¹⁸⁶ or used as a reserve for a special purpose. An example of the latter would be withholding a fixed amount each month to establish a reserve fund for guaranteeing payments to patrons in case a buyer fails to pay for product delivered.¹⁸⁷

Cooperatives often use the funds generated from per-unit retain certificates to redeem certificates issued previously. This enables a cooperative to revolve capital accounts so that patron investment is more nearly related to current patronage or use.

¹⁸⁴ See Neely & Hulbert, *Legal Phases of Farmer Cooperatives*, FCS Information 100 (USDA 1976), at 443. The authors comment that use of "the term 'retains' is unfortunate because it carries the connotation that the cooperative is 'withholding' money or funds from its patrons--perhaps arbitrarily. This, of course, is not the case. These funds are provided by patrons under specific agreements with the cooperative and are, in fact, capital *investments*."

¹⁸⁵ *Riverfront Groves v. Commissioner*, 60 T.C. 435 (1973); Priv. Ltr. Rul. 8033070 (May 22, 1980).

¹⁸⁶ Priv. Ltr. Rul. 8023018 (Feb. 27, 1980).

¹⁸⁷ See *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001 (1981).

Cooperatives with marketing operations may use both per-unit retains and patronage refunds in their financial plan. When members deliver products, the cooperative may deduct a per-unit retain from the cash advance it pays to the members. After the fiscal year end (or, if a pool is involved, when the pool closes), the cooperative calculates the appropriate net margins and pays each patron a patronage refund (in cash or noncash allocations) based on the amount of product that patron delivered.

Per-unit retains also can be paid in money or in certificates which are redeemed shortly after issuance. This is really a device for making cash payments to patrons rather than a means of financing the cooperative. Since per-unit retains are not tied to a cooperative's earnings, they can be paid to patrons before the end of the tax year.

Cash per-unit retains are predominantly used by cooperatives that market member products on a pooled basis and don't close their pools until after the end of the taxable year in which the product was delivered. Patronage refunds can't be distributed until the pool is closed and the related margins determined, so per-unit retains give the association a method of making a cash payment to the members, related to use, and eligible for single tax treatment.

Comparison with Patronage Refunds

It is important to recognize the similarities and differences between per-unit retains and patronage refunds.¹⁸⁸

First, the similarities. Per-unit retains, like patronage refunds, base a patron's capital investment in the cooperative on the extent each patron uses the cooperative's services. Assuming Code requirements are followed, both payment forms are eligible for single tax treatment--tax liability at either the cooperative or

¹⁸⁸ The term "patronage refund" rather than the Code term "patronage dividend" is used in this series of reports in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

patron level, but not both. And both methods generally are used in conjunction with capital financing plans such as a revolving fund or base capital plan.

Several key distinctions should also be noted. The calculation of per-unit retains is not tied to the cooperative's net earnings from business done with or for its patrons as is the case with patronage refunds. Instead, per-unit retains are based on the physical volume or dollar value of product marketed for each patron without regard to net earnings. This non-linkage with earnings gives cooperatives the ability to raise equity in years with low earnings or even losses and the flexibility to make per-unit retain allocations before the end of the fiscal year.

Single tax treatment of per-unit retain allocations is only available for transactions made as part of a cooperative's marketing operations. In contrast, subchapter T tax treatment is available for patronage refunds based on any marketing, supply, or service activity of a cooperative.

Another difference is that single tax treatment of per-unit retains issued as qualified certificates doesn't require that some portion of the allocation be paid in money. At least 20 percent of a qualified patronage refund distribution must be paid in cash or qualified check.¹⁸⁹

The contentious issue of whether a refund is from patronage- or nonpatronage-sourced earnings doesn't arise when considering per-unit retains. A per-unit retain allocation, by definition, can only involve funds derived from marketing a patron's products.¹⁹⁰ This activity is generally accepted as patronage in nature.

HISTORICAL BACKGROUND

Little is known of the exact origin of per-unit retain financing by cooperatives. Experienced cooperative advisers indicated that

¹⁸⁹ I.R.C. 1388(c)(1).

¹⁹⁰ I.R.C. § 1388(f).

the system just evolved as a natural method of financing a cooperative marketing operation.

A review of some of the earlier court decisions involving cooperative finance indicates per-unit retains were used early in the development of the marketing cooperative system.¹⁹¹ In *Reinert v. California Almond Growers Exchange*, the court described an early per-unit retain similar to those in use today:

In view of the fact that the Exchange was a nonprofit, nonstock corporation it did not have funds available from the sale of capital stock to be used for working capital and to acquire a plant in which to conduct its operations. To provide working capital from which to make advances to growers before sale of their nuts and for supplies, the reserve for working capital, also known as the suspense account, was established some time prior to 1919. From the amount described as net proceeds to the grower on the annual pool closing statements a further deduction was made, representing a stated percentage of the grower's net proceeds, usually 5 per cent., and held out by the Exchange, and credited to its reserve for working capital. This reserve was placed on the revolving fund basis, the amounts held out in future years being used in part to repay to growers the contributions of prior years to the account.¹⁹²

¹⁹¹ *Silveria v. Associated Milk Producers*, 219 P. 461, 63 Cal. App. 572 (1923). Members successfully sued their cooperative to secure refunds of per-unit retains collected for capital accumulation because the marketing agreement between the cooperative and its members only authorized deductions to cover transportation and other marketing expenses.

¹⁹² *Reinert v. California Almond Growers Exchange*, 63 P.2d 1114, 1117 (Cal. App. 1936)(unreported in California); *rev'd*, 70 P.2d 190, 9 C.2d 181 (1937). The California Almond Growers Exchange is currently called Blue Diamond Growers.

Per-unit retains (frequently called "deductions" in the earlier years) were authorized by the historically important Bingham Act¹⁹³ and other State cooperative laws.¹⁹⁴

A detailed study by USDA's Farmer Cooperative Service¹⁹⁵ of financial data for association fiscal years ending in 1954 revealed per-unit retain financing was widely used well before Subchapter T was enacted in 1962. Of the \$847 million in equity capital reported by the 1,157 farmer cooperatives supplying data to the study, 10 percent had been acquired through per-unit retains. For marketing associations only, the figure was 18 percent.¹⁹⁶

A follow-up report disclosed the responding cooperatives reported \$489 million of their equity, or 58 percent, was revolving fund capital.¹⁹⁷ For all cooperatives, 17 percent of revolving fund capital was acquired through per-unit retains. The percentage increased to 23 percent for local marketing associations and 26 percent for marketing regionals.¹⁹⁸

¹⁹³ *Burley Tobacco Growers' Co-op Ass'n v. Tipton*, 11 S.W.2d 119, 227 Ky. 297 (1928); *Burley Tobacco Growers' Co-op Ass'n et al. v. Brown*, 17 S.W. 2d 1002, 229 Ky. 696 (1929).

The Bingham Co-operative Marketing Act, adopted in Kentucky in 1922, is sometimes referred to as the "Standard Act" because it served as the model for similar laws adopted in many other States. Baarda, *State Incorporation Statutes for Farmer Cooperatives*, ACS Cooperative Information Report 30 (USDA 1982), p. 3.

¹⁹⁴ *See, e.g., Boyle et al. v. Pasco Growers' Ass'n*, 17 P.2d 6, 170 Wash. 516 (1932).

¹⁹⁵ A predecessor to the Rural Business\ Cooperative Service.

¹⁹⁶ H. Hulbert, Griffin, and Gardner, *Methods of Financing Farmer Cooperatives*, FCS General Report 32 (USDA 1957) pp. 14-16. The study found this method of acquiring capital was insignificant for farm supply cooperatives.

¹⁹⁷ H. Hulbert, Griffin, and Gardner, *Revolving Fund Method of Financing Farmer Cooperatives*, FCS General Report 41 (USDA 1958) p. 8.

¹⁹⁸ *Id.* at p. 19.

Per-unit retains were used extensively in California. The questionnaires from a 1952 survey of California cooperatives by the Department of Agricultural Economics of the University of California (Davis) were made available to USDA for tabulation, using the same methods as USDA's 1954 survey. Of the 157 California cooperatives providing data that had an equity redemption program, 68.4 percent of their revolving fund capital had been acquired by per-unit retains.¹⁹⁹

USDA studies conducted after enactment of Subchapter T document the continued importance of per-unit retain financing. For 1970, marketing cooperatives reported that 35.9 percent of their allocated equity had been acquired by per-unit retains. This amounted to nearly \$460 million.²⁰⁰

Reliance on per-unit retains varied among commodity groups. Two out of every 3 dollars of patronage-sourced equity in fruit and vegetable cooperatives came from per-unit retains. The percentages for other crops included rice (nearly 50 percent), poultry (38 percent), dairy (26 percent), cotton (13 percent), and grain and soybeans (1 percent).²⁰¹

The latest USDA study, covering 1987, found that while the number of marketing cooperatives using per-unit retains fell from 229 in 1976 to 190 in 1987, the amount of new financing provided from per-unit retains increased from \$125 million in 1976 to \$190 million in 1987.²⁰² Thus, for many marketing associations per-unit retains are an integral part of their capital accumulation program.

¹⁹⁹ *Id.* at p. 37. Of these 157 cooperatives, 152 were marketing.

²⁰⁰ Griffin, *A Financial Profile of Farmer Cooperatives in the United States*, FCS Research Report 23 (USDA 1972) at p. 23 (Table 14).

²⁰¹ *Id.* at p. 24 (Table 15).

²⁰² Royer, Wissman and Kraenzle, *Farmer Cooperatives' Financial Profile, 1987*, ACS Research Report 91 (USDA 1990) at p. 17 (Table 9).

LEGISLATIVE AND REGULATORY BACKGROUND

In view of the extensive regulatory, judicial, and legislative history of the tax treatment of patronage refunds, it seems difficult to believe that little consideration was given to per-unit retains until the 1960s. The Revenue Act of 1951 made no mention of them.²⁰³

In 1954, the U.S. Treasury Department (Treasury) issued two administrative rulings that acknowledged per-unit type retains. Rev. Rul. 54-10 set out the IRS's policy regarding the tax treatment of patrons who received noncash allocations from cooperatives. The Service noted that while the term patronage refund "does not include amounts without reference to earnings of the association," the rules in the regulation applied "to all allocations made by a cooperative association in document form."²⁰⁴

In a one-paragraph decision, Rev. Rul. 54-244, a cooperative had retained a portion of sales proceeds due patrons and issued stock with a par value equal to the amount of funds retained. The patrons had reported the face amount of the stock received as part of their income in each year the stock was distributed. The Service held the value of the stock did not represent "earnings and profits of the association."²⁰⁵

In 1958, Treasury issued new regulations to implement the cooperative provisions of the Code as recodified by the Revenue

²⁰³ Revenue Act of 1951, ch. 521, §314, 65 Stat. 452, 491-493 (1951). This law is discussed in Chapter 3 of these reports, Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, Part 1 (USDA 2005) pp. 116-119.

²⁰⁴ Rev. Rul. 54-10, 1954-1 C.B. 24.

²⁰⁵ Rev. Rul. 54-244, 1954-1 C.B. 104. For a thorough discussion of whether payments from patrons to a cooperative are taxable payments for goods and services received or nontaxable contributions to capital, see *United Grocers, Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962), *aff'g* 186 F. Supp. 724 (N.D. Calif. 1960).

Act of 1954.²⁰⁶ The definition of "patronage dividends, rebates, and refunds" specifically excluded "Amounts allocated...by the association for products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association."²⁰⁷

The 1958 version of USDA's *Legal Phases of Farmer Cooperatives* only briefly describes the nature of "deductions" from sales proceeds returned to producers and the legal authority for cooperatives to use them to raise capital.²⁰⁸ In discussing tax law, the statement is made that the only difference between the tax treatment of noncooperative and cooperative corporations is that cooperatives may exclude from gross income "true patronage refunds,"²⁰⁹ ignoring deductions used as retains.

The 1958 USDA report's one paragraph on the tax treatment of retains states:

Amounts authorized by members to be deducted from sales proceeds in the case of a marketing cooperative or to be added to the cost of purchases made for the express purpose of being used by the cooperative as capital also are not taxable to the cooperative. This is because money furnished to any corporation for capital purposes is not income to the corporation (cites omitted).²¹⁰

²⁰⁶ Internal Revenue Code of 1954, 68A Stat. 3, 177-178 (1954).

²⁰⁷ Treas. Reg. § 1.522-1(b)(4)(ii), *published as* T.D. 6301, 1958-2 C.B. 197, 247. *See also* Example 1 of this regulation, which immediately follows the quoted definition.

²⁰⁸ Hulbert and Mischler, *Legal Phases of Farmer Cooperatives*, FCS Bulletin 10 (USDA 1958) at pp. 120-123.

²⁰⁹ *Id.* at p. 209.

²¹⁰ *Id.* at p. 214.

The Revenue Act of 1962,²¹¹ which introduced subchapter T and the present system of cooperative taxation, also didn't mention per-unit retain allocations. It focused on written notices of allocation without, however, casting any particular hindrances in the way of per-unit retain type distributions to patrons.

Some knowledgeable cooperative tax practitioners have suggested in informal conversations that this was an inadvertent omission in the original version of Subchapter T. When Subchapter T was drafted, the Treasury Department was only concerned about making sure a current tax was paid on patronage refunds.²¹²

The new provisions were, by their terms, only applicable to patronage refunds. Cooperative tax experts recall certain cooperative advisers at the time suggesting that because per-unit retains were not covered by subchapter T, patrons receiving "qualified" retains could still avoid tax on the theory the retains had no fair market value when issued and thus were not taxable income.²¹³

²¹¹ Pub. L. No. 87-834, 76 Stat. 960 (1962), *reprinted in* 1962-3 C.B. III.

²¹² The judicial and administrative decisions that defeated the intent of Congress to create a single current tax in the Revenue Act of 1951 are discussed in Chapter 3 of these reports, Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) at pp. 119-122.

²¹³ These recollections are supported by language in the Senate Report accompanying the Foreign Investors Tax Act of 1966, which included statutory language on tax treatment of per-unit retains. The report states, "...because the per-unit retain certificates issued by cooperatives may have a fair market value considerably less than their face amount...some have raised questions as to whether they may be considered as paid out by the cooperatives and whether the patrons can be required to include them in their gross income." S. Rep. No. 1707, 89th Cong., 2d Sess., *reprinted in* 1966 U.S. Cong. & Admin. News 4446, 4515.

Because of this gap in coverage, Treasury amended Treas. Reg. section 1.61-5 to include rules for the deductibility of per-unit retain certificates by cooperative associations as well as their treatment as income by patrons. Proposed rules were published in May 1965.²¹⁴

Cooperatives found several deficiencies in these proposed rules, notably the lack of recognition of bylaw consent to "qualify" per-unit retain certificates and unmanageable effective dates.²¹⁵ Treasury published its final rule that October.²¹⁶ The final rule included most of the changes suggested by cooperatives, but the test for distinguishing qualified and nonqualified per-unit retains was still considered unclear.²¹⁷

In 1966, subchapter T was revised to include comprehensive coverage of per-unit retain distributions. These changes, appearing in the Foreign Investors Tax Act of 1966, amended Code sections 1382, 1383, 1385, and 1388 of subchapter T and the information reporting rules for co-ops in Code section 6044.²¹⁸

The Senate report accompanying this act noted that Treasury's 1965 regulations "provided for the income tax treatment of per-unit retain certificates in a manner that is substantially parallel to the treatment prescribed in the Revenue Act of 1962 with respect to patronage (refunds)."²¹⁹

²¹⁴ 30 FR 6349-50 (May 6, 1965).

²¹⁵ XIV Legal-Tax Memorandum No. 5, National Council of Farmer Cooperatives (May 6, 1965).

²¹⁶ Treas. Reg. § 1.61-5(d)-(h), *published as* T.D. 6855, 30 FR 13134-36 (Oct. 15, 1965).

²¹⁷ XIV Legal-Tax Memorandum No. 11, National Council of Farmer Cooperatives (Oct. 15, 1965).

²¹⁸ Pub. L. No. 89-809, tit. II, § 211(a)-(f), 80 Stat. 1539, 1580-1584 (1966).

²¹⁹ S. Rep. No. 1707, 89th Cong., 2d Sess., *reprinted in* 1966 U.S. Cong. & Admin. News 4446, 4515.

Treasury's authority to tax per-unit retains at the patron level was still being questioned, even after the 1965 regulations were promulgated.²²⁰ The 1966 amendments clarified both the authority of Treasury to collect a single current tax on per-unit retains and answered cooperative questions about the treatment of qualified and nonqualified retains.

The Senate report to the Foreign Investors Tax Act of 1966 summarized the amendments to subchapter T as follows:

The bill amends present law to provide tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends. Providing essentially the same treatment for per-unit retain certificates means, generally, that they are to be treated as income to the patron in the year in which the certificates are issued, if the patrons give their consent in writing to the inclusion of the face amount of these certificates in their income or if there is a provision in the bylaws or charter of the cooperative indicating that membership in the cooperative represents consent to such treatment. Under the amendment, the cooperative is permitted to take a deduction in arriving at gross income for a per-unit retain certificate when issued, only when the certificate qualifies for the treatment specified above at that time in the hands of the patron. Otherwise, the amount involved is deductible by the cooperative only at the time the certificate is redeemed.²²¹

The 1966 amendments to the Code brought per-unit retain financing within subchapter T coverage by providing for the imposition of income taxes at either the cooperative or patron

²²⁰ *Id.*

²²¹ S. Rep. No. 1707, 89th Cong. 2d Sess. 70, *reprinted in* 1966 U.S. Code Cong. & Admin. News 4446, 4515-4516.

level. And per-unit retains were to be taxable at face value, even if the fair market value was considerably less.²²² The 1966 changes also required cooperatives to provide return information on per-unit retain allocations comparable to that already required for patronage refunds.²²³

Just as amendments were enacted to correct an oversight during the original drafting of subchapter T in 1966, a further amendment was needed in 1969 to remedy a deficiency in the 1966 amendments. The 1962 Act authorized cooperatives to deduct patronage refunds paid in "money, qualified written notices of allocation...or other property..."²²⁴ However, the 1966 amendment only permitted the deduction of per-unit retain allocations paid in "qualified per-unit retain certificates..."²²⁵

The Senate report accompanying the 1969 amendment explained that cooperatives that marketed products on a pooling basis were having trouble making cash payments to patrons during the 8½ month payment period following the end of their taxable year. As the pool might not be closed during that period, and net earnings on a pool can't be determined until it is closed, patronage refunds couldn't be made.

While per-unit retain payments could be made during this time, the Code only authorized the deduction of such retains paid in qualified noncash form. Congress saw "no reason why a cooperative should be able to deduct per unit retain allocations paid as qualified certificates during the 8½ month period following

²²² S. Rep. No. 1707, 89 Cong., 2d Sess. 70, *reprinted in* 1966 U.S. Code Cong. & Admin. News 4446, 4515.

²²³ Pub. L. No. 89-809, tit. II, § 211(d), 80 Stat. 1584, *codified at* I.R.C. § 6044.

²²⁴ I.R.C. § 1382(b)(1).

²²⁵ Pub. L. No. 89-809, 80 Stat. 1539, at tit. II, § 211(a)(2) (1966), *codified at* I.R.C. § 1382(b)(3).

the close of the taxable year, but not per unit retain allocations paid in money during the same period."²²⁶

The 1969 amendment of subchapter T made it clear cooperatives could deduct cash per-unit retain allocations under the same rules as qualified per-unit retain certificates.²²⁷

The regulations pertaining to subchapter T haven't been rewritten to reflect the 1966 and 1969 Code changes relating to per-unit retains, so per-unit retains are not expressly covered in Treas. Reg. §§ 1.1381-1 through 1.1388-1. However, where the Code provides parallel treatment for patronage refunds and per-unit retains, the subchapter T regulations should be one source of guidance even though per-unit retains are not specifically referenced. And Treas. Reg. § 1.61-5 with its coverage of per-unit retain certificates, while predating official Code recognition of per-unit retains in 1966, has never been revoked or superseded.²²⁸

CODE DEFINITION OF A PER-UNIT RETAIN

Code section 1388(f) defines "per-unit retain allocation" as any allocation by a cooperative "to a patron with respect to products marketed for him, the amount of which is fixed without reference

²²⁶ S. Rep. No. 552, 91st Cong., 1st Sess. (1969), reprinted in 1969 U.S. Code Cong. & Admin. News 2027, 2331-2332.

²²⁷ Tax Reform Act of 1969, Pub. L. 91-172, § 911, 83 Stat. 487, 722 (1969), reprinted in 1969-3 C.B. 10, 154.

²²⁸ In amending the Code in 1966 to include per-unit retain tax treatment, the Senate Finance Committee acknowledged Treas. Reg. § 1.61-5 (as amended by T.D. 6855, 30 FR 13134, Oct. 15, 1965) and noted on p. 4515 of its report:

By adopting this amendment, your committee does not intend to reflect on the validity of the regulations recently issued by the Treasury Department with respect to per-unit retain certificates..." S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d Sess. 70, reprinted in 1966 U.S. Code Cong. & Admin. News 4446, 4515.

to the net earnings of the organization pursuant to an agreement between the organization and the patron."²²⁹

This definition contains several parts. First, an association making per-unit retain allocations must meet the Code's requirements as a subchapter T cooperative organization.²³⁰

Second, the allocation must be made to patrons²³¹ pursuant to an agreement between the cooperative and the patron.²³²

Third, the calculation of the per-unit retain is not tied to the cooperative's net earnings. This requirement distinguishes per-unit retain allocations from written notices of allocation. The basis for computing per-unit retains is apparently left to agreement between the patron and the cooperative. Normally, a per-unit retain is

²²⁹ I.R.C. § 1388(f).

²³⁰ I.R.C. § 1388(f). I.R.C. § 1381(a) provides that section 521 farmers' cooperatives and other corporations "operating on a cooperative basis" are eligible for tax treatment under subchapter T. Chapter 2 of this series of reports discusses what it means to be "operating on a cooperative basis." Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, Part 1 (USDA 2005) pp. 41-54.

²³¹ Treas. Reg. § 1.1388-1(e) defines "patron" as "any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association."

The issue of distinguishing a patron from a member is discussed in Chapter 1 of these reports, Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, Part 1 (USDA 2005) p. 15.

²³² I.R.C. § 1388(f). By "agreement," the Code means some form of agreement among the members of a cooperative generally, such as a bylaw provision, as to the measure or formula to be used. This concept should be distinguished from "obtaining agreement" from patrons to take into account as income the stated value of qualified per-unit retain certificates required under I.R.C. § 1388(h)(2).

based on the quantity or value of products "marketed"²³³ for the patron.

Per-unit retains usually take the form of a deduction of money from a payment to the patron for products sold (in raw or processed form) by the cooperative. The "per-unit" designation often refers to cents or dollars per bushel of grain, per hundred-weight of milk, per box of fruit or some other unit of quantity of product marketed by the cooperative. Whether a per-unit retain meets the Code requirements is a question of fact.²³⁴

Despite various distinctions, the parallelism in the tax treatment of patronage refunds and per-unit retains has been characterized as "striking."²³⁵ Principles that apply to patronage refunds generally also apply to per-unit retains.²³⁶ However, the statutory provisions for per-unit retains and patronage refunds are distinct and do reflect the differences in their character.²³⁷

²³³ I.R.C. § 1388(f). The Code's specific use of the word "marketed" indicates per-unit retain allocations made with reference to nonmarketing activities of a cooperative don't qualify for single tax treatment.

²³⁴ Rev. Rul. 68-236, 1968-1 C.B. 382. This revenue ruling was prepared for the guidance of cooperative organizations and their patrons in the treatment of per-unit retains for Federal income tax purposes.

²³⁵ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718, 725, n. 17 (8th Cir. 1980), 1980-1 U.S.T.C. ¶ 9352, *rev'g*, 70 T.C. 145 (1978). The court in *Farm Service* noted the similarity of patronage refunds to per-unit retains in supporting its refusal to allow patronage sourced losses to offset nonpatronage sourced income when payments were made in per-unit retain allocations rather than patronage refund allocations.

²³⁶ *See* Priv. Ltr. Rul. 8447038 (Aug. 20, 1984) where the Service approved the issuance of both qualified and nonqualified per-unit retain certificates.

²³⁷ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 at 726 (8th Cir. 1980), 1980-1 U.S.T.C. 9352, *rev'g*, 70 T.C. 145 (1978); *noting* H. Rept. 91-413, 91st Cong., 1st Sess. (1969), *reprinted in* 1969

Subchapter T tax treatment of per-unit retain allocations follows the same basic principles first established for written notices of allocation, taking into account the differences in form between the two equity instruments and the option to make cash per-unit retain allocations prior to pool closing.²³⁸

The tax treatment of per-unit retains to cooperatives is set out in Code section 1382(b). Section 1382 authorizes cooperatives to treat "as a deduction in arriving at gross income"²³⁹ per-unit retains distributed in money, qualified certificates, or other property.²⁴⁰ Treatment similar to that accorded patronage refunds also applies to cooperative payments used to redeem nonqualified per-unit retain certificates.²⁴¹

ADVANCES AND PER-UNIT RETAINS PAID IN CASH

Marketing cooperatives frequently make an initial cash payment to their producers when product is delivered. This is especially true of pooling cooperatives. A final payment or patronage refund may not be made for some time. The accounting and tax consequences of this payment, and any periodic payments that may be made before the final payment, depend on whether the

U.S. Code Cong. & Admin. News 1645, 1821.

²³⁸ See Senate Finance Committee Technical Explanation, Pub. L. 89-809 (1966). The Committee, in adopting the 1966 changes, noted that the new law provided "tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends." S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d Sess. 70, 1966 U.S. Code Cong. & Admin. News 4446, 4515-4516.

²³⁹ I.R.C. § 1382(b).

²⁴⁰ I.R.C. § 1382(b)(3).

²⁴¹ I.R.C. § 1382(b)(4). Redemptions can be in the form of money or other property (except per-unit retain certificates).

preliminary payments are considered a cash advance or a cash per-unit retain.

Prior to the 1969 amendment to subchapter T authorizing cash per-unit retains,²⁴² the Service issued two rulings that involved the treatment of cash advances paid by pooling cooperatives. In Rev. Rul. 67-333, the Service concluded that cash advances are deductible by the cooperative as a cost of products sold in the same year they are considered income to the members.²⁴³

In Rev. Rul. 69-67, the Service modified Rev. Rul. 67-333 to make it clear that cash advances must be capitalized as part of inventory (cost of goods sold). Cash advances were only deductible to the extent that inventory in the pool was sold by the end of the tax year.²⁴⁴ For example, if 70 percent of the inventory from the pool was sold by the end of the year, then 70 percent of the cash advances were deductible in that year. Additional deductions were permitted in subsequent years in proportion to the extent that pool inventory was sold off.

Subchapter T was amended in 1969 so that per-unit retains allocated to patrons in cash or other property could receive the same single tax treatment as per-unit retains issued as qualified certificates.²⁴⁵ Section 1382 of the Code provides, in part:

(b) In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

²⁴² Tax Reform Act of 1969, Pub. L. 91-172, § 911, 83 Stat. 487, 722 (1969), *reprinted in* 1969-3 C.B. 10, 154.

²⁴³ Rev. Rul. 67-633, 1967-2 C.B. 299.

²⁴⁴ Rev. Rul. 69-67, 1969-1 C.B. 142.

²⁴⁵ S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 2027, 2331-2332. The effective date for this provision is October 9, 1969.

...(3) as per-unit retain allocations..., to the extent paid in money, qualified per-unit retain certificates..., or other property...with respect to marketing occurring during such taxable year....²⁴⁶

The Service has taken the position that cash payments made during the 8½ months of the payment period after the close of the tax year are fully deductible per-unit retains paid in money,²⁴⁷ but such payments during the tax year are cash advances that must be capitalized under Rev. Rul. 69-67.²⁴⁸

Another interpretation of this Code language is that it clearly states a cooperative shall not include per-unit retains paid in money in determining taxable income. Thus, a marketing cooperative that makes an initial payment to a patron for product delivered appears to have some flexibility in how it treats that payment for tax purposes. If it chooses cash advance treatment, the payments are capitalized as cost of goods sold. If it chooses cash per-unit retain treatment, the entire amount is deductible if paid anytime during the payment period.

In some situations, flexibility may also exist as to the year that the deduction may be taken. For example, it appears that cash payments for product delivered in one year, but made during the first 8½ months of the following year, may be considered (1) advances in the second year, (2) per-unit retains paid in money relating back to the first year, or (3) per-unit retains paid during the second year, depending on how the cooperative chooses to characterize them.

²⁴⁶ I.R.C. §1382(b)(3).

²⁴⁷ Tech. Adv. Mem. 8005012 (Oct. 29, 1979); Priv. Ltr. Rul. 8540056 (July 8, 1985); Priv. Ltr. Rul. 8838018 (June 23, 1988).

²⁴⁸ Tech. Adv. Mem. 8005012 (Oct. 29, 1979); Priv. Ltr. Rul. 8838018 (June 23, 1988).

PER-UNIT RETAIN CERTIFICATES

Most per-unit retains collected by cooperatives are treated as equity or debt. The funds are retained by the cooperative and the patrons receive written certificates as evidence of their individual capital contributions.

Code Section 1388(g) defines a retain certificate as "any written notice which discloses to the recipient the stated dollar amount of a per-unit retain allocation to him by the organization."²⁴⁹

The regulations to Code section 61 are more specific, providing:

...the term "per-unit retain certificate" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice--

- (1) Which is issued to a patron with respect to products marketed for such patron;
- (2) Which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative association; and
- (3) The stated dollar amount of which is fixed without reference to net earnings.²⁵⁰

A per-unit retain certificate must be a "written notice" issued to the patron.²⁵¹ No particular form of written statement is required.²⁵² Written notices found adequate have included

²⁴⁹ I.R.C. § 1388(g).

²⁵⁰ Treas. Reg. §1.61-5(g).

²⁵¹ I.R.C. § 1388(g) and Treas. Reg. § 1.61-5(g).

²⁵² *Id.*

certificates of retain,²⁵³ common stock,²⁵⁴ revolving fund certificates,²⁵⁵ and equity capital retain certificates.²⁵⁶

The Code and regulations also require that the certificate disclose to the recipient "the stated dollar amount" of the allocation to the patron by the cooperative.²⁵⁷

In Revenue Ruling 68-236,²⁵⁸ IRS described how some cooperatives issue a preliminary statement which indicates the amount of the per-unit retain for that particular transaction. It might be issued on a receipt at the time the goods are delivered, or it might appear on the voucher accompanying a check given as initial payment for goods delivered. A more formal statement is issued later showing the total amount of per-unit retains for a specific time period.

The Service said both sets of documents meet the technical definition of a per-unit retain certificate. The written statement uniformly treated by the parties as the per-unit retain certificate

²⁵³ In *Independent Cooperative Milk Producers Ass'n v. Commissioner*, 76 T.C. 1001 (1981), the court notes a cooperative issued what it simply called "certificate of retains."

²⁵⁴ Priv. Ltr. Rul. 8846030 (Aug. 22, 1988), describes a cooperative issuing one class of common stock for qualified per-unit retain certificates and another class of common stock for nonqualified per-unit retain certificates.

²⁵⁵ *Riverfront Groves, Inc. v. Commissioner*, 60 T.C. 435 (1973).

²⁵⁶ Tech. Adv. Mem. 8023018 (Feb. 27, 1980). The bylaws in this ruling also permitted the issuance of debt certificates.

²⁵⁷ I.R.C. § 1388(g) and Treas. Reg. 1.61-5(g). The regulations for Subchapter T, in discussing what is required for disclosing the stated dollar amount of written notices of allocation, note that "a mere credit to the account of a patron on the books of the organization without disclosure to the patron, is not a written notice of allocation." Treas. Reg. § 1.1388-1(b). This rule is also applicable to per-unit retain certificates.

²⁵⁸ Rev. Rul. 68-236, 1968-1 C.B. 382.

will be treated as the certificate for tax purposes.²⁵⁹ While some degree of informality is tolerated, in *Seiner Association v. Commissioner* the Tax Court made it clear that any notice, whether a per-unit retain certificate or a written notice of allocation, must disclose the amount of the allocation.²⁶⁰

Because both written notices of allocation and per-unit retain certificates are issued under a variety of names, it is important to look beyond the specific name of the instrument to establish its true character. For example, a "retain certificate" could be a patronage refund in the form of a written notice of allocation rather than a per-unit retain certificate.²⁶¹

Cooperatives differ in the timing of the distribution of per-unit retain certificates. Certificates may be issued when patrons deliver their product; or might not be issued until the cooperative sells the product. In pooling arrangements, some time may elapse before the cooperative issues the certificates.²⁶²

Qualified Per-Unit Retain Certificates

Once a per-unit retain certificate has been established, the next question is whether the certificate is qualified or nonqualified. As is the case with written notices of allocation, the qualified/

²⁵⁹ *Id.*

²⁶⁰ *Seiners Ass'n v. Commissioner*, 58 T.C. 949, 957-958 (1972). Although this case dealt with written notices of allocation, it referred to Rev. Rul. 68-236 to support the finding of a need for specific disclosure of the amount retained.

²⁶¹ See I.R.C. § 1388(b), which defines written notice of allocation as "any capital stock, revolving fund certificate, *retain certificate*, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend." (emphasis added)

²⁶² See discussion under "Pooling and Statutory Payment Period" in this chapter.

nonqualified characterization is important because it determines when a cooperative can deduct the allocated amount of the certificate from income.

The Code defines a "qualified per-unit retain certificate" as a certificate which the distributee agrees, through prescribed methods, to include in taxable income "at its stated dollar amount."²⁶³

Patron agreement is obtained by one of two methods: (1) individual written agreement or (2) an appropriate bylaw provision.²⁶⁴ Issues in obtaining agreement are discussed later in this subsection.

As with any per-unit retain certificate, the Code requires that qualified certificates be accounted for at their "stated dollar amount."²⁶⁵ This is true even if the certificates are worth considerably less than face value.

In *Riverfront Groves, Inc. v. Commissioner*,²⁶⁶ the U.S. Tax Court ruled that certain per-unit retain certificates be appraised at their face value even though their worth in real terms was much less. The court explained:

These per-unit retain certificates have no fair market value outside of the citrus industry. They cannot be utilized as security for normal commercial, or banking transactions, or loans, and they are redeemable by the issuing cooperative solely at the discretion of the board of

²⁶³ I.R.C. § 1388(h)(1), referring to the I.R.C. § 1385(a) rule on amounts includible in patron's gross income.

²⁶⁴ I.R.C. § 1388(h)(2). This provision refers to "obtaining agreement" for a qualified per-unit retain certificate. I.R.C. § 1388(c)(2) uses the term "obtaining consent" for qualifying written notices of allocation. While the Code language varies slightly, the procedures outlined under both Code sections are nearly identical except for inclusion of the qualified check option as a form of consent for qualified written notices of allocation [*see* I.R.C. § 1388(c)(2)(C)].

²⁶⁵ I.R.C. §§ 1388(h)(1) and 1388(e)(2).

²⁶⁶ 60 T.C. 435 (1973).

directors. Petitioner has never received any cash payments from [the cooperative] in redemption of the certificates. In fact, redemptions of similar certificates have not been made by the cooperative for at least 10 years.²⁶⁷

The court based its decision on the following rationale:

...this deduction is premised on the consent of the patron to include in his income at their face amount the qualified allocations distributed by the cooperative. It is this voluntary consent of the patron which Congress in enacting subchapter T believed to be sufficient to establish the necessary elements to tax the patron on the noncash distributions.²⁶⁸

No Cash Payment Required

One distinction between qualified per-unit retain certificates and qualified written notices of allocation is that no minimum cash payment has to accompany the distribution of qualified per-unit retain certificates.²⁶⁹ The money or qualified check requirement for qualified written notices of allocation was imposed in part to assist the patron in paying the income tax on the allocation. This requirement was not considered necessary or practical for qualified per-unit retain certificates. As noted in the House Report accompanying the Tax Reform Act of 1969:

With respect to per-unit retains, this requirement is not imposed since retains are not determined with respect to

²⁶⁷ *Riverfront Groves, Inc. v. Commissioner*, 60 T.C. 435, 437 (1973).

²⁶⁸ *Id.* at 441.

²⁶⁹ A written notice of allocation is not "qualified" unless it is distributed as part of a patronage refund with 20 percent or more of the patronage refund paid in money or by qualified check. I.R.C. § 1388(c)(1).

profits, and if the requirement were imposed, many cooperatives would merely increase by 20 percent the amount of the retain, and return the increase as a cash payment in satisfaction of the requirement.²⁷⁰

Tax Treatment

The tax consequences that arise from distribution of qualified per-unit retain certificates parallel those for qualified written notices of allocation. The cooperative can deduct from gross income in the taxable year of issuance payments made in the form of qualified per-unit retain certificates²⁷¹ while patrons must include the stated certificate amount in gross income.²⁷²

Qualification Based On Written Agreement

As mentioned previously, a qualified per-unit retain certificate requires that the patron agree to include as income the certificate's stated dollar amount.²⁷³ Code section 1388(h)(2) specifies two methods for satisfying this requirement.

One method is to have the patron agree in writing to include the certificate's stated dollar amount in gross income for income tax purposes.²⁷⁴ A common practice among marketing cooperatives that obtain agreement by written consent is to include the patron agreement provision in their membership or marketing agreement with each patron. Obtaining written agreement from the patron in this manner parallels the Code's written consent procedures for qualifying written notices of allocation.²⁷⁵

²⁷⁰ H.R. Rep. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969 U.S. Code Cong. & Admin. News 1645, 1821.

²⁷¹ I.R.C. § 1382(b)(3).

²⁷² I.R.C. § 1385(a)(3).

²⁷³ I.R.C. § 1388(h)(1).

²⁷⁴ I.R.C. § 1388(h)(2)(A) and Treas. Reg. § 1.61-5(d)(2).

²⁷⁵ For an explanation of the requirements for obtaining "consent in writing" for qualified written notices of allocation, *see* I.R.C. §

The written agreement with the patron doesn't have to follow any special form so long as there is adequate disclosure to the patron about treating the certificate's stated dollar amount as income. The regulations provide the following example:

I agree that, for purposes of determining the amount I have received from this cooperative in payment for my goods, I shall treat the face amount of any [qualified] per-unit retain certificates issued to me on or after _____ as representing a cash distribution which I have constructively received and which I have reinvested in the cooperative.²⁷⁶ [bracketed language added].

A cooperative can obtain the written agreement from the patron any time during the taxable year. Once obtained, the agreement applies to all products marketed by the patron during the taxable year in which the agreement was made unless another period is specifically provided for.²⁷⁷ This includes products marketed by the cooperative during the taxable year but before the agreement was executed. Once signed, a written agreement remains in effect, unless revoked, for "all subsequent taxable years of the organization."²⁷⁸

Cooperatives which solely rely on individual written agreements to qualify per-unit retain certificates run the risk of not obtaining agreements from all their patrons. If this should happen, the cooperative is limited to deducting only those amounts evidenced by certificates distributed to patrons who did sign such agreements.

1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3).

²⁷⁶ Treas. Reg. § 1.61-5(d)(2)(ii).

²⁷⁷ I.R.C. § 1388(h)(3)(A)(i).

²⁷⁸ *Id.*

Patrons can revoke at any time their written agreements to treat their per-unit retain certificates as income in the year received.²⁷⁹ Such a revocation must be in writing.²⁸⁰ A revocation is not necessarily effective immediately. Once filed with the cooperative, a revocation becomes effective on the first day of the following taxable year.²⁸¹ In pooling arrangements, the revocation does not apply "to any products which were delivered to the organization by the distributee before such revocation."²⁸²

Qualification Based On Bylaw Provision

The other method specified in the Code for obtaining patron agreement is through a bylaw provision that says "membership in the organization constitutes such agreement."²⁸³

For the bylaw consent to take effect, the member must receive written notification of the particular provision and a copy of the bylaw.²⁸⁴ Note that consent through bylaw is operative only for members of the cooperative, and not nonmember patrons.²⁸⁵

The bylaw language should clearly identify the applicable instrument(s) to which the patron's consent applies.²⁸⁶ This is particularly important for cooperatives that distribute more than one type of instrument.

²⁷⁹ I.R.C. § 1388(h)(3)(B)(i).

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² *Id.*

²⁸³ I.R.C. § 1388(h)(2)(B)(i).

²⁸⁴ I.R.C. § 1388(h)(2)(B)(ii).

²⁸⁵ I.R.C. § 1388(h)(2)(B).

²⁸⁶ In one ruling, IRS took a somewhat lenient position. In Tech. Adv. Mem. 8023018 (Feb. 27, 1980), the Service said "certificate of equity" in the bylaws was broad enough to include certificates that were issued as "equity capital retain certificates."

The regulations don't include a sample bylaw provision for qualified per-unit retain certificates as is done for qualified written notices of allocation.²⁸⁷ Such a provision might read:

Each person who hereafter applies for and is accepted as a member in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any per-unit retain allocations with respect to his patronage occurring after _____, which are made in qualified per-unit retain certificates (as defined in 26 U.S.C. 1388(h)) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such per-unit retain certificates are received by him.

Written notification of the adoption of this bylaw, a statement of its significance, and a copy of the provision shall be given separately to each member and prospective member before becoming a member of the association.

For a bylaw consent to be effective, the Code requires that the cooperative provide members with both written notification and a copy of the bylaw.²⁸⁸ While the regulations don't contain specific notification instructions for qualifying per-unit retain certificates, the procedures for qualifying written notices of allocation²⁸⁹ are considered applicable to qualified per-unit retain certificates.

The cooperative's written communication should make the member aware of the bylaw and the significance of the consent.

²⁸⁷ Treas. Reg. § 1.1388-1(c)(3)(ii)(b).

²⁸⁸ I.R.C. § 1388(h)(2)(B)(ii).

²⁸⁹ Treas. Reg. § 1.1388-1(c)(3)(ii)(a).

Each member should be notified individually and not through a notice posted at the association or published in a newspaper.²⁹⁰

Patron consent through a bylaw provision doesn't qualify certificates relating to products delivered after the recipient ceases to be a member of the association.²⁹¹ In addition, it doesn't apply to products delivered after the requisite language is stricken from the bylaw.²⁹²

Nonqualified Per-Unit Retain Certificates

The Code defines a nonqualified per-unit retain certificate as "a per-unit retain certificate which is not" a qualified certificate.²⁹³ Nonqualified certificates have many of the characteristics of qualified ones. Like a qualified per-unit retain certificate, a nonqualified certificate is a written notice which discloses to the patron the stated dollar amount of a noncash allocation. It is based on products marketed without reference to net earnings.

The key distinction is that a nonqualified certificate doesn't include the requisite patron agreement to account for the certificate's stated dollar amount as income when issued.

The tax treatment of nonqualified per-unit retain certificates is comparable to the treatment of nonqualified written notices of allocation. In the taxable year of issue, the cooperative doesn't exclude the stated dollar amount of the nonqualified per-unit retain certificate from income.²⁹⁴ And the patron doesn't include the stated dollar amount of the certificate as income at the time of receipt.²⁹⁵

²⁹⁰ *Id.*

²⁹¹ I.R.C. § 1388(h)(3)(B)(ii).

²⁹² *Id.*

²⁹³ I.R.C. § 1388(i).

²⁹⁴ I.R.C. § 1382(b).

²⁹⁵ I.R.C. § 1385(a).

Only in the taxable year in which nonqualified per-unit certificates are redeemed, can a cooperative reduce its gross income by the amount of the redemption payout to certificate holders.²⁹⁶ Amounts paid in redemption of nonqualified per-unit retain certificates are "treated as a deduction in arriving at gross income" by the cooperative.²⁹⁷

The patron recipient must include the redemption amount paid by the cooperative as income in the taxable year received.²⁹⁸ This finalizes the incidence of taxation for both.

The Service has concluded that a cooperative may issue both qualified and nonqualified per-unit retain certificates in the same year.²⁹⁹ Due to the dissimilar tax treatment between qualified and nonqualified per-unit retain certificates, a cooperative issuing both types of allocations should make it clear to patrons that consent applies only to certificates designated as "qualified per-unit retain certificates" by the board of directors.

PAYMENT OF PER-UNIT RETAINS

Per-unit retain allocations, regardless of the form in which distributed, must be "paid" to patrons.³⁰⁰ And to be deductible from a cooperative's gross income, per-unit retains distributed in money, qualified per-unit retain certificates, or other property must be paid "during the payment period for the taxable year during which the marketing occurred."³⁰¹ Similarly, nonqualified per-unit

²⁹⁶ I.R.C. § 1382(b)(4).

²⁹⁷ I.R.C. § 1382(b).

²⁹⁸ I.R.C. § 1385(c).

²⁹⁹ Priv. Ltr. Rul. 8447038 (Aug. 20, 1984).

³⁰⁰ I.R.C. § 1382(b). The payment also affects the liability of a recipient to take the per-unit retain allocation into account for tax purposes. *Riverfront Groves, Inc. v. Commissioner*, 60 T.C. 435 (1973).

³⁰¹ I.R.C. § 1382(b)(3).

retain certificates must be issued "during the payment period for the taxable year during which the marketing occurred."³⁰²

Payment Period

The "payment period" is the time interval in which per-unit retains must be allocated to receive single tax treatment. Like that for patronage refunds, the "payment period" for per-unit retains begins on the first day of the taxable year and extends for 20½ months, ending on the 15th day of the 9th month following the close of the taxable year.³⁰³ For example, if a cooperative operates on a calendar tax year, the "payment period" extends from January 1 of the taxable year through September 15 of the following year.

Cooperatives may use more of the payment period in making allocations as per-unit retains than as patronage refunds. Per-unit retains can be paid anytime during the 12 month taxable year as well as during the 8½-month interval following the taxable year.³⁰⁴ Patronage refunds can't be paid until after the cooperative's tax year closes because they are based upon earnings for the year from patronage business.

Prior to statutory recognition of cash per-unit retains in the Tax Reform Act of 1969,³⁰⁵ it was questionable whether cash payments made after the taxable year could relate back and affect gross income for that taxable year. With the 1969 Code change, however, cash payments made during the period following the taxable year can relate back to the taxable year's marketing and are deductible as per-unit retains in the taxable year.³⁰⁶

³⁰² I.R.C. § 1382(b)(4).

³⁰³ I.R.C. § 1382(d) and Treas. Reg. § 1.1382-4.

³⁰⁴ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), 1980-1 U.S.T.C. ¶ 9352, *rev'g*, 70 T.C. 145 (1978). Cash per-unit retains were paid when the grower delivered the product.

³⁰⁵ Pub. L. No. 91-172, 83 Stat. 487, (1969), *in* 1969-3 C.B. 10.

³⁰⁶ *See* Priv. Ltr. Rul. 8838018 (June 23, 1988).

Pooling and Statutory Payment Period

The marketing of products pooled on a seasonal or crop year basis will not always coincide with a particular tax year or the 8½ month period that follows. Pools may stay open for longer than one year because the delivered crops need more time for processing or marketing, or because storage might be desired until the market is more favorable.³⁰⁷ Growers, who contribute to pools, need funds in the interim to pay expenses and finance new crops.

The Code recognizes the potential timing problems if multi-year marketing wasn't given appropriate treatment. Section 1382(e)(2) provides that "the marketing of products shall be treated as occurring during any of the taxable years in which the pool is open."³⁰⁸

This gives cooperatives some flexibility in timing per-unit retain allocations under a multi-year pooling arrangement. Under section 1382(e)(2), "marketing" must occur in just one of the years the pool is open. This marketing activity is then attributed to all other open pool years, resulting in a payment period for per-unit retains extending for the life of the pool and the 8½ months immediately following the taxable year that the pool closes.³⁰⁹

³⁰⁷ See Wile, *Taxation of Farmers' Cooperatives and their Patrons*, 18 University of Southern California School of Law Tax Institute 449 (1966). The author notes:

The pooling system is frequently combined with the use of capital or per unit retains. Where commodities require a longer period of time for processing and sale or are to be stored and sold at higher prices when the product supply is lower, the pool may close long after the growers' delivery of their products to the cooperative. *Id.* at 457-458.

³⁰⁸ I.R.C. § 1382(e)(2).

³⁰⁹ Code § 1382(e)(1) provides "patronage" shall be treated as occurring in the taxable year the pool closes. Thus patronage refunds for longstanding pools can only be paid during the payment period for the year the pool closes.

For example, if a pool is open for 2 years, the cooperative can distribute per-unit retains at any time within the 2-year period as well as during the 8 ½-month period that immediately follows the taxable year in which the pool closes.

Assigning per-unit retains paid in subsequent years to the earliest taxable year of the pool may create a pool loss for the first year which is carried over and offsets pool profits in subsequent years in which the pool is open. When such a loss occurs, it must be segregated from nonpatronage gains and carried back or forward separately as the case may be.³¹⁰

The flexibility provided under section 1382(e)(2) for pooling arrangements involving per-unit retains contrasts with section 1382(e)(1) covering pooling that relates to patronage refunds. Under section 1382(e)(1), the patronage is treated as occurring in the taxable year in which the pool closes.³¹¹ If a pool closes 2 years after delivery of the product, the patronage is considered to have taken place in the second year. This is true even if the patron's business with the co-op took place during the first year.³¹²

³¹⁰ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th cir. 1980), *rev'g*, 70 T.C. 145 (1978). As stated by the U.S. Court of Appeals for the Eighth Circuit:

We hold, then, that subchapter T requires a nonexempt cooperative to segregate its patronage and nonpatronage accounts in calculating its gross income, at least in those cases where grower payments or per-unit retain allocations contribute to net operating losses in patronage activities. *Id.* at 726-727.

³¹¹ *See* Priv. Ltr. Rul. 8005012 (Oct. 29, 1979). Here, the Service determined that cash payments made during the 8 ½ month period after the taxable year ended were not patronage refunds because the pool was still open. The Service then held that these cash proceeds, which were distributed within four to six weeks after the close of the taxable year, qualified as per-unit retains.

³¹² Treas. Reg. § 1.1382-5 provides another example where patronage is considered to have occurred in the taxable year in which

Sometimes an important issue in pooling situations is determining the year in which the pool, for tax purposes, closes. The regulations provide that "The determination of when a pool is closed will be made on the basis of the facts and circumstances in each case, but generally the practices and operations of the cooperative organization shall control."³¹³

This regulation was written before the Code was amended to cover per-unit retains, but appears generally applicable to per-unit retains because it is designed to cover products "marketed under pooling arrangements" pursuant to I.R.C. § 1382(b).

To avoid keeping a pool open into the next fiscal year, cooperatives sometimes close a pool just prior to the end of the first fiscal year, and sell the remaining inventory to the next year's pool. However, in at least one instance the Service refused to recognize a cooperative's closing of a pool and selling forward of the remaining inventory. The Service looked to Treas. Reg. § 1.1382-5 and determined that a pool was not closed based on the facts that the marketing cooperative retained title and risk of loss of a substantial amount of the goods in the pool.³¹⁴

the pool closes:

Example. Farmer A delivers to the X Cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a 'per bushel' advance. (Both farmer A and the X Cooperative file returns on a calendar year basis.) On October 15, 1963 farmer A receives an additional "per bushel" payment. The pool sells some of its wheat in 1963 and the remainder in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

³¹³ Treas. Reg. § 1.1382-5.

³¹⁴ Priv. Ltr. Rul. 8005012 (Oct. 29, 1979).

CHAPTER 9

REDEMPTION OF PATRONAGE EQUITY

Several preceding chapters have focused on tax issues raised by the distribution of written notices of allocation and per-unit retain certificates. This chapter looks at the consequences of the subsequent redemption of patronage equity. The financial and legal underpinnings of equity redemption are explained. Then key tax considerations and options are discussed.

The primary factor in analyzing the tax implications of a redemption of patronage equity is whether the written notice of allocation or per-unit retain certificate is qualified or nonqualified. Another factor is whether the redemption payout equals the equity's stated value when issued. For example, the redemption of a qualified written notice of allocation for less than face value may require special tax computations by both the cooperative and the holder of the notice to reflect changed circumstances from the time the equity was issued.

ROLE OF EQUITY REDEMPTION IN COOPERATIVE FINANCE

The regular redemption of patron equity is unique to cooperatives. While other corporations occasionally "buy-back" shares, only cooperatives return equity to investors on a systematic basis. This is somewhat ironic, in view of the difficulty cooperatives have attracting equity. But it is consistent with the equitable concept that since current patrons benefit from service provided by the cooperative, they should also be responsible for capitalizing it.

Equity redemption is defined as returning equity to members and other patrons who have previously invested it, in the form of cash or other property. Over the years, patrons build up allocated

equity from retained patronage refunds and per-unit capital retains. Equity redemption programs provide cooperatives with a mechanism to keep a balance between each member's use of the cooperative's services and that member's share of the responsibility to provide equity capital.

While several methods are used to redeem equity,³¹⁵ the most common plan is to redeem oldest equity outstanding first and work forward toward more current equities. If, each year, a cooperative redeems the equity issued in the earliest year it has equity outstanding, it is said to have a "systematic" redemption program.

For example, if a cooperative is on a 7-year revolving cycle, patronage equities issued in 2005 would be redeemed for cash in 2012. Current patrons would be furnishing equity on the basis of a 7-year moving average of the use they made of the cooperative. Former members would be relieved of their burden of financing the association 7 years after they ceased patronizing it.

Some cooperatives redeem equity on a base capital method. Each member is assigned responsibility for providing a specific amount of equity capital, based on use of the cooperative's services. While more equity is collected from under-invested members, equity is redeemed for over-invested members.

A cooperative that retains patronage refunds and/or collects per-unit retains and also redeems allocated patronage equity on a systematic basis has a way to continually acquire equity while placing the primary responsibility for financing the association on current patrons, in proportion to the extent of their patronage.³¹⁶

³¹⁵ Some equity redemption plans are briefly discussed in chapter 2 of these reports. For a thorough explanation of cooperative equity redemption, see D. Cobia, et al., *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, ACS Research Report No. 23 (USDA 1982).

³¹⁶ For a report of current cooperative equity redemption practices, see Rathbone and Wissman, *Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives*, ACS Research Report No. 124 (USDA 1993).

TAX TREATMENT OF EQUITY REDEMPTION

The term "redemption" is not defined in subchapter T of the Code or the Treasury Regulations (regulations). One private letter ruling characterized redemption as "the act of buying back or repurchasing"³¹⁷ something which may be accomplished in a number of different ways, including "repurchase, cancellation, repayment, or any other action otherwise satisfying one's obligations."³¹⁸

Redemption of patronage equity, like its issuance, signifies a form of payment by the cooperative to the patron. However, it is important to view the issuance and redemption acts as separate and distinct events for purposes of tax treatment.

As indicated in earlier chapters on patronage refunds and per-unit retains, tax consequences at the time of redemption, for both the cooperative and its patrons, depends on whether the equity was originally issued in qualified or nonqualified form.

Redemption of Qualified Patronage Equity

When qualified written notices of allocation or qualified per-unit retain certificates are redeemed, the cooperative and the patron recipients generally do not make any adjustments to income in the taxable year of redemption.³¹⁹

The cooperative deducted the stated value of qualified written notices of allocation³²⁰ or qualified per-unit retain certificates³²¹

³¹⁷ Priv. Ltr. Rul. 7926068 (March 29, 1979), *quoting* Marker v. Scotts Bluff County, 289 N.W. 534, 537 (1939).

³¹⁸ Priv. Ltr. Rul. 7926068 (March 29, 1979), *citing* Stoller v. State, 105 N.W.2d 852 (1960).

³¹⁹ This statement assumes redemption payment is for the full face amount of the equity.

³²⁰ I.R.C. § 1382(b)(1) and Treas. Reg. § 1.1382-2(b)(1). Qualified written notices of allocation are treated "as an item of gross income and

from gross income in the taxable year of issue. Patron recipients include the face value of the qualified equity in gross income in the taxable year received.³²² As a result, single tax treatment for the cooperative and patrons was finalized at the time the qualified equity was issued.

Redemption of Nonqualified Patronage Equity

The tax treatment of nonqualified written notices of allocation³²³ and nonqualified per-unit retain certificates³²⁴ is not finalized at the time of initial distribution. In the year of issue, cooperatives must include the stated value of the nonqualified written notices or nonqualified per-unit retain certificates in gross income. Patrons don't account for the stated value of the nonqualified equity at the time of issue for tax purposes.³²⁵

as a deduction therefrom." I.R.C. § 1382(b). *See also* I.R.C. § 1382(c)(2)(A), specifically permitting § 521 farmer cooperatives to deduct qualified written notices of allocation representing nonpatronage earnings distributed to patrons on a patronage basis.

³²¹ I.R.C. § 1382(b)(3) and Treas. Reg. § 1.61-5(d). Qualified per-unit retain certificates are treated "as a deduction in arriving at gross income." I.R.C. § 1382(b).

³²² I.R.C. § 1385(a).

³²³ I.R.C. § 1388(d) defines "nonqualified written notice of allocation" as "...a written notice of allocation which is not described in subsection (c) [i.e., a qualified written notice of allocation] or a qualified check which is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is a part is paid."

³²⁴ A per-unit retain certificate is nonqualified if the cooperative fails to meet the necessary requirements for obtaining patron agreement. *See* I.R.C. § 1388(i).

³²⁵ For financial accounting purposes it may be appropriate for patrons to account for the value of the certificates as a receivable in the year issued. This matter may be relevant for corporate patrons who

In the year of redemption, however, the cooperative can deduct from income the value of payments in money or other property to patron recipients to redeem nonqualified allocations.³²⁶ Payments to redeem nonqualified written notices of allocation are treated by the cooperative "in the same manner as an item of gross income and as a deduction therefrom," while amounts paid in redemption of nonqualified per-unit retain certificates are "treated as a deduction in arriving at gross income."³²⁷

Patrons must recognize as ordinary income the amount of the redemption payment in the tax year the funds or property are received.³²⁸ Single tax treatment is thus finalized at the time of redemption, with the tax obligation placed on the patron.

To be deductible by a cooperative, payments in redemption of nonqualified equity must be made "in money or other property."³²⁹ Payment in "other property" is accounted for at fair market value.³³⁰

While "other property" is not defined by the Code,³³¹ issuance

report on audited financial statements and it indicates that the book treatment and tax treatment of accounting for patronage equity certificates are not necessarily the same.

³²⁶ I.R.C. § 1382(b)(2) for redemption of nonqualified written notices of allocation; I.R.C. § 1382(b)(4) for redemption of nonqualified per-unit retain certificates.

³²⁷ I.R.C. § 1382(b).

³²⁸ I.R.C. § 1385(c)(2)(C).

³²⁹ I.R.C. §§ 1382(b)(2), 1382(b)(4), and 1382(c)(2)(B).

³³⁰ I.R.C. § 1388(e). *See also* Treas. Reg. § 1.1382-2(c) which states in part: "In determining the amount paid which is allowable as a deduction under this paragraph, property...shall be taken into account at its fair market value when paid."

³³¹ *See* Priv. Ltr. Rul. 7926068 (March 29, 1979), wherein IRS interpreted "amounts paid...in other property" to include the cancellation of accounts receivable, issued to patrons to recover an operating loss. *See, also*, Rev. Rul. 81-103, 1981-1 C.B. 447.

of new written notices of allocation to redeem outstanding nonqualified written notices of allocation is not permitted.³³² Similarly, new per-unit retain certificates may not be issued to redeem other nonqualified per-unit retain certificates.³³³

If all or part of the redemption payment is in a noncash form, cooperative records should reflect the payment and patrons should receive tangible evidence of the redemption.³³⁴ No specific form of notification is mandated, although some written notice is probably required.³³⁵

The issuance of new nonqualified written notices of allocation in the same year that outstanding nonqualified notices are redeemed doesn't affect the tax treatment of either issue. In determining total tax liability, a cooperative must account for both transactions.³³⁶ This concept should apply as well to nonqualified per-unit retain certificates issued in the same year that other nonqualified per-unit retain certificates are redeemed.

A cooperative's ability to use Code section 1383 is not affected by subsequent adjustments to its underlying net margins which

³³² I.R.C. §§ 1382(b)(2) and 1382(c)(2)(B).

³³³ I.R.C. § 1382(b)(4).

³³⁴ In Rev. Rul. 81-103, 1981-1 C.B. 447, the redemption of nonqualified written notices by crediting account receivables was evidenced by "clearly identified book entries and notification to its patrons."

³³⁵ In Priv. Ltr. Rul. 7926068 (Mar. 29, 1979), the cooperative had "properly notified its patrons at each of the steps involved in the transaction" including "the redemption of previously issued nonqualified written notices of allocation." *See also* Rev. Rul. 70-407, 1970-2 C.B. 52, wherein IRS emphasized the use of written notices to patrons in approving cancellation of equity credits representing qualified written notice of allocation to recover an operating loss.

³³⁶ Priv. Ltr. Rul. 7925101 (March 23, 1979). Recall, however, a cooperative will not receive a deduction if the new issue of written notices are used to redeem previously issued nonqualified written notices. I.R.C. § 1382(b)(2).

were the basis for the original issue of nonqualified written notices of allocation.³³⁷

Corporate reorganizations may also take place without impacting the tax status of nonqualified equity. In one instance, a cooperative issued nonqualified written notices of allocation to patrons of a particular division. When the division was spun off as a separate cooperative, the nonqualified allocations were transferred to the new cooperative as part of a tax-free reorganization under Code section 368(a)(1)(D). IRS held the nonqualifieds would be deductible when redeemed by the new cooperative, just as they would have been had the reorganization not occurred.³³⁸

And in a tax-free reorganization in which nonqualified per-unit retain certificates were exchanged for a class of stock, a cooperative was allowed to treat redemption of the stock as redemption of the original nonqualified per-unit retain certificates.³³⁹

Typically, nonqualified written notices of allocation or nonqualified per-unit retain certificates are issued some time prior to the taxable year of redemption. However, redemption may quickly follow the time of issue, even within the payment period of the same taxable year.

For example, a cooperative with a taxable year ending on June 30, can take a deduction based on redemption of nonqualified written notices of allocation and per-unit retain certificates so long as the issue and redemption take place by March 15 of the following year.³⁴⁰ Or, a cooperative may simply distribute cash

³³⁷ Priv. Ltr. Rul. 8540051 (July 3, 1985), and Priv. Ltr. Rul. 8540056 (July 8, 1985). Nonqualified written notices of allocation issued without regard to a I.R.C. § 481 adjustment caused by change in pool accounting methods.

³³⁸ Priv. Ltr. Rul. 8613017 (Dec. 23, 1985).

³³⁹ Priv. Ltr. Rul. 8846030 (Aug. 22, 1988).

³⁴⁰ Priv. Ltr. Rul. 7728030 (no date), 1977.

patronage refunds³⁴¹ or per-unit retains.³⁴² Cooperatives may choose to do this if the objective is to return income to patrons instead of providing equity capital to the cooperative.

One technical rule must be followed. Both nonqualified written notices of allocation and nonqualified per-unit retain certificates may be redeemed within the payment period of 2 different tax years. The payment period extension of one tax year 8½ months into the following tax year causes the overlap.

If this occurs, a cooperative must take the redemption-based deduction in the *first* taxable year. The regulation includes this example: "[I]f a cooperative which reports its income on a calendar year basis pays an amount in redemption of a nonqualified written notice of allocation on January 15, 1966, it will be allowed a deduction for such amount only for its 1965 taxable year."³⁴³

Tax Computation Upon Redemption of Nonqualified Equity

Nonqualified written notices of allocation and per-unit retain certificates may be redeemed years after original issue. Yet, the single tax principle cannot be finalized in the redemption year by a simple "reversal" of the tax burden between the recipient and cooperative. It wouldn't be feasible to reopen the tax returns of all the patron recipients for the year in which the nonqualified paper was issued.

³⁴¹ I.R.C. § 1381(b)(1).

³⁴² I.R.C. § 1382(b)(3).

³⁴³ Treas. Reg. § 1.1382-2(c). A separate regulation, § 1.1382-3(d), pertaining specifically to section 521 cooperatives, contains the same rule. Although these regulations only mention nonqualified written notices of allocation, the same rule would appear applicable to the redemption of nonqualified per-unit retain certificates.

Cooperatives and patron recipients recognize all tax adjustments brought about by redemption of nonqualified paper in the year of redemption. The applicable rules are found in Code section 1383. It deals exclusively with the tax computations where a cooperative redeems nonqualified written notices of allocation and nonqualified per-unit retain certificates.³⁴⁴

Section 1383(a) contains a general statement that allows cooperatives to deduct redemptions of nonqualified patronage equities in the year of redemption. It then provides two methods for a cooperative to use in computing the deductible amount and specifically states the tax due is the lesser of the two amounts. The following analysis discusses the two methods and provides examples to illustrate when each is advantageous.

Patrons include payments in redemption of nonqualified equities in taxable income in the year of receipt, regardless of the method the cooperative uses to determine its tax adjustment.³⁴⁵

Redemption Year Alternative

Under the first method, the cooperative takes a regular deduction for amounts "paid in redemption" of nonqualified equities.³⁴⁶ The redemption amount is treated as a deduction under the relevant Code section 1382 provision:

- Section 1382(b)(2) for regular nonqualified written notices of allocation,
- Section 1382(b)(4) for nonqualified per-unit retain certificates, or
- Section 1382(c)(2)(B) for nonqualified written notices of allocation representing patronage-based distributions of nonpatronage income by a section-521 farmer cooperative.

³⁴⁴ I.R.C. § 1383.

³⁴⁵ I.R.C. § 1385(c). The tax treatment of patrons is discussed in chapter 10.

³⁴⁶ I.R.C. § 1383(a)(1); Treas. Reg. § 1.1383-1(a)(1)(i).

Prior Year Alternative

The alternative method for calculating tax on redemption of nonqualified equity involves redoing certain calculations for the year(s) the nonqualifieds were issued and using the results to adjust the cooperative's tax deemed paid in the year of redemption.

Under the prior years alternative, a cooperative first recalculates the amount of tax for the prior year or years.³⁴⁷

The regulations provide that the first step in determining the change in tax for the prior taxable year is to determine the amount of tax paid in that prior year. As the base figure, take the tax reported on the cooperative's applicable tax return, add any tax assessed (or collected without assessment) as deficiencies, and then subtract the amount of any rebates paid by IRS to the cooperative.³⁴⁸ This step produces the actual tax liability of the cooperative for the year the nonqualified equities were issued.

The cooperative next computes the aggregate decrease in tax for the prior taxable year that results from treating the nonqualified written notices of allocation and/or nonqualified per-unit retain certificates issued during that year as if they had been issued in qualified form.³⁴⁹ In calculating the decrease in tax for the prior taxable year, appropriate adjustment is made to "any item which is dependent upon the amount of gross income or taxable income (such as charitable contributions, net operating losses, the foreign tax credit, and dividends received credit)."³⁵⁰

Finally, the cooperative subtracts any decrease in taxes caused by treating the nonqualified notices as qualified in the year of

³⁴⁷ I.R.C. § 1383(a)(2) and Treas. Reg. § 1.1383-1(b)(1). The phrase "year or years" is used because a cooperative may, in its current taxable year, redeem nonqualified equities issued in more than one previous year. The singular term "year" is used in this section to simplify the explanation.

³⁴⁸ Treas. Reg. § 1.1383-1(b)(3).

³⁴⁹ I.R.C. § 1383(a)(2)(B); Treas. Reg. § 1.1383-1(a)(1)(ii).

³⁵⁰ Treas. Reg. § 1.1383-1(b)(3).

allocation from otherwise taxable income in the year of redemption.³⁵¹

Examples of Nonqualified Redemptions

A numerical model will illustrate how the various computations work and how a cooperative determines which of the two methods results in the least tax.

General Model

As illustrated in Example 1, assume that in 2003 Cooperative A had \$20,000 in margins and the entire amount was distributed to member-patrons as nonqualified written notices of allocation.³⁵² The \$20,000 is reported as taxable income in 2003 by Cooperative A. Cooperative A was in the 15-percent tax bracket in 2003, so the total tax due was \$3,000.

In 2010, Cooperative A has margins of \$30,000. This amount is also distributed entirely to patrons as nonqualified notices. In addition, Cooperative A redeems the nonpatronage notices distributed in 2003.

Under the **redemption year alternative**, Cooperative A starts its tax computation by first recognizing the \$30,000 in margins distributed as nonqualified notices as taxable income. Then, it deducts the \$20,000 paid in redemption of the 2003 nonqualified notices, leaving net taxable income for 2010 of \$10,000. At the 15 percent tax rate, the tax due is \$1,500.

Under the **prior year alternative**, Cooperative A recomputes its taxable income for 2003 assuming it had distributed the \$20,000 margin for that year as qualified written notices of allo-

³⁵¹ I.R.C. § 1383(a)(2), Treas. Reg. § 1.1383-1(a)(ii).

³⁵² The same analysis would be valid if the cooperative had issued nonqualified per-unit retain certificates, either exclusively or in combination with nonqualified written notices of allocation.

EXAMPLE 1: GENERAL MODEL

a) Redemption Year Alternative

2003

| | |
|--------------------------|---------------|
| Net Margin | 20,000 |
| Nonqualified Allocations | 20,000 |
| Taxable Income | <u>20,000</u> |
| Tax Due (15% x 20,000) | 3,000 |

2010

| | |
|---------------------------------------|---------------|
| Net Margin | 30,000 |
| Nonqualified Allocations | 30,000 |
| Redemption of Nonqualifieds from 1988 | (20,000) |
| Taxable Income | <u>10,000</u> |
| Tax Due (15% x 10,000) | 1,500 |

b) Prior Year Alternative

2003 (recomputed)

| | |
|---|--------------|
| Net Margin | 20,000 |
| Assume Payment as Qualified Allocations | (20,000) |
| Taxable Income | 0 |
| Tax with Recomputation | 0 |
| Tax Paid in 2003 | <u>3,000</u> |
| Tax Savings from Recomputation | 3,000 |

2010

| | |
|--------------------------------|----------------|
| Net Margin | 30,000 |
| Nonqualified Allocations | 30,000 |
| Taxable Income | 30,000 |
| Unadjusted Tax (15% x 30,000) | 4,500 |
| Tax Savings from Recomputation | <u>(3,000)</u> |
| Tax Due | 1,500 |

cation. The entire \$20,000 patronage refund is now deductible and the tax savings for 2003 is \$3,000.³⁵³ Cooperative A next figures the tax on its \$30,000 in taxable income for 2010. At the 15-percent rate, the tax is \$4,500. Finally, it subtracts the tax it would have saved using qualified notices in 2003 (\$3,000) from the tax otherwise due in 2010 (\$4,500), and arrives at tax due in 2010 of \$1,500.

Under these or similar facts (no change in the applicable tax rate and margins in the year of redemption at least equal to those in the year of issuance), both methods produce the same result. The regulations provide that when this happens, the tax shall be computed under the simpler redemption year method and other parts of section 1383 shall be disregarded.³⁵⁴

Change in the Applicable Tax Rate

Assume the same facts in Example 1, except that in 2008 a change in tax rates became effective so that the minimum corporate rate was increased from 15 percent to 20 percent.

As reflected in Example 2, under the redemption year alternative, the 20 percent rate would be applied to Cooperative A's otherwise taxable income for 2010 (\$30,000) less the deduction for redemption of the 2004 nonqualified notices (\$20,000). The tax due would be \$2,000 ($\$10,000 \times .20$).

Under the prior year alternative, the recomputation of the 2004 tax would reflect the tax rate in effect in that year. The deduction would still be \$3,000 ($\$20,000 \times .15$). However, now the cooperative's unadjusted tax for 2010 is \$6,000 ($\$30,000 \times .20$). The tax due under this method is \$3,000 ($\$6,000 - \$3,000$).

Thus, other things being comparable, if the applicable tax rate in the year of redemption is higher than in the year of distribution, then the redemption year method will be more favorable to the

³⁵³ To keep the example simple, the assumption is made that there are no adjustments to other items dependent on the amount of gross or taxable income.

³⁵⁴ Treas. Reg. § 1.1383-1(a)(3).

**EXAMPLE 2: INCREASE IN TAX RATE FROM
15% TO 20% IN YEAR OF REDEMPTION**

a) Redemption Year Alternative

2003

| | |
|--------------------------|---------------|
| Net Margin | 20,000 |
| Nonqualified Allocations | 20,000 |
| Taxable Income | <u>20,000</u> |
| Tax Due (15% x 20,000) | 3,000 |

2010

| | |
|---------------------------------------|---------------|
| Net Margin | 30,000 |
| Nonqualified Allocations | 30,000 |
| Redemption of Nonqualifieds from 1988 | (20,000) |
| Taxable Income | <u>10,000</u> |
| Tax Due (20% x 10,000) | 2,000 |

b) Prior Year Alternative

2003 (recomputed)

| | |
|---|--------------|
| Net Margin | 20,000 |
| Assume Payment as Qualified Allocations | (20,000) |
| Taxable Income | 0 |
| Tax with Recomputation | 0 |
| Tax Paid in 1988 | <u>3,000</u> |
| Tax Savings from Recomputation | 3,000 |

2010

| | |
|--------------------------------|----------------|
| Net Margin | 30,000 |
| Nonqualified Allocations | 30,000 |
| Taxable Income | 30,000 |
| Unadjusted Tax (20% x 30,000) | 6,000 |
| Tax Savings from Recomputation | <u>(3,000)</u> |
| Tax Due | 3,000 |

cooperative. If the applicable rate is lower in the year of redemption, then the prior year method will be more favorable.

Higher Marginal Tax Rate in Redemption Year

With the progressive nature of the income tax rate structure, a similar result to Example 2 occurs if the cooperative's margins are such that it is in a higher marginal tax bracket in the year of redemption.

Example 3 assumes the same facts as in Example 1, including the actual tax rates, except that in 2010 Cooperative A has margins of \$100,000. Again, all of the margin is distributed to patrons as nonqualified written notices of allocation.

Under the redemption year alternative, Cooperative A would deduct the \$20,000 paid in redemption of the 2003 nonqualified notices from its otherwise taxable income of \$100,000. The tax due on the resulting \$80,000 in taxable income would be \$15,450 $[(\$50,000 \times .15) + (\$25,000 \times .25) + (\$5,000 \times .34)]$.³⁵⁵

Under the prior year method, the adjustment for redemption of the 2003 nonqualified notices is still the amount of tax that would have been saved had qualified notices been issued in 2003, or \$3,000 $(\$20,000 \times .15)$. When this is subtracted from the cooperative's unadjusted tax obligation of \$22,250 $[(\$50,000 \times .15) + (\$25,000 \times .25) + (\$25,000 \times .34)]$, the tax due is \$19,250.

Thus, the result of the cooperative being in a higher tax bracket because of higher earnings in the year of redemption is the same as a tax rate increase. Other things being comparable, the redemption year method will be more favorable to the cooperative.

³⁵⁵ This example reflects the corporate income tax rates in effect for 2004: 15 percent on the first \$50,000 of taxable income; 25 percent on taxable income from \$50,001 to \$75,000; and 34 percent on taxable income above \$75,000. I.R.C. § 11.

EXAMPLE 3: HIGHER MARGINS IN YEAR OF REDEMPTION

a) Redemption Year Alternative

2003

| | | |
|--------------------------|--|--------|
| Net Margin | | 20,000 |
| Nonqualified Allocations | | 20,000 |
| Taxable Income | | 20,000 |
| Tax Due (15% x 20,000) | | 3,000 |

2010

| | | |
|---------------------------------------|--|----------|
| Net Margin | | 100,000 |
| Nonqualified Allocations | | 100,000 |
| Redemption of Nonqualifieds from 1988 | | (20,000) |
| Taxable Income | | 80,000 |

| | | |
|-----------------------|--------------|--------|
| Tax Due | | |
| (15% on first 50,000) | 7,500 | |
| (25% on next 25,000) | 6,250 | |
| (34% on final 5,000) | <u>1,700</u> | 15,450 |

b) Prior Year Alternative

2003

| | | |
|---|--|-----------------|
| Net Margin | | 20,000 |
| Assume Payment as Qualified Allocations | | <u>(20,000)</u> |
| Taxable Income | | 0 |
| Tax with Recomputation | | 0 |
| Tax Paid in 1998 | | <u>3,000</u> |
| Tax Savings from Recomputation | | 3,000 |

2010

| | | |
|--------------------------|--|---------|
| Net Margin | | 100,000 |
| Nonqualified Allocations | | 100,000 |
| Taxable Income | | 100,000 |

| | | |
|--------------------------------|--------------|-----------------|
| Unadjusted Tax | | |
| (15% on first 50,000) | 7,500 | |
| (25% on next 25,000) | 6,250 | |
| (34% on final 25,000) | <u>8,500</u> | 22,250 |
| Tax Savings from Recomputation | | <u>(3,000)</u> |
| Tax Due | | 19,250 |

Lower Margins or Loss in Redemption Year

As shown in Example 4, if margins in the year of redemption are substantially lower than in the year nonqualified notices being redeemed were issued and thus the cooperative is subject to a lower marginal tax rate, the prior year method is more favorable. This advantage might be made even more significant by a special rule permitting cooperatives to recapture tax paid in the year of issuance that might otherwise be lost under the computation methods.

Assume the same basic facts as in Example 3, only reverse the margins so that Cooperative A earned \$100,000 in 2003 and only \$20,000 in 2010. All margins are again distributed as nonqualified allocations.

Under the redemption year method, deduction of the \$100,000 paid in redemption of 2003 nonqualified notices from the \$20,000 in otherwise taxable income for 2010 would yield a tax loss of (\$80,000). The only benefit would be a savings of the \$3,000 in taxes otherwise due on the \$20,000 in 2010 margins ($\$20,000 \times .15$).

Under the prior year method, the cooperative would have a potential deduction of \$22,250, the savings by treating the nonqualified notices issued in 2003 as qualified notices for that year. The tax obligation, without adjustment, for 2010 would be only \$3,000 ($\$20,000 \times .15$).

Access to the tax loss carryback or carryover provided in Code section 172 to use the (\$80,000) loss generated under the redemption year method is apparently precluded. The regulations provide that the prior year alternative in Code section 1383(a)(2)

**EXAMPLE 4: LOWER MARGINS OR A LOSS
IN YEAR OF REDEMPTION**

a) Redemption Year Alternative

2003

| | | |
|--------------------------|--------------|---------|
| Net Margin | | 100,000 |
| Nonqualified Allocations | | 100,000 |
| Taxable Income | | 100,000 |
| Tax Due | | |
| (15% on first 50,000) | 7,500 | |
| (25% on next 25,000) | 6,250 | |
| (34% on final 5,000) | <u>8,500</u> | 22,250 |

2010

| | | |
|---------------------------------------|-----------|----------|
| Net Margin | | 20,000 |
| Nonqualified Allocations | | 20,000 |
| Redemption of Nonqualifieds from 1988 | (100,000) | |
| Taxable Income | | (80,000) |
| Tax Due | | 0 |

b) Prior Year Alternative

2003

| | | |
|---|-----------|---------------|
| Net Margin | | 100,000 |
| Assume Payment as Qualified Allocations | (100,000) | |
| Taxable Income | | 0 |
| Tax with Recomputation | | 0 |
| Actual Tax Paid | | <u>22,250</u> |
| Tax Savings from Recomputation | | 22,250 |

2010

| | | |
|-------------------------------|--|--------|
| Net Margin | | 20,000 |
| Nonqualified Allocations | | 20,000 |
| Taxable Income | | 20,000 |
| Unadjusted Tax (15% x 20,000) | | 3,000 |

| | |
|--------------------------------|-----------------|
| Tax Savings from Recomputation | <u>(22,250)</u> |
| Tax Credit | 19,250 |

must be used "when a credit or refund would be allowable for the taxable year under section 1383(b)(1)."³⁵⁶

If a cooperative uses the prior year alternative in section 1383(a)(2), then redemption deductions available under sections 1382(b) or 1382(c) cannot be used in calculating taxable income or loss for that year, "including the computation of any net operating loss carryback or carryover."³⁵⁷

The tax calculated under the prior year alternative relates back to the year the nonqualified paper was first issued. The tax impact triggered by redemption, however, is confined to the taxable year in which redemption takes place. The Code emphasizes the relation back concept and the limited use of the prior year method when it states that a deduction based on section 1383(a)(2) "shall not be taken into account for any purposes of (subchapter T) other than for purposes of this section."³⁵⁸

The special rule applies here. Code section 1383(b)(1) provides that if the decrease in tax determined under the prior year alternative exceeds the redemption year tax computed without the deduction, then the excess amount "shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year."³⁵⁹ The excess is then "refunded or credited in the same manner as if it were an overpayment for such taxable year...."³⁶⁰

³⁵⁶ Treas. Reg. § 1.1383-1(a)(3).

³⁵⁷ Treas. Reg. § 1.1383-1(a)(2).

³⁵⁸ I.R.C. § 1383(b)(3). This does not prevent a cooperative from deducting, in the year of redemption, the value of nonqualified distributions made in a year a refund or credit is claimed under § 1383(b)(1). Priv. Ltr. Rul. 7925101 (March 23, 1979).

³⁵⁹ I.R.C. § 1383(b)(1). *See also* Treas. Reg. § 1.1383-1(c).

³⁶⁰ *Id.*

In the example, Cooperative A would be entitled to a refund or credit for 2010 of \$19,250, the difference between the recovery of 2003 taxes (\$22,250) and the tax otherwise due on margins for 2010 (\$3,000). The tax adjustment for using the prior year alternative is returned to the taxpayer as if it were a tax deposited in the year the return is filed for the year of redemption and no interest is recovered, regardless of how old the certificates are.

An additional, more complex example of the application of Code section 1383 is provided in the regulations.³⁶¹

REDEMPTION AT LESS THAN FACE VALUE, FOR REASONS OTHER THAN LOSS RECOUPMENT

While cooperatives normally redeem written notices of allocation and per-unit retain certificates at face value, this is not always the case. Cooperatives have, from time to time, redeemed outstanding patronage-based equities at less than face value for two general reasons. The first is to recoup losses. The IRS has given cooperatives considerable flexibility in redeeming equities for less than face value in these instances. Rulings and determinations that discuss handling of losses at the cooperative level are covered in Part 5 of these reports.³⁶² As a redemption at less than face value always creates a loss for the patrons, tax treatment at the patron level is reported later in this chapter.³⁶³

The second reason equities are redeemed at less than face value is as part of an ongoing capital management strategy. Early redemption may be implemented, for example, to sever financial

³⁶¹ Treas. Reg. § 1.1383-1(d).

³⁶² Donald A. Frederick, *Income Tax Treatment of Cooperatives: Handling of Losses*, Cooperative Information Report 44, Part 5 (USDA 2005), pp. 43-54.

³⁶³ See *infra* pp. 142-148.

relations with an inactive or terminated member,³⁶⁴ as part of a financial restructuring,³⁶⁵ or to convey some cash to the members as rapidly as possible.³⁶⁶ This section of these reports looks at the Service's rather restrictive approach to redemptions as less than face value that are part of capital management, and the court reactions thereto.

Code Sec. 311

The Service's first examination of the tax consequences at the cooperative level involved a co-op that wished to both simplify its capital structure by eliminating a class of capital credits that represented older retained qualified patronage refunds and get some cash into the hands of the retired or otherwise inactive patrons who held most of that paper. The cooperative proposed to do so at a steep discount, \$.20 cents per \$1.00 of face value. IRS held the cooperative need not recognize a gain as a result of the proposed redemption.³⁶⁷

The Service found the redemption of qualified equity was governed by Code sec. 311(a). Sec. 311(a) provides a corporation doesn't recognize gain or loss on a distribution of (1) its stock or rights to acquire its stock or (2) property that hasn't increased in value.³⁶⁸

³⁶⁴ Priv. Ltr. Rul. 8015048 (Dec. 31, 1979); Tech. Adv. Mem. 9249005 (Dec. 4, 1992). For a discussion of the practical and legal reasons to terminate memberships of former patrons, see Donald A. Frederick, *Keeping Cooperative Membership Rolls Current*, ACS Cooperative Information Report 37 (USDA 1991).

³⁶⁵ Priv. Ltr. Rul. 8225100 (Mar. 25, 1982).

³⁶⁶ Priv. Ltr. Rul. 7840010 (June 22, 1978), Priv. Ltr. Rul. 8031041 (May 8, 1980), Priv. Ltr. Rul. 8033070 (May 22, 1980), among others.

³⁶⁷ Priv. Ltr. Rul. 7410291300A (Oct. 29, 1974).

³⁶⁸ I.R.C. § 311(a).

The rationale for this approach is as follows. The term "property," as used in this part of the Code, includes money.³⁶⁹ The term "distribution with respect to its stock" includes distributions made in redemption of stock (other than distributions in complete or partial liquidation).³⁷⁰ Finally, the term "stock" as used in the Code is considered broad enough to include equity interests not specifically called stock, such as the many terms cooperatives use to refer to retained patronage allocations.³⁷¹ Thus, under Code section 311(a), money paid by a cooperative in redemption of patronage-based equities is a distribution of property with respect to its stock that doesn't produce a gain or loss to a cooperative for tax purposes.

The Tax Benefit Rule

In a short time, IRS reversed its position. A second cooperative, that also planned to redeem old paper representing retained qualified patronage refunds for 20 cents on the dollar, asked for a similar determination that it would not recognize a gain for tax purposes on the transactions. This time the Service said the co-op would have to recognize gain to the extent that previously claimed patronage refund deductions exceeded the amounts paid in redemption of the old equities. The Service asserted that the "tax benefit rule," a tool of judicial interpretation not found in the Code, prevailed over section 311.³⁷²

The tax benefit rule provides that recovery of an item which produced an income tax benefit in a prior year must be added to

³⁶⁹ I.R.C. § 317(a).

³⁷⁰ Treas. Reg. § 1.311-1(a).

³⁷¹ *Pasco Packing Ass'n v. U.S.*, 1957-2 USTC (CCH) 58,049 (So. D. Fla. 1957); *Atwood Grain and Supply Co. v. Commissioner*, 60 TC 412 (1973).

³⁷² Priv. Ltr. Rul. 7743054 (July 28, 1977).

income in the year of recovery.³⁷³ The tax benefit rule has been in force in one form or another almost since enactment of the 16th Amendment and the decision to levy the income tax on an annual accounting basis. It was immediately recognized that some transactions would take 1 or more tax years to complete. When a taxpayer was able to deduct something in one year and recover the amount deducted in a subsequent year, the courts said taxpayer had to include the recovered amount in income in the year of recovery.³⁷⁴

A common example involves a seemingly uncollectible debt. The debtor may believe the debt is uncollectible and legitimately deduct it in one year. However, if it is repaid in a later year, the repayment must be included in income in the year of repayment.

Sometimes this results in an unfair tax obligation. The taxpayer may not have had any tax liability in the year the deduction was taken, so it didn't produce a tax savings. However, if the taxpayer had taxable income in the year of recoupment, a tax would be due on the repayment amount.

In 1942, the predecessor to current Code sec. 111 was enacted to protect taxpayers in this situation. Section 111 states that a taxpayer need not include in gross income "income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax" owed in the prior year.³⁷⁵ Thus, while Congress didn't specifically codify the tax benefit rule, it implicitly recognized it and limited its applicability to the amount of tax savings realized in the earlier year.

³⁷³ See, e.g., *Twitchco Inc. v. United States*, 348 F. Supp. 330 (M.D. Ala. 1972); *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

³⁷⁴ *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Putnam National Bank v. Commissioner*, 50 F.2d 158 (1931); *Commissioner v. Liberty Bank & Trust Co.*, 59 F.2d 320, 325 (1932).

³⁷⁵ I.R.C. § 111(a).

Today, the tax benefit rule is characterized as one of inclusion and exclusion. "Recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded*."³⁷⁶

Where a co-op redeems qualified patronage equity at less than face value, the tax benefit rule says the co-op obtains an income tax benefit because the deduction for full value in the year of issue is not offset by the same amount of payment at redemption.

IRS said that a cooperative's cash redemption of qualified equity credits for less than face value:

...is distinguishable from the situation in which a corporation redeems its stock as described in section 311 of the Code...[For qualified patronage based equities the] full face amount of the equity credits was either excluded from income or deducted from income in accordance with the provisions of Subchapter T of the Code when they were issued. The cooperative now plans to distribute only a fraction of the face value of these equity credits to its patrons.

In this situation the tax benefit rule prevails over the provisions of section 311 of the Code. The tax benefit rule is of judicial origin, and is not expressly stated in the Code. The rule requires that if an amount is deducted from gross income in one taxable year and provides a tax benefit to the taxpayer in that year, and the amount is recovered in a later year, the recovery must be included in income in the later year (citation omitted).

It is also apparent that the tax benefit rule acts as an override of specific statutory non-recognition provisions (citation omitted).³⁷⁷

³⁷⁶ Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

³⁷⁷ Priv. Ltr. Rul. 7743054 (July 28, 1977).

The Service issued subsequent letter rulings also applying the tax benefit rule to find a cooperative that redeems patronage-based equity at less than face value must recognize a gain, in the year of redemption, for the difference between the deductions taken in the year(s) of issuance and the amount of the distribution in redemption.

The first involved a Section 521 farmer cooperative that redeemed qualified written notices of allocation at a discount in response to patron requests for cash before the equities would be redeemed under the co-op's eight-year revolving cycle. The co-op accepted the applicability of the tax benefit rule and included the discounted amount as income in the year discounted.

IRS then refused to permit the cooperative to deduct the amounts paid out to patrons at the time of redemption under either of two theories advocated by the cooperative.³⁷⁸ First, even though the amounts were paid on the basis of patronage, IRS said they were not "patronage dividends" deductible under Code sec. 1382(b). Second, the amounts were not "earnings" and thus did not qualify for the deduction available for an amount paid on a patronage basis with respect to nonpatronage sourced earnings during the taxable year under Code sec. 1382(c). So the cooperative had to pay tax on the amount of its gain.

The next ruling also concerned a cooperative (without section 521 tax status) that conceded that the gain was taxable income.³⁷⁹ The Service agreed with the request of this cooperative to treat the gain as nonpatronage income, retain the net amount of such income as permanent capital in an unallocated reserve, and assign interest and tax expenses related to the early redemption at less than face value entirely to the resulting nonpatronage income. This allowed the cooperative to distribute all of its patronage-sourced income as deductible patronage refunds.

³⁷⁸ Tech. Adv. Mem. 7840010 (June 22, 1978).

³⁷⁹ Priv. Ltr. Rul. 8033070 (May 22, 1980).

In 1981, a federated marketing cooperative came up with a novel attempt to circumvent the tax benefit rule.³⁸⁰ It argued the patrons who agreed to take less than full value for their retained qualified written notices of allocation were making a tax-free gift to their cooperative. The Service found no intent to make such a gift and, again applying the tax benefit rule, said the cooperative must recognize the gain as income.

Gold Kist Decision

At the time under consideration, Gold Kist was a large farmer cooperative that had provided a variety of goods and services to farmers in the Southeast for several decades. For many years, Gold Kist allocated the bulk of its margins to members as qualified patronage refunds. Gold Kist traditionally redeemed outstanding retains at face value under a regular revolving cycle (usually about 20 years) or upon the death of the holder of the retains.

Gold Kist also regularly honored requests by producers who terminated their membership in Gold Kist to promptly redeem that person's retains. However, to make sure remaining patrons weren't disadvantaged, Gold Kist reduced the amount it paid to former members choosing this option to the present value of the retains.

Gold Kist did not report as income the difference between the face value of the retains and the discounted amount paid to patrons. The Service challenged Gold Kist on this issue. In 1992, after a period of negotiation, IRS issued a technical advise memorandum again applying the tax benefit rule. It said a cooperative must recognize as taxable income the difference between the stated dollar amount of qualified written notices of allocation and a lesser amount paid to redeem the notices.³⁸¹

³⁸⁰ Priv. Ltr. Rul. 8225100 (March 25, 1982).

³⁸¹ Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

The IRS assessed deficiencies against the cooperative for three open tax years. Gold Kist sued in the U.S. Tax Court to void those assessments.

The positions of the parties reflected the arguments discussed in the previous subsection of this report. The Service argued that the cooperative realized a tax benefit when it deducted the face value of the qualified retains when issued and, under the tax benefit rule, loses that benefit when the retains are cancelled.

Gold Kist raised two arguments. First, it said that the tax benefit rule did not apply in this case. Gold Kist relied on the U.S. Supreme Court's interpretation of the tax benefit rule in *Hillsboro National Bank v. Commissioner*.³⁸² In *Hillsboro*, the Court stated:

Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed *fundamentally inconsistent* with the premise on which the deduction was initially based. (emphasis added)³⁸³

Gold Kist asserted that the transaction creating the patronage refund deduction at the cooperative level was completed when the allocation was made and the patron consented to include the amount of any retained allocation in its income. As subchapter T didn't require that any amount ever be paid out in redemption of the retained allocation, there could not be a "fundamental inconsistency" between the original patronage refund distribution and the later redemption of the retained portion at less than face value.³⁸⁴

³⁸² *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

³⁸³ 460 U.S. at 383.

³⁸⁴ The synopsis of Gold Kist's position is based on Pinney L. Allen, Timothy J. Paeden & Ben E. Muraskin, *New Opportunities for*

Second, Gold Kist resurrected the position first accepted and then discarded by the Service in the 1970s, that this redemption of equity was a distribution with respect to stock that should not be recognized for tax purposes under Code sec. § 311.

The Tax Court rejected both arguments.³⁸⁵ First, it held that the purpose of Subchapter T is to ensure that someone pays a tax on patronage earnings. When a cooperative redeems a qualified patronage refund for less than face value and treats the residual as unallocated equity, the retained portion is no longer a patronage refund.

The Tax Court relied on the tax benefit rule. It concluded that "...the redemption of qualified written notices of allocation at less than their stated amounts is fundamentally inconsistent with the deduction of notices at their stated amounts and that the difference represents an amount which no longer qualifies as a patronage refund."³⁸⁶

Second, the Tax Court found that since Gold Kist's written notices of allocation were not issued as formal shares of stock, they "are not stock for purposes of section 311 and that section 311(a) therefore does not apply. Consequently, we need not address whether section 311 overrides the tax benefit rule."³⁸⁷

Cooperatives Regarding the Redemption of Equity, XLX The Cooperative Accountant 3-7 (Fall 1997).

³⁸⁵ Gold Kist v. Commissioner, 104 T.C. 696 (1995), *rev'd*, 110 F.3d 769 (11th Cir. 1997).

³⁸⁶ 104 T.C. at 715.

³⁸⁷ 104 T.C. at 719. Some cooperative advisers are upset over this finding, as it may call into question the applicability of other tax rules covering "stock" to retained cooperative equity. They feel the court could have merely relied on the tax benefit rule to justify its holding. As the 11th Circuit didn't find it necessary to address this finding, it remains unclarified at this time.

Gold Kist appealed this decision. The U.S. Court of Appeals for the 11th Circuit reversed the Tax Court and relieved Gold Kist of any tax liability on the transactions under review.³⁸⁸

The Court of Appeals found that the original distribution of the patronage refund and its constructive receipt by the patrons is a single, completed transaction. The voluntary reinvestment of the funds and their ultimate redemption for less than face value is a second, unrelated transaction. The court summarized:

So, as the structure and legislative history of Subchapter T make clear, Gold Kist's deduction is premised on its patrons' consent to include the stated amount of the written notice in gross income. We cannot say that Gold Kist's redemption of qualified written notices of allocation for less than their stated amounts is fundamentally inconsistent with this premise. A tax year 1987 deduction, for example, is not initially premised on a commitment by Gold Kist to pay in real dollars the stated value of the qualified written notice of allocation; payment twenty years later of that amount is simply not the equivalent of the 1987 stated value.³⁸⁹

As this determination decided the case for Gold Kist, the court did not address the Code sec. 311 issue.

The Service decided not to appeal the 11th Circuit decision. However, IRS has also not embraced it. In a subsequent letter ruling, the Service, in finding a requesting organization would be “operating on a cooperative basis,” noted that the organizational documents provided, “...a withdrawing member may have its retained patronage allocation redeemed for amounts agreeable to the Cooperative and the withdrawing member in full satisfaction

³⁸⁸ Gold Kist v. Commissioner, 110 F.3d 769 (11th Cir. 1997), *rev'g.*, 104 T.C. 696 (1995).

³⁸⁹ 110 F.3d at 773.

of the claim.” The Service then said, “Any discount would be includable in the Cooperative’s non-patronage income pursuant to the tax benefit rule.”³⁹⁰

A later ruling involved a cooperative in bankruptcy that was liquidating all of its assets to satisfy the claims of its creditors. The cooperative’s equity was now worthless, but under bankruptcy law, would not be canceled. The Service restated its belief in the tax benefit rule but distinguished this situation from that of *Gold Kist*, saying:

...Coop should not recognize any gain or loss with respect to the patronage equity. In situations in which a cooperative has redeemed its patronage equity from its patronage equity holders at a discount, the Service position is that the cooperative must recognize income in an amount equal to the discount under the tax benefit rule. However, Coop herein will not be cancelling the patronage equity. Coop will not be recovering for itself the amount it previously deducted, since all amounts will be paid to Coop’s creditors in partial settlement of the amount due Coop’s creditors.³⁹¹

Persons interested in learning more about the implications of the *Gold Kist* decision might want to work through the following example. It illustrates why the Service is not pleased.

Assume Cooperative C has a marginal tax rate of 34% and Patron P a marginal tax rate of 25%. These are the basic rates applied to middle-income taxpayers at the time this report was written.³⁹²

³⁹⁰ Priv. Ltr. Rul. 200224017 (March 15, 2002).

³⁹¹ Priv. Ltr. Rul. 200414019 (Dec. 15, 2003).

³⁹² The marginal tax rate for many individuals was reduced to 25 percent, beginning with 2003, under the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 105(a), 117 Stat. 752,

Year of Allocation. In 2005, C paid a patronage refund of \$100 to P, consisting of \$20 in cash and a qualified written notice of allocation for \$80, which was credited to P's equity account in C.

- C acquired \$80 of equity and had no tax liability on this \$100 in margins.
- P received \$20 in cash.
- P included the entire patronage refund in taxable income, so P had a tax liability of \$25 ($\$100 \times .25$).
- P acquired an ownership interest of \$80 in C equity.

Year of Redemption at Less Than Face Value, IRS Method. In 2009, C redeems P's 2005 equity allocation at \$.50 on the dollar.

- C reduces its member equity account by \$80.
- C pays \$40 in cash to P.
- C recognizes the \$40 of canceled equity as taxable income and pays a federal income tax of \$13.60 on it ($\$40 \times .34$).
- The remaining \$26.40 is accounted for as unallocated equity.
- P receives \$40 in cash from Cooperative C.
- P deducts the face value of the canceled equity, \$40, from other taxable income and realizes a tax savings of \$10.00 ($\$40 \times .25$). Thus P has received a total of \$50.00 for equity with a former book value of \$80.00.

Year of Redemption, *Gold Kist* Method. In 2009, C redeems P's 2005 equity allocation at \$.50 on the dollar.

- C reduces its member equity account by \$80. C pays \$40 to P.
- C does not have to recognize the \$40 of canceled equity as taxable income and therefore pays no

additional federal income tax. This leaves \$40 to be accounted for as unallocated equity.

- Patron tax treatment is the same. P receives \$40 in cash. P deducts the face value of the canceled equity, \$40, from other taxable income and realizes a tax savings of \$10.00 ($\$40 \times .25$). P still receives a total of \$50.00 for equity with a former book value of \$80.00.

Now that the facts are laid out, the real issue is: Where did the money go? The following summary 2 shows who received what under both the IRS and Gold Kist approaches. This illustrates why this decision is favorable to cooperatives and upsetting to IRS.

Where Did the Money Go?

IRS Method:

| | |
|-----|--|
| C | \$26.40 in unallocated equity |
| P | \$45.00 cash |
| | 2005: \$ -5.00 (\$25 in taxes less \$20 cash received) |
| | 2009: \$50.00 (\$40 cash from C and \$10.00 tax reduction) |
| IRS | \$28.60 cash |
| | 2005: \$25.00 (P's tax on entire \$100 qualified allocation) |
| | 2009: \$3.60 (C's tax of \$13.60 less P's \$10.00 deduction) |
| | <hr/> |
| | \$100.00 |

Gold Kist Method:

| | | |
|-----|-------------------------------|--|
| C | \$40.00 in unallocated equity | |
| P | \$45.00 cash | Same as IRS method |
| IRS | \$15.00 cash | (P's 2005 tax of \$25.00 less P's 2005 deduction of \$10.00) |
| | <hr/> | |
| | \$100.00 | |

Thus, no tax is paid on the \$40 now held by C as unallocated equity. P has received a total of \$60 in cash from C and paid a total tax of \$15.00.

The more equity canceled, the less money IRS ultimately receives. If the entire \$80 in retained equity is canceled, P receives a tax deduction in 2009 of \$20.00. C would now have \$80 of tax-free unallocated equity. P would have \$15.00 (\$20 cash received in 2005, less \$25 tax obligation in 2005, plus \$20.00 tax deduction in 2009) and IRS only \$5.00.

While it would appear from these numbers that redeeming qualified allocations at a discount is a good idea, it is a decision that, in reality, should be approached cautiously. Any program to redeem written notices of allocation at less than face has broader implications.

Members are generally willing to invest in their cooperative because they expect it will use the money to provide them services and, when it no longer needs the money, return it to them. Redemptions at less than face value turn members' money into the cooperative's money. It undermines member-patron ties to and confidence in their cooperative and conflicts with the cooperative principle of member ownership and control. While the *Gold Kist* method may be a tempting apple, consider whether a bite could be poisonous to your cooperative.

Other Issues

The Service has taken other positions that may complicate redeeming patronage-sourced equities at less than face value. For one thing, it considers such income to be nonpatronage-sourced income to the cooperative.³⁹³

For another, IRS asserts that a section 521 cooperative may not deduct the allocation of such nonpatronage-sourced income to patrons on a patronage basis. Code section 1382(c)(2)(A) permits a section 521 cooperative to deduct amounts paid on a patronage basis with respect to nonpatronage sourced "earnings." The Service has said amounts realized as a result of a discounting procedure are not "earnings" and therefore are not deductible.³⁹⁴ Instead of section 1382(c) earnings, IRS characterized the income as "amounts recovered which were previously deducted against 'earnings' of another taxable year."³⁹⁵

³⁹³ Tech. Adv. Mem. 7840010 (June 22, 1978) dealt with qualified written notices of allocation; Priv. Ltr. Rul. 8033070 (May 22, 1980) covered qualified per-unit retain certificates. *See also*, Priv. Ltr. Rul. 200224017 (March 15, 2002).

³⁹⁴ Tech. Adv. Mem. 7840010, (June 22, 1978). The Service relied, in part, on I.R.C. § 911(b) definition of "earned income" as well as definition of "earnings" appearing in *Black's Law Dictionary*.

³⁹⁵ Priv. Ltr. Rul. 7840010 (June 22, 1978).

CHAPTER 10

TAXATION OF PATRONS

While most administrative and judicial law on taxation focuses on the cooperative, the patron is an equally important element of the equation. A patron is usually perceived as an individual dealing with his or her local cooperative. However, if that local cooperative is part of a federated system, the local is a patron of the federated cooperative and must deal with the tax laws as they apply to both cooperatives and patrons.³⁹⁶

Patrons, if they are also members,³⁹⁷ not only share in the earnings of a cooperative but also have ultimate control, as the user-owners, of the method used by their cooperative to allocate those earnings (and losses). Thus, any analysis of cooperative taxation must also consider the taxation of patrons.

Subchapter T generally imposes a single current tax obligation on cooperative margins. Whether the cooperative or the patrons assumes this tax obligation for a given payment generally depends on a mutual arrangement on how to recognize the income for tax purposes. This gives cooperative members valuable flexibility in planning the tax consequences of their business transactions.

Before 1962, when rules clarifying cooperative and patron taxation were established in subchapter T,³⁹⁸ patron treatment of refunds or other payments from the cooperative was not always

³⁹⁶ See, e.g., Rev. Rul. 70-249, 1970-1 C.B. 181 (concerns proper year to include certain per-unit retains from the regional to the local in the local's taxable income).

³⁹⁷ While the terms "member" and "patron" are sometimes used interchangeably, there is an important distinction between them for tax purposes. A member is allowed to vote on issues presented to the membership. A patron is any person, member or nonmember, with whom the cooperative does business on a cooperative basis. Treas. Reg. § 1.1388-1(e).

³⁹⁸ Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962), reprinted in 1962-3 C.B. III.

consistent with the tax treatment of these distributions taken by the cooperative. Code section 1385, titled "Amounts Includible in Patron's Gross Income," was added to the Code as part of subchapter T. Section 1385 provides specific rules on the taxation of income received by patrons based on the cooperative-patron relationship.³⁹⁹

Generally, when patrons receive taxable distributions of earnings from a cooperative, they are included in the patrons' gross income along with other income received in the course of farming or other business operations.⁴⁰⁰ Patrons recognize the income in the tax year it is received from the cooperative.

Cooperative distributions to patrons may be in the form of money, property, or noncash allocations of equity or debt in the cooperative, evidenced by written notices of allocation or per-unit retain certificates. The tax consequences to the patron of any distribution of written notices of allocation and retain certificates when received, and later when redeemed, depends primarily upon whether the notices or certificates are "qualified" or "nonqualified" distributions.

Written notices of allocation and per-unit retain certificates may be redeemed by the cooperative for less than or more than face value. Holders may be able to sell or exchange them, although this isn't common.

Patrons may incur losses in connection with patronage distributions from a cooperative. Such losses are recognized for tax purposes in a number of situations.⁴⁰¹

In addition to receiving distributions from it, members and patrons sometimes make payments to their cooperative. The potential tax effects of patron payments to a cooperative depends on the nature and purpose of the payment.

³⁹⁹ Treas. Reg. § 1.1385-1 provides explanation and examples.

⁴⁰⁰ An exception for consumer goods is discussed beginning on the next page.

⁴⁰¹ *See infra* pp. 142-148

INCLUSIONS IN GROSS INCOME

Code section 1385 begins with a general rule that for tax purposes patrons must include in gross income:

(1) patronage refunds⁴⁰² paid in money, qualified written notices of allocation, and other property (but not nonqualified written notices of allocation),⁴⁰³

(2) patronage-based distributions of nonpatronage income from a section 521 cooperative paid in money, qualified written notices of allocation, or other property (but not nonqualified written notices),⁴⁰⁴ and

(3) per-unit retains paid in qualified per-unit retain certificates.⁴⁰⁵

Subchapter T only covers amounts received from the cooperative based on the cooperative-patron relationship. Other kinds of income are covered by rules not specific to cooperatives.

Exclusion for Personal, Living, and Family Items

Code section 1385(b) provides that in two instances the amount of any patronage refund and any amount received on re-

⁴⁰² "Patronage refund" rather than "patronage dividend," the term in the Code, is used in this report in accord with general cooperative preferences and to avoid confusion with dividends paid to patrons on their capital stock.

⁴⁰³ I.R.C. § 1385(a)(1) and Treas. Reg. § 1.1385-1(a)(1).

⁴⁰⁴ I.R.C. § 1385(a)(2) and Treas. Reg. § 1.1385-1(a)(2).

⁴⁰⁵ I.R.C. § 1385(a)(3). While § 1385 doesn't mention per-unit retains paid in cash, they undoubtedly are also taxable income to the recipient in the tax year received. While the regulations for section 1385 don't mention per-unit retains, their inclusion in patrons' gross income is supported by Treas. Reg. § 1.61-5(a).

demption, sale, or other disposition of a nonqualified written notice of allocation isn't included in a patron's gross income.⁴⁰⁶

One is when the distribution is "attributable to personal, living, or family items."⁴⁰⁷ The regulations describe personal, living, or family items in terms of the tax status of the item purchased. A patron doesn't include as income patronage refunds "received with respect to the purchase of supplies, equipment, or services, which are not used in the trade or business and the cost of which is not deductible under section 212."⁴⁰⁸

Similarly excluded are amounts received in redemption of nonqualified written notices of allocation which were received as a patronage refund with respect to the purchase of supplies, equipment, or services not used in a trade or business and the cost of which was not deductible under Code section 212.⁴⁰⁹

Code section 212 allows individuals to deduct expenses incurred in the "production of income."⁴¹⁰ If a patron can't deduct the expense of supplies, equipment, or services obtained from a cooperative under section 212, then patronage refunds received from a cooperative "with respect to" such purchases are not income to the patron.⁴¹¹

⁴⁰⁶ As the Code doesn't mention per-unit retains in this section, no exclusions are available for per-unit retain distributions.

⁴⁰⁷ I.R.C. § 1385(b)(2).

⁴⁰⁸ Treas. Reg. § 1.1385-1(c)(1)(i).

⁴⁰⁹ Treas. Reg. § 1.1385-1(c)(1)(ii).

⁴¹⁰ I.R.C. § 212. "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income" *Id.*

⁴¹¹ Treas. Reg. § 1.1385-1(c)(1)(ii).

Exclusion for Adjustment to Basis of Depreciable Property

Patrons may also exclude from gross income patronage refunds and amounts received in redemption of nonqualified written notices of allocation "properly taken into account as an adjustment to basis of property."⁴¹² Regulations say this exclusion covers patronage refunds distributed with respect to the marketing or purchasing of a capital asset (as defined in section 1221) or business property depreciable for tax purposes under Code section 167.⁴¹³

In this case, the patronage refund or payment in redemption of a nonqualified allocation should be treated as an adjustment to the basis of the property or asset rather than as ordinary income by the patron.⁴¹⁴ The adjustment is effective as of the first day of the taxable year in which the distribution is received.⁴¹⁵ To the extent that the amount received exceeds the adjusted basis of the property, it shall be considered ordinary income.⁴¹⁶

The primary beneficiaries of the "adjustment to basis" rule are patrons who purchase from their cooperative property used in their business and depreciable under Code section 167. The principal kind of depreciable property is permanent and tangible such as buildings (but not the land), office furniture and machines, and farm machinery. Normally, a taxpayer can't deduct the total cost of such items in the year of purchase, but rather must depreciate the cost over a number of years.

The regulations provide that Code section 167 property includes all farm buildings (except the residence of the owner), machinery, and physical property (except land). Livestock

⁴¹² I.R.C. § 1385(b)(1).

⁴¹³ Treas. Reg. § 1.1385-1(c)(1).

⁴¹⁴ Treas. Reg. § 1.1385-1(c)(2).

⁴¹⁵ Treas. Reg. § 1.1385-1(c)(2)(i).

⁴¹⁶ *Id.*

acquired for work, breeding, and dairy purposes may, under certain conditions, also be section 167 property.⁴¹⁷

Related Patronage Refunds

Amounts received by patrons which are excludible from gross income if used as basis adjustment are (1) cash and qualified noncash patronage refunds⁴¹⁸ and (2) amounts received upon redemption, sale, or other disposition of a nonqualified written notice of allocation to the extent treated as ordinary income.⁴¹⁹

The portion of a patronage refund or redemption amount that a patron can apply to basis and exclude from gross income is limited to amounts "received with respect to the marketing or purchasing" of the property whose basis is adjusted.⁴²⁰

The refund portion must qualify as a "patronage dividend" as defined in the Code.⁴²¹ It cannot include any portion of a section 521 cooperative refund or redemption amount that was derived from U.S. Government or nonpatronage sourced income.⁴²²

Patrons need to establish what portion of the amount received from the cooperative relates to the eligible property. The determination may be based on the patron's own records or the notices received from the cooperative. These examples illustrate how to make the proper calculation.

⁴¹⁷ Treas. Reg. § 1.167(a)(6)(b).

⁴¹⁸ Treas. Reg. § 1.1385-1(c)(1)(i).

⁴¹⁹ Treas. Reg. § 1.1385-1(c)(1)(ii).

⁴²⁰ Treas. Reg. §§ 1.1385-1(c)(1)(i) and (c)(1)(ii).

⁴²¹ Treas. Reg. § 1.1385-1(c)(1)(i). The Code definition of "patronage dividend" appears at I.R.C. § 1388(a).

⁴²² Treas. Reg. § 1.1385-1(c)(1)(i) only applies to patronage refunds described in Treas. Reg. § 1.1385-1(a)(1). Refund or redemption amounts paid by I.R.C. § 521 cooperatives and derived from U.S. Government or nonpatronage sourced income are described in Treas. Reg. § 1.1385-1(a)(2).

Example 1. Patron A receives a qualified written notice of allocation totaling \$100 from a cooperative. Patron A's only business with the cooperative during the cooperative's taxable year was the purchase of property eligible for basis adjustment. The entire \$100 received by Patron A can be applied to basis adjustment if otherwise qualified.

Example 2. Assume a similar situation to Example 1, except the cooperative notifies patron A that \$80 of the payment qualifies as a refund from patronage sources, while \$20 is from nonpatronage sources. Patron A has \$80 available for basis adjustment and exclusion. The remainder must be included in gross income and cannot be used to adjust eligible property basis.

Example 3. Patron B receives \$100 in patronage refunds from the cooperative, all of which is from patronage sources. During the cooperative's taxable year, patron B purchased \$1,000 in supplies and equipment from the cooperative, \$200 of which was properly eligible for basis adjustment. Patron B applies only the allocable portion of the refund, which is \$20 ($200/1000 \times 100$), to the eligible property basis adjustment.

Basis Adjustment

The regulations provide that if a patron purchases eligible assets or property from the cooperative and owns the asset or property any time during the taxable year in which the amount is received, the adjustment to the property's basis occurs "as of the first day of the taxable year in which such amount is received."⁴²³ This important rule frees patrons, who purchase a covered item in one year and receive the related patronage refund the following year, from having to file an amended return for the previous year to adjust their depreciation deduction.

The following example, based on the regs, illustrates this timing issue. More complex examples, including some dealing

⁴²³ Treas. Reg. § 1.1385-1(c)(2)(i).

with redemptions of nonqualified written notices of allocation and other aspects of basis adjustment, are found in the regulations.⁴²⁴

Example 4. On July 1, 2004, a cooperative patron purchases an implement for use in her farming business for \$2,900. The implement has an estimated useful life of 3 years and an estimated salvage value of \$200, which the patron chooses to take into account in computing depreciation. She files her income tax returns on a calendar-year basis. For 2004, she claims depreciation of \$450 pursuant to her use of the straight-line method of depreciation at the rate of \$900 per year.

On July 1, 2005, the cooperative pays a patronage refund to the patron of \$300 in cash regarding her purchase of the farm implement. She will adjust the basis of the implement and compute her depreciation deduction for 2005 (and subsequent taxable years) as follows:

| | | |
|--|------------|--------------|
| Cost of farm implement, July 1, 2004 | | 2,900 |
| Less: | | |
| Salvage value | 200 | |
| Depreciation for 2004 (6 months) | 450 | |
| Adjustment as of Jan. 1, 2005 for cash patronage dividend | <u>300</u> | <u>950</u> |
| Basis for depreciation for remaining 2 ½ years of estimated life | | <u>1,950</u> |
| Depreciation deduction for 2005 (\$1,950 divided by the 2½ years of remaining life) | | 700 |

⁴²⁴ Treas. Reg. § 1.1385-1(c)(3).

When Exclusion Not Available

A patron's application of patronage refunds or redemption amounts to property basis is a substitute for recognizing it as gross income. This exclusion isn't available in all circumstances.

For example, the distribution from the cooperative may exceed the property's adjusted basis. In this case, the amount of the distribution is first applied to basis. To the extent the distribution exceeds the adjusted basis, it is ordinary income to the patron.⁴²⁵

Another example is when a patron has sold or otherwise disposed of the property before the taxable year in which the patron receives the distribution. This usually occurs where the distribution is in redemption of a nonqualified written notice of allocation. In such cases, the basis adjustment is not used and the amounts received are "included in gross income as ordinary income."⁴²⁶

The regulations also describe special rules for situations involving losses deductible under Code section 165 on long-term capital assets no longer owned by the taxpayer.⁴²⁷

A patron, who markets eligible property through a cooperative, may receive patronage refunds based on that sale in the same taxable year as the property was sold. In that case, the distribution is treated as additional proceeds from the sale of that property.⁴²⁸

Finally, if a patron receiving a patronage refund or proceeds from the disposition of nonqualified written notices of allocation is unable to identify the related property, basis adjustment isn't available and the patron must treat the distribution as ordinary income.⁴²⁹

⁴²⁵ Treas. Reg. § 1.1385-1(c)(2)(i).

⁴²⁶ Treas. Reg. § 1.1385-1(c)(2)(ii).

⁴²⁷ Treas. Reg. §§ 1.1385-1(c)(2)(ii)(a) and (b).

⁴²⁸ Treas. Reg. § 1.1385-1(c)(2)(iii).

⁴²⁹ Treas. Reg. § 1.1385-1(c)(2)(iv).

Taxable Year

Code section 1385 designates the taxable year in which a patron must include patronage refunds,⁴³⁰ amounts received as nonpatronage distributions from a section-521 cooperative,⁴³¹ and per-unit retains⁴³² in gross income. Generally, such amounts are included in patron income in the taxable year received.⁴³³

Patrons frequently receive taxable distributions from cooperatives in a tax year subsequent to the time the related transactions took place. These four examples illustrate how this may occur:

1. The cooperative and patron have different tax years, resulting in different years for income recognition.⁴³⁴

2. Cooperatives usually distribute patronage refunds or per-unit retain allocations during the eight and one-half month period after the cooperative's tax year, as provided in Code section 1382(d). The year payment is received by patrons, which may follow the tax year in which the cooperative took its deduction, is the year the patron recognizes the distribution for tax purposes.⁴³⁵

If the cooperative fails to make payments within the payment period and thereby loses its deduction, patrons must still include

⁴³⁰ I.R.C. § 1385(a)(1).

⁴³¹ I.R.C. § 1385(a)(2).

⁴³² I.R.C. § 1385(a)(3).

⁴³³ I.R.C. § 1385(a). At one time, IRS said cooperatives had to "trace" margins back to the specific transactions that generated them and allocate the margin to the patrons of that year. Rev. Rul. 79-45, 1971-1 C.B. 284. The IRS position was rejected in *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982) and *Kingfisher Cooperative Elevator Association v. Commissioner*, 84 T.C. 600 (1985). For a discussion of "tracing," see Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, Cooperative Information Report 44, Part 2 (USDA 2005), pp. 90-94.

⁴³⁴ See, e.g., Tech. Adv. Mem. 7936017 (May 31, 1979).

⁴³⁵ Treas. Reg. § 1.1385-1(a).

the amount received in gross income in the year of receipt.⁴³⁶

3. Cooperatives frequently redeem nonqualified written notices of allocation and nonqualified per-unit retain certificates several year after issuance. These payments are taxable income to patrons in the year of receipt.⁴³⁷

4. Cooperative payments may also be treated as occurring in a subsequent tax year when they are from a local cooperative belonging to a federated system. Because each cooperative in the system has its own tax year and payment period, the actual income from the patron's initial transaction with its local cooperative may not be recognized for some time.

For example, a local marketing cooperative might receive product from a patron in year one. In that same year, the local cooperative delivers the product to a federated cooperative for further processing and sale. The local receives a patronage refund or per-unit retain from the federated in year two, based on business done with or for its patrons in year one.⁴³⁸

The Code provides that the local can make patronage refunds during the payment period of year two based on the amounts received from the federated.⁴³⁹ Local patrons will likely receive their appropriate share of the federated cooperative's earnings in patrons' tax year three.

⁴³⁶ *Id.*

⁴³⁷ I.R.C. § 1385(c).

⁴³⁸ In this situation the local association is a "cooperative" for tax purposes when dealing with its patrons and a "patron" itself when dealing with the federated cooperative. The local cooperative includes cash payments and qualified patronage refunds and per-unit retains received from the federated cooperative in gross income in the year of receipt. These amounts are then deductible by the local if passed on to its patrons as cash or qualified distributions within the payment period for the year of receipt of the local.

⁴³⁹ Rev. Rul. 70-249, 1970-1 C.B. 181, applying I.R.C. § 1382(f) and Treas. Reg. § 1.1382-6.

IRS has said that patrons who receive such payments in a year subsequent to the year the underlying transaction took place may not "accelerate" the recognition of an expected distribution. A patron may not "accrue an estimated patronage refund" in order to recognize it as income in a tax year prior to the time the cooperative issues the refund.⁴⁴⁰

Patrons receive other kinds of payments from their cooperative for which subchapter T provides no special timing rules. In these instances, general tax principles apply.

Marketing cooperatives frequently make partial payments to producers for product delivered at or shortly after delivery. After the end of the its fiscal year, the cooperative determines net margins allocable to each patron and pays them during the cooperative's payment period. Questions have arisen as to the correct year for the patron to include the advance payment in taxable income.

As a general rule, the advance is considered a partial payment for product delivered and must be treated by patrons as income from the sale of product in the year received. "The grower is not to defer the accounting for the payments until the year in which the final settlement is made with him by the association for his entire crop...."⁴⁴¹

Similarly, a patron can't postpone the tax liability on an advance to a subsequent tax year by simply having the cooperative postpone payment. If the patron could have received the advance in the first year, IRS has applied the doctrine of constructive receipt to require the patron to include it in income for the first year.⁴⁴² This is consistent with the cash receipts and disbursements method of accounting that requires amounts to be included in gross income when actually or constructively received.⁴⁴³

⁴⁴⁰ Tech. Adv. Mem. 7936017 (May 31, 1979).

⁴⁴¹ Rev. Rul. 71-430, 1971-2 C.B. 219.

⁴⁴² Priv. Ltr. Rul. 8004074 (Oct. 31, 1979).

⁴⁴³ Treas. Reg. § 1.451-1(a).

If the patron hasn't met all the conditions for securing a right to payment, no income has been received for tax purposes. In a letter ruling, one of several options under the cooperative's marketing program permitted patrons to defer making a pricing decision until the year following harvest and delivery of grain to the cooperative. No advance was payable until the patron made the pricing decision. IRS said constructive receipt did not apply and no current tax liability resulted for deferring payment until the second year.⁴⁴⁴

The regulations discuss one other issue concerning the year patrons include amounts received from cooperatives in income. Patrons must recognize payments by qualified check in the taxable year received, if the check is endorsed and cashed on or before the 90th day following the close of the payment period for the cooperative's taxable year in which the relevant patronage occurred.⁴⁴⁵

PAYMENT FORM

Section 1385 of subchapter T lists specific forms of cooperative payments that must be included in gross income by patrons. These include patronage refunds⁴⁴⁶ and patronage-based distributions of nonpatronage income by section-521 cooperatives⁴⁴⁷ paid in money, qualified written notices of allocation, or other property, and per-unit retain allocations paid as qualified per-unit retain certificates.⁴⁴⁸

⁴⁴⁴ Priv. Ltr. Rul. 8004074 (Oct. 31, 1979).

⁴⁴⁵ Treas. Reg. § 1.1385-1(d)(3). Thus, if a patron on a calendar tax year receives a qualified check in November of one year and cashed it in January of the following year, for tax purposes the amount received is income to the patron in the first year.

⁴⁴⁶ I.R.C. § 1385(a)(1) and Treas. Reg. § 1.1385-1(a)(1).

⁴⁴⁷ I.R.C. § 1385(a)(2) and Treas. Reg. § 1.1385-1(a)(2).

⁴⁴⁸ I.R.C. § 1385(a)(3). *See also* Treas. Reg. § 1.61-5(f)(1)(i). Although the Code doesn't specifically mention cash per-unit retain

Patrons must also recognize as income all amounts received in redemption of nonqualified written notices of allocation and nonqualified per-unit retain certificates.⁴⁴⁹

For other kinds of income received by the patron from the cooperative, subchapter T provides no special rules and general tax principles therefore apply.

Money or Other Property

The term "money" includes cash, negotiable bank checks, and qualified checks.⁴⁵⁰

The term "other property" includes payments of merchandise or other property in kind. Payments made in property are accounted for by the patron at the property's fair market value when received.⁴⁵¹

Qualified Written Notices and Per-Unit Retains

Code section 1385(a) provides that patrons must include the amount of any patronage refunds distributed in cash or as qualified written notices of allocation⁴⁵² and qualified per-unit retain certificates⁴⁵³ in gross income in the taxable year received.

distributions, the same rules undoubtedly apply.

⁴⁴⁹ I.R.C. § 1385(c)(1), Treas. Reg. § 1.1385-1(b) (nonqualified written notices of allocation), and Treas. Reg. § 1.61-5(f)(1)(ii) (nonqualified per-unit retain certificates).

⁴⁵⁰ Treas. Reg. §§ 1382-2(b)(1), 1.1388-1(c)(1)(ii).

⁴⁵¹ Treas. Reg. § 1.1385-1(d)(1). For an example involving the stock of a successor noncooperative company being issued as a patronage refund allocation to the patrons of a predecessor cooperative and its valuation, *see* Priv. Ltr. Rul. 8617040 (Jan. 24, 1986) and Priv. Ltr. Rul. 8638054 (June 24, 1986).

⁴⁵² I.R.C. § 1385(a)(1).

⁴⁵³ I.R.C. § 1385(a)(3).

Qualified notices and certificates are valued by patrons at their "stated dollar amount."⁴⁵⁴

Patrons recognize the income in the tax year they receive the qualified allocation(s). Subsequent redemption of the notice or certificate is not a taxable event for the patron as long as the redemption payment is for the face amount. Redemptions for less than, or in excess of, the face value are discussed later in this chapter.

Nonqualified Written Notices and Per-Unit Retains

Patrons who receive nonqualified written notices of allocation or nonqualified per-unit retain certificates recognize no income at the time of issuance. The single tax obligation is transferred from the cooperative to the patron when the nonqualified equity is redeemed by the cooperative.⁴⁵⁵

If the redemption payment is applied against a debt owed by the patron to the cooperative, the patron receives property (and thus income) to the extent of debt satisfaction.⁴⁵⁶

Code section 1385(c) includes basis and gain rules by which patrons determine the income they must recognize from the redemption of nonqualified written notices of allocation paid as patronage refunds,⁴⁵⁷ patronage-based distributions of nonpatron-

⁴⁵⁴ I.R.C. § 1388(c)(1) and Treas. Reg. § 1.1385-1(d)(2) for qualified written notices of allocation, I.R.C. § 1388(h)(1) for qualified per-unit retain certificates. Similarly for "certificates of indebtedness," *James W. Salley, Inc. v. United States*, 1976-1 U.S.T.C. ¶ 9443 (W.D. La. 1976).

⁴⁵⁵ I.R.C. § 1385(c)(2) and Treas. Reg. § 1.1385-1(b).

⁴⁵⁶ *See* Priv. Ltr. Rul. 7926068 (Mar. 29, 1979) where IRS permitted a cooperative to offset accounts receivable, established to allocate a loss, against outstanding nonqualified written notices of allocation.

⁴⁵⁷ I.R.C. § 1385(c)(1)(A)(i).

age earnings by a section-521 farmer cooperative,⁴⁵⁸ and nonqualified per-unit retain certificates.⁴⁵⁹

The first step in determining a patron's taxable income when nonqualified written notices of allocation and nonqualified per-unit retain certificates are redeemed is to establish the patron's basis in that property. The basis of these equities in the hands of the patron is zero.⁴⁶⁰ The assignment of basis is statutory and the equity's fair market value has no tax effect at either issuance or redemption. The Code also provides that if such equities are acquired from a decedent, the basis of the heir shall be the basis in the hands of the decedent.⁴⁶¹

Second, the amount of taxable income must be determined. The realized gain upon redemption is the amount received which exceeds basis.⁴⁶² In most situations, the basis of a nonqualified written notice of allocation or nonqualified per-unit retain certificate is zero; so patrons will realize taxable income for the full amount paid in redemption.

Third, the nature of the income must be established. The Code states the amount received by the patron, up to the stated dollar amount of the nonqualified written notice or per-unit retains being redeemed, shall "be considered as ordinary income,"⁴⁶³ that is, "gain from the sale or exchange of property which is not a capital asset."⁴⁶⁴ Treatment as ordinary income applies to the original patron recipient and subsequent holders.⁴⁶⁵

⁴⁵⁸ I.R.C. § 1385(c)(1)(A)(ii).

⁴⁵⁹ I.R.C. § 1385(c)(1)(B).

⁴⁶⁰ I.R.C. § 1385(c)(2)(A) and Treas. Reg. § 1.1385-1(b)(3).

⁴⁶¹ I.R.C. § 1385(c)(2)(B) and Treas. Reg. § 1.1385-1(b)(3). The basis is not increased to the fair market value as of the date of death.

⁴⁶² I.R.C. § 1385(c)(2)(C).

⁴⁶³ *Id.*

⁴⁶⁴ Treas. Reg. § 1.1385-1(b)(1).

⁴⁶⁵ *Id.*

The redemption, sale, or other disposition of nonqualified written notices of allocation or nonqualified per-unit retain certificates may result in a gain that exceeds their stated face value. Excess amounts "will be treated under the applicable provisions of the Code."⁴⁶⁶ For instance, the regulations say amounts received in excess of a nonqualified written notice's stated dollar amount should be treated as interest by the recipient if the amounts "in effect, constitute interest."⁴⁶⁷

The following example from the regulations illustrates the tax treatment of nonqualified allocations by patrons.

Example. A, a farmer, receives a patronage dividend from the X Cooperative, in the form of a nonqualified written notice of allocation, which is attributable to the sale of his crop to that cooperative organization. The stated dollar amount of the nonqualified written notice of allocation is \$100. The basis of the written notice of allocation in the hands of A is zero and he must report any amount up to \$100 received by him on its redemption, sale, or other disposition, as ordinary income. If A gives the written notice of allocation to his son B, B takes A's (the donor's) basis which is zero, and any gain up to \$100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to \$100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Such gain is income in respect of a dece-

⁴⁶⁶ *Id.*

⁴⁶⁷ *Id.*

dent within the meaning of section 691(a) and section 1.691(a)-1.⁴⁶⁸

REDEMPTION AT GREATER THAN FACE VALUE

Cooperative payments in redemption of retained patronage refunds or per-unit retain certificates may exceed the face value of the notice or certificate.⁴⁶⁹ Although the whole payment to patrons may be termed "redemption" and paid simultaneously, any amount in excess of the notice or certificate redeemed is not a true redemption. Rather, it is a payment that falls into some other category for tax purposes.

The regulations provide that if a patron receives an excess payment, the distribution is divided into two parts. Amounts received up to the notice or certificate's face value are ordinary income. The excess is then treated "under applicable provisions of the Code."⁴⁷⁰

The tax classification of excess paid at the time of redemption can turn on the facts of the situation. In *Agway, Inc. v. United States*,⁴⁷¹ a federated cooperative issued preferred stock to a

⁴⁶⁸ Treas. Reg. § 1.1385-1(b)(4). Examples from the regulations were written only for written notices of allocation and don't specifically include per-unit retain certificates. However, principles involved are the same, as should be the results.

⁴⁶⁹ See *Agway, Inc. v. United States*, 524 F.2d 1194 (Ct. Cl. 1975), and *Agway, Inc. v. United States*, 1981-2 U.S.T.C. ¶ 9700 (Ct. Cl. 1981), *aff'd* 696 F.2d 1367 (Fed. Cir. 1982).

⁴⁷⁰ Treas. Reg. § 1.1385-1(b)(1). For example, this regulation states "amounts received in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which, in effect, constitute interest shall be treated by the recipient as interest."

⁴⁷¹ In this protracted litigation, the Service actually raised the same issue twice. The first case involved stock a cooperative, that was

member cooperative as part of a patronage refund in one year and redeemed it in a later year for an amount greater than its face value. IRS argued the amount received above face value was essentially a dividend and should be taxable to the patron-recipient as ordinary income. The cooperative asserted that the premium was a long-term capital gain.

The court said the hallmarks of a dividend are pro rata distribution of earnings and profits and no change in basic shareholder relationships. The cooperative's bylaws provided retained equities were to be "retired in the order in which they have been received." The court found the premium payments, based on the amount of the underlying equity redemption, did not meet the "pro rata distribution" test.

As the members of the federated cooperative received different distributions of preferred stock each year depending on the proportion of business each did with the federated that year, a redemption of that stock issued in a prior year would not be in the same proportion as the total equity investment of each member in the federated.

The only way a distribution could be "pro rata" would be if every stockholder received the same number of shares in each year at issue. Consequently, the court ruled the excess over face value

subsequently merged into Agway, received from being a member of yet another cooperative in 1957. This stock was redeemed for a premium in 1960. *Agway, Inc. v. United States*, 524 F.2d 1194 (Ct. Cl. 1975), 1975-2 U.S.T.C. ¶ 9777.

The second case involved stock the predecessor cooperative received in 1960 that was redeemed in 1962. *Agway, Inc. v. United States*, 1981-2 U.S.T.C. ¶ 9700 (Ct. Cl. 1981), *aff'd* 696 F.2d 1367 (Fed. Cir. 1982). IRS justified the repeat litigation on the grounds that a regulation issued in 1959 supported its position and if not controlling in the first case because it could not be applied retroactively, it was controlling in the second case. The courts held the regulation wasn't applicable to this situation and decided both cases on other grounds for the cooperative.

was not a dividend on capital stock, but rather a long-term capital gain for the recipient.⁴⁷²

Good accounting practice would suggest cooperatives clearly identify payment in redemption and payment in excess of redemption so patron recipients can treat each portion appropriately for tax purposes. This is particularly true when part of the payment is a redemption of a qualified written notice of allocation or a qualified per-unit retain certificate upon which patrons had previously been taxed.

The Service has said no gain or loss need be recognized if the payment is part of a tax-free reorganization. In a letter ruling, a cooperative proposed to restructure its capital to allocate accumulated nonpatronage income to its members. The cooperative would issue various classes of capital stock in exchange for members' current holding of common voting stock, per-unit retain certificates, and a proportionate share of the surplus built from nonpatronage sourced income.

Even though the members received additional value in the form of a more direct interest in the nonpatronage earnings retained by their cooperative, the ruling held "no gain or loss will be recognized by the members" as the transactions were a "recapitalization" under Code section 368(a)(1)(E), a reorganization that does not trigger a gain or loss under Code section 354(a)(1).⁴⁷³

⁴⁷² The court in *Agway* relied on other decisions that addressed the basic character of patronage refunds paid during that time, such as *Tomlinson v. Massey*, 308 F.2d 168 (5th Cir. 1962), 1962-2 U.S.T.C. ¶ 9730; and *Raley v. United States*, 491 F.2d 136 (5th Cir. 1974), 1974-1 U.S.T.C. ¶ 9300.

⁴⁷³ Priv. Ltr. Rul. 8846030 (Aug. 22, 1988).

REDEMPTION AT LESS THAN FACE VALUE

While redemptions of outstanding patronage equity for more than face value is preferable from the patron's perspective, there are many more rulings dealing with redemptions by the cooperative of retained patronage equity for less than face value.

As discussed elsewhere in these reports, the IRS position is somewhat different toward cooperatives who redeem equity at less than face value depending on whether the redemption is part of a capital restructuring⁴⁷⁴ or to recover a loss from the patrons whose business generated the loss.⁴⁷⁵ Regardless of the motive of the cooperative in redeeming equity for less than face value, the impact on patrons is the same: the value of their investment has been reduced.

In fact, the landmark IRS ruling⁴⁷⁶ doesn't even mention why the equity was redeemed for less than face value. It merely reports a cooperative issued qualified written notices of allocation to patrons in 1963, which the patrons properly included as ordinary income. Then, in 1968, it redeemed them at less than the stated dollar amount.

The Service stated matter-of-factly that the patron had suffered a loss in 1968. The question addressed was whether the loss was an ordinary or a capital loss. IRS said:

The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer's trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified

⁴⁷⁴ See *supra* pp. 107-121.

⁴⁷⁵ Donald A. Frederick, *Income Tax Treatment of Cooperatives: Handling of Losses*, RBS Cooperative Information Report 44, Part 5 (USDA 2005), pp. 43-54.

⁴⁷⁶ Rev. Rul. 70-64, 1970-1 C.B. 36, *suspended by* Notice 87-68, 1987-2 C.B. 378.

written notice of allocation is an ordinary loss deductible for 1968 under the provisions of section 165 of the Code. See *Corn Products Refining Company v. Commissioner*, 350 U.S. 46 (1955). [other citations omitted] The loss is measured by the difference between the stated amount included in income in 1963 and the amount received upon redemption.⁴⁷⁷

IRS expanded on this holding in Revenue Ruling 70-407.⁴⁷⁸ It presented facts wherein a cotton marketing cooperative suffered a loss when it made cash advances to patrons that proved to be excessive because of an unanticipated decline in the price of cotton. In the following year the cooperative recovered the loss by offsetting each patron's pro rata share against book credits representing retained qualified written notices of allocation. The Service said:

- The patrons are entitled to an ordinary loss, equal to the value of the credits canceled, under Code section 165(a).
- As to those patrons who lacked sufficient book credits to cover their share of the loss, it can be offset against future patronage allocations. The full amount of the patronage allocation should be included in the patron's gross income pursuant to Code sec. 1385, and then the allocated loss reported as a deduction.

Even greater flexibility was approved in a letter ruling to a section 521 cooperative with three departments: a supply function, a grain marketing program that handled both sunflowers and soybeans, and a cotton ginning and marketing program.⁴⁷⁹ The cooperative suffered a loss in one year on its sunflower marketing.

⁴⁷⁷ *Id.*

⁴⁷⁸ Rev. Rul. 70-407, 1970-2 C.B. 52.

⁴⁷⁹ Priv. Ltr. Rul. 7804083 (Oct. 28, 1977).

The cooperative prorated the loss among sunflower patrons. It proposed offsetting the loss first against any grain department book credits of each patron. Next, any remaining loss would be offset against each patron's cotton and supply department credits. Any loss still not recouped would be recognized as an account receivable and collected from future grain, cotton, or supply department patronage refunds or any other normal method of collecting accounts receivable.

Citing Revenue Ruling 70-407, IRS said the patrons could treat any offset of book credits or future patronage allocations as an ordinary loss under Code section 165(a). It also said recovering the loss in this manner would not adversely impact the cooperative's section 521 status.

Similarly, in a letter ruling involving a bank that qualified as a Subchapter T cooperative, IRS said:

To the extent a member/patron has previously recognized income with respect to qualified written notice of allocation pursuant to section 1385(a) of the Code, the member/patron may take an ordinary loss under section 165(a) for the year that the notice of cancellation is received.⁴⁸⁰

The IRS point of emphasis is recovering the loss, on a pro rata basis, from the patrons whose business generated the loss. It doesn't require that the business producing the equity that is canceled be related to the loss. Canceling equity is simply a convenient alternative, acceptable to the Service, to having the patrons write checks to the cooperative for their shares of the loss. It makes good sense as the funds conveyed by checks from the patrons could have come from any source of income available to the patrons.

⁴⁸⁰ Priv. Ltr. Rul. 8624019 (March 10, 1986).

These rulings dealt with equity accumulated as retained qualified written notices of allocation. Patrons have likewise been allowed to claim an operating loss under Code section 165(a) when patronage losses are recouped by canceling equity representing qualified per-unit capital retains.⁴⁸¹

All of the rulings discussed in this subsection concern qualified patronage allocations. From a tax standpoint, holders of nonqualified written notices of allocation or nonqualified per-unit retain certificates lose nothing if redemption is for less than face value. The patron's basis in nonqualified notices or certificates is zero, so gain is realized only for amounts received at redemption. Because the patron recognized no income when the nonqualified equity was issued, the patron has no loss for tax purposes if the equity is cancelled and taxable income to the extent of any cash received if the nonqualified allocation is redeemed for something less than face value.

One cloud hangs over this favorable tax treatment for patrons. Revenue Ruling 70-64 cited the U.S. Supreme Court decision in *Corn Products Refining Co. v. Commissioner*.⁴⁸² For over 30 years, *Corn Products* had been construed to permit ordinary income (and loss) treatment for certain business-motivated transactions in stock and other capital assets. Because patrons acquire equity in a cooperative as part of their on-going business relationship with it, the tie-in between the case and ordinary loss treatment for patrons when equity is canceled or redeemed at less than face value appeared beneficial to patrons.

However, in 1986, the U.S. Court of Appeals for the Eighth Circuit reinterpreted *Corn Products*. It said that capital stock (not held by a dealer or otherwise within the exceptions listed in Code

⁴⁸¹ Priv. Ltr. Rul. 7950064 (Sept. 14, 1979); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987); Priv. Ltr. Rul. 8952019 (Sept. 28, 1989).

⁴⁸² *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

section 1221) is always a capital asset, regardless of the taxpayer's business motivation in acquiring or holding the stock.⁴⁸³

IRS responded to the Eighth Circuit decision by suspending its published revenue rulings that relied on the so-called *Corn Products* doctrine, pending Supreme Court review in *Arkansas Best*.⁴⁸⁴ Revenue Ruling 70-64 was one of three rulings specifically listed in Notice 87-68.

In March of 1988, the U.S. Supreme Court affirmed the Eighth Circuit opinion in *Arkansas Best*.⁴⁸⁵ Under this decision, all property not specifically excluded under Code section 1221 is a "capital asset" for tax purposes and the gain or loss on the sale of such assets, regardless of the motive for their purchase or disposition, is a capital and not an ordinary gain or loss.

To date, the rulings mentioned in Notice 87-68, including Revenue Ruling 70-64, have not been revoked but remain temporarily suspended. It is also noteworthy that the notice itself concluded, "No inference is intended as to whether the result reached in any suspended ruling would be correct using another rationale."⁴⁸⁶

When IRS next addressed this issue, it continued to permit patrons to take an ordinary loss deduction when qualified patronage equities are redeemed at less than face value.⁴⁸⁷ It mentioned Code section 1221's definition of "capital asset," but then relied on Revenue Ruling 70-407, which was not mentioned in Notice 87-68.

A second cloud over the ordinary loss treatment for patrons when qualified patronage equities are redeemed at less than face

⁴⁸³ *Arkansas Best v. Commissioner*, 800 F.2d 215 (8th Cir. 1986).

⁴⁸⁴ Notice 87-68, 1987-2 C.B. 378.

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

⁴⁸⁶ Notice 87-68, 1987-2 C.B. 378.

⁴⁸⁷ Priv. Ltr. Rul. 8952019 (Sept. 28, 1989).

value is the decision in *Gold Kist v. Commissioner*.⁴⁸⁸ Favorable treatment for patrons was part of an overall taxing scheme which required cooperatives that redeemed qualified equities at less than face value (and had deducted the value of the allocations when made) to include the difference between face value and cash paid out in gross income in the year of redemption. *Gold Kist* holds that the cooperative need not include the difference in taxable income, thus permitting the cooperative to transfer the retained portion of the cancelled qualified equities to a tax-free unallocated reserve. The Tax Court opinion in the *Gold Kist* case raises the issue of whether patrons are entitled to ordinary loss treatment when they receive less than face value for their qualified retained allocations and then specifically declines to address it.⁴⁸⁹

Now that the cooperative's duty to include the value of the canceled equity in income has been questioned, whether the Service will challenge the ability of patrons to claim an ordinary loss is unclear. However, to date the Service has not done so and at least one IRS training manual provides that a discounted redemption "...gives rise to an ordinary loss to the farmer in the amount of the discount. See Rev. Rul. 70-407, 1970-2 C.B. 52."⁴⁹⁰

In summary, when a qualified written notice of allocation or per-unit retain certificate is redeemed at less than face value or cancelled altogether, patron holders can claim an ordinary loss to the extent they had previously recognized the qualified allocation as income under Code sec. 165(a). The amount of the loss is the difference between the equity's stated value and the amount received.

⁴⁸⁸ *Gold Kist v. Commissioner*, 110 F.3d 769 (11th Cir. 1997), *rev'g*, 104 T.C. 696 (1995).

⁴⁸⁹ 104 T.C. 696, 708 (1995) n.20.

⁴⁹⁰ *Farming -- Specific Income Issues and Farm Cooperatives*, Market Segment Specialization Program training document No. 3147-114, Department of the Treasury, Internal Revenue Service (1997), p. 6-2.

The loss is recognized in the tax year the redemption occurs. This offsets the patron's previous recognition of the face amount of the qualified equity as ordinary income in the year received.⁴⁹¹

SALE OR EXCHANGE OF EQUITY INTERESTS

Under some circumstances a member or patron may have an interest in a cooperative that can be sold or exchanged to others. The tax issues to be considered when a holder sells or exchanges a written notice of allocation or per-unit retain certificate are: (1) the effect on the seller when the sale or exchange is made, and (2) the effect on the purchaser when the cooperative redeems the notice or certificate.

IRS dealt with both issues in a letter ruling.⁴⁹² Shortly after issuance, cooperative members sold qualified written notices of allocation to an unrelated third party at less than face value. Soon thereafter the members purchased similar certificates from another patron, also for less than face value. The members reported their loss on the sale of their written notices as an ordinary loss. When the certificates purchased by the members were redeemed by the cooperative, the members treated these certificates as a capital asset eligible for long-term capital gain treatment.

The Service disallowed the members' loss deduction for the sale of their written notices of allocation on the ground that no actual loss was incurred. The mere exchange of one interest for a similar interest was not sufficient to generate a tax loss as the members had exactly what they had before the transactions, qualified allocation certificates from the same cooperative issued in the same year.

⁴⁹¹ See, e.g., Rev. Rul. 70-407, 1970-2 C.B. 52; Priv. Ltr. Rul. 8624019 (March 10, 1986); Priv. Ltr. Rul. 8812019 (December 16, 1987).

⁴⁹² Tech. Adv. Mem. 8432010 (April 27, 1984).

IRS determined that the gain on the sale of the written notices by a third party subsequent holder (the difference between the discounted purchase price and the amount paid to the holder by the cooperative at the time of redemption) was a capital gain. This was true regardless of whether the holder was a member of the cooperative, because the certificates were not acquired in the ordinary course of a trade or business, but rather as an investment.⁴⁹³

TRANSFER OF RIGHTS TO PATRONIZE A COOPERATIVE

In some situations, the right to patronize a cooperative is a valued asset in itself. When patronage rights are limited, the right to patronize is often tied to some equity ownership or capital contribution. An example of limited patronage rights is the issuance of milk bases by dairy cooperatives.

A milk base has been described in one revenue ruling as "an intangible right permitting the [patron] the opportunity to sell a designated amount of milk at a premium price pursuant to a program designed to alleviate the ill effects of seasonal fluctuations on the supply of milk."⁴⁹⁴ A milk base is an intangible property right that qualifies as a capital asset⁴⁹⁵ if held by a taxpayer who is not a dealer in milk bases.⁴⁹⁶

⁴⁹³ *Id.* The U.S. Tax Court, in dealing with transactions that occurred before the enactment of subchapter T, reached the same conclusion in *Greenvine Corp. v. Commissioner*, 40 T.C. 926 (1963).

⁴⁹⁴ Rev. Rul. 77-168, 1977-1 C.B. 248. Holding period and termination of base under the California Agric. Code are discussed in Rev. Rul. 73-416, 1973-2 C.B. 304. *See also* Rev. Rul. 72-384, 1972-2 C.B. 479, *modifying* Rev. Rul. 70-644, 1970-2 C.B. 167; and Rev. Rul. 73-429, 1973-2 C.B. 205, *clarifying* Rev. Rul. 70-644, 1970-2 C.B. 167.

⁴⁹⁵ I.R.C. § 1221.

⁴⁹⁶ I.R.C. § 1221. *See* Rev. Rul. 70-644, 1970-2 C.B. 167 and Rev. Rul. 65-228, 1965-2 C.B. 43.

Revenue Ruling 77-168⁴⁹⁷ addresses the issue of determining the cost of a milk base when it has been allocated to or purchased by patrons over time. Patrons received their initial milk base allocations according to their past supply record.

In subsequent years, patrons could purchase additional milk base in varying quantities and prices, normally from other dairy farmers who no longer had a need for some or all of the milk base they owned. When patrons transferred bases, the cooperative updated its records to reflect the total number of pounds each patron was entitled to deliver. Certificates issued by the cooperative to the base purchaser didn't identify the specific base acquired.

A patron sold some milk base when the price of the base was deflated. The patron computed the tax basis of the milk base sold by assigning to it the weighted average cost of the total milk base acquired over the years.

The Service likened the sale of milk base to the sale of some stock shares from a larger lot of shares which had been purchased at different times and prices. In stock transactions, if the particular shares sold cannot be linked to the purchase of the same shares, the stock sold or transferred must be charged against the earliest of such shares purchased to determine the cost or other basis of the stock.⁴⁹⁸

Relying on this analogy to stock transactions, the Service ruled the patron could not use the weighted average method in determining gain or loss from the sale of the milk base. Instead, the patron had to use the "first in, first out" method as described in the regulations for stock sales.⁴⁹⁹

⁴⁹⁷ Rev. Rul. 77-168, 1977-1 C.B. 248.

⁴⁹⁸ Treas. Reg. § 1.1012-1(c)(1).

⁴⁹⁹ Rev. Rul. 77-168, 1977-1 C.B. 248, discussing Treas. Reg. § 1.1012-1(c)(1). One other comment on milk bases. In Revenue Ruling 65-228, the Service ruled that since a milk base has a life of indefinite duration, payments are capitalized and not subject to amortization or depreciation under Code section 167. Rev. Rul. 65-228, 1965-2 C.B. 43.

TAXATION OF DIRECT INVESTMENTS

When a member makes a direct purchase of a share of common voting membership stock in a cooperative (or purchases a membership in a nonstock cooperative), IRS treats that transaction as it would any direct investment in a noncooperative firm. The purchase has no immediate tax effect.

For example, in Revenue Ruling 65-241, a farmers' cooperative was denied a deduction for the cost of the Class C stock it was required to buy to borrow from a bank for cooperatives. The cooperative had attempted to treat the purchase as either a business expense under Code section 162 or as interest under Code section 163. IRS also stated that whether such stock would be considered a capital asset if disposed of by the cooperative for a gain or loss would depend upon the facts of each case.⁵⁰⁰

INCOME NOT BASED ON PATRONAGE

In analyzing the taxation of cooperative patrons, the primary focus is on payments resulting from patronage business: advances, patronage refunds, and per-unit retain allocations. Members and other patrons, however, may receive payments from a cooperative which are not based on patronage-related business.

For the most part, any payment a member or patron receives from a cooperative which is not based on patronage is treated the same as a payment from a noncooperative source. The single tax principle of subchapter T applies only to the distribution of income from the patronage relationship.⁵⁰¹

⁵⁰⁰ Rev. Rul. 65-241, 1965-2 C.B. 44.

⁵⁰¹ The exception is the nonpatronage sourced income passed to patrons by an I.R.C. § 521 cooperative. Section 521 is discussed in detail in Part 4 of these reports.

There are several ways a patron may receive a payment from a cooperative that is outside the patronage relationship. They may receive payments that, although paid to them in proportion to their business with the cooperative, don't qualify as patronage refunds because the underlying income wasn't directly related to that business. Payments to patrons may be in proportions not related to their patronage business with the cooperative. Or patrons may collect dividends based on capital stock ownership in the cooperative or other dividend-like distributions.

Income From Nonpatronage Sources

Income from nonpatronage sources is sometimes distributed to patrons in proportion to the amount of patronage business conducted with the cooperative.⁵⁰²

Frequently, each patron receives a single payment consisting of two parts--a true patronage refund and a distribution of nonpatronage sourced income. It is important that the supporting documentation properly distinguish the two types of payments. Otherwise, the failure to provide the patrons with a proper written notice of allocation or per-unit retain certificate may jeopardize the subchapter T tax status of the patronage-sourced distribution.

Section 521 cooperatives are allowed to deduct distributions of nonpatronage income to patrons that are made on a patronage basis.⁵⁰³ Patrons must include such distributions in their gross income in the taxable year received in the same manner as their patronage refund.⁵⁰⁴

⁵⁰² The issue of distinguishing patronage and nonpatronage income and their tax treatment at the cooperative level is the subject of Chapter 5 of these reports. See Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, Cooperative Information Report 44, Part 2 (USDA 2005).

⁵⁰³ I.R.C. § 1382(c)(2).

⁵⁰⁴ I.R.C. § 1385(a)(2) and Treas. Reg. § 1.1385-1(a)(2).

The Service has looked at the correct way for patrons of non-section 521 cooperatives to treat patronage-based distributions of nonpatronage income on two occasions and reached apparently conflicting conclusions.

Letter ruling 8031057 concerned a federated cooperative without section 521 status and a member cooperative with it.⁵⁰⁵ The federated cooperative distributed nonpatronage earnings (after taxes) to its members on the basis of the patronage purchases for the prior 3 years. The member cooperative claimed the distribution was a dividend and therefore eligible for the 85 percent dividends received deduction under Code section 243(a)(1).

However, IRS determined that a dividend had to be a distribution in accordance with the equity interests of the members in a cooperative. A distribution based on patronage, not total equity investment, could not be a dividend and therefore didn't qualify for the 85 percent dividends received deduction. IRS decided the distribution was "other income" and noted that the local cooperative with section 521 status could have avoided taxation by including the distribution in total income refunded to members as a patronage refund.

Letter ruling 8547039 appears to have been drafted to correct a perceived error in the previous ruling.⁵⁰⁶ It began by citing the definition of a dividend in Code section 316 as "any distribution of property made by a corporation to its stockholders out of its earnings and profits." It then noted several cases that held a dividend may be distributed to stockholders on some basis other than equity holdings. IRS stated that such distributions out of earnings on nonpatronage business were dividends. If the recipients were corporations, they were entitled to claim the 85 percent dividends received deduction under Code section 243.

⁵⁰⁵ Tech. Adv. Mem. 8031057 (April 29, 1980).

⁵⁰⁶ Priv. Ltr. Rul. 8547039 (August 27, 1985).

Not Paid on Patronage Basis

Members and patrons may receive payments from a cooperative which are not based on the amount of business they transacted with the cooperative. Examples would be a cooperative making an interest payment on a loan provided by a patron or director fees paid a patron-director as compensation for time spent on cooperative business. These payments don't qualify for subchapter T treatment because they are made without regard to the amount of cooperative business done with or for patrons.

Dividends on Capital Stock

Cooperatives may pay dividends on capital stock.⁵⁰⁷ No Code provision specifically addresses patron receipt of dividends on capital stock from cooperatives. They are treated by the patron the same as a dividend distribution from any other corporation.

Amounts Not Deductible by Cooperative

The single tax principle ultimately places the tax incidence of patronage refunds and per-unit retains on the final recipient and not the cooperative. But this applies only if payments are distributed according to subchapter T rules. Just because a distribution to a patron is taxable to the cooperative doesn't make it automatically deductible by the patron-recipient.

For example, if a cooperative fails to make a distribution within the proper payment period outlined in subchapter T, then the payment must be included in gross income by the cooperative and the patron recipient.⁵⁰⁸

⁵⁰⁷ This ability to pay dividends is subject to rate of return restrictions found in various laws affecting cooperatives. These include state incorporation statutes for cooperatives, the Capper-Volstead Act (7 U.S.C. § 291), and § 521(b)(2) of the Internal Revenue Code.

⁵⁰⁸ Treas. Reg. § 1.1385-1(a).

PASS-THROUGH DEDUCTION AND CREDITS

The American Jobs Creation Act of 2004 provides new flexibility to agricultural and horticultural cooperatives in allocating a major new tax deduction and two energy production-based credits between the cooperative entity and its patrons.

Qualified Production Activities Income Deduction

The American Jobs Creation Act of 2004 added a new sec. 199 to the Code. This section allows businesses to deduct so-called Qualified Production Activities Income (QPAI).⁵⁰⁹

Among other things, Code sec. 199 allows patrons of agricultural and horticultural cooperatives to take a deduction on their tax returns for QPAI allocated to them as part of a *qualified* patronage refund or *qualified* per-unit retain.⁵¹⁰ The amount each patron can deduct must be computed by the cooperative and a written notice must be provided each patron explaining the computation.⁵¹¹

An example, also included in Chapter 6 of these reports, illustrates how the deduction and the pass-through might work at a typical agricultural or horticultural cooperative. Assume Co-op C has \$100,000 of QPAI. Also assume it is a tax year beginning in 2005 or 2006, so the available deduction is 3 percent of QPAI, or \$3,000.

Co-op C allocates the \$100,000 to its member-patrons as a qualified patronage refund. It is allowed to deduct the \$3,000 in

⁵⁰⁹ American Jobs Creation Act of 2004, Pub. L. 108-357, § 102, 118 Stat. 1418. The development and application to cooperatives of the QPAI deduction is discussed at Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds and other Income Issues*, RBS Cooperative Information Report 44, Part 2 (USDA 2005), pp. 108-112.

⁵¹⁰ I.R.C. § 199(d)(3)(A).

⁵¹¹ *Id.*

QPAI under the new law and the remaining \$97,000 as a traditional patronage refund. Thus the result is the same for the cooperative as it was before the new law was enacted, the entire \$100,000 is deductible.

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

For tax planning purposes, it is important to remember that this is a deduction and not a credit. Tax credits, such as the energy-related credits discussed below, can be used dollar-for-dollar to offset taxes due. Deductions can only be used to reduce taxable income, so their value depends on each taxpayer's tax bracket.

Energy Credits

The American Jobs Creation Act of 2004 authorizes cooperatives to choose to pass some or all of two energy-based tax credits through to their patrons.⁵¹² The first is the small ethanol producer credit⁵¹³ and the second is the small low-sulfur diesel fuel producer credit.⁵¹⁴

In each instance, any credit that is passed through to patrons must be apportioned among patrons on the basis of the quantity or value of business done with or for such patrons during the tax

⁵¹² The credits are described at Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds and other Income Issues*, RBS Cooperative Information Report 44, Part 2 (USDA 2005), pp. 119-120.

⁵¹³ American Jobs Creation Act of 2004, § 313, Pub. L. 108-357, 118 Stat. 1467-1468 (codified at 26 U.S.C. § 40(g)(6)).

⁵¹⁴ American Jobs Creation Act of 2004, § 339(a), Pub. L. 108-357, 118 Stat. 1481-1484 (codified at 26 U.S.C. § 45H(g)).

year. Any credit not passed through to patrons is treated as a general business credit by the cooperative.

PATRON PAYMENTS TO A COOPERATIVE

Cooperative taxation from the patron's perspective usually focuses on income passing from cooperative to patron. However, members and other patrons may make payments to the cooperative as well. Generally, patron payments to cooperatives are for (1) payment for products or services received from the cooperative or (2) contributions to capital. A patron payment to the cooperative may or may not be deductible.

Patrons can generally deduct ordinary and necessary business expenses incurred in the conduct of their business.⁵¹⁵ On the other hand, Code section 263 disallows deductions for amounts paid for the acquisition or creation of a capital asset. For a cost to be capitalized under section 263, the payment must create or enhance what is essentially a separate and distinct property interest.

Contributions to Capital

Members and other patrons contribute to their cooperative's capital by payment of membership fees or dues, purchase of membership or other classes of stock, and patronage-based capitalization.

An example of a capital investment in a cooperative that is an acquisition of capital rather than an ordinary and necessary business expense is a one time membership fee. IRS has said that such a fee, used to capitalize the cooperative, creates a "separate and distinct capital asset" and the payor/member may not deduct any part of the fee under Code section 162.⁵¹⁶

⁵¹⁵ I.R.C. § 162.

⁵¹⁶ Priv. Ltr. Rul. 8723018 (March 5, 1987).

Contributions to cooperative capital by members and other patrons often serve as a pre-condition for using the cooperative. The compulsory nature of these contributions has been used to support the view that such payments should be expenses rather than contributions to capital for tax purposes. The courts have dealt with this issue on several occasions, not always with consistent results.

In *United Grocers v. United States*,⁵¹⁷ a case predating subchapter T, a grocery supply cooperative argued that various monthly payments required from its members for them to do business with the cooperative were nontaxable contributions to capital. IRS claimed the payments were for goods and services rendered and should be taxed as ordinary income to the co-op.

The Ninth Circuit Court of Appeals held that the determinant as to whether a payment to a cooperative was a contribution to capital or ordinary income was the intent of the patron making the payment. The court found that the only reason members paid the fees was because the fees were required to obtain merchandise and services at the lowest possible price; the members had no true investment motive. Therefore the cooperative had to treat the payments as ordinary income.

While *United Grocers* didn't deal specifically with the tax impact on patrons, the district court noted that evidence offered by the government indicated that members deducted the payments to the cooperative as business expenses on their own income tax returns. The district court, however, struck that evidence from the record and disregarded it as not properly admissible on the issue of the cooperative's claims.⁵¹⁸

In a letter ruling issued after *United Grocers*, the Service held that periodic payments may be considered contributions to capital. The ruling described a taxi cooperative whose members purchased

⁵¹⁷ *United Grocers, Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962), *aff'g*, 186 F. Supp. 724 (N.D. Cal. 1960).

⁵¹⁸ *United Grocers v. United States*, 186 F. Supp. at 737.

one share of stock at a fixed price and made periodic payments based on use of the cooperative. IRS ruled these periodic payments were contributions to capital, stating "the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company."⁵¹⁹ This ruling didn't address the tax consequences to members making such payments.

An interesting line of cases developed in the late 1960's concerning the proper treatment by member-patrons of payments made to banks for cooperatives for class C stock. At the time, member-borrowers from the banks were required to purchase class C stock in an amount equal to 15 percent of the interest payable on the loan each quarter.⁵²⁰

In Revenue Ruling 65-241, IRS stated that:

...costs incurred by cooperatives in purchasing class C stock are not deductible either as a business expense under section 162 or as interest under section 163 of the Internal Revenue Code of 1954. Whether such stock will be considered a capital asset upon subsequent disposition by a farmers' cooperative will depend upon the facts in the particular case.⁵²¹

In *M.F.A. Central Cooperative v. Bookwalter*,⁵²² a Federal district court determined that the stock was of no use or benefit to

⁵¹⁹ Priv. Ltr. Rul. 8129050 (Apr. 22, 1981).

⁵²⁰ The banks for cooperatives have replaced this interest-override method of financing with a loan-based capital plan. However, the same factors are likely to apply in determining the tax consequences to patrons of capitalizing the banks.

⁵²¹ Rev. Rul. 65-241, 1965-2 C.B. 44, 45.

⁵²² *M.F.A. Central Cooperative v. Bookwalter*, 286 F. Supp. 956 (E.D. Mo. 1968).

the member-cooperative. It paid no dividend and conveyed no rights to the cooperative. The court found that interest was a term of art meaning an amount one contracted to pay for the use of borrowed funds. These payments weren't deductible as interest payments because they didn't meet the court's strict interpretation of interest. However, the stock was purchased only because it was a precondition to borrowing from the bank. So the cost was deductible as an ordinary and necessary business expense.

In *Mississippi Chemical Corp. v. United States*,⁵²³ decided in February 1969, a U.S. District Court in Mississippi reasoned that any charge required as a precedent to a loan of money is interest. The court held that although the Class C stock cost \$100 a share, it had only a nominal value of \$1 per share. The \$99 difference was deductible as interest by the purchasing cooperative member.

In *Penn Yan Agway Cooperative v. United States*,⁵²⁴ decided in November 1969, the United States Court of Claims noted *M.F.A. Central Cooperative v. Bookwalter*, but reached the same conclusion as the court in *Mississippi Chemical*. This court held the interest override payments were deductible on the grounds that they were measured as a percentage of the interest payable on the outstanding loan obligation to the bank.

After *Penn Yan Agway*, the U.S. Court of Appeals for the Eighth Circuit reviewed the earlier decision in *M.F.A. Central Cooperative v. Bookwalter*. In June 1970, the appellate court affirmed the finding of the district court that the payments for the class C stock weren't deductible as interest but reversed the original finding that the payments were deductible as necessary

⁵²³ *Mississippi Chemical Corp. v. United States*, 69-1 U.S.T.C. ¶ 9266 (S.D. Miss. 1969).

⁵²⁴ *Penn Yan Agway Cooperative v. United States*, 417 F.2d 1372 (Ct. Cl. 1969). The U.S. Court of Claims opinion in *Penn Yan Agway Cooperative v. United States* is dated November 14, 1969. The U.S. Court of Appeals (Eighth Circuit) decision in *M.F.A. Central Cooperative v. Bookwalter* followed shortly thereafter on June 8, 1970.

and ordinary business expenses.⁵²⁵ The Eighth Circuit found the class C stock had substantial value and must be treated as a capital asset by the purchaser-cooperative.

In September 1970, the U.S. Court of Appeals for the Fifth Circuit reviewed of the district court holding in *Mississippi Chemical Corp.* The Fifth Circuit affirmed the district court's determination that most payments for class C stock were deductible as interest expense.⁵²⁶

In a rare venture into cooperative taxation, the U.S. Supreme Court decided to review the Fifth Circuit opinion in *United States v. Mississippi Chemical Corp.*⁵²⁷ In an opinion long on history of the Farm Credit System and short on analysis of tax law, a unanimous Supreme Court accepted the IRS position that the class C stock acquired by cooperatives to borrow from banks for cooperatives is a capital asset under Code section 1221.⁵²⁸ The Court held the class C stock had substantial valued derived from attributes other than marketability.

The Court also noted that Congress, in the Farm Credit Act of 1955, required co-op borrowers to purchase "stock" on a quarterly basis⁵²⁹ as part of a scheme to retire government investments in the Farm Credit System.⁵³⁰ If Congress had meant for the quarterly payments to be interest, it could have called them interest.⁵³¹

⁵²⁵ M.F.A. Central Cooperative v. Bookwalter, 427 F.2d 1341 (1970), *aff'g in part, rev'g in part*, M.F.A. Central Cooperative v. Bookwalter, 286 F. Supp. 956 (E.D. Mo. 1968).

⁵²⁶ Mississippi Chemical Corp. v. United States, 70-2 U.S.T.C. ¶ 9601 (5th Cir. 1970), *aff'g* 69-1 U.S.T.C. ¶ 9266 (S.D. Miss. 1969).

⁵²⁷ United States v. Mississippi Chemical Corp., 401 U.S. 908 (1971).

⁵²⁸ United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972).

⁵²⁹ 69 Stat. 655, 12 U.S.C. § 1134.

⁵³⁰ 405 U.S. at 305, 312.

⁵³¹ *Id.* at 312.

Payments to Cover Operating Losses

Members and patrons may make direct payments to their cooperative to cover operating losses. For instance, a grain marketing company was a member of a cooperative that transported and stored grain. In 1982, cooperative began suffering losses because some of its charges were subject to government control and couldn't be raised to reflect changes in the marketplace. Instead, the cooperative began monthly assessments of its members to recover its losses.

The member-patron deducted these assessments as ordinary and necessary expenses under Code sec. 162. A revenue agent proposed that these deductions be disallowed and that the member-patron be required to treat the expenditures as contributions to capital under Treas. Reg. 1.263(a)-1 and 1.263(a)-2, increasing the member's basis in its stock in the cooperative.

The Service sided with the member, holding the prompt and patronage-based assessments to cover operating losses were not capital expenditures or investments within the meaning of Reg. 1.263(a)-2(f), but rather were deductible by the patron as ordinary and necessary business expenses under Code sec. 162(a).⁵³²

⁵³² Tech. Adv. Mem. 9128007 (March 28, 1991). In an earlier letter ruling that found a proposed cooperative venture would be operating on a cooperative basis, IRS said that payments to the cooperative to cover annual operating deficits were also deductible by the members as ordinary and necessary business expenses. Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).