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**INCOME TAX TREATMENT OF
COOPERATIVES: Handling of Losses**

Cooperative Information Report 44, Part 5

2005 Edition

Donald A. Frederick

Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Handling of Losses
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, loss, tax

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Preface¹

As with other businesses, cooperative financial results are computed on a yearly basis, consistent with generally accepted accounting practices. Even highly successful cooperatives can report a loss during one of these years. Cooperatives can learn to weather financial storms better if they know their options and plan ahead for possible losses.

Handling losses has been a longstanding, contentious issue between cooperatives and the Internal Revenue Service (IRS). In 1986, amendments to the Internal Revenue Code resolved some of the uncertainties in combining patronage-sourced gains and losses for tax purposes. But many other issues remain.

Handling a loss can be one of the most difficult tasks for cooperative leaders. Cooperatives anticipating or actually facing a loss should consult with professional advisers who understand the options available and can provide a disinterested assessment of the likely outcome of choosing particular options.

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

This report provides a general, comprehensive summary of the issues and rules applicable to cooperatives faced with losses. It begins with an explanation of how cooperatives can suffer losses. Examples illustrate loss situations arising from operations, disposition of assets, and those related to accounting rules.

For many years, the IRS resisted the idea that a cooperative could suffer a loss for tax purposes. IRS asserted that since cooperatives "operate at cost," they couldn't have a loss. Since cooperatives distribute margins in good years to patrons based on patronage and are allowed a deduction for the distributions, IRS said they should issue negative patronage refunds in loss years and collect from each patron his or her *pro rata* share of the loss. The courts, however, rejected the IRS position and now the premise that cooperatives can have losses for tax purposes is generally accepted.

The next dispute was over the degree of flexibility available to cooperatives in recouping a loss. IRS insisted the loss had to be recovered from the specific patrons whose business generated the loss. Methods approved included direct billing, canceling equity, and establishing accounts receivable that could be offset against funds due the patrons. However, cooperatives insisted that members had more options, including allocating the losses to patrons of the same business activity in other years and allocating the losses to patrons of other activities. The courts again have generally supported the cooperative position. And in 1986, amendments to the Internal Revenue Code (Code) established rules that, if followed, give cooperatives significant latitude in combining patronage-sourced gains and losses.

Other issues continue to fester. The courts have thus far rebuffed efforts of cooperatives to combine patronage and nonpatronage gains and losses for tax purposes. While the courts have generally barred IRS from applying Code sec. 277 to Subchapter T agricultural cooperatives, IRS maintains that it pertains to other cooperative organizations. And a judicial decision holding a cooperative that redeemed qualified retained patronage distributions at less than face value (creating a loss for tax purposes for its patrons) did not have to report its "gain" as income at the time of redemption is being rejected by IRS.

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CHAPTER 13

HANDLING OF LOSSES

It seems ironic indeed that cooperatives may face more difficult income tax problems in years when they suffer a loss than in years in which they generate net income. This, however, is frequently the case.

Part of the difficulty in handling losses is business related. Cooperative leaders may be under considerable pressure to handle a traumatic situation, usually with little or no clear guidance from incorporation statutes, cooperative bylaws, or precedence.

Several alternative actions may be available, each with some positive and negative consequences. Portions of this chapter discuss how cooperatives can generate losses and the options for dealing with them. Hopefully, this will encourage cooperative leaders and advisers to anticipate potential losses and plan to handle them before the stresses actually occur.

Another factor that complicates handling cooperative losses is the lack of direction in the Internal Revenue Code (Code) and Treasury Department regulations (regulations). While the Code has provisions on the general treatment of losses by corporations and individuals,² the only references to losses in Subchapter T are relatively recent language dealing with netting of patronage gains and losses³ and a definition of "completed crop pool method of accounting" that recognizes an individual crop-year pool may have a loss.⁴

² Notably IRC § 165 (provides a deduction of losses) and § 172 (authorizes net operating loss carrybacks and carryovers).

³ IRC § 1388(j), Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, § 13210, 100 Stat. 82, 323-324 (1986). This provision is discussed *infra* pp. 74-77.

⁴ IRC § 1382(g)(2).

The regulations mention cooperative losses when discussing redemption of nonqualified written notices of allocation,⁵ and the distribution of patronage refunds related to the disposition of a capital asset.⁶ The regulations also refer to the possibility of a loss at the patron level related to the redemption of a patronage distribution from a cooperative.⁷ But nowhere is guidance provided to cooperatives in reporting common losses for tax purposes.⁸ Thus most ground rules for handling cooperative losses have developed through court decisions and Internal Revenue Service (IRS or the Service) administrative rulings.

LOSSES ON DIRECT INVESTMENTS

As indicated throughout these reports, one way cooperatives acquire equity is through direct investment by their member-patrons. These contributions of capital are usually made to gain access to goods and services for the patron's business or personal life, rather than to make money off the efforts of others. They are usually represented by shares of stock or other representations of membership interests. And they are at-risk investments that can lose some or all of their value.

In many instances, the required direct investment to join a cooperative is relatively small, \$100 or less. If the organization fails and that money is lost, it is not worth the cost to challenge any IRS finding as to the nature of the loss.⁹ However, occa-

⁵ Treas. Reg. § 1.1383-1(a)(2), § 1.1383-1(b)(3), and § 1.1383-1(d).

⁶ Treas. Reg. § 1.1385-1(c)(2)(ii)(b).

⁷ Treas. Reg. § 1.1385-1(e).

⁸ "Subchapter T says nothing about the appropriate treatment of net operating losses,...." *Farm Service Cooperative v. Commissioner*, 619 F.2d 718, 723 (8th Cir. 1980).

⁹ The impact of the loss is cushioned by the fact that non-corporate taxpayers can deduct up to \$3,000 in capital losses from ordinary

sionally a large sum is lost and the way it is classified for tax purposes can involve substantial amounts of money.

In 1975, Cenex Inc., a predecessor to today's CHS Inc., together with eight other regional cooperatives, formed what became known as Energy Cooperative, Inc. (ECI), to purchase and operate a petroleum refinery.¹⁰ The venture's objective was to obtain access to an assured supply of petroleum products for the cooperatives' producer members. It failed and dissolved in bankruptcy.

Cenex claimed a substantial ordinary tax loss deduction for the amount of its unrecoverable investment in ECI, under Code sec. 165(a).¹¹ After an audit, IRS determined that the loss was a capital loss, deductible only in accordance with Code sec. 165(f).¹²

taxable income each year under Code § 1211(b).

¹⁰ Thus, while Cenex was itself a large federated farm supply cooperative, in this instance it was a member-patron of another federated cooperative.

¹¹ Most of this equity was obtained as the result of a direct purchase of an equity interest in ECI, and a small amount as a retained patronage refund allocation. The courts did not indicate whether they would have reached a different conclusion if most of the canceled equity had been qualified written notices of allocation.

¹² It is frequently important from a tax perspective whether a loss is classified as an "ordinary" or a "capital" loss. As a general rule, "ordinary" losses can be deducted from ordinary income in the year the loss is realized. IRC § 165(a). "Capital" losses can (must) be offset against capital gains. IRC §§ 165(f), 1211(a).

Cenex only contested the IRS position that the loss was a capital loss, not an ordinary loss. Cenex was willing to accept nonpatronage status for the loss. The Cenex board had adopted a policy of allocating only 90 percent of patronage-sourced earning each year to the members, placing 10 percent of annual patronage earnings in an unallocated reserve, and paying tax on that amount at the cooperative level. Cenex was willing to have the loss on the ECI stock classified as a nonpatronage ordinary loss as it could then carry that loss back and forward to offset, for tax purposes, its operating earnings in other years

Cenex paid the assessment and then sued for a refund. It asserted that because the investment was made to guarantee a source of inventory for its farm supply operations, ECI stock comes within the "inventory" exception to the Code section 1221 definition of "capital asset." The court disagreed, finding the cooperative:

...might indeed have been motivated to acquire stock in an oil refinery by its desire to secure a source of inventory. But through that stock purchase, plaintiff did more than secure a supply of petroleum; plaintiff became the owner of a refining company. ...

Unless the taxpayer in question is a dealer in securities, an ownership interest in a corporation cannot fit within even a strained interpretation of the term "inventory." ... (P)laintiff's loss on its investment in the ECI stock is properly subject to capital-asset treatment under § 1221.¹³

on patronage business that were not allocated on the basis of patronage.

¹³ *Cenex v. United States*, 38 Fed.Cl. 331, 338-339 (1997), *aff'd*, 156 F.3d 1377 (Fed. Cir. 1998); *cert. denied*, 525 U.S. 1146 (1999). The court herein noted that it had earlier held, on essentially the same facts, that the loss on the sale of stock purchased to secure a "source of supply" of petroleum products did come within the "inventory" exception, *Circle K Corp. v. United States*, 23 Cl.Ct. 665, 672 (1991). The court now said it could no longer accept the rationale of that decision. 38 Fed.Cl. at 339, n.5.

Before the U.S. Supreme Court ruled in *Arkansas Best* that stock, even when purchased for a business purpose, is always a capital asset unless specifically excluded from that classification under Code § 1221, a cooperative had prevailed on essentially the same facts. *FS Services v. United States*, 413 F.2d 548 (Ct. Cl. 1969) (Stock purchased in oil refiner to alleviate petroleum product supply procurement problems was not a "capital asset" and loss on sale of stock after product shortage ended is "ordinary loss").

On appeal, the U.S. Court of Appeals for the Federal Circuit affirmed the trial court, saying:

The ECI stock transaction is more akin to vertical integration than it is to an inventory substitute. If CENEX were to produce petroleum products itself, it would not be able to classify its refinery operation as inventory; once petroleum products were produced, they would be considered inventory and other assets would have to meet the requirements of section 1221 to escape classification as capital assets. Allowing CENEX to declare its refinery operation an ordinary asset simply because it owns stock would circumvent Congress' intent in creating only the five exclusions of section 1221. Perhaps excluding stock of an inventory supplier from the definition of "capital asset" is good policy, but we prefer to leave this decision to Congress.¹⁴

A lengthy discussion of a series of IRS rulings and a court decision concerning disputes between Farmland Industries and the Service over the tax status of gains and losses on the disposition of stock owned by Farmland in various other entities is found in Part 2 of these reports.¹⁵ The Tax Court ultimately decided that gains and losses on the stock sales were patronage-sourced capital gains and losses.¹⁶

¹⁴ *Cenex v. United States*, 156 F.3d 1377, 1381 (Fed. Cir. 1998), *aff'g*, 38 Fed.Cl. 331 (1997); *cert. denied*, 525 U.S. 1146 (1999)

¹⁵ Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, Cooperative Information Report 44, Part 2 (USDA 2005) pp. 55-62.

¹⁶ *Farmland Industries v. Commissioner*, T.C. Memo 1999-388 (Nov. 29, 1999), 78 T.C.M. (CCH) 846. Farmland acquired the stock of three smaller companies to secure access to an assured supply of crude oil for its refinery operations. When forced to sell the stock to cover other operating losses in later years, Farmland realized a

When IRS announced its acquiescence in the *Farmland* decision, it issued an Action on Decision abandoning its position that gains and losses on certain transactions listed in Treas. Reg. 1.1382-3(c)(2), including the sale or exchange of capital assets, are per se nonpatronage sourced. More specifically, it said, “Gains or losses from the sale or exchange of a capital asset will be considered nonpatronage sourced where the asset was not used for a cooperative business purpose, but will be considered patronage sourced where the asset actually facilitates the cooperative business.”¹⁷

As to the losses involved in this case, Farmland was willing to have them classified as patronage and capital because it had a corresponding large gain to offset with the losses. When other cooperatives are confronted with future losses on the sale of direct investments, they may not have a ready source of capital gains, let alone patronage-sourced capital gains. So, in light of the *Arkansas Best*¹⁸ decision holding stock purchased by anyone other than securities dealers is a capital asset, they may have trouble claiming a tax benefit from the loss.

substantial gain on one sale and had modest losses on the other two.

Farmland was primarily concerned with establishing that the large gain was “patronage” rather than “nonpatronage” sourced. Farmland first applied the small losses on the disposition of the other two blocks of stock to offset part of the gain. Then, as part of a negotiated settlement with the Service on numerous tax issues, Farmland was allowed to offset the remainder of the gain, on a pro rata basis, with patronage and nonpatronage losses realized in a number of petroleum “pools.” Apparently the Service felt this was an “equitable” use of the gain in this instance. This aspect of the case was not in the decision and therefore is not precedent for allowing the netting of a patronage-sourced capital gain with ordinary patronage and nonpatronage sourced losses in future disputes.

¹⁷ Action on Decision 2001-03 (2001), *acquiescing in Farmland Industries v. Commissioner*, T.C. Memo 1999-388.

¹⁸ *Arkansas Best v. Commissioner*, 485 U.S. 212 (1988).

LOSSES RELATED TO ACCOUNTING METHODS

Special situations arise periodically under standard accounting procedures that also produce losses for cooperatives. These can be contentious with the Service as they may appear to be more the result of creative bookkeeping than legitimate losses. But the need to use consistent accounting methods, even when they produce unusual results, makes these losses valid for tax purposes.

Sometimes disputes arise over events which produce a different patronage refund calculation under generally accepted accounting rules than under the applicable tax rules. Problems occur when the accounting patronage refund is greater than the one computed under tax rules and the cooperative attempts to deduct the higher number on its "books," producing a loss for tax purposes.

Book v. Tax Accounting

In 1974, the Service addressed the "book" versus "tax" issue.¹⁹ The cooperative in question used straight line depreciation for book purposes and accelerated depreciation for tax purposes. It had a larger depreciation expense under the tax rules and thus a smaller margin available for distribution as a patronage refund than under the book rules.

The IRS cited the definition of a "patronage dividend" in Code sec. 1388(a). It interpreted the phrase "net earnings of the organization from business done with or for its patrons" to mean only net earnings "from patronage business reported for Federal income tax purposes."²⁰ It said that the cooperative could not claim a patronage refund deduction for the amount of a distribution that exceeds net earnings reported for Federal income tax purposes.

¹⁹ Rev. Rul. 74-274, 1974-1 C.B. 247.

²⁰ *Id.* at 248.

The validity of the Service's position was questioned by the U.S. Tax Court in *Associated Milk Producers (AMPI) v. Commissioner*.²¹ In 1960, Rochester Dairy (a part of AMPI when the litigation occurred) wrote-down the value of a building it owned to reflect its obsolescence, but didn't attempt to deduct it on its 1960 tax return.

In 1961, it sold the building and deducted the loss on its tax return. But the loss had already been recorded on the cooperative's books in 1960, so in 1961 its "book" income exceeded its "tax" income. The cooperative paid a patronage refund on "book" and claimed the difference between "book" and "tax" income as a tax "loss" for 1961 to be carried forward to subsequent years. The Service, relying on Revenue Ruling 74-274, denied the loss carry forward because it resulted from claiming a patronage refund deduction that exceeded net income from patronage business reported for Federal income tax purposes.

The court allowed AMPI to carry the 1961 tax loss forward. It noted that the 1961 patronage refund did not exceed 1961 "book" income and resulted "from merely a timing difference in connection with the reporting of the loss on the building."²² In a footnote, the court said that while Revenue Ruling 74-274 didn't apply to tax year 1961, "we have serious doubts as to its correctness even as an interpretation of sec. 1388."²³

In a later case, the Tax Court reviewed various issues involving a cooperative whose book income was greater than its taxable income. Among other things, it did not include tax-exempt income in taxable income and it claimed larger deductions for tax purposes than for book purposes. The cooperative issued patronage refunds based on book income and reported the differ-

²¹ *Associated Milk Producers v. Commissioner*, 68 T.C. 729 (1977).

²² *Id.* at 741.

²³ *Id.*, n. 8.

ence as a loss. The court recognized this as a valid loss for tax purposes.²⁴

The court didn't discuss the matter in detail, saying that the IRS "herein now appears to concede that a cooperative may have a net operating loss...and that it can be caused by the payment of patronage (refunds) based upon book income which exceeds taxable income from patronage."²⁵

In 1991, the Service prepared a number of proposed coordinated issues papers concerning cooperatives, including one on the "book" v. "tax" issue. The paper noted that the *AMPI* and *Certified Grocers* decisions had created some doubt as to IRS's position and its willingness to defend the issue. The paper concluded that the Service stands behind Revenue Ruling 74-274 and that the use of "book" earnings to compute a patronage refund deduction is not available to cooperatives.

In a written statement dated June 8, 1992, the National Council of Farmer Cooperatives (NCFC) attempted to persuade IRS that patronage refunds could be based on "book" earnings. Since that time the issue has festered but IRS has not challenged cooperatives that have used "book" consistently.

Cooperatives may have both tax and book losses in the same year, but the amounts may differ because they are calculated differently. In one instance, the differences between the book and tax losses were due to amounts accrued for lawsuits, fixed asset valuation, and unfunded pension plans that were deducted for book purposes but not for tax purposes because the liability had not become fixed and determinable. IRS noted the difference but didn't discuss it.²⁶

²⁴ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987).

²⁵ *Id.* at 250.

²⁶ Priv. Ltr. Rul. 8248048 (August 30, 1982).

Changes in Tax Year or Accounting Method

A cooperative may incur a loss because it is reporting results for tax purposes for a period less than a full year. A short taxable year may result from adjusting the tax years of the participants in a merger²⁷ or from changing the tax year of a single cooperative for any reason acceptable to IRS.²⁸

A cooperative may incur a loss from changes in accounting methods from one year to another, losses indirectly related to operations but not necessarily reflecting economic loss for the year in which the loss is recognized. For example, letter rulings²⁹ describe a cooperative that changed the method of closing its marketing pools from the "net realizable value" method to closing each pool in the year all the products in the pool are finally sold. The change resulted in a Code sec. 481 negative adjustment.

The cooperative took the full amount of the adjustment into account in the year of change, resulting in a substantial loss for that year. The rulings compared that accounting change with a change from LIFO method of valuing ending inventory to the FIFO method described in a revenue ruling³⁰ that resulted in a gain. IRS cited a statement therein that the adjustment described "facilitates a cooperative's ability to pass through gains or losses" and said the losses in this instance should be treated in a similar fashion.

LOSSES ON OPERATIONS

Cooperatives generally provide two types of services to their member-users. They sell them supplies and business services and

²⁷ Ford-Iroquois FS v. Commissioner, 74 T.C. 1213 (1980).

²⁸ Tech. Adv. Mem. 8043019 (July 24, 1980).

²⁹ Priv. Ltr. Rul. 8540051 (July 3, 1985); Priv. Ltr. Rul. 8540056 (July 8, 1985).

³⁰ Rev. Rul. 79-45, 1979-1 C.B. 284.

market products produced by members. These operations are often called "functions."

Cooperatives may provide services in only one or in both functions. For example, a cooperative may only market wheat for its members, only sell farm supplies, or do marketing and supply functions.

When computing their financial results for the year, cooperatives that operate both functions will usually account separately for revenues and costs of each function.³¹ A co-op may also provide more than one service within a function. For example, it may sell diesel fuel, seed, and crop protectants to its farmer-members. The cooperative would usually account separately for the results of each department within a function.³²

Determining the extent of margins and losses on a line-of-business basis is critical to evaluating current operations and planning for the cooperative's future. It also has important tax implications. The next two subsections explain how losses can occur within each function. Later, more complex issues such as combining the financial results for tax purposes of a department or function that generates a margin with one suffering a loss, called "netting," will be discussed.

Losses in the Supply Function

Cooperatives that manufacture or purchase and resell supplies and equipment can suffer a loss just like any similar noncooperative firm: *e.g.*; from competitive pressures on prices, orders not arriving on time, strikes, uncollectible accounts, etc.³³

³¹ AICPA Audit and Accounting Guide, Audits of Agricultural Producers and Agricultural Cooperatives, § 10.16 (Am. Inst. of Certified Pub. Accountants 1987, with conforming changes as of May 1, 1996) p. 44.

³² *Ibid.*

³³ *See, e.g.*, Priv. Ltr. Rul. 8248048 (Aug. 30, 1982).

Local supply cooperatives that typically purchase in bulk and resell in small lots to individuals can be hit by any of these conditions. However, they commonly suffer a loss when the retail price of a major product they handle falls after they have purchased a large quantity but before they can resell it to their patrons. They are compelled to resell the product at a loss to meet competition and maintain member loyalty.

**Example 1. Cooperative Loss Caused by Price Decline
in Supplies Purchased for Resale**

Expected	<u>(1 million units)</u>
Purchase Price (\$0.85/unit)	\$850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Product Sales Proceeds (\$1.10/unit)	1,100,000
Net Margins	\$50,000

Actual	<u>(1 million units)</u>
Purchase price (\$0.85/unit)	\$850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Product Sales Proceeds (\$1.00/unit)	1,000,000
Net Loss	(\$50,000)

Example 1 illustrates how a decline in the market price of a product purchased for resale to members can generate a loss. The cooperative paid \$.85 per unit for an item with the expectation the

article could be resold to patrons for \$1.10 per unit, covering costs and generating a net margin to be distributed as patronage refunds. When it could only sell the item for \$1.00 per unit, a net loss occurred.

A modest shortfall in the anticipated price of the product, from \$1.10 to \$1.00, turned a reasonable potential margin into a significant loss. In today's highly competitive markets, where profit margins are thin in good times, this is a perfectly plausible event.

Supply cooperatives can also suffer losses when patrons simply don't buy as much product as anticipated. For example, a cooperative might make an advance purchase of seed corn to meet normal member demand during the spring. However, unusually wet weather may prevent members from getting into their fields during the planting season for corn. As a result, they switch some of their acreage to other crops that can be planted later, such as soybeans, and purchase less seed corn than anticipated.

In Example 2, the cooperative experienced no price changes for the product supplied and had no operating cost changes. A 20-percent shortfall in deliveries to patrons was sufficient to cause the cooperative's total costs to considerably exceed its total proceeds.

Example 2. Cooperative Loss Caused by 20-Percent Shortfall in Orders for Supplies Furnished Patrons

Expected	<u>(1 million units)</u>
Purchase Price (\$0.85/unit)	\$850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Product Sales Proceeds (\$1.10/unit)	1,100,000
Net Margins	\$50,000

Actual	<u>(800,000 units)</u>
Purchase Price (1,000,000 units at \$0.85/unit)	\$850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Product Sales Proceeds (\$1.10/unit)	880,000
Net Loss	(\$170,000)

Unfortunately for cooperatives caught in this situation, they may actually suffer additional pressure on prices and costs. If competitors also have too much supply resulting from the depressed demand, market conditions may force down prices. And if that product remains in inventory, variable costs may actually rise. Thus supply cooperatives should plan their purchases carefully to avoid this predicament, if possible.

Losses in the Marketing Function

Marketing cooperatives also can suffer operating losses for a variety of reasons.³⁴ A primary buyer may file for bankruptcy and be unable to pay for products already delivered.³⁵ A Government regulator may keep prices the cooperative can charge for its services so low the cooperative can't cover its expenses.³⁶

More typical is the cooperative trapped by fluctuations in the markets in which it sells patrons' products. A cooperative may purchase these products at a cost reflecting the current market

³⁴ See, e.g., Priv. Ltr. Rul. 9202026 (Oct. 11, 1991)(high processing costs and interest expenses, erosion of commercial markets, uncollectible accounts).

³⁵ Priv. Ltr. Rul. 8842018 (July 22, 1988).

³⁶ Tech. Adv. Mem. 9128007 (March 28, 1991).

price to producers at the time of delivery to the cooperative, or make advances to patrons based on that price. The price paid or advance is established with an expectation that the commodity or product(s) made from the commodity can be sold at a price sufficient to cover those payments and all other costs. If the actual proceeds are less than anticipated, a loss can result.³⁷

In Example 3, the cooperative made advances of \$0.85 per unit anticipating the product could be sold for \$1.10 per unit, cover costs, and generating a net margin to be distributed as patronage refunds. When prices fell to \$1.00 per unit, however, a net loss occurred.

Example 3. Cooperative Loss Caused by Price Decline of Product to be Marketed

Expected	<u>(1 million units)</u>
Product Sales Proceeds (\$1.10/unit)	\$1,100,000
Advances Paid to Patrons (\$0.85/unit)	850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Net Margins	\$50,000

³⁷ Rev. Rul. 70-407, 1970-2 C.B. 52 (cash advances to patrons proved to be excessive because of unanticipated decline in the price of cotton); Priv. Ltr. Rul. 8248034 (Aug. 30, 1982)(sharp decreases in market prices of commodities subsequent to cooperative's entering into fixed-price contracts with its members); Priv. Ltr. Rul 7926068 (March 29, 1979)(cotton processing cooperative suffered a loss resulting from a sudden decline in the price of denim).

Actual	<u>(1 million units)</u>
Product Sales Proceeds (\$1.00/unit)	\$1,000,000
Advances Paid to Patrons (\$0.85/unit)	850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Net Loss	(\$50,000)

Market factors other than price changes may affect a cooperative's ability to generate enough income to cover costs and advances to patrons. Marketing cooperatives depend on deliveries by patrons. Fluctuations in patronage may lead to cooperative losses, whether the fluctuation is an excess or deficiency.

For instance, patrons may deliver more product than a cooperative can market at prices adequate to cover grower payments and its operating costs. Overproduction is frequently accompanied by a general market price decline, so the conditions work together to compound the problem.

A shortfall in anticipated product delivery may also induce losses, especially if prices don't rise enough to cover the revenue decline. A product shortage can be particularly troublesome if the cooperative has contracted to deliver product to a buyer at a fixed price and, in a time of rising prices, is forced to obtain substitute product in the open market.

The cooperative in Example 4 had a 30-percent shortfall in deliveries from patrons that resulted in a loss. This simplified example doesn't deal with price changes for product bought or sold, but does reflect changes in variable costs.

Example 4. Cooperative Loss Caused by 30-Percent Delivery Shortfall

Expected	<u>(1 million units)</u>
Product Sales Proceeds (\$1.10/unit)	\$1,100,000
Advances Paid to Patrons (\$0.85/unit)	850,000
Operating Costs	
Variable Costs (\$0.05/unit)	50,000
Fixed Costs	150,000
Total Costs	<u>1,050,000</u>
Net Margins	\$50,000
Actual	<u>(700,000 units)</u>
Product Sales Proceeds (\$1.10/unit)	\$770,000
Advances Paid to Patrons (\$0.85/unit)	595,000
Operating Costs	
Variable Costs (\$0.05/unit)	35,000
Fixed Costs	150,000
Total Costs	<u>780,000</u>
Net Loss	(\$10,000)

Startup Situations

Forming a new cooperative, or entering a new line of business, forces members to incur costs before the cooperative generates much, if any, income. While the members may realize an immediate benefit from the new service, it may be some time before the cooperative realizes positive financial results.³⁸ Persons starting a new cooperative must provide sufficient capital to cover these early losses and develop a financial and tax plan to recoup them as swiftly and efficiently as possible.

³⁸ Tech. Adv. Mem. 8245082 (Dec. 31, 1981); Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

In summary, numerous factors may lead to operating losses for both marketing and supply cooperatives, particularly if they can't adequately adjust their prices received for supplies provided, or payments to patrons for products delivered, to reflect changes in market conditions. A cooperative is vulnerable to operating losses just like any other businesses in similar situations.

SHOWING AN OPERATING LOSS FOR TAX PURPOSES

A sign in numerous small retail establishments reads, "This business is a nonprofit organization. We didn't intend it to be that way, that's just how things worked out."

Cooperatives are often referred to as "nonprofit" businesses that "operate at cost." Many State cooperative incorporation laws use the term "nonprofit" to describe organizations they cover.³⁹ The terminology was often written into those laws decades ago, to emphasize that cooperatives are not operated to generate profits for themselves, but rather to provide goods and services to members at the lowest possible cost. They describe the relationship between cooperatives and their members, not a formal accounting and tax principle.

Nonetheless, in the 1970s, IRS devised an "operation at cost" theory it applied to determine cooperatives could not have a loss for tax purposes on operations conducted on a cooperative basis. Much of the resulting controversy focused on the ability of cooperatives to use Code sec. 172.⁴⁰

³⁹ James R. Baarda, *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises*, ACS Research Report No. 54, at 18-20 (USDA 1986).

⁴⁰ IRC § 172.

Introduction to Code Sec. 172

Code sec. 172 permits most taxpayers to deduct in the current tax year an eligible net operating loss suffered in another tax year.⁴¹ A net operating loss is defined as the amount by which allowable deductions exceeds gross income.⁴²

For tax years beginning after August 5, 1997, a net operating loss may be carried back and deducted against taxable income in the 2 years before the loss year and then carried forward and applied against taxable income for up to 20 years after the loss year.⁴³ Generally, the loss is to be used in the earliest tax year it can be applied.⁴⁴

However, a taxpayer may forgo the carry back period and use the loss exclusively in the years following the loss year.⁴⁵ Such an election might be beneficial when the taxpayer expects higher marginal tax rates to apply to its taxable income in the next few years than applied in the most recent years. This flexibility to use a net operating loss to offset taxable income paid in prior years (and generate a refund) and/or in future years (and avoid a tax liability) is a valuable tax planning tool.

The Service hasn't questioned the ability of cooperatives to generate losses on nonpatronage activity or to carry them back and forward to offset otherwise taxable nonpatronage-sourced earnings in other years.

However, the Service has questioned whether a cooperative can even have a net operating loss on patronage activity and barred

⁴¹ IRC § 172(a).

⁴² IRC § 172(c).

⁴³ IRC § 172(b)(1)(A). For tax years beginning before August 6, 1997, the loss can be carried back for three years and carried forward for 15 years. Net operating losses that occurred in tax years ending in 2001 and 2002 can be carried back for 5 years.

⁴⁴ IRC § 172(b)(2).

⁴⁵ IRC § 172(b)(3).

the use of patronage-sourced losses to offset nonpatronage earnings. Cooperatives claimed that when expenses exceeded income, they had a net operating loss and attempted to carry it back or forward.

IRS countered that since a cooperative operates at cost, it could not generate a "net operating loss" and use it to reduce taxes due in other years. IRS would disallow the claimed net operating loss deduction and tell the cooperative to recoup the loss from the patrons whose business created the loss.

Early Indications Support Co-op Losses

Prior to the 1970s, handling of losses by cooperatives received little attention. Exempt cooperatives were truly exempt from taxation and nonexempt cooperatives were taxed just as other corporations, except they were permitted to treat income allocated to the accounts of member-patrons as discounts or rebates.

The Revenue Act of 1951⁴⁶ terminated the true "tax exempt" status of certain farmer cooperatives and included a provision to insure that cooperative earnings would be currently taxable either to the cooperative or to its patrons.⁴⁷ The cooperative provisions originated as a Senate amendment to the House bill. The Senate Finance Committee report acknowledged a cooperative could have a loss, stating:

It is to be noted that in computing (under Section 122 of the Code) *the net operating loss deduction* provided by Section 23(s) of the Code [Section 172 of the 1954 Code], not only will the amounts allowable as deductions under

⁴⁶ Revenue Act of 1951, ch. 521, § 314, 65 Stat. 452, 491-491 (1951).

⁴⁷ For a discussion of the cooperative provisions in the Revenue Act of 1951, see Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) pp. 116-119.

Section 101(12)(B)(i) and (ii) of the Code as amended by the bill be taken into account but such computation will also reflect the patronage dividends, refunds, and rebates made by the cooperative which are taken into account in computing net income. [emphasis added]⁴⁸

During the 1950s and 1960s, it apparently was general practice for cooperatives to net losses both within a function and between functions and to make patronage refund distributions of the remainder. If an association suffered an overall loss, even though one or more operation(s) might have margins, no patronage refunds were paid. This mutual risk-sharing was accepted by member-patrons.⁴⁹

Until the early 1970s, the IRS gave at least passive acceptance to the idea that a cooperative could have a loss.⁵⁰ In Revenue Ruling 65-106, the Service said that a net operating loss could be carried back or forward under Code section 172 without necessarily reducing the earnings of the cooperative available for patronage refunds in the year to which the loss may be carried.⁵¹ The ruling indicated that if the cooperative had a legal obligation to reduce future patronage refunds to recapture the loss, such as a bylaw or provision in a contract between the cooperative and its members to that effect, that obligation would control.⁵²

⁴⁸ S. Rep. No. 781 (Supp. 2), 82nd Cong., 1st Sess. (1951) p. 29, reprinted at 1951-2 C.B. 565.

⁴⁹ Marion M. Winkler, *Treatment of Losses of Farmer Cooperatives*, The Cooperative Accountant, Fall 1971, at 8, 12.

⁵⁰ See, e.g., references to cooperatives suffering losses in the regulations on redemption of nonqualified written notices or allocation, Treas. Reg. § 1.1383-1(a)(2), § 1.1383-1(b)(3), and § 1.1383-1(d); and the distribution of patronage refunds related to the disposition of a capital asset, Treas. Reg. § 1.1385-1(c)(2)(ii)(b).

⁵¹ Rev. Rul. 65-106, 1965-1 C.B. 126.

⁵² See also, Letter Ruling 6503036020A (March 3, 1965).

Revenue Ruling 67-128 concerned a cooperative with section 521 status that marketed both vegetables and grain. It accounted for the income and expenses of each department separately. It realized nonpatronage gains and losses on these lines of business. The Service approved a plan to allocate the nonpatronage income and losses to the patrons of the department to which they relate, rather than to all patrons, "provided that the allocation is not discriminatory among patrons similarly situated."⁵³

Revenue Ruling 70-328 discussed a cooperative's treatment of an unused investment tax credit during a "taxable year its operations resulted in a net operating loss as defined in section 172(c) of the Code."⁵⁴

Revenue Ruling 70-420 examined whether a cooperative that earned 600x dollars on member business and "sustained a net loss" of 500x dollars under a contract with a foreign government had a net operating loss for tax purposes. IRS said the cooperative had to net the results of the two and had a single margin of 100x dollars. The ruling seems to indicate that if the numbers had been reversed so that the loss on the foreign contract exceeded member earnings, the result would have been an overall net operating loss of 100x.⁵⁵

⁵³ Rev. Rul. 67-128, 1967-1 C.B. 147. For an explanation of the special rules in § 521, including those pertaining to patronage-based allocations of nonpatronage income and losses, see Donald A. Frederick, *Income Tax Treatment of Cooperative: Internal Revenue Code Section 521*, RBS Cooperative Information Report 44, Part 4 (USDA 2005) pp. 102-108.

⁵⁴ Rev. Rul. 70-328, 1970-1 C.B. 5. This ruling held a cooperative couldn't claim an investment tax credit (ITC) in a year it has an operating loss. Rev. Rul. 85-126, 1985-2 C.B. 5, revoked this ruling and said that under current law a cooperative may have unused ITC for carry back and carryover purposes "in a year during which it has a net operating loss."

⁵⁵ Rev. Rul. 70-420, 1970-2 C.B. 64, *revoked by* Rev. Rul. 74-377, 1974-2 C.B. 274.

This is consistent with language in Rev. Rul. 67-128 indicating that allocation of losses by department is conditioned on its not discriminating among similarly situated patrons. By implication, the approach IRS preferred at the time was to allocate a loss in a given department "to all patrons of the association."⁵⁶

IRS's Operation-at-Cost Principle

Contemporaneous reports indicate that the IRS staff shocked cooperative tax advisers during a presentation at the 1971 Annual Meeting of the National Council of Farmer Cooperatives. They announced that from now on (1) cooperatives were not to net between functions and (2) losses were to recouped from the patrons of the year that the loss was recognized.⁵⁷

A summary of the session in TAXFAX reported:

Representatives of the IRS National Office participated in the January meeting of the Legal, Tax and Accounting Committee of the National Council of Farmer Cooperatives. In reporting on cooperative problems then under consideration in the National Office, they dropped a "super bomb" with respect to departmental losses of a multi-departmental operation.

Presume that one department earns \$100 and the second loses \$40; the IRS representatives suggested that the \$40 loss should be assessed against patrons of the loss department and patronage dividends of \$100 should be paid to patrons of the profitable department! This is wholly contrary to the beliefs many of us have grown up with over the years.⁵⁸

⁵⁶ Rev. Rul. 67-128, 1967-1 C.B. 147.

⁵⁷ Marion M. Winkler, *Treatment of Losses of Farmer Cooperatives*, *The Cooperative Accountant*, Fall 1971, at 8, 12-13.

⁵⁸ TAXFAX, *The Cooperative Accountant*, Fall 1971, at 38.

A few years later, Gerald Holmes suggested, "The change in the Service's position on losses may have evolved from its philosophical definition of a cooperative. The axiom cited most by the Service in recent years concerning cooperative losses is the 'cost principle.'"⁵⁹

The operation-at-cost principle was first voiced by the Service in a ruling that concerned inventory valuation, not losses. The Service said:

One of the fundamental principles associated with a farmers' cooperative is that it is operated at cost for its patrons. This principle is usually evident when the net earnings (net savings) resulting from the operation of the cooperative from business done with or for its patrons are returned by the cooperative to its patrons in proportion to the amount of business done with or for each patron.⁶⁰

After IRS announced its new position on losses in 1971, it issued a letter ruling in 1972 that applied its operation-at-cost principle to determine a cooperative could not net losses of its marketing department with margins of its purchasing department.⁶¹ IRS cited Revenue Ruling 69-67 as the source of its position that cooperatives must operate at cost with their patrons. It then stated, "A corollary to this cost principle of operation is that any losses of the cooperative operation attributable to excess advances or undercharges to the patrons are recoverable from the patrons."⁶²

The Service provided several options available to recoup the loss:

⁵⁹ Gerald A. Holmes, *Cooperatives and Losses: An Historical Perspective on Current Issues*, *The Cooperative Accountant*, Winter 1975, at 2, 4.

⁶⁰ Rev. Rul. 69-67, 1969-1 C.B. 142.

⁶¹ Ltr. Rul. 7207319410A (July 31, 1972).

⁶² *Id.*

1. Requiring direct reimbursement from the patrons whose business generated the loss.
2. Establishing an account receivable due from each patron. For accrual basis taxpayers, this recoups the loss for tax purposes.
3. Canceling outstanding credits in the patron's account with the cooperative representing retained patronage refunds and per-unit retains.
4. The Service acknowledged that recoupment through the first three methods is not always feasible. It said a cooperative may carry over the excess advances and undercharges to the next year and treat them as a cost of operation to the department that sustained the loss, provided it can show that this method of recoupment doesn't result in inequitable treatment of the patrons of that department in the subsequent year. IRS was emphatic, however, that the cooperative did not have a Code sec. 172 loss for the year in which the loss was sustained.⁶³

The Courts Speak

The courts first addressed IRS's operation-at-cost principle in *Associated Milk Producers, Inc. v. Commissioner*.⁶⁴ From 1959 to 1961, Rochester Dairy reported deductions in excess of gross income.⁶⁵ The board of directors decided it would be inequitable to charge the current losses against patrons' capital reserve accounts. The directors were also concerned that reducing member equities would anger patrons, resulting in a serious loss of business to competing dairies.

⁶³ *Id.* This ruling concerned a § 521 farmers cooperative. For the application of the same rules to a non-section 521 wholesale grocery cooperative, see Let. Rul. 7301319420A (Jan. 31, 1973). For background, see Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

⁶⁴ *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729 (1977).

⁶⁵ In 1969, Rochester Dairy merged into AMPI, which was pursuing the case as a successor in interest.

The board decided the losses should be carried forward to future profitable years. From 1962 through 1966, net income was offset and patronage refund allocations eliminated until the entire amount of the prior years' losses was recouped. For each of these years, the cooperative claimed net operating loss carry forward deductions pursuant to Code sec. 172. IRS disallowed the deductions.

The court described the IRS's argument:

Respondent's position in this case is not based on any statutory exception to the loss carryover privilege, clearly stated in section 172, but upon respondent's theoretical perception of a cooperative as an exceptional entity which by its nature cannot ordinarily have a net operating loss for tax purposes. Respondent argues that the basic principle of a cooperative is that it operates at cost (after patronage dividend allocations) for its member-patrons. Pursuant to this "cost" principle, respondent contends, in any year in which expenses exceed gross income, this "loss" must be recouped from the members who were patrons for that period (i.e., the exact converse of a patronage dividend allocation when income exceeds expenses), so that the cooperative will then have operated at cost. The recovery of the operating deficit from the current patrons would thus eliminate any net operating loss for tax purposes.⁶⁶

The court rejected the argument as a reason to restrict the use of section 172 by cooperatives. It stated:

We consider respondent's position herein not only contrary to the express provisions of section 172, but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax

⁶⁶ Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, 735 (1977).

structure applicable to cooperatives. The deductions claimed are clearly authorized by section 172. There is nothing within that section or the regulations thereunder which indicates that the net operating loss deduction is not applicable in the case of a cooperative subject to subchapter T. In fact, quite to the contrary, the utilization of the net operating loss deduction by cooperatives is clearly implicit in certain subsections of the Code and the Income Tax Regulations, and in various of respondent's rulings dealing with cooperatives.⁶⁷

At the same time the Tax Court was considering the AMPI case, a similar suit was before it involving Farm Service Cooperative of Fayetteville, AR. Farm Service had four accounting units: a broiler marketing pool, a turkey marketing pool, a farm supply function, and a separate allocation unit for nonpatronage activity. In 1971, broiler pool expenditures exceeded receipts. The cooperative paid patronage refunds to patrons of the turkey and supply units, offset all nonpatronage income against the broiler pool loss, and carried the remaining broiler pool loss back 3 years, charging it against an unallocated, general reserve account.⁶⁸

IRS disallowed the deductions based on offsets of the broiler pool losses and told the cooperative to recover them from the broiler pool reserve. The Court described the Service's approach and its tax consequences:

Respondent views a cooperative as a sort of conduit that can distribute patronage profits to its patrons and thereby avoid paying tax on the profits. ...From this observation, respondent carries the conduit approach

⁶⁷ *Id.* at 736.

⁶⁸ In 1972, the cooperative also suffered a loss in the broiler pool, which was totally offset against nonpatronage income.

beyond the statutory framework and concludes that in a loss year--in a year when patronage expenses exceed patronage income--the only proper recourse is for the cooperative to obtain capital contributions or refunds from cooperative members, thereby running the cooperative on a 'cost' principle.⁶⁹

IRS said the implication of applying the operation-at-cost principle is to conclude that cooperatives operate their patronage activities without a profit motive. Lacking a profit motive, deductions are not allowed under section 162, and "without deductions under section 162, it is not possible for patronage activities to incur net operating losses under section 172."⁷⁰

The Tax Court rejected IRS's application of an operation-at-cost principle and its suggested implications concerning Code sec. 162 deductions, reaffirming the court's opinion in *Associated Milk Producers*:

[W]e conclude that cooperatives are entitled to net operating loss deductions resulting from patronage activities. Implicit in this conclusion, as it was in *Associated Milk Producers*, is the conclusion that patronage activities are carried on for a profit, hence ordinary and necessary expenditures, unless otherwise disallowed, are deductible by the cooperative under section 162.⁷¹

On appeal, the IRS did not pursue its operation-at-cost principle.⁷²

⁶⁹ *Farm Service Cooperative v. Commissioner*, 70 T.C. 145, 153 (1978), *rev'd on other grounds*, 619 F.2d 718 (8th Cir. 1980).

⁷⁰ 70 T.C. at 152.

⁷¹ 70 T.C. at 154.

⁷² "The Commissioner does not contest the proposition that a cooperative can have a net operating loss, or that it can carry such losses

The operation-at-cost principle was urged in a third Tax Court case,⁷³ following closely on the heels of *Associated Milk Producers* and *Farm Service*. This cooperative incurred losses in both its marketing and supply functions which it wanted to carry forward and apply against future net margins.

IRS conceded that a cooperative can sustain net operating losses and carry them back and forward under Code sec. 172. It did note, however, that some former patrons had terminated their memberships during the loss years. It now argued that the operation-at-cost principle required the cooperative to recoup their share of the losses directly from the terminating members. The court reported the Service said:

...a cooperative's right to avail itself of section 172 for losses incurred in business operations with cooperative members is restricted by what are...certain fundamental principles of cooperative operation, in particular the concepts of equitable allocation and operation at cost. ...a net operating loss may only be carried over to offset income in other years of the same members whose business produced the losses. Moreover, to the extent the loss is attributable to business conducted with or on behalf of members who terminate their membership, it is (the IRS) view that the loss must be recovered currently.⁷⁴

forward and back as provided in IRC § 172." *Farm Service Cooperative, Inc. v. Commissioner*, 619 F.2d 718, 724 (8th Cir. 1980).

The Court of Appeals reversed and remanded the Tax Court opinion because it permitted the cooperative to offset the patronage sourced losses against the nonpatronage income. "A nonexempt cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income. Taxpayer's accounting procedures cannot supersede this statutory principle." 619 F.2d at 727.

⁷³ *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213 (1980).

⁷⁴ *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213, 1218 (1980).

The Tax Court, as it did in *Association Milk Producers and Farm Service*, declined to accept the implications of the operation-at-cost principle for cooperative patronage losses. It did not reject operation-at-cost as a valid cooperative characteristic. Rather, it did not apply the concept rigidly to reach a required method of loss handling. It said the "concept of operation at cost simply means that a cooperative was organized for the purpose of rendering economic services, without gain to itself, to shareholders or to members who own and control it."⁷⁵

The court said "The 'operation at cost' principle describes a feature of a cooperative's relations with its members, not a codified requirement of tax accounting. Accordingly, we reject [the Commissioner's] argument that the principle of 'operation at cost' absolutely bars a cooperative from carrying forward and deducting losses allowable to its terminated members."⁷⁶

The Section 521 Rulings

Each of the cases in the previous subsection involved a nonsection 521 cooperative. As these cases were developing, an interesting series of administrative rulings were handed down by IRS concerning section 521 cooperatives.

In late 1978, IRS issued a series of letter rulings on applications for section 521 status conditioning approval on adoption of a bylaw provision reading: "In the event the cooperative suffers a loss in any year the cooperative will trace the deficit or loss to the patrons whose business gave rise to it and will take whatever steps are necessary to recover such losses or deficits from those patrons."⁷⁷

⁷⁵ *Id.* at 1219, *citing* *United Grocers, Ltd v. United States*, 186 F. Supp. 724, 733 (N.D. Cal. 1960).

⁷⁶ *Id.* at 1222.

⁷⁷ Priv. Ltr. Rul. 7843060 (July 27, 1978); Priv. Ltr. Rul. 7852005 (August 31, 1978); Priv. Ltr. Rul. 7905125 (Nov. 6, 1978).

However, by late 1979 IRS had softened its position. In one ruling, it said a cooperative with section 521 status did not have to replace language giving the board discretion over handling a loss with the provision quoted above.⁷⁸ In another, it granted an application for § 521 status on the condition a bylaw is adopted reading: "...such loss will, to the extent practicable, be borne by the patrons of the loss year on an equitable basis."⁷⁹

By early 1983, IRS was permitting cooperatives to retain their section 521 status that had disregarded conditional determinations letters requiring bylaw language on tracing losses to the patrons whose business gave rise to the losses. The Service said that while it didn't acquiesce in *Associated Milk Producers*, it would permit section 521 cooperatives to carry losses back and forward under Code sec. 172.⁸⁰

These cases and rulings establish that cooperatives can have a net operating loss and carry a loss back and forward pursuant to Code sec. 172. In spite of these decisions, the Service continues to refer to its "operation at cost" theory as a fundamental cooperative principle.⁸¹ And while these determinations establish that a cooperative can have an operating loss for tax purposes, they do little to clarify how that loss should be allocated among past, present, and future members.

⁷⁸ Tech. Adv. Mem. 8019003 (Nov. 20, 1979).

⁷⁹ Priv. Ltr. Rul. 8021073 (Feb. 28, 1980).

⁸⁰ Tech. Adv. Mem. 8316002 (Jan. 7, 1983) (also TAM's 8316003 through 8316018); Tech. Adv. Mem. 8316156 (Jan. 5, 1983). IRS also allowed a section 521 cooperative to utilize the net operating loss provisions of § 172 in Priv. Ltr. Rul. 8842018 (July 22, 1988) and Priv. Ltr. Rul. 9021013 (Feb. 21, 1990).

⁸¹ Tech. Adv. Mem. 8707005 (Nov. 7, 1986); Tech. Adv. Mem. 9128007 (March 28, 1991). The Service has also taken the position that non-Subchapter T cooperatives must operate "at cost." *See the description of the government's brief and argument in* *Buckeye Power v. U.S.*, 38 Fed. Cl. 154, 159 (1997) (rural electric cooperative exempt under IRC § 510(c)(12)).

HANDLING A PATRONAGE-SOURCED LOSS

Once it is established that a cooperative has suffered a loss, the tough issue becomes, "Who will absorb it?" Ultimately, in some manner, the loss will be allocated to the members. The more difficult questions are which members, and on what basis.

Regardless of what the courts have said about its "operation at cost" theory, the Service's preference since at least 1972 has been clear and consistent. IRS wants cooperatives to recoup patronage-sourced losses from the specific patrons whose business generated the losses, and in proportion to their patronage during the year that the loss occurred.⁸² But even this seemingly straightforward approach may become complicated in some instances, such as when the loss results from an event that occurred over several years or recovery from the patrons at the time is not feasible.

Cooperatives have countered that the members, not the IRS, should determine what is fair and equitable. They say that they are essentially risk-sharing ventures. They assert that if, for example, cotton farmers and cattle ranchers want to be part of a diversified cooperative and share the financial risks of marketing cotton and supplying cattle feed, the decisions on the extent of risk-sharing and how the risk is allocated among past, present and future users should be theirs and IRS shouldn't tell them what they can and can't do.

Cooperatives have attempted to achieve the maximum possible flexibility in handling losses. As a general rule, the more diversified the cooperative, the more flexibility it seeks. Cooperatives often strive for the same ability to use Code sec. 172

⁸² As mentioned previously, IRS hasn't questioned the ability of cooperatives to generate losses on nonpatronage activity or to carry those losses back and forward to offset otherwise taxable nonpatronage-sourced earnings in other years. However, it has resisted cooperative efforts to combine, or "net," patronage and nonpatronage gains and/or losses. Issues involving nonpatronage gains and losses are discussed near the conclusion of this chapter.

and to "net" the results of different operations as do their noncooperative competitors. This has led to major confrontations with the IRS, at least one of which was settled by Congress.

Both sides make liberal use of terms such as "equitable" and "fair" to bolster their positions. For example, once "operation at cost" was discredited by the courts, the Service sought to achieve essentially the same result, require recoupment from the patrons whose business led to the loss, by applying an "equitable allocation" standard.⁸³

The remainder of this chapter covers how this central disagreement over what is an "equitable" allocation of losses has played out in various factual situations. It is a difficult topic to cover because several variables can apply. Factors affecting how a loss may be handled include:

- Whether the loss is patronage or nonpatronage sourced;
- Whether the loss is an operating loss or a nonoperating loss;
- Whether the cooperative has sec. 521 tax status;
- Whether the cooperative provides only marketing or supply services or has operations in both functions; and
- How the cooperative wants to allocate the loss.

Because of the numerous variables involved, any approach to describing cooperative losses will be somewhat arbitrary. This chapter generally attempts to look at the options from the perspective of a cooperative board of directors. Research suggests three general approaches have been adopted:

- Recovering the loss from the patrons whose business generated the loss, on a pro rata basis;
- Recovering the loss from patrons of the same allocation unit, but from patrons of different years, by

⁸³ See Gen. Couns. Mem. 37,751 (Nov. 21, 1978).

carrying the loss back or forward under Code sec. 172;
and

- Recovering some or all of the loss from patrons of other allocation units, by netting the financial results of the allocation units. Netting can involve combining the patronage-sourced results of different allocation units within the same function, netting between functions (marketing and supply operations), and netting patronage and nonpatronage results both within and between functions.

The approaches will be discussed in the preceding order.

RECOUPING PRO RATA FROM PATRONS WHOSE BUSINESS GENERATED THE LOSS

The IRS has a long-standing preference for cooperatives to recoup patronage-sourced losses on a pro rata basis from the patrons whose business generated the loss. In 1970, the Service issued revenue rulings stating a cooperative could recover losses by redeeming retained qualified written notices of allocation at less than face value⁸⁴ or canceling such retains outright.⁸⁵ In one of the earliest letter rulings released to the public, it specifically approved three recovery methods: (1) direct payment, (2) canceling retained patronage equities, and (3) accruing accounts receivable.⁸⁶

For a period after these ruling was issued, the Service pressured cooperatives to force their patrons to write checks to cover their share of any losses. Over time, the common practice has evolved, with the Service's blessing, of creating accounts receivable from the patrons whose business generated the loss and

⁸⁴ Rev. Rul. 70-64, 1970-1 C.B. 36.

⁸⁵ Rev. Rul. 70-407, 1970-2 C.B. 52.

⁸⁶ Tech. Adv. Mem. 7207319410A (July 31, 1972).

collecting those accounts by canceling retained patronage equities or withholding the amount due from subsequent payments by the cooperative to the patrons.

After a brief discussion of the three methods, letter rulings covering recoupment of losses by various types of cooperative and equity allocations will be reviewed.

Direct Billing and Reimbursement

One loss recoupment method that has enjoyed consistent acceptance by the Service is for the cooperative to assess and bill each patron for his or her share of any loss and for the patrons to promptly write checks to the cooperative to cover the shortfall. The justification for this approach is that when a cooperative generates a margin, it must allocate and distribute that margin within 8½ months of the end of the fiscal year to protect single tax treatment for that margin. So when a loss occurs, it is logical that it be allocated and recovered directly from the patrons also in a short period of time.

An early IRS ruling gave patrons the option of making a one-time payment of the amount each owed the cooperative, paying in monthly installments, or applying certificates of indebtedness due shortly toward their assessments. The co-op was allowed to offer an incentive to encourage payment in the manner most beneficial to the cooperative, a lump sum cash payment of the assessment.⁸⁷

Direct assessment, however, can be a member relations disaster, evoking strong negative reactions from both current and former members.⁸⁸ The Tax Court has acknowledged this

⁸⁷ Letter Ruling, Nov. 21, 1975. Members received an 8 ½ percent reduction in assessment owed if they made a single cash payment rather than paying under the installment plan or offsetting certificates of indebtedness previously issued by the cooperative.

⁸⁸ For an example of the difficulties a cooperative can encounter when attempting to recoup a loss by direct assessment, *see* Plywood Marketing Associates v. Astoria Plywood Corp., 16 Wash. App. 566,

situation. In *AMPI*, the Service argued a cooperative had to recover losses from patrons of the years the losses occurred. IRS said a cooperative could do this, where possible, by canceling retained equities. But when a patron's equity account was insufficient to cover its share of the loss, generally the case with newer members, it had to seek cash reimbursement.⁸⁹

The court responded:

...regardless of what might have been [the co-op's] legal rights, we consider such a recoupment attempt highly impractical for a cooperative operating in a competitive environment, as was [the cooperative]. The impracticality of such a step merely to preserve the 'cost' principle of cooperative operation certainly calls into question the sanctity with which [the IRS] views that principle."⁹⁰

IRS permits members who pay a direct assessment to deduct it under Code section 162(a) as an ordinary and necessary business expense and does not require them, as suggested by a revenue agent, to treat the payment as a contribution to capital merely increasing the member's basis in its stock in the cooperative.⁹¹

While the impact at the cooperative level is a wash, an event with no overall tax consequences, how that is determined depends on the timing of the repayments. If repayments are made in the same year as the loss, the cooperative includes them in income and it has no net operating loss.⁹² If the repayments are for losses of a

558 P. 2d 283 (1976).

⁸⁹ *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729 (1977).

⁹⁰ *Id.* at 739.

⁹¹ Tech. Adv. Mem. 9128007 (March 28, 1991); *see also*, Priv. Ltr. Rul. 8850027 (Sept. 16, 1988).

⁹² *Id.* The cooperative computed operating losses on a monthly basis and they were promptly covered by an assessment of the patrons.

prior year, IRS suggests it be assumed the cooperative established and collected an accrued receivable, even if it didn't actually do so.⁹³ The implications of setting up receivables are discussed in the next portion of this report.

Canceling Equity

Over the years, if a cooperative has margins, members will usually build up equity accounts reflecting retained patronage refunds and per-unit retains. A second method of recouping a loss from patrons is to cancel an amount of retained equity each has in the cooperative that equals each patron's pro rata share of the loss. The advantage of recouping losses in this manner is that the members don't have to write checks to the cooperative. The disadvantage is that it reduces the co-op's equity base and weakens its balance sheet.

Part 3 of these reports contains a discussion of the Service's aggressive approach to compel cooperatives who cancel qualified retained equities or redeem them at less than face value, for business reasons other than the recoupment of losses, to include the difference in taxable income under the tax benefit rule.⁹⁴ IRS has been more flexible when the equities are cancelled to recover a loss.

Accounts Receivable

A third method of handling patronage losses approved by IRS is for the cooperative to determine each patron's share of a loss and then establish an account receivable from the patron for that amount. Using accounts receivable gives the members flexibility

⁹³ Letter Ruling, November 21, 1975.

⁹⁴ Donald A. Frederick, *Income Tax Treatment of Cooperatives: Distributions, Retains, Redemptions, and Patrons' Taxation*, RBS Cooperative Information Report 44, Part 3 (USDA 2005) pp. 107-121.

in paying off their obligations. Programs can be devised that make recouping the loss less painful to the patrons than writing a check to their cooperative. A disadvantage is that the cooperative receives nothing but a receivable and has no immediate cash inflow to pay its bills and maintain or improve services to members.

Apparently IRS first envisioned accounts receivable as a tool to recoup losses from patrons who lacked enough equity in their cooperative to cover their pro rata share of losses. It suggested cooperatives establish such accounts for these patrons to be satisfied by direct payment or offsetting future patronage allocations.⁹⁵ However, a series of subsequent rulings provides considerable flexibility in collecting accounts receivable established to facilitate recovering losses.

Establishing Accounts Receivable and Collecting Them by Cancelling Equities

Rulings issued over the years cover a variety of factual situations wherein the cooperative has recouped losses from the patrons whose business created the loss by establishing accounts receivable and collected them by cancelling retained patronage equities.

Nonqualified Allocations

When allocations are made in nonqualified form, the cooperative is not permitted a tax deduction and the patrons have no reportable income. Two of the earliest rulings on recouping losses involved the cancellation of nonqualified allocations.

The first, a letter ruling⁹⁶ involved a section 521 cotton cooperative with two departments, a gin division and a cotton

⁹⁵ TAXFAX, *The Cooperative Accountant* (Spring 1976) pp. 44, 45; Priv. Ltr. Rul. 7804083 (Oct. 28, 1997); Priv. Ltr. Rul. 7937041 (June 13, 1979).

⁹⁶ Priv. Ltr. Rul. 7926068 (March 29, 1979).

division that operated a denim plant and sold raw cotton. The cooperative closed its cotton pool each year by selling cotton awaiting manufacture to the denim plant. A fall in the price of denim resulted in a loss for the co-op.

The cooperative issued patronage refunds as non-qualified written notices of allocation. The cooperative proposed to set up accounts receivable and collect them by cancelling non-qualifieds issued the previous year to cotton division patrons, the patrons whose business generated the loss.

The Service noted that Code sec. 1382(b)(2) provides that a cooperative need not include in its taxable income payments to patrons of “money or other property...in redemption of a nonqualified written notice of allocation.”⁹⁷ It then said that what the cooperative proposed would have the same result as if the cooperative wrote checks to the patrons to redeem the non-qualified allocations and then the patrons wrote checks back to the cooperative to settle their accounts receivable. As accounts receivable have the attributes of “property,” the cooperative can use book entries to replicate paying cash to patrons to redeem last year’s nonqualified allocations and patrons then paying off their accounts receivable. The cooperative was allowed to deduct the amounts of the nonqualified written notices redeemed to satisfy the accounts receivable under Code sec. 1382(b)(2).

Revenue Ruling 81-103 expanded somewhat the finding of this letter ruling.⁹⁸ The Service provided an example of a redemption of nonqualifieds involving a payment in cash and a notice that the account receivable had been satisfied. In this instance, the cooperative established an account receivable of \$4 for a sample patron to cover that patron’s share of losses in one year (1976), issued that patron a nonqualified written notice of allocation for \$15 in the next year (1977), and redeemed that nonqualified written notices of allocation by paying the patron \$11 and

⁹⁷ 26 U.S.C. § 1382(b)(2).

⁹⁸ Rev. Rul. 81-103, 1981-1 C.B. 447.

notifying the patron that its \$4 account receivable had been satisfied in a subsequent year (1979).

The Service noted that for Federal income tax purposes, the cooperative is treated as having paid the patron \$15 in cash in redemption of the nonqualified allocation. The cooperative is also considered to have received \$4 in cash to cover the amount of the account receivable. Because the cooperative is an accrual basis taxpayer, it has already taken the account receivable into income. Therefore, satisfaction of the account receivable does not result in income to the cooperative. It is entitled to a \$15 deduction under Code sec. 1382(b)(2).

Qualified Allocations

Qualified written notices of allocation and per-unit retain certificates are deductible by the cooperative in the year to which they relate and taxable income to the patrons in the year of receipt. This has not, however, resulted in a substantially different approach by the IRS when a cooperative cancels such equities to recoup a loss.

In one letter ruling,⁹⁹ a cooperative bank eligible for tax treatment under Subchapter T distributed margins as patronage refunds, partly in cash and the remainder as qualified written notices of allocation. The bank anticipated a substantial patronage-sourced loss in an upcoming year. The Service made certain decisions consistent with earlier rulings, namely that:

- The cooperative might recover part of the loss by cancelling part or all of its outstanding qualified written notices of allocation for certain tax years. The bank's patronage-sourced loss in the upcoming year will be reduced by an amount equal to the value of the cancelled qualified notices.
- To the extent patrons had reported the qualified allocations when issued, they could take an ordinary loss deduction under Code sec. 165(a) for the year that the notice of cancellation is received.

⁹⁹ Priv. Ltr. Rul. 8624019 (March 10, 1986).

- The cooperative could carry any patronage-sourced loss remaining after the equity cancellations forward at the cooperative level under Code sec. 277, to offset future patronage-sourced income, provided the carry forward results in an equitable allocation of the loss.¹⁰⁰

Another ruling¹⁰¹ involved a section 521 marketing cooperative that sustained significant losses in one year. It apparently had a large group of inactive members. It proposed to let each member decide whether an account receivable would be set up and collected by cancelling qualified retains. This would allow inactive members to get their capital out of the cooperative but permit continuing members to leave theirs in if they so elect.

The Service said again that the cooperative could recover the loss by cancelling qualified equities without adverse tax consequences and the patrons could take an ordinary loss for the value of the cancelled equities under Code sec. 165(a). In this instance, since Code sec. 277 doesn't apply to "exempt" organizations, the Service let the cooperative carry the loss back or forward pursuant to Code sec. 172.

Two rulings concerned the appropriate handling of losses by cancelling qualified equity allocations of cooperatives approaching liquidation.

In one instance,¹⁰² a vegetable processing and marketing cooperative had both patronage and nonpatronage losses and decided to liquidate. The cooperative proposed to establish

¹⁰⁰ Farmer cooperatives battled the Service for nearly 3 decades (approximately 1970-1997) to establish that § 277 did not apply to non-521 cooperatives (*see infra* pp. 90-96). Code § 277 provides that social clubs and other membership organizations, not exempt from taxation, may carry losses forward, but not back, to offset income in future years. From time to time individual cooperatives found it convenient to concede the issue to IRS when they only wanted to carry losses forward at the entity level, not back to earlier years, as is permitted under § 277.

¹⁰¹ Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

¹⁰² Priv. Ltr. Rul. 8952019 (Sept. 28, 1989).

accounts receivable from its patrons to the extent of its patronage-sourced losses and credit those accounts when it canceled qualified per-unit retains previously allocated to those patrons.

The Service concluded:

- As an accrual basis taxpayer, the cooperative must recognize the accounts receivable in taxable income when established. The income will be patronage-sourced because it is from the patrons and is used to offset the patronage losses from prior years that are the responsibility of the patrons.

- Once the loss carryover of the cooperative is reduced by the establishment of the receivables, it will not have any further income to recognize. The offset of the per-unit retain certificates with the accounts receivable shouldn't result in tax to the cooperative since its net equity has not changed. It has merely altered the form of its assets and liabilities.

- To the extent the patrons have included the value of the qualified per-unit retains in income in prior years, they may deduct the value of that equity under Code sec. 165(a) in the year they receive notice of cancellation.

- The cooperative may carry any remaining patronage-sourced losses forward under Code sec. 277.

Another ruling,¹⁰³ involving essentially the same facts as the one above except this cooperative had section 521 tax status, resulted in a similar determination by the Service. A vegetable processing and marketing cooperative that had both patronage and nonpatronage losses decided to liquidate. It proposed setting up accounts receivable to recoup a patronage-sourced loss and cancelling qualified per unit retains to recoup some of the loss.

The Service again said setting up accounts receivable will create patronage-sourced income for the co-op, which can be offset with the loss carryforwards. The transactions will have no tax impact on the cooperative, except a reduction in available loss

¹⁰³ Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

carryforwards. Cancellation of the qualified per-unit retains by crediting the accounts receivable will not result in income to the cooperative.

Loss Allocation Based on Retained Patronage Equity

The flexibility the Service will allow a cooperative in recovering a loss, if the association presents a well-reasoned justification for its actions, is illustrated by letter ruling 8233051.¹⁰⁴ The taxpayer was a federated cooperative with a dozen grain marketing associations as members. After a successful start-up, it suffered substantial operating losses. When an infusion of capital became necessary, some members wanted to withdraw and others wanted to continue.

IRS said the association was “operating on a cooperative basis” under a plan whereby:

- The losses would be allocated to and collected only from the continuing members,
- The losses would be allocated on the basis of each member’s capital stock, all of which consisted of retained patronage refunds, to the total shares of capital stock outstanding in the cooperative, not recent patronage,
- The losses would be accounted for as an account receivable from each continuing member, and
- Each continuing member could repay its receivable by any of the following means, or a combination thereof; payments in cash, the cancellation of stock received as a patronage refund or otherwise, and application of the principal and accrued interest on funds they had loaned to the cooperative.

IRS noted that the cooperative had shown that this plan resulted from extensive discussion and negotiation among the members, that State law did not authorize an assessment of withdrawing members, and that the withdrawing members had sufficient votes to block an assessment. It observed that the

¹⁰⁴ Priv. Ltr. Rul. 8233051 (May 19, 1982), based on Gen. Couns. Mem. 38,885 (April 23, 1982).

members agreed the losses resulted from the plan for rapid expansion, so it wasn't equitable to allocate them on the basis of any one year's patronage. Also, some members felt a factor in the losses was the failure of other members to patronize the cooperative. Using a recent patronage base would have penalized those members who supported the cooperative and rewarded those who did not.

The Service determined:

- The cooperative could allocate the losses on the basis of stock held rather than patronage,
- There is no tax consequence to cooperative from establishing accounts receivable when they are established or collected, except that the cooperative's losses are reduced by the amount assessed the continuing members,
- The cooperative can carry the losses allocated to withdrawing members forward under Code sec. 277, and
- The continuing members are entitled to an ordinary loss deduction under Code sec. 165(a) for the amount of their assessment in the year their account receivable is established. (Both the federated and its member-patron cooperatives all used the accrual method of accounting).

This ruling is notable for the flexibility permitted the member-patrons. Terminating members could get their capital out of the cooperative while continuing members could leave theirs in to finance future operations.¹⁰⁵ The continuing members were then allowed to choose from several options to satisfy their receivables.

Three months later, IRS issued another letter ruling¹⁰⁶ that also concerned a cooperative that couldn't match a loss to specific patronage transactions. A farm supply cooperative with both individual and cooperative members sustained significant losses for several years. Another cooperative agreed to purchase all of

¹⁰⁵ See also, Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

¹⁰⁶ Priv. Ltr. Rul. 8248048 (August 30, 1982).

the assets and assume all of the liabilities of the failing cooperative, after certain write-downs are made to the equity accounts of the failing cooperative's member equity accounts.

The failing cooperative intends to allocate the losses to its member-patrons on the basis of each member's pro rata share of the cooperative's total retained patronage equity. The cooperative asserted that the losses were hard to allocate on the basis of patronage as they were, in large measure, the result of uncollected receivables, lawsuits, and general obsolescence of plant and equipment. The write-downs would be applied, in order, to: (1) qualified written notices, (2) nonqualified written notices, and (3) unallocated retained earnings.

Again, the Service provided favorable rulings for the cooperative. It approved the proposed allocation and collection method. It said the transactions would have no tax consequences to cooperative beyond reductions in its losses otherwise reportable by an amount equal to (i) the amount assessed and (ii) the deduction allowable to the cooperative for the redemption of the nonqualified allocations. Patrons can claim an ordinary business loss under Code sec. 165(a) for the amount of qualified allocations that are cancelled and can also claim a deduction for nonqualified allocations that are cancelled, but only after reporting the amount of cancelled nonqualified allocations as income pursuant to Code sec. 1385.

Absorbing Loss at Co-op Level After Reasonable Recoupment Effort

Another letter ruling¹⁰⁷ concerned a marketing cooperative with one primary line of business (the extraction of cotton seed oil from cottonseed) that suffered a substantial loss in a minor line of business (sunflower marketing) that threatened the continued operation of the co-op. The cooperative's leadership believed that if it tried to recover this loss by an assessment against the cottonseed-producing members, they would resign and the cooperative would fail.

¹⁰⁷ Priv. Ltr. Rul. 8248034 (August 30, 1982).

To ensure continued patronage, the cottonseed members and the cooperative signed 5-year marketing agreements. Under its terms, any margins earned during that time period would be offset against each patron's allocable portion of the losses, and any unrecovered losses remaining after the agreements expired would be absorbed by the cooperative.

The Service approved this arrangement. It said any unrecovered losses remaining at the end of the 5 years would be deductible at the cooperative level under Code sec. 165 in the year the marketing agreements expire.

The Farmland Industries Liquidation Rulings

Farmland Industries operated as a major federated cooperative providing farm supplies and marketing products for its local cooperative and producer members. For many years, it earned substantial margins on its patronage-sourced business with its members and patrons. The cooperative allocated these earnings to its patrons primarily as qualified written notices of allocation, although a portion was issued as nonqualified written notices.

In the late 1990s, Farmland began incurring significant net operating losses. A substantial portion of those losses were attributable to business done with, or for, its member/patrons, and the remainder were nonpatronage-sourced losses. As a result of these losses and a resulting lack of liquidity, Farmland filed for bankruptcy on May 31, 2002.¹⁰⁸

As part of its reorganization, the cooperative sold all of its assets and passed the proceeds through to its creditors. During the process, Farmland submitted two requests for letter rulings to IRS for clarification of the tax implications of parts of the reorganization plan.

¹⁰⁸ The cooperative community owes a debt of gratitude to the members, directors, and management of Farmland for their willingness to share non-proprietary information about the issues they confronted during their bankruptcy proceedings, so that others might learn from their experiences.

First, Farmland proposed to recover at least a portion of its patronage-sourced losses from its member-patrons by cancelling their qualified written notices of allocation. Apparently some creditors were concerned that the equity cancellation would create nonpatronage income subject to tax, thus reducing the amount of funds available for distribution to creditors.

The Service said no, the cooperative should reduce its net operating losses but would not otherwise recognize any taxable income upon the cancellation of such patronage equity.¹⁰⁹ It cited Revenue Ruling 70-407¹¹⁰ as recognizing this procedure, cancelling member patronage equities to offset a net patronage sourced loss.

The second letter ruling concerns outstanding patronage equity remaining after the cancellations occur.¹¹¹ Although the stock has no value and its holders will not receive or retain any interest in any property of the cooperative, the equity will remain outstanding. Again, creditors wanted a clarification that having the equity declared worthless but not cancelled would not trigger a tax liability for the cooperative.

The Service took this opportunity to restate its disagreement with the decision in the *Gold Kist* case,¹¹² without forcing the cooperative to take the value of the equity into income. First, it stated:

In situations in which a cooperative has redeemed its patronage equity from its patronage equity holders at a

¹⁰⁹ Priv. Ltr. Rul. 200341017 (July 3, 2003).

¹¹⁰ Rev. Rul. 70-407, 1970-2 C.B. 52.

¹¹¹ Priv. Ltr. Rul. 200414019 (Dec. 15, 2003).

¹¹² *Gold Kist v. Commissioner*, 110 F.3d 769 (11th Cir. 1997), *rev'g*, 104 T.C. 696 (1995). See, Donald Frederick, *Income Tax Treatment of Cooperatives: Distributions, Retains, Redemptions, and Patrons' Taxation*, RBS Cooperative Information Report 44, Part 3 (USDA 2005) pp. 113-120.

discount, the Service position is that the cooperative must recognize income in an amount equal to the discount under the tax benefit rule. However, cooperative herein will not be canceling the patronage equity. Coop will not be recovering for itself the amount that it previously deducted, since all amounts will be paid to Coop's creditors in partial settlement of the amount due Coop's creditors. Therefore, because the patronage equity will not be cancelled or redeemed for less than face value, Coop will not recognize any tax benefit income.¹¹³

The Service then determined:

Coop will not recognize any income if Coop's patronage equity holders do not receive consideration equal to the face amount of their outstanding Coop patronage equity issued as qualified written notices of allocation, when Coop completely liquidates its assets to pay its creditors and does not actually cancel its patronage equities.¹¹⁴

Thus, the Service continues to advocate its position that the tax benefit rule requires a cooperative that redeems qualified patronage-based equity for less than face value to include the amount of the discount in its taxable income. But it also isn't forcing the issue in situations where the cooperative is recovering a loss from the patrons whose business created the loss.

Document Language Issues

A State Court decision illustrates the need for cooperatives to understand the importance of language in related legal documents

¹¹³ Priv. Ltr. Rul. 200414019 (Dec. 15, 2003).

¹¹⁴ *Id.*

when recouping losses by cancelling equities.¹¹⁵ In 1999, TruServ, a cooperative wholesale supplier of products and services to its hardware retail store owners, suffered a substantial loss. On April 10, 2000, TruServ accepted the request of one of its members, Bess Hardware and Sports, to terminate its Membership Agreement. On that date, TruServ's bylaws provided that:

Upon the effective date of the termination of a Membership Agreement...all of this Corporation's stock owned by such stockholder...shall be deemed to be and shall be and become the property of this Corporation; from and after such date all rights and privileges incident to the ownership of the shares...shall cease, except only the right to receive the purchase price and a sum equal to any dividends declared by unpaid at said date....

TruServ's bylaws also required it to redeem all of a member's equity interests upon the termination of its membership, except that if the funds of the Corporation legally available for such purpose aren't sufficient, the Corporation can delay redeeming the equity until sufficient funds are legally available for that purpose.

On March 17, 2000, the board of directors learned that because of the 1999 loss, the book value of its stock had fallen to \$35.60, while the par value was \$100. The board unanimously adopted a resolution placing a moratorium on all equity redemptions.

On August 28, 2000, TruServ's board of directors passed a second resolution creating a "Loss Allocation Plan" to allocate the 1999 loss among its members. The Loss Allocation Plan assigned a pro rata share of the loss to "each *current* TruServ Stockholder" based upon the percentage each member's retained patronage refund account bears to such holdings of all members (emphasis added). Under the plan, an account receivable would be established for each member, who would satisfy the "loss

¹¹⁵ TruServ Corporation v. Bess Hardware and Sports, 346 Ill. App. 3d 194 (2004).

allocation account” by application of future patronage refunds. If a member left the cooperative prior to satisfying its loss allocation account, any unsatisfied portion would be offset against the amount otherwise due the member for its retained equity. Even though Bess’s membership had been terminated, the cooperative allocated a portion of the loss to Bess.

In May, 2002, TruServ sued Bess Hardware to collect unpaid charges for merchandise and services. Bess counterclaimed to force TruServ to redeem its equity. Bess argued that the moratorium was not legally adopted and that the loss allocation plan did not apply to it as it was not a stockholder of TruServ when the plan was adopted.

In an unreported decision, a County Court found in favor of TruServ on its claim for unpaid merchandise and services. It held for Bess on its claim that the loss allocation plan didn’t apply to Bess. The court also held that Bess was entitled to offset what TruServ owed Bess for its stock against what Bess owed TruServ for goods and services. TruServ appealed.

A State Appellate Court upheld the validity of the moratorium on the basis that applicable State law (Delaware) provides that a corporation may not redeem its stock if the redemption would cause an impairment of capital. As the aggregate par value of TruServ’s stock exceeded its net assets, redemption would impair its capital under Delaware law so the moratorium was appropriate under the circumstances.

However, the court affirmed the lower court ruling that the Loss Allocation Plan did not apply to Bess. It reasoned that under TruServ’s bylaws, the date that a membership agreement is terminated determines when a member ceases to be a TruServ stockholder. Upon the effective date of the termination, the terminated member’s stock becomes the property of TruServ. In this case, Bess’s membership was terminated on April 10, 2000, and Bess ceased being a stockholder in TruServ on April 10, 2000. Since the language of the Loss Allocation Plan adopted by TruServ on August 28, 2000, said it applied only to “current Tru-

Serv stockholders,” the cooperative could not allocate a share of the 1999 loss to Bess.

TruServ also argued to because Bess was a member in 1999 when the underlying loss occurred, it should be liable for a portion of the loss. The Appellate Court found this argument unpersuasive where, as here, the loss allocation was made after the membership was terminated.

This case should serve as a reminder to cooperative directors and managers to make sure your bylaw provision on handling of losses and any documents adopted to implement a plan to recoup a loss are carefully crafted to reflect your intentions in implementing a loss recovery strategy.

RECOVERING A PATRONAGE-SOURCED LOSS FROM PATRONS OF THE SAME ACTIVITY, BUT DIFFERENT YEARS

The Service clearly prefers that patronage-sourced losses be absorbed by the patrons whose business generated the loss, on a pro rata basis. The members, however, may prefer to spread the burden over several years rather than absorb the entire loss in a single year. If a cooperative has only one line of business, such as marketing milk, this is the only alternative to direct recoupment.

But it is also a viable option for cooperatives with more than one line of business, whether they be in the same or different functions. This is usually accomplished by carrying the loss forward or back to other taxable years under Code sec. 172.

Carry Forward and Carry Back under Code Sec. 172

Carrying the loss to other years eliminates the direct allocation of the loss to individual patrons.¹¹⁶ The loss is carried over to

¹¹⁶ A general description of § 172 is provided *supra* pp. 25-26.

other years at the cooperative level. It is offset against margins of other years, resulting in reduced patronage refunds for patrons of those years.¹¹⁷

An example is found in the leading case of *Associated Milk Producers*.¹¹⁸ The cooperative conducted a single line of business. It received raw milk from its members and processed it into various products, including pasteurized fluid milk, butter, and dried milk powder. From 1959 to 1961, the cooperative's deductions exceeded gross income. The board of directors decided it would be inequitable to charge the current losses against patrons' capital reserve accounts. The directors were also concerned that reducing member equities would anger patrons, resulting in a serious loss of business to competing dairies.

The board decided the losses should be carried forward to future profitable years. From 1962 through 1966, the cooperative claimed net operating loss carry forward deductions pursuant to Code sec. 172. Net income was offset and patronage refund allocations eliminated until all losses from 1959 through 1961 were recouped. As previously noted, the court found this a permissible tax practice for cooperatives, stating "We fail to see any legitimate interest of (IRS) in the mechanics of (cooperative's) allocation of losses among its past, current, and future member-patrons."¹¹⁹

Even as IRS was litigating to prevent loss carryovers, it issued an apparently conflicting letter ruling. The cooperative had two

¹¹⁷ This is to be distinguished from situations where the loss is allocated to patrons in the loss year and only an obligation to pay the assessed loss is carried to following years. In this case an account receivable is established and patronage refunds otherwise distributable in money are applied to extinguish the patron's obligation. This does not reduce the net margins available for distribution, but only affects the distribution's form.

¹¹⁸ *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729 (1977).

¹¹⁹ *Id.* at 739.

marketing allocation units and a supply function, and suffered a loss in one of the marketing units.

Without mentioning Code sec. 172, the Service stated "A cooperative may also carry over such losses, to be treated as a cost of operation in the unit that sustained the loss in the succeeding year, if the cooperative can demonstrate that recoupment of the loss in this manner does not create an inequitable burden on the patrons of the succeeding year."¹²⁰

After the *AMPI* decision and subsequent cases holding cooperatives could have losses for tax purposes,¹²¹ the IRS begrudgingly has allowed cooperatives to carry losses in one activity back and forward to other tax years under Code sec. 172.

The first dispute to reach the Service involved a sugar marketing cooperative that suffered an operating loss. The revenue agent refused to let the cooperative carry the loss forward.

The cooperative appealed and the Appellate Division allowed an operating loss carry forward, reduced by the loss attributable to terminating members. The cooperative appealed again, asking to carry the entire loss forward. Its bylaws gave the board of directors the option of recouping a loss from current patrons or carrying it forward as an operating expense of subsequent years.

The Director of IRS's Corporate Tax Division referred the matter to the Office of General Counsel for review. After noting

¹²⁰ Priv. Ltr. Rul. 7804083 (Oct. 28, 1977). Shortly thereafter, the Tax Court again rejected IRS's position that patronage sourced losses had to be recovered from the specific patrons whose business created them. *Ford Iroquois FS v. Commissioner*, 74 T.C. 1213 (1980). The *Ford Iroquois* opinion is discussed in a subsequent section dealing with recovering the loss from patrons of a different activity than the one producing the loss.

¹²¹ *See supra* pp. 21-25.

the Tax Court opinions in *AMPI*¹²² and *Ford Iroquois*¹²³ the General Counsel sided with the cooperative on all counts, suggesting:

1. The cooperative could use the net operating deduction provided by Code sec. 172.

2. The cooperative could carry the loss of one allocation unit back or forward to offset income of that same unit without tracing the loss to any particular patrons. The memorandum mentioned that the cooperative had a low member turnover rate and all members were bound by long-term contracts. Thus carrying the loss to other years as an operating expense would not be an inequitable burden on patrons of those years.

3. The cooperative should not be required to recover from its terminating members the losses generated by those members.¹²⁴

A letter ruling on the same facts and reaching the same conclusions was issued shortly.¹²⁵

The Service has permitted a cooperative to carry a loss to other years and reduce patronage-sourced income from the same activity that generated the loss under Code sec. 172 in several circumstances. In one instance, the loss resulted from a change in the method of closing pools.¹²⁶ In another, the terminating members of a cooperative with substantial losses had their equities

¹²² *Associated Milk Producers Inc. v. Commissioner*, 68 T.C. 729 (1977).

¹²³ *Ford Iroquois F.S. v. Commissioner*, 74 T.C. 1213 (1980).

¹²⁴ Gen. Couns. Mem. 39,170 (June 3, 1982). This cooperative and the ones in the subsequent rulings mentioned in this subsection all had § 521 status. As mentioned in footnote 1 of this GCM, the Service had by this time taken the position the § 277 applied to other cooperatives and precluded them from using § 172. The Service's position on § 277 and its ultimate rejection by the courts is covered *infra* pp. 90-103.

¹²⁵ Tech. Adv. Mem. 8247011 (July 28, 1982).

¹²⁶ Priv. Ltr. Rul. 8540051 (July 3, 1985); Priv. Ltr. Rul. 8540056 (July 8, 1985).

redeemed at a discount while continuing members exercised an election not to have accounts receivable established for them but rather to have the losses carried forward to other taxable years.¹²⁷ In another, a cooperative in dissolution was allowed to carry forward net operating losses and offset them against nonpatronage income from the sale of its office building and equipment.¹²⁸

Unallocated Reserves

An unallocated reserve consists of funds held by a cooperative that aren't allocated on the books to any particular patron. Income placed in the unallocated reserve may come from patronage- or nonpatronage-sourced business. Because the income generating the unallocated reserves cannot qualify for deductibility as a written notice of allocation or per-unit retain, these reserves are frequently called "tax paid reserves."

As cooperatives without section 521 status can't deduct nonpatronage income, they frequently place it into an unallocated reserve and use that reserve, if necessary, to cover subsequent nonpatronage losses. Patronage income (and nonpatronage income of section 521 cooperatives) is usually allocated on a patronage basis to maximize the benefits for patrons and to protect access to single taxation on those earnings. However, cooperatives occasionally will put patronage-sourced income into an unallocated reserve in good years to lessen the pain in loss years, particularly those in cyclical industries. It helps them recoup losses efficiently and removes the "cloud" that would otherwise hang over present and future members. Without that cushion, they might not receive patronage refunds for years to come after a loss year or two.

Unallocated reserves are reduced by the amount of a loss much like a noncooperative corporation reduces earned surplus or other

¹²⁷ Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

¹²⁸ Priv. Ltr. Rul. 9021013 (Feb. 21, 1990).

residual accounts in the case of a loss. The loss amount from the income statement is transferred as a reduction of unallocated reserve. No entries are made for individual patrons to reduce any allocated equity interest they have in the cooperative in the form of membership stock, written notices of allocation, or per-unit retain certificates.

The question occasionally arises as to whether a section 521 cooperative can have an unallocated reserve. The Code provides "(Section 521 status) shall not be denied...because there is accumulated and maintained...a reserve required by State law or a reasonable reserve for any necessary purpose."¹²⁹

The regulations also say a section 521 cooperative can have a reserve.¹³⁰ They also state that to maintain this status, the association "must establish that it has no taxable income for its own account *other than that reflected in a reserve or surplus authorized in paragraph (a) of this section* (emphasis added)."¹³¹ This suggests the only time a section 521 co-op can hold taxable income is when it is placed in a required or a reasonable reserve.

One early letter ruling involved a cooperative that had section 521 tax status and suffered operating losses in years both before and after enactment of Subchapter T.¹³² The cooperative's bylaws said that if it suffered an operating loss, such loss shall be charged against "reserves" to the extent they are available. The board determines how the charge against "reserves" is allocated so that the loss is "borne by the patrons on as equitable a basis as the board of directors finds practicable."¹³³

The IRS stated that whether the losses occurred before or after enactment of Subchapter T, the net operating loss of a section 521 cooperative:

¹²⁹ I.R.C. § 521(b)(3).

¹³⁰ Treas. Reg. § 1.521-1(a)(3).

¹³¹ Treas. Reg. § 1.521-1(c).

¹³² Ltr. Rul. 6503036020A (March 3, 1965).

¹³³ *Id.*

...(I)s to be treated in the same manner as the net operating loss of any other corporation under section 172 of the Code...(T)he method used by a particular cooperative in handling a loss on its books will not affect the treatment of the loss for Federal income tax purposes. Thus, a loss incurred by a cooperative will not be diminished merely because such a loss is charged against a reserve for losses, or charged against revolving fund accounts. The particular method employed to handle the loss for book purposes will be governed by applicable provisions in the cooperative's bylaws, charter, or marketing agreements."¹³⁴

Although not specifically stated in the ruling, apparently the cooperative was allowed to carry the loss back to prior years and offset it against unallocated and presumably taxable reserves from earnings of patronage-sourced business in those years.

A later letter ruling concerned a section 521 cooperative with declining membership.¹³⁵ Terminating members were offered the option of having their retained patronage equities redeemed ahead of the normal revolving cycle at less than face value. The difference between the face value and the amount paid was assigned to an unallocated equity account.

When the cooperative began suffering losses, they were applied against this unallocated equity. The Service found this an acceptable method of handling the loss, provided (1) the account could be allocated to current patrons on a patronage basis and (2) the extent each patron's current losses offset against the account did not exceed that patron's respective share.

Research has failed to uncover any rulings concerning nonsection 521 cooperatives. However, the Chief Counsel has

¹³⁴ *Id.*

¹³⁵ Tech. Adv. Mem. 8015048 (Dec. 31, 1979).

written that such a cooperative "may offset any deficit in operations by use of a reserve set up for such purpose."¹³⁶

The tax consequences of reducing an unallocated reserve to recoup a loss do not normally extend beyond the cooperative. That is, the cooperative treats the loss as a noncooperative corporate loss and does not recover the loss from patrons in a way that impacts their tax obligation.

RECOVERING A PATRONAGE-SOURCED LOSS FROM PATRONS OF OTHER ACTIVITIES

Cooperatives may serve different groups of members by performing some services for one set and another service for others, all on a patronage basis. A cooperative may establish allocation units to calculate net margins for each activity.

For many years, conflicts existed between cooperatives and IRS over the extent members who patronized different services could share their risks by combining, or "netting," the financial results of those allocation units for tax purposes. The conflicts usually arose when one unit would have a margin and another a loss in the same tax year. Much of this controversy was put to rest by 1985 legislation permitting cooperatives to net the patronage-sourced results of different allocation units, provided they followed a set of rules in the legislation.

IRS Objections to Netting

IRS objected to cooperative netting even before enactment of Subchapter T. A grain marketing cooperative with storage capacity purchased member-patrons' grain before delivery to its elevator. Other members delivered grain for storage, and paid fees for this service, before selling the grain to the cooperative or

¹³⁶ Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

turning it over to Commodity Credit Corporation (CCC) under the loan program. All grain storage and marketing earnings were combined and allocated to patrons based on bushels marketed.

IRS denied the cooperative's patronage refund deduction on the basis that it was unfair to those patrons who stored grain to have a portion of the margin from this service allocated to patrons who sold their grain to the cooperative before delivery. The Tax Court agreed with the Service, finding such an allocation conflicted with the requirement that to be deductible, a patronage refund must be made equitably "to the particular patrons whose patronage created each particular type of profit."¹³⁷

On appeal the 8th Circuit, while affirming much of the Tax Court opinion, reversed this holding.¹³⁸ It stated:

There appears to be no requirement that a patronage (refund) a member receives be based on the profit made on his particular transaction. It appears to be sufficient if the profits arising from member business are equitably distributed among the members who have transacted business with the cooperative.¹³⁹

The court noted that the cooperative's grain marketing and storage activity was an integrated business using the same facilities. It also mentioned that passing back margins to each member on their specific business would be a costly accounting nightmare. Finally, the court rebuked the Service saying:

¹³⁷ *Pomeroy Cooperative Grain Company v. Commissioner*, 31 T.C. 674, 686 (1958); *aff'd in part, rev'd in part*, 288 F.2d 326 (8th Cir. 1961).

¹³⁸ *Pomeroy Cooperative Grain Company v. Commissioner*, 288 F.2d 326 (1961), *rev'g in pertinent part*, 31 T.C. 674, 686 (1958).

¹³⁹ 288 F.2d at 332.

From a revenue standpoint, the commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members.¹⁴⁰

In 1963, the IRS adopted the position taken by the Eighth Circuit Court of Appeals.¹⁴¹

Nonetheless, netting between allocation units was a major issue for 20 years. A series of General Counsel Memoranda drafted during this time illustrate how the Service wrestled with it.

The first responded to a proposed technical advice memorandum concerning a section 521 cooperative that had margins on its supply operations and losses on its marketing activity. The bylaws required the cooperative to allocate margins and losses to the patrons of the function that generated them.¹⁴²

The Income Tax Division proposed to deny the cooperative's entire patronage refund deduction for the year in question because it didn't net. It relied on the Code definition of "patronage dividend," which provides it must be computed on the basis of "the net earnings *of the organization*" from business with patrons (emphasis added).¹⁴³

The Chief Counsel said that while his office had previously approved the memorandum, it was now having second thoughts. He noted cases and rulings holding cooperatives could departmentalize operations to determine how patronage refunds would be allocated.¹⁴⁴ He concluded that while staff was literally

¹⁴⁰ 288 F.2d at 333.

¹⁴¹ Rev. Rul. 63-58, 1963-1 C.B. 109.

¹⁴² Gen. Couns. Mem. 33,631 (Sept. 22, 1967).

¹⁴³ I.R.C. § 1388(a)(3).

¹⁴⁴ *Pomeroy Cooperative Grain Co. v. Commissioner*, 288 F.2d 326 (1961), *rev'g in pertinent part*, 31 T.C. 674 (1958); *Juniata Farmers Cooperative Ass'n*, 43 T.C. 836 (1965), *acq. in result*, 1966-1 C.B. 2;

reading the law properly, the cooperative's contention that it could allocate margins and losses on a functional basis and still qualify for the patronage refund deduction might be the better position.

Barely 6 months later, the Chief Counsel reversed his position.¹⁴⁵ This time, he was commenting on a proposed revenue ruling concerning a section 521 cooperative that had margins on its supply operations and losses on its marketing activity. The bylaws required the cooperative to net margins and losses between the functions and pay any remainder to the patrons of the function with margins. The issue was whether netting was permissible under Code sec. 521.

The proposed ruling, drafted by the Exempt Organizations Division, would have approved this approach, perhaps reflecting G.C.M. 33,631. However, in apparently unrelated litigation, the Tax Court Division was taking the position that a section 521 cooperative could not net between functions.

The Chief Counsel sided with the litigation team, suggesting this time that losses not be recouped from the margin of the other function but rather from the patrons whose business occasioned the loss. He cited Revenue Ruling 67-253, which said that to qualify for section 521 status a cooperative had to maintain separate records of income and expenses for its marketing and purchasing departments and of the patrons' business with each function.¹⁴⁶

This was an active time for the issue of losses and cooperatives. Congress was passing Code sec. 277, which says that membership organizations not exempt from taxation may only deduct expenses for providing services to members to the extent of income derived from member payments for those services. Any remaining deduction could be carried forward and offset against

Rev. Rul. 67-128, 1967-1 C.B. 147.

¹⁴⁵ Gen. Couns. Mem. 33,795 (April 11, 1968).

¹⁴⁶ Rev. Rul. 67-253, 1967-2 C.B. 214.

income from member payments in the following year(s).¹⁴⁷ The applicability of sec. 277 to cooperatives is explored in detail in the last section of this report. Also, the Service was developing its position that a cooperative simply couldn't have a loss for tax purposes.¹⁴⁸

By now, everyone at IRS seemed to have an opinion on netting. The next G.C.M. explained that the Income Tax Division was asserting that netting at the functional level was mandatory and the Exempt Organizations Division thought it was permissible. Both had asked the Chief Counsel to reconsider the position taken in G.C.M. 33,795 that it was prohibited. Although a new Chief Counsel had been named, the office refused to alter its position.¹⁴⁹

The Chief Counsel buttressed his position with the view emerging within the Service that cooperative principles required that the organization operate "at cost" with each patron, not necessarily on a transaction-by-transaction basis, but certainly over the course of each tax year. He said that if a "loss" occurs, it is to be recouped from those patrons whose business generated the loss. He stated that this policy should apply to all cooperatives, whether or not they had section 521 status. It would appear that this position would argue as strongly against netting among allocation units within a function as it did against netting between functions.

The next G.C.M. responded to a request from the Income Tax Division to review proposed technical advice memoranda finding cooperatives could not net margins and losses between functions and had to recover losses from the patrons whose business generated the losses. This conformed with the position set forth in G.C.M. 34,334.

However, another new Chief Counsel took a slightly modified approach. While he still said inter-functional netting was not

¹⁴⁷ I.R.C. § 277.

¹⁴⁸ *Supra*, pp. 19-21.

¹⁴⁹ Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

permitted, he suggested allowing a cooperative to carry over the loss in one allocation unit to the same allocation unit as a cost of operation for the next year, provided the carryover was equitable treatment of the patrons of the succeeding year.¹⁵⁰

This G.C.M. is notable for the insight it provides into the decision making process within IRS. First, it reports that in August, 1971, the Regulations Policy Committee met to review G.C.M. 34,344. The committee decided:

1. Co-ops, whether they have section 521 status or not, cannot net earnings of one function against losses of the other function.

2. Co-ops, whether they have section 521 status or not, can elect to net the results of different allocation units within a function.¹⁵¹ If a cooperative wants to net within a function, it must notify the Commissioner and any change in the netting plan would require the Commissioner's approval.

3. Section 277 applies to cooperatives and should be vigorously enforced.

A second meeting on May 11, 1972, concerned how netting should be approached in litigation and involved several IRS divisions. It was decided to follow the same course outlined earlier. Netting between functions would be resisted. The court would be urged to support the methods of recoupment set out in G.C.M. 34,334.¹⁵² Also, the cooperative could carry the loss forward in the same allocation unit as a cost of operation in the succeeding year(s).

¹⁵⁰ Gen. Couns. Mem. 34,935 (July 3, 1972). Key elements of the G.C.M. were published as Tech. Adv. Mem. 7207319410A (July 31, 1972).

¹⁵¹ *See also*, Ltr. Rul. 7729062 (no known date) (co-op permitted to allocate any remaining margins to patrons of the unit that had earnings).

¹⁵² Gen. Couns. Mem. 34,334 (Aug. 17, 1970). The methods of recoupment, discussed throughout this chapter, were direct reimbursement, setting up accounts receivable, canceling retained patronage refunds and per-unit retains, and offsetting the deficit against reserves set up for that purpose.

The relaxed position on carrying losses forward was dictated by the firm IRS position that Code sec. 277 applied to cooperatives. Since a carry-forward was specifically permitted under sec. 277, IRS had to make it available to cooperatives.

The final G.C.M. in this series was issued after the Service's operation-at-cost theory was rejected by the Tax Court.¹⁵³ It said that these cases were wrongly decided and the IRS should continue to resist attempts by cooperatives to net between functions or among allocation units within a function.¹⁵⁴

The Chief Counsel relied heavily on his belief that a co-op had to operate "at cost" and this meant losses had to be recouped from the patrons whose business led to the loss. He also asserted that permitting netting violated the requirement that a pre-existing legal agreement cover all deductible patronage refunds.

This view was reflected in subsequent letter rulings. In one, a section 521 cooperative with both marketing and purchasing operations made patronage refund allocations based on each patron's total dollar business with the association. IRS said that the Code and regulations require each function to be treated as a separate allocation unit.¹⁵⁵

The Service revoked the cooperative's section 521 status because its allocation method didn't reflect the relative level of margins earned by each function. It said, "A dual function cooperative does not qualify under section 521 of the Code if it fails to turn back the proceeds of sales less expenses to the marketing patrons, or fails to provide the purchasing patrons with the supplies and equipment actual cost plus necessary expenses."¹⁵⁶

¹⁵³ *Associated Milk Producers Inc. v. Commissioner*, 68 T.C. 729 (1977); *Farm Service Cooperative v. Commissioner*, 70 T.C. 145 (1978).

¹⁵⁴ Gen. Couns. Mem. 37,578 (June 16, 1978).

¹⁵⁵ I.R.C. § 521(b)(1) and Treas. Reg. §§ 1.521-1(a)(1) and 1.521-1(c).

¹⁵⁶ Tech. Adv. Mem. 7902004 (Sept. 27, 1978).

In a second ruling,¹⁵⁷ a section 521 cooperative that operated a feed mill began an egg marketing program to increase the volume and reduce per-unit costs of its feed operation. The current members agreed to this, knowing that the egg business would lose money for several years and the feed division would have to absorb those losses. Eventually the egg business became profitable and paid back all the advances from the feed division.

The cooperative continued to divert all margins on egg marketing to the feed division and patronage refunds were made only on the basis of patronage with the feed division. The Service, relying on the same arguments as the previous ruling, again found the cooperative no longer qualified for section 521 status.

The courts, particularly the U.S. Tax Court, did not accept the strictness of IRS's position against netting between patrons of different activities. The *Ford-Iroquois FS* case¹⁵⁸ concerned a non-section 521 cooperative that operated both a grain storage and marketing function and a farm supply function. The Tax Court held that not only could the cooperative carry losses in its grain operation forward under Code sec. 172, but it could, in subsequent years, use those losses to offset income from its farm supply operations. The court noted substantial overlap between the marketing and supply function patrons and the regular reporting of how the losses were being handled to the membership, suggesting the members were aware of the allocation formula being used by the cooperative and found it acceptable.

The *Lamesa Cooperative Gin* case¹⁵⁹ involved a section 521 cooperative that performed primarily marketing functions but also purchased a small quantity of farm supplies that it resold to patrons at approximately cost. Because its purchasing operation was quite small compared with its marketing business, it didn't keep separate accounts for its purchasing activities and allocated

¹⁵⁷ Tech. Adv. Mem. 8245082 (Dec. 31, 1981).

¹⁵⁸ *Ford-Iroquois FS v. Commissioner*, 74 T.C. 1213 (1980).

¹⁵⁹ *Lemesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982).

patronage refunds solely on the patronage of its marketing operation.

During audit, IRS asked the cooperative to compute its margin on farm supply operations for the year in question and then disallowed that portion of its patronage refund deduction. The court found this unjustified. It held that nothing in Code sec. 521 or the applicable regulations "explicitly refers to any separate accounting requirement for cooperatives engaged in both purchasing and marketing; all that is required is that the Code requirements, including equitable allocation, be satisfied with respect to each function."¹⁶⁰

The court concluded:

This is not to say that the particular method of allocation employed by petitioner would have been the only proper way of allocating these gains. We hold merely that petitioner's board of directors did not unjustly discriminate against one group of patrons at the expense of another group, given the practicalities of the allocation, the substantial similarity in the identity of patrons over the years, the absence of any indication that any of the patrons complained about such allocations, and, with respect to the profit from the purchase and resale of supplies, the de minimis nature of the item.¹⁶¹

Gold Kist Letter Ruling

Any hope cooperatives had that IRS would permit greater flexibility in handling losses was shattered in early 1985 by the issuance of a letter ruling revoking the section 521 status of Gold Kist Inc.¹⁶²

¹⁶⁰ *Id.* at 907.

¹⁶¹ *Id.* at 910.

¹⁶² Tech. Adv. Mem. 8521003 (Jan. 25, 1985).

Gold Kist divided its diverse operations into four major "groups": 1) Poultry Group (poultry and egg marketing departments); 2) Foods Group (fish and pork marketing departments); 3) Marketing Group (cotton, pecan, peanut, grain, soy and livestock marketing departments); and 4) Agriservices (supply function). Gold Kist netted margins and losses among the departments within a group. It also netted margins and losses among the four groups, both within the marketing function and between marketing groups and the Agriservices unit.

The Service raised three familiar objections to Gold Kist's handling of losses:

1. Code sec. 521 and the applicable regulations require that marketing and purchasing functions be treated as separate activities.

2. Patronage refund allocations must reflect an "equitable allocation" of margins to members whose business created them. IRS said evidence of equity in netting within a function can include a showing that patrons of one unit are also patrons of the other, geographical separation is limited, and patrons are informed of the extent of the risk sharing before the loss transactions occur. While no opinion was offered as to the propriety of Gold Kist's netting among departments within a function, the Service said that any netting among any of the four major groups failed the equitable allocation test.

3. IRS determined that the board of directors had sufficient discretion to determine how margins and losses would be allocated to destroy the preexisting legal obligation requirement in the definition of deductible patronage refund at Code sec. 1388(a)(2).

The Service (a) revoked Gold Kist's section 521 status, (b) disallowed any offsetting of losses in one group against gains in another group (although it said these losses could be treated as an operating cost in subsequent years within the group in which it was sustained), and (c) disallowed the deduction of any patronage refunds that the board had discretion to offset against losses in any other department.

A Legislative Solution

Gold Kist and other cooperatives determined they could not accept IRS's position. They launched a lobbying effort that resulted in legislative clarification of the rules for netting patronage-sourced margins and losses among allocation units.

Most of the problems for cooperatives wishing to net patronage-sourced margins and losses among different allocation units were addressed and alleviated by the Consolidated Omnibus Budget Reconciliation Act of 1985, adding section 1388(j) to Subchapter T.¹⁶³ The act clarifies Subchapter T to explain netting options available to cooperatives and institutes a notice requirement for cooperatives exercising their option to net patronage gains and losses.

Option To Net

Paragraph (1) of section 1388(j) specifically provides that in computing net earnings for purposes of the patronage refund deduction, a cooperative has the option to offset patronage losses attributable to one or more allocation units against margins earned by another allocation unit. This is true whether the allocation units are functional, divisional, departmental, geographic, or determined on some other basis. Thus, a cooperative may net losses against margins within the patronage operation, but is not required to do so. For purposes of this provision, a patronage loss can include losses carried back or forward to such year as well as losses arising in a particular year.¹⁶⁴

Paragraph (2) makes clear that netting is also allowed after a cooperative acquires the assets of another cooperative through the

¹⁶³ Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Pub. L. No. 99-272, 100 Stat. 82, 323-324 (1986), § 13210, *codified as* I.R.C. § 1388(j). For legislative history, *see* S. Rep. 146, 99th Cong., 1st Sess (1985), *reprinted in* 1986 U.S. Code Cong. & Admin. News 42, 334-337.

¹⁶⁴ I.R.C. § 1388(j)(1).

liquidation of a subsidiary or other reorganization, such as a merger, described in Code sec. 381(a). The surviving cooperative may compute its net earnings by offsetting losses of one or more of its patronage allocation units against patronage earnings of the acquired organization or by offsetting losses in one or more patronage allocation units of the acquired organization against its patronage earnings. However, the earnings which may be offset in this manner are limited to earnings allocable to periods after the date of acquisition.¹⁶⁵

Notice Requirement

If a cooperative exercises its option to net margins and losses for a particular tax year, paragraph 3 of section 1388(j) states that the cooperative must provide its patrons a written notice that the netting has occurred.¹⁶⁶ This notice requirement was a necessary part of obtaining Congressional approval of the legislation. Congress wanted to be sure that patrons were advised of the cooperative's netting practices.

The notice must be given within the payment period for making patronage distributions for the year (within 8½ months after the close of such taxable year) and must state the following:

- (1) that the cooperative has offset earnings and losses from one or more of its allocation units and that such offset may have affected the amount which is being distributed to its patrons,
- (2) generally, the identity of the offsetting allocation units, and
- (3) briefly, what rights, if any, the patrons have to additional financial information about the cooperative under the terms of its charter, articles of incorporation, bylaws, or under any provision of the law.¹⁶⁷

Despite these disclosure requirements, a cooperative need not reveal detailed or specific information about the earnings or losses

¹⁶⁵ I.R.C. § 1388(j)(2).

¹⁶⁶ I.R.C. § 1388(j)(3).

¹⁶⁷ I.R.C. § 1388(j)(3)(A).

of its allocation units which it determines is commercially sensitive and, if released, could put the organization at a competitive disadvantage.¹⁶⁸

In the event the Service determines that a cooperative failed to provide sufficient written notice to its patrons, it may require the cooperative to provide a revised written notice to the patrons which does satisfy the requirements stated above. However, IRS cannot disallow a patronage refund deduction, revoke a cooperative's section 521 status, or impose any other penalty as a result of the cooperative's failure to provide an adequate notice.¹⁶⁹

Section 521 Status

A new provision is added to Code Sec. 521 making it clear that should a section 521 cooperative exercise its option to net, its 521 status will not be jeopardized.¹⁷⁰

Effective Dates

All of the provisions other than the notice requirements were made effective retroactive to tax years beginning after December 31, 1962.¹⁷¹ This made sure the new permissive rules applied to Gold Kist and similarly situated cooperatives that had netted patronage-sourced margins and losses in a prior year. The notice requirements became effective on the date of enactment of the law, April 7, 1986.¹⁷²

¹⁶⁸ I.R.C. § 1388(j)(3)(B).

¹⁶⁹ I.R.C. § 1388(j)(3)(C).

¹⁷⁰ I.R.C. § 521(b)(6).

¹⁷¹ COBRA, Pub. L. No. 99-272, § 13210(c)(1), 100 Stat. 324 (1986). The subparts of the act concerning dates the new rules became effective weren't codified.

¹⁷² COBRA, § 13210(c)(2), 100 Stat. 324.

No Effect on Treatment of Nonpatronage Losses

This legislation only deals with netting between and among allocations units of a cooperative's patronage operation. It specifically avoids the issue of netting patronage earnings and nonpatronage losses, stating:

Nothing in the amendments made by this section shall be construed to infer that a change in law is intended as to whether any patronage earnings may or not be offset by nonpatronage losses, and any determination of such issue shall be made as if such amendments had not been enacted.¹⁷³

These amendments concluded the controversy over netting patronage-sourced margins and losses among allocation units. The Service quickly accepted the new law and its retroactive application to interfunctional netting that occurred before COBRA's enactment.¹⁷⁴

It is a testament to all parties involved in drafting it that research has not uncovered a single dispute in this area since its enactment. The same cannot be said, however, for the situation the Act sidestepped, the netting of patronage- and nonpatronage-sourced margins and losses.

NONPATRONAGE ACTIVITY

One of the factors that determines how a loss is handled is whether it is patronage or nonpatronage sourced. An entire chapter in this series is devoted to distinguishing patronage and

¹⁷³ COBRA, § 13210(c)(3), 100 Stat. 324. This language also was not codified.

¹⁷⁴ Gen. Couns. Mem. 39,587 (Dec. 3, 1986).

nonpatronage income.¹⁷⁵ The same rationale for determining the proper characterization for income also applies to losses. A loss is patronage sourced if it results from a transaction directly related to and actually facilitating the cooperative's patronage activity. However, if the transaction producing the loss is incidental to patronage activity, the loss is from nonpatronage sources.¹⁷⁶

Section 521 Cooperatives

Netting patronage gains and losses with nonpatronage gains and losses is seldom a contentious issue for section 521 cooperatives. As they must treat members and nonmembers alike and can deduct patronage-based allocations of both, whether they net or not generally has no tax consequences and has not been a contentious issue in recent years. The few rulings in this area involving section 521 cooperatives are summarized below.

The ground rules for section 521 treatment of nonpatronage losses were established in the *Juniata Farmers Cooperative* decision.¹⁷⁷ Although the case dealt with the allocation of nonpatronage income, it became the precedent for giving section 521 cooperatives flexibility in handling nonpatronage losses.

Juniata was a section 521 cooperative that marketed grain and had feed and fertilizer supply operations. Like many local cooperative elevators at the time, it realized substantial income from storage fees paid by CCC for grain it accepted in lieu of farmers repaying USDA loans. Such fees are nonpatronage income.

¹⁷⁵ Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, Chapter 5, Cooperative Information Report 44, Part 2 (USDA 2005) p. 27.

¹⁷⁶ Tech. Adv. Mem. 8707005 (Nov. 7, 1986); Gen. Couns. Mem. 39,610 (March 5, 1987).

¹⁷⁷ *Juniata Farmers Cooperative v. Commissioner*, 43 T.C. 836 (1965), *acq.*, 1966-1 C.B. 1, 2.

Juniata allocated the earnings on that nonpatronage income to its grain marketing patrons on the basis of bushels of grain each delivered to the cooperative. IRS disallowed Juniata's patronage refund deduction and challenged its section 521 status on the grounds that allocating these earnings only to grain patrons was not equitable. IRS wanted them allocated to both the marketing and supply function patrons.

The court found the Service's position without precedent or merit. It noted that no perceivable revenue was at stake in this matter, significant overlap existed between the marketing and supply function patrons, and the patrons were regularly informed of the allocation method used. Thus the court, over IRS objection, ruled a section 521 cooperative could allocate nonpatronage income only to patrons of the function that generated the income.

In a subsequent revenue ruling the IRS applied the *Juniata* decision to a situation involving intra-functional netting.¹⁷⁸ A section 521 marketing cooperative had several departments, including a vegetable marketing department and a grain marketing department. When it had nonpatronage income or losses, they were allocated to the department to which such income or losses related, rather than to all patrons. IRS, citing *Juniata*, approved this allocation method, provided it did not discriminate among similarly situated patrons.

A letter ruling involved a section 521 cooperative that suffered a loss on the sale of the stock representing ownership in a subsidiary. In a subsequent year it realized a gain on the sale of real estate. The requested ruling said: (1) the loss was a nonpatronage capital loss and the gain was a nonpatronage capital gain and (2) it could carry the nonpatronage loss forward and offset a like amount of the gain for tax purposes.¹⁷⁹

A later letter ruling concerned a section 521 cooperative in the process of dissolution. It was permitted to carry forward a net

¹⁷⁸ Rev. Rul. 67-128, 1967-1 C.B. 147.

¹⁷⁹ Ltr. Rul. 7202281240A (Feb. 28, 1972).

operating loss and net it against nonpatronage income realized from the sale of assets during the dissolution period.¹⁸⁰

Non-section 521 Cooperatives, Netting Nonpatronage Losses with Patronage Earnings

For non-section 521 cooperatives, the preferred approach of the Service to handling losses on nonpatronage business is to carry those losses back and forward under Code sec. 172 to offset nonpatronage earnings in other years.¹⁸¹

Some cooperatives don't object to this standard. They use a nonpatronage loss to shield nonpatronage earnings in other years from taxation.

However, instances arise when a cooperative prefers to net its nonpatronage losses with patronage earnings. For example, it may not want to pay out more in patronage refunds than its overall book income. IRS opposes such netting as inconsistent with "operating on a cooperative basis."

Two early rulings concerning the same facts, neither written with total clarity, are a part of this controversy. The first, Revenue Ruling 70-420,¹⁸² presents a simple example of a fertilizer supply cooperative that had a margin of \$600 on member sales and a loss of \$500 on nonmember sales. A cooperative had apparently asked for permission to deduct the \$600 patronage refund based on the margin on its member business and to carry the nonmember loss back to prior years under Code sec. 172. IRS said the loss should be netted against member income, reducing the patronage refund for the tax year to \$100.

¹⁸⁰ Priv. Ltr. Rul. 9021013 (Feb. 21, 1990).

¹⁸¹ Rev. Rul. 74-377, 1974-2 C.B. 274; Tech. Adv. Mem. 8707005 (Nov. 7, 1986); Gen. Couns. Mem. 39,610 (March 5, 1987).

¹⁸² Rev. Rul. 70-420, 1970-2 C.B. 64, *revoked by* Rev. Rul. 74-377, 1974-2 C.B. 274.

The ruling caused confusion among cooperatives because it didn't specify whether the nonmember loss was patronage or nonpatronage sourced. In 1974, IRS revisited the issue. In a second ruling on the same facts it clearly stated the nonmember loss was a nonpatronage loss.¹⁸³

The Service also changed its suggested tax treatment. It phrased the issue as whether the cooperative *must* offset member earnings with the loss sustained on nonmember, nonpatronage transactions. It stated that "the amount of net earnings *available for distribution* as patronage (refunds) is the entire (\$600) undiminished by the loss incurred with the nonmembers." (emphasis added)

IRS then said, "*If* the taxpayer distributes the (\$600) to members as a patronage (refund), then the (\$500) loss incurred with the nonmember is a net operating loss" (emphasis added) and may be carried back and forward to offset nonpatronage income in other years.¹⁸⁴

The whole handling of losses issue was very contentious during the following decade. As discussed previously, the Service was aggressively pursuing its "operation-at-cost" theory to challenge whether a cooperative could have a loss on patronage operations. While the handling of nonpatronage losses seemed to lay dormant until the mid-1980s, when another cooperative attempted to net nonpatronage losses and patronage margins, it was clearly on people's minds.

For example, while addressing other issues, the U.S. Court of Appeals for the 8th Circuit commented on nonpatronage losses. *Farm Service Cooperative v. Commissioner*¹⁸⁵ is an important de-

¹⁸³ Rev. Rul. 74-377, 1974-2 C.B. 274, *revoking* Rev. Rul. 70-420, 1970-2 C.B. 64.

¹⁸⁴ *Id.*

¹⁸⁵ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (1980), *rev'g* 70 T.C. 145 (1978).

cision on the issue of netting patronage losses and nonpatronage earnings that is discussed later in this chapter. The court noted:

Fewer problems are presented when a cooperative incurs a loss on its nonpatronage activities. The Commissioner has held that, in such a case, a cooperative *need not* reduce its patronage income to cover the loss. Rev. Rul. 74-377, 1974-2 C.B. 274. No avoidance of tax would result...; indeed, if the cooperative chose to offset the loss with current patronage income, it would have to forego the deduction for otherwise allowable patronage (refunds).¹⁸⁶ (emphasis added)

This opinion would seem to support the view of cooperatives that Revenue Ruling 74-377 is permissive, giving cooperatives the option to net nonpatronage losses with patronage margins or to keep them separate and carry the nonpatronage losses back or forward under Code sec. 172.¹⁸⁷

However, when next faced with a cooperative attempting to net nonpatronage losses and patronage earnings, the IRS, after several years of deliberation, determined that such netting violated the "universal" cooperative principle of operation at cost.¹⁸⁸ IRS acknowledged that the cooperative had followed this practice on a consistent basis and the members were apparently cognizant of it and supported it. Nonetheless, the Service said the association

¹⁸⁶ 619 F.2d at 725, n. 16.

¹⁸⁷ For a thorough explanation of the cooperative perspective, see Clifford R. Fulton, *Relationship Netting Under Rev. Rul. 67-128: An End to the Isolation of Nonpatron Loss*, *The Cooperative Accountant*, Summer 1986, at 55.

¹⁸⁸ Tech. Adv. Mem. 8707005 (Nov. 7, 1986). The length of time the issue was under consideration is reflected in a General Counsel Memorandum involving the same case which states the matter was referred by the Director, Corporate Tax Division, in June 1984. Gen. Couns. Mem. 39,610 (March 5, 1987).

had a pre-existing legal obligation to return all margins on patronage business to the patrons. By reducing current patronage refunds with the offset of nonpatronage losses, IRS said the patrons were illegally underpaying themselves.

IRS added salt to the wound by pointing out that the netting practice of the cooperative resulted in a smaller patronage refund deduction than would have otherwise been available. However, since the payment period for the year is dispute had expired, the cooperative could not now claim the additional deduction.¹⁸⁹

Shortly after the taxpayer received this ruling, the U.S. Tax Court commented on the issue in *Certified Grocers of California, Ltd. v. Commissioner*.¹⁹⁰ Although the decision denied the cooperative's attempt to offset nonpatronage income with patronage expenses in a consolidated return, the court noted:

As the Court of Appeals intimated in *Farm Service Cooperatives, supra* at 725, n. 16, the same rule would not appear to apply where the facts are reversed. Thus, if a cooperative has net *income* from patronage sources, even after taking the special deductions provided by sections 1382 and 1383, there appears to be no reason why such income may not be combined and netted with the income or loss from nonpatronage sources, for tax purposes, at least.¹⁹¹

As the courts have not directly addressed netting patronage earning and nonpatronage losses, cooperatives that have legitimate business reasons to do so may face uncertain consequences. If a cooperative chooses to net nonpatronage losses against patronage-sourced income, net margins otherwise available for distribution

¹⁸⁹ *Id.*

¹⁹⁰ *Certified Grocers of California, Ltd v. Commissioner*, 88 T.C. 238 (1987).

¹⁹¹ *Id.* at 251 n.21.

as patronage refunds are reduced. The cooperative has no net loss and can distribute the remaining net margin as patronage refunds eligible for deduction under Subchapter T.

If a cooperative chooses not to reduce patronage income by nonpatronage losses, it will have a net margin from which a deduction may be taken upon payment of patronage refunds and a nonpatronage-sourced net operating loss. The net operating loss may be carried back and forward under Code sec. 172 to offset past or future income from business done with persons to whom the cooperative has no obligation to return patronage dividends. Net margins available for allocation as patronage refunds are unreduced by the loss and may be deducted in full under subchapter T.¹⁹²

Non-section 521 Cooperatives, Netting Nonpatronage Earnings with Patronage Losses

Cooperatives with patronage and nonpatronage activities may generate a profit on nonpatronage activities but incur a loss from business with or for patrons. If a cooperative could net patronage losses and nonpatronage earnings, it would reduce the amount of tax it otherwise would owe on the nonpatronage income. This tax consequence has caused IRS and, unfortunately from the cooperative perspective, the courts to bar such offsets.

An early letter ruling concerned a wholesale grocery supply cooperative that divided its operations into five geographic divisions.¹⁹³ Each division conducted both member-patronage and nonmember-nonpatronage business. When one division suffered a loss, the cooperative wanted to offset that loss against nonpatronage income of the other divisions. IRS said the cooperative had to keep its patronage and nonpatronage financial results separate. It could net the nonpatronage portion of the loss

¹⁹² Rev. Rul. 74-377, 1974-2 C.B. 274.

¹⁹³ Tech. Adv. Mem. 7301319420A (Jan. 31, 1973).

against nonpatronage income of the other divisions, but not the patronage portion of the loss. That had to be recouped from the patrons of the division with the loss.

The leading case on this issue is *Farm Service Cooperative v. Commissioner*.¹⁹⁴ The cooperative had four allocation units. The "broiler pool" and the "turkey pool" were marketing units that conducted all of their business with member-patrons. The "regular pool" was a farm supply operation that did business with members on a patronage basis and nonmembers on a commercial basis. The "taxable pool" represented income from nonoperational sources, such as gains on the sale of property, dividends on stock owned by the association, and other incidental income that the cooperative was willing to treat as nonpatronage sourced.

The cooperative incurred a loss in the "broiler pool" and applied the loss to offset nonmember nonpatronage income of the "regular pool" (supply function) and the nonpatronage income of the "taxable pool."

The U.S. Tax Court, drawing heavily on its recent opinion in *Associated Milk Producers*,¹⁹⁵ found the cooperative did not, as IRS asserted, have to recover its broiler pool loss from the broiler pool patrons. It accepted the cooperative's argument that subchapter T was silent on the appropriate treatment of net operating losses and as it was a corporation it could aggregate gains and losses of its various divisions just as other corporations could. The Tax Court again rejected the Service's operation-at-cost theory and said the cooperative's board could determine the most equitable and appropriate method of allocating the broiler pool loss, so long as it followed the association's bylaws. This in-

¹⁹⁴ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), *rev'g*, 70 T.C. 145 (1978).

¹⁹⁵ *Associated Milk Producers v. Commissioner*, 68 T.C. 729 (1977).

cluded offsetting the loss against otherwise taxable nonpatronage earnings.¹⁹⁶

The Tax Court decision was reversed by the U.S. Court of Appeals for the 8th Circuit.¹⁹⁷ The court accepted the IRS position in the earlier letter ruling that subchapter T requires a cooperative without section 521 status to separate its patronage and nonpatronage accounts in calculating its gross income. It reviewed the development of Subchapter T and concluded it "forbids (a cooperative without section 521 status) to aggregate patronage losses with its income from taxable activities."¹⁹⁸

The court examined the tax consequences of netting patronage losses with nonpatronage earnings and found the result is "to shift the broiler pool losses from the broiler pool to [the cooperative] itself and, more significantly, to the United States Treasury.... [The cooperative] in this case is seeking to avoid taxation on income for which no patronage dividend deduction is available."¹⁹⁹

The court went on, "A (non-section 521) cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income. Taxpayer's accounting procedures cannot supersede this statutory principle."²⁰⁰

The court also compared tax treatment of section 521 cooperatives with nonsection 521 cooperatives and concluded the disparate tax treatment was significant. It said permitting netting of patronage-sourced losses against nonpatronage income:

...would result in obliterating this statutory distinction.
If patronage losses could be used to offset nonpatronage-

¹⁹⁶ *Farm Service Cooperative v. Commissioner*, 70 T.C. 145 (1978), *rev'd*, 619 F.2d 718 (8th Cir. 1980).

¹⁹⁷ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), *rev'g*, 70 T.C. 145 (1978).

¹⁹⁸ 619 F.2d at 727.

¹⁹⁹ 619 F.2d at 724.

²⁰⁰ 619 F.2d at 727.

sourced income, then a (nonsection 521) cooperative could gain the tax advantages of a (section 521) cooperative without meeting the qualifications set forth in IRC § 521(b). Not only would taxpayer itself gain the benefits of (section 521 status)--notably, the exclusion of nonpatronage-sourced income from taxation--but all other cooperatives could do so as well. That is, any (nonsection 521) cooperative could avoid tax on nonpatronage-sourced income by the simple expedient of operating at a loss on its patronage activities.²⁰¹

Farm Service Cooperative argued the abuse of the tax treatment for patronage refunds would only occur if patronage-sourced losses were incurred deliberately. The court, however, said the distinction between deductions allowed section 521 cooperatives and other cooperatives do not turn on subjective factors. The result reached depends only on subchapter T, not an investigation of cooperative motivations.

Even while the Tax Court opinion in *Farm Service* was being appealed, the Service continued to press its position administratively. In a letter ruling to a cooperative applying for section 521 status, IRS conditioned approval on the adoption of a bylaw allocating any patronage losses to those patrons whose business gave rise to the loss. Even though the issue was section 521 status, the IRS said that "...patronage sourced gains and losses may not be netted with nonpatronage sourced gains and losses."²⁰²

In 1986, IRS issued two letter rulings that relied on the *Farm Service* opinion to deny a cooperative's request to net patronage losses and nonpatronage earnings. They also injected Code section 277 into the discussion, holding that section 277 prevents cooperatives from offsetting patronage losses against

²⁰¹ *Id.*

²⁰² Priv. Ltr. Rul. 7937041 (June 13, 1979). Note that the *Farm Service* opinion concerns a nonsection 521 cooperative.

nonpatronage income and further that patronage losses may only be carried forward to succeeding taxable years.²⁰³ While the Service has accepted the Tax Court's rejection of its position that Code sec. 277 applies to nonsection 521 cooperatives,²⁰⁴ the rule that patronage losses can't be netted with nonpatronage income remains firmly in place.²⁰⁵

A similar rule prohibits netting patronage-sourced expenses against nonpatronage income. *Certified Grocers of California v. Commissioner*²⁰⁶ concerned a grocery wholesale cooperative with several noncooperative subsidiaries. The cooperative filed a consolidated return including the results of its subsidiaries. The earnings of the subsidiaries were nonpatronage income to the cooperative.

The cooperative had substantial interest income and interest expense. In its first determination, the court recognized that the interest expense was patronage sourced but found the cooperative failed to establish that the funds that earned the interest income were so closely related to its primary cooperative activity to

²⁰³ Tech. Adv. Mem. 8641003 (June 26, 1986), Tech. Adv. Mem. 8641005 (June 30, 1986). *See also*, Gen. Couns. Mem. 39,587 (Dec. 3, 1986).

²⁰⁴ *Buckeye Countrymark v. Commissioner*, 103 T.C. 547 (1994), *acq.*, A.O.D. CC-1997-003 (May 2, 1997), *noted* 1997-1 C.B. 1. The attempt by IRS to bring cooperatives under § 277 is detailed *infra* pp. 90-103.

²⁰⁵ 103 T.C. at 559-560. Legislative history of a law enacting special rules for netting patronage income and losses reflects congressional approval of this finding. The Senate Budget Committee report expresses agreement with the 8th Circuit's holding in *Farm Service Cooperative* "that a (non-section 521) cooperative could not offset patronage losses against nonpatronage earnings." S. Rep. No. 146, 99th Cong., 1st Sess. (1985), *reprinted in* 1986 U.S.C.C.A.N. 43, 336. *See also*, Priv. Ltr. Rul. 9326006 (March 16, 1993).

²⁰⁶ *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987).

substantiate a finding that the interest income was patronage sourced.

Under a stipulation agreed to by the parties, the court next looked at whether the cooperative could offset patronage-sourced interest expenses against nonpatronage-sourced interest income. In its first discussion on netting patronage results with nonpatronage earnings since *Farm Service*, the Tax Court decided to follow the 8th Circuit.

The Tax Court held that cooperatives must determine their patronage-sourced income separately from their nonpatronage income, in order to properly compute their patronage refunds. As part of this process, expenses must be assigned to the type of income to which they apply. Therefore, nonpatronage income may not be reduced by patronage expenses.

The court also looked at the impact of the cooperative's filing a consolidated return with its noncooperative subsidiaries. The court accepted with conviction the cooperative's position that it could file such a consolidated return. However, it rejected the premise that by using a consolidated return, the cooperative could net a patronage loss against nonpatronage income.

In 1980, the cooperative paid a patronage refund based on "book" income that exceeded its "taxable" income. On its consolidated return, it attempted to offset the resulting tax loss against nonpatronage income earned by the subsidiaries. The court cited with approval a regulation providing that other tax law applies to an affiliated group filing a consolidated return unless the regulations say otherwise.²⁰⁷

Again following *Farm Service*, the Tax Court said that since a cooperative can't net patronage losses and nonpatronage earnings on a regular return, it can't net patronage losses with nonpatronage income of subsidiaries in a consolidated return. However, it can carry the patronage loss back and forward to other tax years under Code sec. 172 "for application only against net income from

²⁰⁷ Treas. Reg. § 1.1502-80.

patronage in those years." The court also said it could carry nonpatronage earnings and losses, whether from its own operations or those of a subsidiary, to other years to offset against other nonpatronage earnings from both sources in those years.

In summary, certain rules and guidelines govern the treatment of losses where nonpatronage operations are involved:

1. Section 521 cooperatives can combine patronage and nonpatronage income and losses and distribute the result as deductible patronage refunds. Therefore, netting patronage and nonpatronage results is usually not an issue for them.

2. Non-section 521 cooperatives must separate patronage and nonpatronage income and expenses when computing taxable income.

3. Non-section 521 cooperatives may carry nonpatronage losses back and forward to reduce taxable nonpatronage income in other years under Code sec. 172. As the loss can be used to offset otherwise taxable income in other years, this is generally an acceptable strategy for cooperatives.

4. The Service opposes non-section 521 cooperatives netting nonpatronage losses and patronage margins, even though under this scenario the cooperative voluntarily forfeits the option to carry those losses to other tax years and reduce taxable nonpatronage income in those years. This reflects the Service's commitment to its "operation-at-cost theory" which requires all losses be recouped from the persons whose business generated the loss.

5. Non-section 521 cooperatives may not net patronage losses or expenses with nonpatronage income, as this would avoid the tax otherwise due on the nonpatronage income at the cooperative level.

SECTION 277

The Tax Reform Act of 1969 added a new provision, section 277, to the Internal Revenue Code. It states that a social club or other membership organization that operates primarily to furnish

services or goods to its members, and is not exempt from taxation, may only deduct costs associated with providing such services and goods to members in an amount equal to the income derived from transactions with its members.²⁰⁸ Section 277 also provides that to the extent deductions from providing services and goods to members exceed member income in any year, the difference can be carried forward and deducted in the succeeding tax year. This section also eliminates deductions relating to dividends received by corporations to which it applies.²⁰⁹

Section 277 was enacted to reverse court decisions permitting taxable membership organizations to escape taxation of investment and nonmember income by offsetting it with losses incurred in providing goods and services to members.²¹⁰

Subchapter T Agricultural Cooperatives

Because section 521 cooperatives are considered "exempt" by terms of the Code, the application of section 277 to section 521 cooperatives was never an issue. But it was a contentious point between nonsection 521 cooperatives and the IRS for many years.

IRS staff was quick to apply Code sec. 277 to cooperatives. Shortly after enactment, the Chief Counsel simply wrote, "Section 277 of the Code...applies to (nonsection 521) cooperative associations."²¹¹

On August 20, 1971, the Service's Regulations Policy Committee decided "Section 277 should be applied to cooperatives and

²⁰⁸ I.R.C. § 277(a).

²⁰⁹ *Id.* See also, Tech. Adv. Mem. 8815001 (Nov. 3, 1987).

²¹⁰ H.R. Rep. 413, 91st Cong., 1st Sess (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 1694, 1695; S. Rep. 552, 91st Cong., 1st Sess (1969), *reprinted in* 1969 U.S. Code Cong. & Admin. News 2103. See, *Concord Consumer Housing Cooperative v. Commissioner*, 89 T.C. 105, 120-121 (1987).

²¹¹ Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

should be vigorously enforced."²¹² Yet, it was nearly 15 years before the Service began to routinely apply section 277 to co-ops.

The first authoritative discussion of the applicability of section 277 to nonsection 521 cooperatives is in the Tax Court opinion in *Farm Service Cooperative*.²¹³ The Court held the Commissioner did not meet his burden of proof that section 277 should apply to cooperatives. However, it provided some analysis of the substantive issue. The court stated that the purpose of enactment was to attack "sham losses" intentionally generated in dealings with members free of tax. It noted that IRS produced no evidence that the cooperative loss under consideration was a sham.²¹⁴

After the Tax Court's statement in *Farm Service*, private rulings indicated a continuing but somewhat tentative effort to apply section 277 to nonsection 521 cooperatives. A 1982 letter ruling²¹⁵ mentioned section 277 as a guide for carrying losses forward when they aren't recouped from members in the loss year. Another private ruling described how section 277 directs losses to be carried forward.²¹⁶ However, under the circumstances of the case the ruling found carry forward under section 172 acceptable and did not otherwise press the application of section 277.

In 1986, the IRS finally began to apply Code sec. 277 to cooperatives aggressively. It used section 277 to support holdings that (1) a cooperative could carry operating losses forward but not back to offset taxable income in earlier years and (2) a cooperative can't net patronage losses and nonpatronage earnings.²¹⁷

²¹² Gen. Couns. Mem. 34,935 (July 3, 1972).

²¹³ *Farm Service Cooperative v. Commissioner*, 70 T.C. 145 (1978), *rev'd on other grounds*, 619 F.2d 718 (8th Cir. 1980). The Eighth Circuit declined to address the section 277 issue. 619 F.2d 728, n.23.

²¹⁴ 70 T.C. at 156-157.

²¹⁵ Priv. Ltr. Rul. 8233051 (May 19, 1982).

²¹⁶ Tech. Adv. Mem. 8247011 (July 28, 1982).

²¹⁷ Priv. Ltr. Rul. 8624019 (March 10, 1986); Tech. Adv. Mem. 8641003 (June 26, 1986); Priv. Ltr. Rul. 8641005 (June 30, 1986).

In 1987, the Tax Court again discussed the applicability of section 277 to cooperatives without deciding it. As in the *Farm Service* case, the court noted doubt as to its applicability.²¹⁸

Also in 1987, cooperatives decided to identify and fund a test case to have the courts determine whether Code sec. 277 covered nonsection 521 cooperatives. Buckeye Countrymark, the successor to Fayette Landmark, a local grain marketing and farm supply cooperative in Ohio, became the test vehicle.

In 1977, Fayette Landmark reported \$85,275 in taxable income from business with or for patrons. In 1980, it suffered operating losses of \$62,424 on business with or for patrons and attempted to carry the loss back to offset taxable income in 1977.

An IRS agent auditing Fayette Landmark questioned the loss carry back and requested technical advice from the IRS National Office. The National Office response took the position that Code sec. 277 applied and that the patronage-sourced loss could not be carried back.²¹⁹

As the cooperative had already received a refund based on an amended 1977 tax return filed in 1981, IRS sent it a notice of deficiency. The cooperative responded by initiating litigation in the Tax Court. The only issue in the case was whether Code sec. 277 applied to Fayette Landmark, a nonsection 521 cooperative covered by Subchapter T.

For unexplained reasons, the Tax Court took 6 years to issue its decision. In the interim, another case involving Code sec. 277 was decided by the U.S. Claims Court.²²⁰ Landmark was a federated cooperative whose members were local grain marketing and supply cooperatives, also located in Ohio.

²¹⁸ *Washington-Oregon Shippers Cooperative, Inc. v. Commissioner*, 52 T.C.M. (CCH) 1406, 1413, n.13 (1987).

²¹⁹ Tech. Adv. Mem. 8641005 (June 30, 1986). Neither the TAM nor the court opinion explains why Fayette Landmark had substantial taxable income from business with or for patrons.

²²⁰ *Landmark v. United States*, 25 Cl. Ct. 100 (1992).

In tax year 1981, Landmark was allowed to claim (after lengthy negotiations with IRS) an operating loss of more than \$9.9 million on an investment in a failed petroleum refinery venture. Landmark attempted to carry much of that loss back to tax years 1978-1980 to "free-up" investment tax credits previously claimed in those years. Then it asked to carry the freed-up credits back to offset taxable income at the cooperative level in 1975-1977.

Landmark initiated litigation in the Claims Court to recover the funds represented by the unrealized credits. IRS countered with two arguments. First, Code sec. 277 barred Landmark from carrying the 1981 loss back to prior years to free-up the credits. Second, if the credits were freed, Code sec. 46(h) required they be passed through to Landmark's members rather than used to offset taxable income at the cooperative level in earlier years.

The Claims Court rejected the Government's argument that Code sec. 277 applies to Subchapter T cooperatives. However, it also held that IRS was correct in asserting that the freed credits could not be carried back at the cooperative level but rather must be passed through to Landmark's patrons.

The court based its section 277 holding on fundamental inconsistencies between that provision and Subchapter T. It said Subchapter T provides a comprehensive taxing scheme for cooperatives and superimposing the more generalized rules of section 277 onto it would "produce results that extend from legislative redundancy to a repeal by implication. These are not results we can reasonably suppose Congress meant to achieve."²²¹

The court concluded Landmark was entitled to carry back the 1981 net operating loss under Code sec. 172. However, no refund of prior years' taxes was realized because it had to pass the freed investment tax credits through to its members.

Finally, in late 1994, the Tax Court handed down its opinion in *Buckeye Countrymark v. Commissioner*.²²² While it never cited

²²¹ 25 Cl. Ct. at 108.

²²² *Buckeye Countrymark v. Commissioner*, 103 T.C. 547 (1994).

the Claims Court opinion in *Landmark*, the Tax Court adopted essentially the same logic. It based its ultimate finding upon an analysis of cooperative taxation under Subchapter T and the purposes and language of Code sec. 277, concluding:

As discussed in detail above, we find that the provisions of section 277 conflict with the provisions of subchapter T and the application of section 277 to (nonsection 521) cooperatives would lead to absurd or futile results. This is a strong indication that Congress did not intend section 277 to be applied to (nonsection 521) cooperatives. We also find that the arguments by (the Service) in support of the position that section 277 applies to (nonsection 521) cooperatives are flawed.

Accordingly, we hold that section 277 does not apply to (nonsection 521) cooperatives subject to tax under subchapter T and that (nonsection 521) cooperatives are not "membership organizations" within the meaning of section 277.²²³

While the lengthy opinion focuses on several arguments, one is particularly noteworthy. The court looked at the underlying policy for enacting Code sec. 277 and found:

Congress enacted section 277 to foreclose the possibility that membership organizations could obtain an unwarranted subsidy of their membership activities by offsetting losses from those activities with investment or other nonmembership income....However, as discussed above, the rules of subchapter T forbid a (nonsection 521) cooperative from using patronage losses to offset nonpatronage income. [citations omitted] Thus, irrespective of section 277, a (nonsection 521) cooperative

²²³ 103 T.C. at 581-582.

is not entitled to use nonpatronage income to subsidize its patronage activities.²²⁴

While this language was a disappointment to cooperatives that disagreed with the Eighth Circuit's opinion in *Farm Service*,²²⁵ it provided a rationale for the Tax Court to conclude in this case that the policy concerns that led to enactment of Code sec. 277 would not be served by applying section 277 to nonsection 521 cooperatives.

During the six years *Buckeye Countrymark* was under consideration, the Service raised the Code sec. 277 issue in numerous contexts.²²⁶ But IRS did not appeal the decision and soon began conceding pending cases involving farmer cooperatives where Code sec. 277 was at issue. Finally, in mid-1997, it released an action on decision indicating acquiescence in the Tax Court's decision, stating:

We will no longer take the position that (nonsection 521) cooperatives subject to subchapter T of the Code are subject to the limitations of section 277 of the Code. (Nonsection 521) cooperatives subject to subchapter T may avail themselves of loss carry backs allowed by section 172 of the Code.²²⁷

²²⁴ 103 T.C. at 570.

²²⁵ *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), *rev'g*, 70 T.C. 145 (1978).

²²⁶ Occasionally, a cooperative whose only concerns were having its losses recognized and carrying them forward, asked to be found subject to § 277, Priv. Ltr. Rul. 8952019 (Sept. 28, 1989); or didn't object to having § 277 applied, Priv. Ltr. Rul. 9314013 (Jan. 6, 1993).

²²⁷ AOD CC-1997-003 (May 2, 1997), *noted* 1997-1 C.B. 1.

Other Cooperatives

While the Tax Court had the *Buckeye Countrymark* case under consideration, IRS raised the issue of the applicability of Code sec. 277 to numerous other, non-farmer cooperatives. While the *Buckeye Countrymark* decision essentially ended the need for Subchapter T farmer cooperatives to concern themselves with Code sec. 277, the Service wasn't totally throwing in the towel. It drew a new distinction between cooperatives clearly subject to Subchapter T and those it considered outside of that Code section, either by specific legislative exception or its own administrative determinations.

Housing Cooperatives

A key tax code provision for housing cooperatives is section 216, which states that owner-tenants of a housing cooperative are to be treated, for tax purposes, as if they owned the real property rather than stock in the cooperative.²²⁸ While Code sec. 216 offers a framework for determining the tax treatment of housing cooperative members, neither this nor any other Code language specifically addresses taxation of housing cooperatives.

As early as 1972, the Tax Court had rejected an IRS position that housing cooperatives couldn't deduct patronage refunds under Subchapter T, stating:

We disagree with the Commissioner's assertion that Subchapter T, section 1381, *et seq.*, does not apply. Part I of that subchapter applies to the taxable year of any corporation operating on a cooperative basis after December 31, 1962, and that necessarily includes a section 216 cooperative housing corporation. Sec. 1381(a)(2).²²⁹

²²⁸ IRC § 216.

²²⁹ *Park Place v. Commissioner*, 57 T.C. 767, 779 (1972). *Also*, *Concord Village v. Commissioner*, 65 T.C. 142 (1975).

In 1985, the IRS issued two letter rulings stating that housing cooperatives were membership organizations within the meaning of Code sec. 277. It then said that interest earned by the cooperatives on their reserve funds was not membership income and therefore could not be used to offset membership losses for tax purposes.²³⁰

The housing cooperatives involved in these rulings obtained special legislative relief declaring the interest income was membership income.²³¹ While this solved the problem of the two cooperatives it covered, it did not address the issue of the applicability of Code sec. 277 to housing cooperatives.²³²

In 1987, the Tax Court decided a case involving a housing cooperative that did not contest the applicability of Code sec. 277. The cooperative's only argument was that interest earned on certain reserve accounts was membership income under Code sec. 277. The court rejected the cooperative's position.²³³

The majority opinion didn't treat Concord as a Subchapter T cooperative because it presented no evidence that it was. The majority expressly stated "we leave to another day any exploration of the possible interrelationship and full sweep of Sections 216, 277, and Subchapter T."²³⁴

But a concurring opinion, written by Judge Koener (and agreed to by 6 other judges), cited *Park Place* and *Concord Village* for

²³⁰ Tech. Adv. Mem. 8532004 (April 17, 1985); Tech. Adv. Mem. 8532005 (April 17, 1985).

²³¹ Tax Reform Act of 1986, § 644(e), Pub. L. No. 99-514, 100 Stat. 2085, 2287 (1986).

²³² The legislative language contained a specific statement that it was not to be construed as a change in the tax law concerning the applicability of § 277 to housing cooperatives. Tax Reform Act of 1986, § 644(e)(2)(B).

²³³ *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987).

²³⁴ 89 T.C. at 107, n.3.

the proposition that housing cooperatives were covered by Subchapter T and said:

...those code provisions preempt other more general code provisions which otherwise might be applicable....I thus concur in the result reached by the majority here, as long as it is clear, as I think it should be, that we are *not* holding that the provisions of section 277 supersede the provisions of subchapter T in a case where the latter provisions apply. (court's emphasis)²³⁵

Although the court didn't discuss the matter, the IRS issued a revenue ruling, citing *Concord Consumer Housing Cooperative*, that stated Code sec. 277 applied to limit the deductions of a housing cooperative as defined in Code sec. 216(b)(1).²³⁶

One week before *Buckeye Countrymark* went to trial, the first of numerous cases concerning the applicability of Code sec. 277 to housing cooperatives was filed with the Tax Court. It involved Trump Village, an 1800-unit housing cooperative in Brooklyn, NY, named for Donald Trump's father, who was involved in its original development.

The Trump Village litigation and the other housing cases were assigned to the same judge handling the Buckeye Countrymark case. Likewise, the original disputes languished for several years and more cases were filed in the interim.

Finally, in June of 1995, several months after *Buckeye Countrymark*, the Tax Court issued its opinion in *Trump Village*.²³⁷ It didn't discuss Code sec. 216. Citing *Buckeye Countrymark*, the court held that Code sec. 277 did not apply to Trump Village because it was "operated on a cooperative basis"

²³⁵ 89 T.C. 125, 126-127.

²³⁶ Rev. Rul. 90-36, 1990-1 C.B. 59.

²³⁷ *Trump Village Section 3 v. Commissioner*, 69 T.C.M. (CCH) 2985 (1995).

within the meaning of Code sec. 1381(a)(2) and, as a Subchapter T cooperative, is not subject to Code sec. 277. Implicit in the decision is a finding that interest income Trump Village earned on various reserve and escrow accounts was patronage sourced as the court held it could be offset with operating expenses and losses without discussing the issue.

In October, 1995, the Service issued an Action on Decision acquiescing in the *Trump Village* decision. It still took an aggressive attitude toward housing cooperatives, saying:

We will no longer take the position that cooperative housing corporation subject to subchapter T of the Code are subject to the limitation of section 277. We will continue to assert in litigation that the limitations of section 277 apply to cooperative housing corporations that do not qualify as subchapter T cooperatives. In considering whether subchapter T is applicable, we will consider whether the cooperative housing corporation in question has the three traditional characteristics of cooperative operation essential to be “operating on a cooperative basis.” Only where all three characteristics are present, so that the housing corporation is a subchapter T cooperative, will section 277 not be applied. Rev. Rul. 90-36 will be modified to be consistent with our litigating position.²³⁸

While *Trump Village* ignored Code sec. 216, a different Tax Court judge, in a subsequent decision involving similar facts, relied on it heavily.²³⁹ Noting that the parties had stipulated that the taxpayer was a Code sec. 216 cooperative, the court cited *Park Place* as creating at the least a presumption that a cooperative

²³⁸ A.O.D. 1995-011 (Oct. 30, 1995).

²³⁹ *Thwaites Terrace House Owners Corp. v. Commissioner*, 72 T.C.M. (CCH) 578 (1996).

meeting the tests of Code sec. 216 is also operating as a cooperative for Subchapter T purposes. The court then followed an independent analysis finding Thwaites Terrace was operating as a cooperative with a legal conclusion that because it is subject to Subchapter T, it is not covered by Code sec. 277.²⁴⁰

The court also addressed the nature of the interest income leading to the litigation. It found that the issue of whether it was patronage or nonpatronage sourced was in dispute and that the cooperative had the burden of establishing it was derived from activity directly related to its principal business purpose. As Thwaites Terrace failed to introduce any evidence establishing the income was patronage sourced, the court felt compelled to hold it was nonpatronage sourced and could not be offset with patronage-sourced losses.

Trump Village and *Thwaites Terrace* indicate that the Tax Court, at least, is convinced that housing cooperatives are covered by Subchapter T and are not subject to Code sec. 277.

Rural Electric Cooperatives

In a 1991 letter ruling, the IRS applied Code sec. 277 to a "nonexempt" rural electric cooperative.²⁴¹ The cooperative had surrendered its exempt status under § 501(c)(12) when it entered into a safe-harbor lease agreement to finance a new power plant. Under the contract, the cooperative sold the power plant to a third party for a down payment and a note. It then leased back the plant.

The cooperative filed a tax return claiming Code sec. 277 status and asserting that both the interest and rent were from nonmember transactions. The co-op sold electricity to member

²⁴⁰ Of particular interest in the discussion of "operating on a cooperative basis" is the court's outright rejection of the Service's contention that Thwaites Terrace as not democratically controlled because it both allowed proxy voting and used weighted voting based on patronage, not one-member one-vote. 72 T.C.M. (CCH) at 581.

²⁴¹ Tech. Adv. Mem. 9214009 (Dec. 13, 1991).

distribution cooperatives on a cooperative basis and nonmembers on a for-profit basis.

IRS surprised the cooperative when, on audit, it took the position that the "phantom" rent it paid had to be allocated between member and nonmember income based on their relative purchases of electricity. This reduced its "nonmember" expenses, creating excess "nonmember" income which, under Code sec. 277, could not be offset by the "member" portion of the rental expense.

Only after the agent challenged its treatment of the "phantom" rent did the cooperative argue it was not subject to Code sec. 277. In the letter ruling, the IRS national office affirmed the agent's position on both the applicability of Code sec. 277 and the treatment of the interest.

In 1996, the Service released proposed examination guidelines for rural electric cooperatives. They included a statement that nonexempt electric cooperatives are subject to Code sec. 277.²⁴²

As all rural electric and telephone cooperatives are expressly excluded from Subchapter T coverage,²⁴³ they aren't specifically covered by the cases holding Subchapter T takes precedence over Code sec. 277. One case before the Court of Federal Claims might have settled the issue. However, the court rejected the Service's position that the cooperative was not entitled to exempt status under Code sec. 501(c)(12).²⁴⁴ As a tax-exempt organization, Buckeye Power was automatically excluded from the scope of Code sec. 277 and the court never raised the issue in its opinion.

Farm Credit System Institutions

The Service also issued a letter ruling expressing the view that Code sec. 277 applied to production credit associations, and that as a result member losses could not be carried back.²⁴⁵

²⁴² Announcement 96-24, 1996-16 I.R.B. 30, 45.

²⁴³ I.R.C. § 1381(a)(2)(c).

²⁴⁴ *Buckeye Power, Inc. v. United States*, 38 Fed.Cl. 154 (1997).

²⁴⁵ Tech. Adv. Mem. 9124004 (March 13, 1991).

This position was also rejected by the Tax Court.²⁴⁶ The association attempted to carryback a net operating loss to offset otherwise taxable income in previous years. IRS denied the loss carryback on the basis that the association was subject to Code sec. 277. The parties stipulated that the association was not a Subchapter T cooperative (many such associations don't have a pre-existing legal obligation to return earnings to patrons), so the cases holding that a Subchapter T cooperative is not covered by Code sec. 277 weren't applicable.

The court examined the purpose of Code sec. 277 and the activities of the production credit association and concluded the association "was not a membership organization for purposes of section 277."²⁴⁷ The court found that all persons who did business with the association were treated alike, so there was no use of member losses to offset nonmember income. Furthermore, everyone who applied for a loan was a nonmember and once the loan was approved, they became members. Also, the losses resulted from certain borrowers not making enough money farming to repay them, not because members were given preferential treatment over nonmembers. The court determined it was improper to broaden the scope of Code sec. 277 to cover this situation.

While the IRS may continue to raise the Code sec. 277 issue in a cooperative context in the future, substantial precedent exists to indicate it will be a difficult position to defend.

²⁴⁶ *Farm Credit Services of Northwest North Dakota, ACA, v. Commissioner*, 70 T.C.M. (CCH) 655 (1995).

²⁴⁷ *Id.* at 663.

