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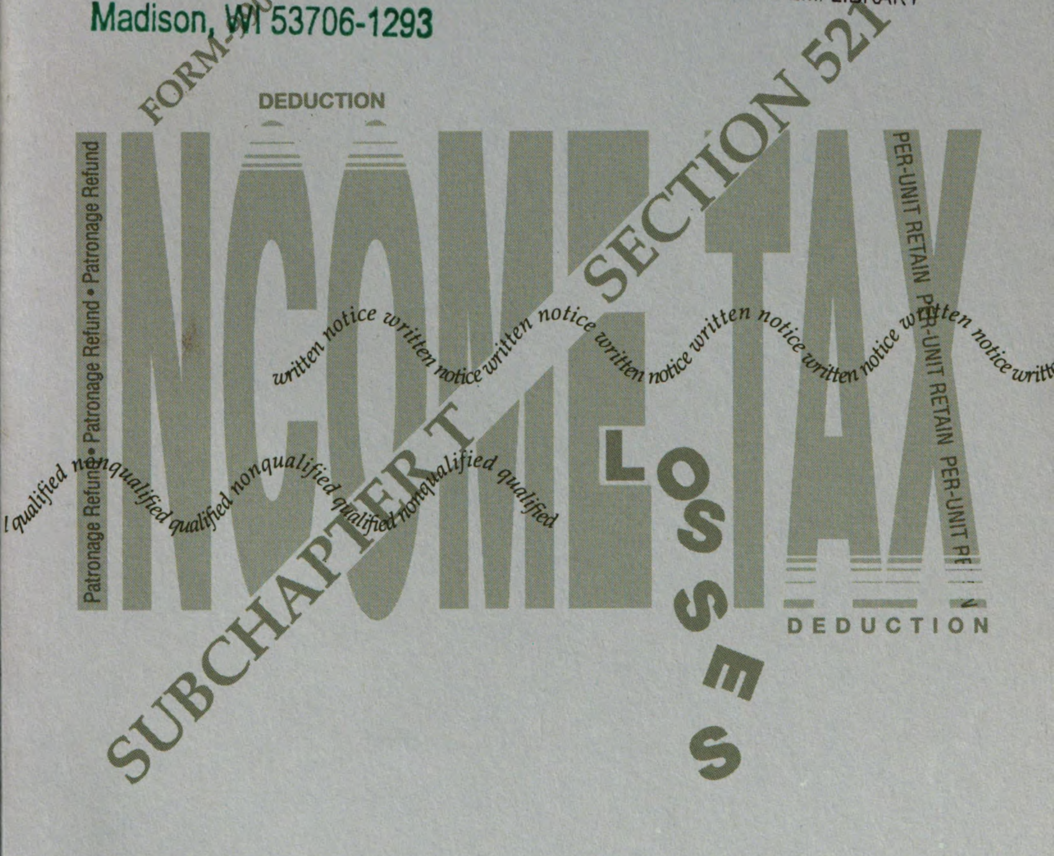
Income Tax Treatment of Cooperatives:
Handling of Losses



Abstract

INCOME TAX TREATMENT OF COOPERATIVES:
Handling of Losses

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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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Preface[1]

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.

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[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 losses[3] and a definition of "completed crop pool method of accounting" that recognizes an individual crop-year pool may have a loss.[4]

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

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[2] Notably I.R.C. § 165 (provides a deduction of losses) and § 172 (authorizes net operating loss carrybacks and carryovers).

[3] I.R.C. § 1388(j), Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, § 13210, 100 Stat. 82, 323-324 (1986). This provision is discussed at pp. 101-106.

[4] I.R.C. § 1382(g)(2).

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

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 groundrules for handling cooperative losses have developed through court decisions and Internal Revenue Service (IRS or the Service) administrative rulings.

HOW COOPERATIVES HAVE LOSSES

Cooperatives, like other business entities, generally compute their financial results on an annual basis. A loss occurs whenever expenses assigned to a given tax year exceed revenues generated during that year.

Cooperatives may experience a loss for several reasons, such as operations that fail to cover expenses, dispositions of assets, and changes in accounting procedures.

Losses on Operations

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

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[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).

separately for revenues and costs of each function.[9] A cooperative 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.[10]

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.[11]

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 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

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[9] 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.

[10] *Ibid.*

[11] *See, e.g.*, Priv. Ltr. Rul. 8248048 (Aug. 30, 1982).

refunds. When it could only sell the item for $1.00 per unit, a net loss occurred.

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

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

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

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

Actual	(800,000 units)
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	1,050,000
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.[12] A primary buyer may file for bankruptcy and be unable to pay for products already delivered.[13] A Government regulator may keep prices the cooperative can charge for its services so low the cooperative can't cover its expenses.[14]

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

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

[13] Priv. Ltr. Rul. 8842018 (July 22, 1988).

[14] 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.[15]

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	(1 million units)
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	$1,050,000
Net Margins	$50,000

[15] 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	(1 million units)
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	1,050,000
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	(1 million units)
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	1,050,000
Net Margins	$50,000
Actual	(700,000 units)
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	780,000
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 years before the cooperative realizes positive financial results.[16] 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.

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.

Losses on Disposition of Assets

Cooperatives can also suffer losses when disposing of assets. This report will not attempt to decipher all of the complex rules in this area, but two determinations that apply to cooperatives are worth mentioning.

First, IRS has said that gains and losses on the sale of capital stock are Code sec. 1221 capital gains and losses and therefore nonpatronage sourced.[17] This controversy is discussed in detail in an earlier report in this series.[18]

Second, a letter ruling addressed issues arising when a cooperative suffered losses on the disposition of Code sec. 1231 property as part of a plan to withdraw from an unsuccessful business.[19] IRS said this was a patronage-sourced loss and provided guidelines for handling the tax consequences concerning property put to other uses by the cooperative, sold, held for possible use as supplies or scrap, or simply abandoned.

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[16] Tech. Adv. Mem. 8245082 (Dec. 31, 1981); Priv. Ltr. Rul. 9292026 (Oct. 11, 1991).

[17] Tech. Adv. Mem. 8815001 (Nov. 3, 1987) and Tech. Adv. Mem. 8941001 (June 14, 1989)(same facts).

[18] Donald A. Frederick and John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds*, RBS Cooperative Information Report 44, Part 2 (USDA 1993) pp. 42-44.

[19] Priv. Ltr. Rul. 9213030 (Nov. 27, 1991).

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.[20] 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."[21] 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.

The validity of the Service's position was questioned by the U.S. Tax Court in *Associated Milk Producers (AMPI) v.*

[20] Rev. Rul. 74-274, 1974-1 C.B. 247.

[21] *Id.* at 248.

Commissioner.[22] 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."[23] 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."[24]

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 difference as a loss. The court recognized this as a valid loss for tax purposes.[25]

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

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[22] Associated Milk Producers v. Commissioner, 68 T.C. 729 (1977).

[23] *Id.* at 741.

[24] *Id.*, n. 8.

[25] Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238 (1987).

patronage (refunds) based upon book income which exceeds taxable income from patronage."[26]

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.[27]

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 merger[28] or from changing the tax year of a single cooperative for any reason acceptable to IRS.[29]

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

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[26] *Id.* at 250.

[27] Priv. Ltr. Rul. 8248048 (August 30, 1982).

[28] Ford-Iroquois FS v. Commissioner, 74 T.C. 1213 (1980).

[29] Tech. Adv. Mem. 8043019 (July 24, 1980).

year in which the loss is recognized. For example, letter rulings[30] 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 ruling[31] 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.

SHOWING A 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.[32] 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

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[30] Priv. Ltr. Rul. 8540051 (July 3, 1985); Priv. Ltr. Rul. 8540056 (July 8, 1985).

[31] Rev. Rul. 79-45, 1979-1 C.B. 284.

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

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.[33]

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.[34] A net operating loss is defined as the amount by which allowable deductions exceeds gross income.[35]

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.[36] Generally, the loss is to be used in the earliest tax year it can be applied.[37]

However, a taxpayer may forgo the carry back period and use the loss exclusively in the years following the loss year.[38] 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.

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[33] I.R.C. § 172.

[34] I.R.C. § 172(a).

[35] I.R.C. § 172(c).

[36] I.R.C. § 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.

[37] I.R.C. § 172(b)(2).

[38] I.R.C. § 172(b)(3).

However, the Service has questioned whether a cooperative can even have a net operating loss on patronage activity and barred 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 1951[39] 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.[40] 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 Section 101(12)(B)(i) and (ii) of the

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

[40] For a discussion of the cooperative provisions in the Revenue Act of 1951, *see* Donald A. Frederick and John D. Reilly, *Income Tax Treatment of Cooperatives: Background,* RBS Cooperative Information Report 44, Part 1 (USDA 1993) pp. 85-88.

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][41]

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.[42]

Until the early 1970s, the IRS gave at least passive acceptance to the idea that a cooperative could have a loss.[43] 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.[44] 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.[45]

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

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

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

[43] *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).

[44] Rev. Rul. 65-106, 1965-1 C.B. 126.

[45] *See also*, Letter Ruling 6503036020A (March 3, 1965).

realized unspecified 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."[46]

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."[47]

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.[48]

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."[49]

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[46] 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 1996).

[47] 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."

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

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

IRS's Operation-at-Cost Principle

Contemporaneous reports indicate that the IRS staff shocked cooperative tax advisers during a presentation at the 1971 NCFC Annual Meeting. 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.[50]

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.[51]

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.'"[52]

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

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

[51] TAXFAX, The Cooperative Accountant, Fall 1971, at 38.

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

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.[53]

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.[54] 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."[55]

The Service provided several options available to recoup the loss:

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

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[53] Rev. Rul. 69-67, 1969-1 C.B. 142.

[54] Ltr. Rul. 7207319410A (July 31, 1972).

[55] *Id.*

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.[56]

The Courts Speak

The courts first addressed IRS's operation-at-cost principle in *Associated Milk Producers, Inc. v. Commissioner*.[57] From 1959 to 1961, Rochester Dairy reported deductions in excess of gross income.[58] 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, 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

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[56] *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).

[57] Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977).

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

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.[59]

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 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.[60]

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

[60] *Id.* at 736.

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.[61]

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 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.[62]

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

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

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

deductions under section 162, it is not possible for patronage activities to incur net operating losses under section 172."[63]

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.[64]

On appeal, the IRS did not pursue its operation-at-cost principle.[65]

The operation-at-cost principle was urged in a third Tax Court case,[66] 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

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[63] 70 T.C. at 152.

[64] 70 T.C. at 154.

[65] "The Commissioner does not contest the proposition that a cooperative can have a net operating loss, or that it can carry such losses forward and back as provided in I.R.C. § 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.

[66] Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213 (1980).

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.[67]

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."[68]

The court concluded "The 'operation at cost' principle describes a feature of a cooperative's relations with it 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."[69]

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

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

[69] *Id.* at 1222.

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."[70]

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.[71] 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."[72]

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.[73]

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

[71] Tech. Adv. Mem. 8019003 (Nov. 20, 1979).

[72] Priv. Ltr. Rul. 8021073 (Feb. 28, 1980).

[73] 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).

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.[74] 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.

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.[75] 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.

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[74] 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 I.R.C. § 510(c)(12)).

[75] 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.

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 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.[76]

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.

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[76] *See* Gen. Couns. Mem. 37,751 (Nov. 21, 1978).

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 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

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. It has specifically approved three recovery methods: (1) direct payment, (2) canceling retained patronage equities, and (3) accruing accounts receivable.[77]

Two or three methods may be used together. For example, the cooperative may set up accounts receivable and have the patrons pay them off by direct payment or cancellation of outstanding equities.

[77] Tech. Adv. Mem. 7207319410A (July 31, 1972).

Direct Billing and Reimbursement

The loss recoupment method preferred 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 entire amount due the cooperative, paying in several installments, or applying certificates of indebtedness toward the payment. The cooperative 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.[78]

Direct assessment, however, can be a member relations disaster, evoking strong negative reactions from both current and former members.[79] The Tax Court has acknowledged this 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.[80]

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[78] Letter Ruling, Nov. 21, 1975. Members received an 8 1/2 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.

[79] 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, 558 P. 2d 283 (1976).

[80] Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977).

The court responded:

> ...regardless of what might have been [the cooperative'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."[81]

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.[82]

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.[83] If the repayments are for losses of a prior year, IRS suggests it be assumed the cooperative established and collected an accrued receivable, even if it didn't actually do so.[84] 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

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[81] *Id.* at 739.

[82] Tech. Adv. Mem. 9128007 (March 28, 1991).

[83] *Id.* The cooperative computed operating losses on a monthly basis and promptly covered by the patrons.

[84] Letter Ruling, November 21, 1975.

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.

Revenue Ruling 70-64,[85] the first IRS discussion of the issue, concerned a farmer-patron who had received a qualified written notice of allocation in one year. In a subsequent year, the cooperative announced that it would redeem such notices of allocation, but at less than face value. The Service held the farmer could take an ordinary loss deduction, in the year of redemption, for the difference between the stated amount of the allocation included in income in the year of issuance and the amount received in redemption. No explanation was offered as to why the cooperative redeemed patron equities at a discount.

Revenue Ruling 70-407[86] involved a marketing cooperative that suffered a loss in one year because it overpaid patrons for product delivered during that year. In the following year, it "collected back" the excess by canceling qualified written notices of allocation issued in years prior to the loss year. The patrons were allowed to claim an ordinary loss for the value of the canceled equity under Code sec. 165.[87]

A subsequent letter ruling provided that the equity canceled need not be from the activity that generated the loss. It discussed a cooperative with grain and cotton marketing departments and a supply function. In one year the grain marketing department suffered a loss. The co-op asked permission to recoup the loss by canceling outstanding equity credits of the patrons. The Service approved this method and said that if a patron didn't have

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[85] Rev. Rul. 70-64, 1970-1 C.B. 36, *suspended by* Notice 87-68, 1987-2 C.B. 378.

[86] Rev. Rul. 70-407, 1970-2 C.B. 52.

[87] A letter ruling dated Nov. 21, 1975, stated,"Rev. Rul. 70-407...recognizes that a cooperative may cancel outstanding marketing credits on a patronage basis to allocate a loss to its patrons." Ltr. Rul. (Nov. 21, 1975); Priv. Ltr. Rul. 7937041 (June 13, 1979).

sufficient retained patronage paper from grain marketing margins in prior years to cover the loss, the cooperative could cancel such paper from cotton marketing or supply purchases.[88]

Other rulings that permit cooperatives to recoup a loss by canceling retained equities are discussed in the next two subsections on accounts receivable and redeeming equities at less than face value.

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 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.[89] However, a series of subsequent rulings have provided considerable flexibility in collecting accounts receivable established to facilitate recovering losses.

In a letter ruling, a cooperative was permitted to collect such accounts by canceling outstanding nonqualified written notices of allocation, issued *in the year prior to the loss*, and to treat the cancellation as a redemption deductible under Code sec. 1382(b)(2).[90]

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[88] Priv. Ltr. Rul. 7804083 (Oct. 28, 1977).

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

[90] Priv. Ltr. Rul. 7926068 (March 29, 1979.)

In Revenue Ruling 81-103, the cooperative was permitted to establish accounts receivable to cover losses in one year (1976), pay out margins *in the next year* (1977) in nonqualified written notices of allocation, and then collect the accounts receivable by canceling the nonqualifieds in a subsequent year (1979).[91]

In 1982, the Service issued two letter rulings concerning losses from complex situations that accumulated over several years. IRS said that where it wasn't possible to match a loss to specific patronage transactions, a cooperative could establish accounts receivable for its patrons and collect them by canceling various forms of equity provided by those patrons--qualified allocations, nonqualified allocations, and direct investments.[92]

Subsequent rulings have approved paying off accounts receivable established to cover patronage sourced losses by redeeming qualified per-unit retain certificates[93] and preferred and common stock.[94]

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.[95] The taxpayer was a federated cooperative with a dozen grain marketing associations as members. After a successful start-up, it expanded into risky export operations and 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:

1) the losses would be allocated to and collected from only the continuing members,

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[91] Rev. Rul. 81-103, 1981-1 C.B. 447.

[92] Priv. Ltr. Rul. 8233051 (May 19, 1982); Priv. Ltr. Rul. 8248048 (August 30, 1982).

[93] Priv. Ltr. Rul. 8952019 (Sept. 28, 1989); Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

[94] Priv. Ltr. Rul. 9326006 (March 16, 1993).

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

2) the losses would be allocated on the basis of each continuing member's capital stock in the cooperative, not recent patronage,

3) the losses would be accounted for as an account receivable from each continuing member, and

4) each continuing member could repay its receivable by any of the following means, or a combination thereof: payment in cash, cancellation of equity, or cancellation of principal and accrued interest on loans the members had made to the cooperative.

IRS noted that the cooperative had shown that this plan had 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 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 patronage base would have penalized those members who supported the cooperative and rewarded those who did not.

IRS also permitted the cooperative to carry forward any losses not assessed against continuing members (under Code sec. 277, not sec. 172) and said continuing members may deduct the assessments as an ordinary loss under Code sec. 165(a).[96]

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.[97] The continuing members were then allowed to choose from several options to satisfy their receivables.

Three months later, the IRS again displayed a tolerance for flexibility. It permitted a cooperative to sign agreements with members providing that margins for the next 5 years would be

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[96] *Id.*

[97] *See also,* Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

used to offset each patron's share of a prior year's loss. Any unamortized losses remaining at the end of the 5 years would be absorbed by the cooperative and deductible at the cooperative level under Code sec. 165.[98]

When using accounts receivable, a cooperative that is an accrual basis taxpayer will, for tax purposes, recognize income when the receivables are established. The accounts receivable will be patronage-sourced income if the income is from patrons and is used to offset patronage losses that are the responsibility of the patrons.[99]

However, the cooperative can frequently offset that income with the loss carry forwards that the receivables are established to recoup. Thus, another wash situation may be created, with no direct tax consequences for the cooperative.[100] But the association will have to consider the alternative tax net operating loss deduction limit of 90 percent of any loss carryover and other required adjustments in computing its alternative minimum taxable income for the year.[101]

When the patrons pay off the receivables, the cooperative doesn't have to recognize the amounts received as income because it has previously recognized the receivable.[102]

The Service permits accrual-basis patrons to deduct the amount of the assessment as an ordinary loss under Code sec. 165(a) in the year the account receivable is established.[103] Cash basis patrons can claim the loss in the year the account is settled.

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[98] Priv. Ltr. Rul. 8248034 (Aug. 30, 1982).

[99] Priv. Ltr. Rul. 8952019 (Sept. 28, 1989); Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

[100] Rev. Rul. 81-103, 1981-1 C.B. 447; Priv. Ltr. Rul. 8233051 (May 19, 1982); Priv. Ltr. Rul. 8952019 (Sept. 28, 1989); Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

[101] I.R.C. § 56(a)(4) and § 56(d).

[102] Priv. Ltr. Rul. (Nov. 21, 1975); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

[103] Priv. Ltr. Rul. 8233051 (May 19, 1982).

Redeeming Equities at Less Than Face Value

The general issues of redeeming equity at less than face value, and the tax consequences thereof, are discussed at the end of Chapter 9 of this series of reports.[104] At the risk of redundancy, the topic is revisited, primarily in response to a court decision that calls into question the tax treatment of a cooperative that redeems qualified patronage-based equities as reported in the earlier report.[105]

A review of the applicable IRS rulings indicates cooperatives redeem equity at less than face value for one or more of four primary reasons:

1. To remove old equity from the books without seriously depleting cash.[106] This is sometimes done as part of a program to remove former patrons from the membership rolls.[107]

2. To get cash into the hands of current members as promptly as possible. Members may be given the option to redeem recently issued patronage-based equities before they would be paid off during the regular revolving cycle. This is done at a discount, usually reflecting the current value of the paper, to protect the interests of members who leave their allocations in the cooperative.[108]

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[104] Donald A. Frederick and John D. Reilly, *Income Tax Treatment of Cooperatives: Distribution, Retains, Redemptions and Patrons' Taxation*, RBS Cooperative Information Report 44, Part 3 (USDA 1996), pp. 90-96, 113-115.

[105] Gold Kist v. Commissioner, 110 F.3d 769 (11th Cir. 1997); *rev'g*, 104 T.C. 696 (1995). At the time Part 3 was written, Gold Kist had just petitioned the Tax Court challenging IRS's position. CIR 44, Part 3, p. 96.

[106] Priv. Ltr. Rul. 7410291300A (Oct. 29, 1974); Priv. Ltr. Rul. 7743054 (July 28, 1977).

[107] *See*, Tech. Adv. Mem. 8015048 (Dec. 31, 1979). For a discussion of the practical and legal reasons to terminate memberships of former patrons, see Donald A. Frederick, *Keeping Cooperative Membership Rolls Current*, ACS Cooperative Information Report 37 (USDA 1991).

[108] Tech. Adv. Mem. 7840010 (June 22, 1978); Priv. Ltr. Rul. 8031041 (May 8, 1980); Priv. Ltr. Rul. 8033070 (May 22, 1980); Priv. Ltr. Rul. 8225100 (March 25, 1982); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987); Tech.

3. To recoup a loss from the patrons whose business led to the loss.[109]

4. To clear the books of old equity as part of an effort to establish a systematic equity redemption program.

One advantage of this approach is that it conforms to the IRS desire that the loss be allocated to the patrons whose business generated it. A second advantage is a practical one. The patron doesn't have to make any cash outlays to the cooperative.

One disadvantage is that the cooperative doesn't receive any cash. Another is that redeeming part of its equity may have negative consequences on its balance sheet. Also, patrons' investments may be less commensurate with current use of its services.

In this context, two distinct "losses" may be involved. The redemption at less than face value may or may not be triggered by a financial loss at the cooperative level. From the patron's perspective, a loss is always involved, regardless of the motivation for the cooperative's action.

Nonqualified Allocations

The rulings dealing with redemption of nonqualified allocations involve recouping an operating loss. In each instance, the cooperative allocated the loss to its patrons by establishing accounts receivable from the patrons. It then recovered the loss by offsetting the accounts receivable with the nonqualified allocations.[110]

When allocations are made in nonqualified form, the cooperative is not permitted a tax deduction and the patrons have no reportable income. When the accounts receivable are offset against the nonqualified equity, the Service assumes the cooperative redeemed the nonqualified allocation in cash at face

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

[109] *See, e.g.*, Rev. Rul. 70-407, 1970-2 C.B. 52; Rev. Rul. 81-103, 1981-1 C.B. 447; Priv. Ltr. Rul. 8624019 (March 10, 1986); Priv. Ltr. Rul. 9202026 (Oct. 11, 1991).

[110] Rev. Rul. 81-103, 1981-1 C.B. 447; Priv. Ltr. Rul. 7926068 (March 29, 1979); Priv. Ltr. Rul. 8248048 (August 30, 1982).

value and the patron then paid money to the cooperative to settle the account receivable. The cooperative is allowed a deduction for the redemption of the nonqualified allocation under Code sec. 1382(b)(2).[111]

The patrons are entitled to an ordinary loss deduction under Code sec. 165(a) for the amount of the assessment in the year the account receivable is established. However, when the nonqualified allocations are "redeemed" to collect the account receivable, the patrons have taxable income as provided in Code sec. 1385.[112]

This situation creates an overall wash at both the cooperative and patron level. The cooperative realizes income when it issues the nonqualifieds and a deduction when it redeems them. The patrons have a deduction for an ordinary loss when the accounts receivable are issued as "negative patronage refunds" and income when the nonqualifieds are redeemed to collect the accounts receivable.

Qualified Allocations

For many years, recouping losses by canceling qualified allocations was also treated as a wash, although a different path was taken to reach that end, one reflecting the differing initial tax implications when qualified allocations are distributed. However, the recent *Gold Kist* opinion[113] has challenged that result.

While it might be more logical to look first at the tax consequences of redeeming equity at less than face value for the cooperative, this discussion will focus first on the impact on patrons. This is primarily because *Gold Kist* looks only at the cooperative.

Patron Tax Treatment.

The basic rule for patrons was established even before enactment of Subchapter T:

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[111] Rev. Rul. 81-103, 1981-1 C.B. 447; Priv. Ltr. Rul. 7926068 (March 29, 1979).

[112] Priv. Ltr. Rul. 8248048 (August 30, 1982).

[113] *Infra*, note 146.

- If the amount of the original allocation that the patron included in taxable income in the year of distribution was more than the amount of money the patron received at the time of redemption, the difference was an ordinary loss in the year of redemption.
- If the amount of the original allocation that the patron included in taxable income in the year of distribution was less than the amount of money the patron received at the time of redemption, the difference was ordinary income in the year of redemption.[114]

For example, assume patron "P" received a patronage refund of $100 in 1950 and the entire refund was retained by the cooperative as equity allocated to P. In 1956 the cooperative redeemed that equity for $60. If P reported the $100 patronage refund as income in 1950, then P could claim an ordinary loss in 1956 of $40 ($100-$60). If P did not report the allocation in 1950, then P would have to report the $60 payment as income in 1956 ($60-$0).

The same general scheme was applied to losses occurring after enactment in 1962 of subchapter T. This treatment is available regardless of the reason the cooperative redeems the equity for less than face value. In fact, the landmark IRS ruling[115] doesn't even mention why the equity was redeemed for less than face value. It merely reports a cooperative issued qualified written notices of allocation to patrons in 1963 and redeemed them in 1968 at less than the stated dollar amount.

The Service stated matter-of-factly that the patron had suffered a loss. The question addressed was whether the loss was an ordinary or a capital loss. IRS said:

> The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer's trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the

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[114] Priv. Ltr. Rul. 8225100 (March 25, 1982).

[115] Rev. Rul. 70-64, 1970-1 C.B. 36, *suspended by* Notice 87-68, 1987-2 C.B. 378.

> qualified written notice of allocation is an ordinary loss deductible for 1968 under the provisions of section 165 of the Code. See *Corn Products Refining Company v. Commissioner*, 350 U.S. 46 (1955). [other citations omitted] The loss is measured by the difference between the stated amount included in income in 1963 and the amount received upon redemption.[116]

IRS expanded on this holding in Revenue Ruling 70-407.[117] It presented facts wherein a cotton marketing cooperative suffered a loss when it made cash advances to patrons that proved to be excessive because of an unanticipated decline in the price of cotton. In the following year the cooperative recovered the loss by offsetting each patron's pro rata share against book credits representing retained qualified written notices of allocation. The Service said:

- The patrons are entitled to an ordinary loss, equal to the value of the credits canceled, under Code section 165(a).
- As to those patrons who lacked sufficient book credits to cover their share of the loss, it can be offset against future patronage allocations. The full amount of the patronage allocation should be included in the patron's gross income, and then the allocated loss reported as a deduction.

Even greater flexibility was approved in a letter ruling to a section 521 cooperative with three departments: a supply function, a grain marketing program that handled both sunflowers and soybeans, and a cotton ginning and marketing program.[118] The cooperative suffered a loss in one year on its sunflower marketing.

The cooperative prorated the loss among sunflower patrons. It proposed offsetting the loss first against any grain department book credits of each patron. Next, any remaining loss would be

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[116] *Id.*

[117] Rev. Rul. 70-407, 1970-2 C.B. 52.

[118] Priv. Ltr. Rul. 7804083 (Oct. 28, 1977).

offset against each patron's cotton and supply department credits. Any loss still not recouped would be recognized as an account receivable and collected from future grain, cotton, or supply department patronage refunds or any other normal method of collecting accounts receivable.

Citing Revenue Ruling 70-407, IRS said the patrons could treat any offset of book credits or future patronage allocations as an ordinary loss under Code section 165(a). It also said recovering the loss in this manner would not adversely impact the cooperative's section 521 status.

Similarly, in a letter ruling involving a bank that qualified as a Subchapter T cooperative, IRS said:

> To the extent a member/patron has previously recognized income with respect to qualified written notice of allocation pursuant to section 1385(a) of the Code, the member/patron may take an ordinary loss under section 165(a) for the year that the notice of cancellation is received.[119]

The IRS point of emphasis is recovering the loss, on a pro rata basis, from the patrons whose business generated the loss. It doesn't require that the business producing the equity that is canceled be related to the loss. Canceling equity is simply a convenient alternative, acceptable to the Service, to having the patrons write checks to the cooperative for their shares of the loss. It makes good sense as the funds conveyed by checks from the patrons could have come from any source of income available to the patrons.

These rulings dealt with equity accumulated as retained qualified written notices of allocation. Patrons have likewise been allowed to claim an operating loss under Code section 165(a) when patronage losses are recouped by canceling equity representing qualified per-unit capital retains.[120]

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[119] Priv. Ltr. Rul. 8624019 (March 10, 1986).

[120] Priv. Ltr. Rul. 7950064 (Sept. 14, 1979); Priv. Ltr. Rul. 8812019 (Dec. 16, 1987); Priv. Ltr. Rul. 8952019 (Sept. 28, 1989).

One cloud hangs over this favorable tax treatment for patrons. Revenue Ruling 70-64 cited the U.S. Supreme Court decision in *Corn Products Refining Co. v. Commissioner.*[121] For over 30 years, *Corn Products* had been construed to permit ordinary income (and loss) treatment for certain business-motivated transactions in stock and other capital assets. Because patrons acquire equity in a cooperative as part of their on-going business relationship with it, the tie-in between the case and ordinary loss treatment for patrons when equity is canceled or redeemed at less than face value appeared beneficial to patrons.

However, in 1986, the U.S. Court of Appeals for the Eighth Circuit reinterpreted *Corn Products*. It said that capital stock (not held by a dealer or otherwise within the exceptions listed in Code section 1221) is always a capital asset, regardless of the taxpayer's business motivation in acquiring or holding the stock.[122]

IRS responded to the Eighth Circuit decision by suspending its published revenue rulings that relied on the so-called *Corn Products* doctrine, pending Supreme Court review in *Arkansas Best.*[123] Revenue Ruling 70-64 was one of three rulings specifically listed in Notice 87-68.

In March of 1988, the U.S. Supreme Court affirmed the Eighth Circuit opinion in *Arkansas Best.*[124] Under this decision, all property not specifically excluded under Code section 1221 is a "capital asset" for tax purposes and the gain or loss on the sale of such assets, regardless of the motive for their purchase or disposition, is a capital and not an ordinary gain or loss.

The Court of Federal Claims applied *Arkansas Best* in a cooperative context in *Cenex v. United States.*[125] Cenex was one of nine farm supply cooperatives that formed a new association, Energy Cooperative Inc. (ECI), to purchase and operate a petroleum refinery. The venture's objective was to obtain access

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[121] Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

[122] Arkansas Best v. Commissioner, 800 F.2d 215 (8th Cir. 1986).

[123] Notice 87-68, 1987-2 C.B. 378.

[124] Arkansas Best v. Commissioner, 485 U.S. 212 (1988).

[125] Cenex v. United States, 38 Fed.Cl. 331 (1997), *aff'd*, No. 98-5046 (Fed. Cir. Oct. 9, 1998).

to a secure supply of petroleum products for the cooperatives' producer members. It failed and dissolved in bankruptcy.

Cenex claimed an ordinary loss deduction for the amount of its unrecoverable investment in ECI.[126] 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. ... (P)laintiff's loss on its investment in the ECI stock is properly subject to capital-asset treatment under § 1221.[127]

To date, the rulings mentioned in Notice 87-68, including Revenue Ruling 70-64, have not been revoked but remain temporarily suspended. It is also noteworthy that the notice itself concluded, "No inference is intended as to whether the result reached in any suspended ruling would be correct using another rationale."[128]

When IRS next addressed this issue, it continued to permit patrons to take an ordinary loss deduction when qualified patronage equities are redeemed at less than face value.[129] It mentioned Code section 1221's definition of "capital asset," but then relied on Revenue Ruling 70-407, which was not mentioned in Notice 87-68.

Thus a wash situation is created at the patron level. The patron includes the face value of retained qualified allocations in

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[126] Most of this equity was obtained as the result of a direct purchase of an equity interest in ECI, a small amount as a retained patronage refund allocation.

[127] *Id.* at 338-339.

[128] Notice 87-68, 1987-2 C.B. 378.

[129] Priv. Ltr. Rul. 8952019 (Sept. 28, 1989).

taxable income when received and claims an ordinary loss under Code sec. 165(a) when the allocation is canceled or redeemed for less than face.

Whether this treatment of patrons will continue is uncertain.[130] It was part of an overall taxing scheme which required cooperatives that redeemed qualified equities at less than face value (and had deducted the value of the allocations when made) to include the difference between face value and cash paid out in gross income in the year of redemption. Now that the cooperative's duty to include the value of the canceled equity in income has been questioned, whether the Service will continue to permit patrons to claim an ordinary loss is unclear.[131]

Cooperative Tax Treatment

The tax consequences for a cooperative that redeems qualified allocations at less than face value has shifted more than once.

In a case predating Subchapter T, the court was asked to determine a single narrow issue, whether retained patronage refunds represented debts of the cooperative or capital contributions to it. The Service had agreed with the cooperative that if the court found (as it did) that the retains were equity, no gain or loss resulted from their cancellation in a partial liquidation.[132]

In a 1974 letter ruling,[133] the IRS reviewed a proposal of a cooperative that wished to simplify its capital structure and put

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[130] *See, e.g.*, note 20 in the Tax Court's opinion in the Gold Kist case, 104 T.C. 696 (1995), wherein the court raises the issue of whether patrons are entitled to ordinary loss treatment when they receive less than face value for their qualified retained allocations and then specifically declines to address it.

[131] A recently released Market Segment Specialization Program document, *Farming -- Specific Income Issues and Farm Cooperatives*, does state that a discounted redemption "gives rise to an ordinary loss to the farmer in the amount of the discount. See Rev. Rul. 70-407, 1970-2 C.B. 52." IRS Training Document No. 3147-114, p. 6-2 (1997).

[132] Pasco Packing Ass'n v. United States, 57-2 USTC (CCH) ¶ 9849 (S.D. Fla. 1957).

[133] Priv. Ltr. Rul. 7410291300A (Oct. 29, 1974).

some money into the hands of former patrons by redeeming old patronage allocations at 20 cents on the dollar. Many allocations were made before 1962 and the cooperative didn't know whether the patrons had reported them as income in the year received. But the cooperative had deducted them from its taxable income in the years of issuance.

Citing *Pasco Packing*, the Service first determined that these allocations were equity, not debt. Then, relying on Code section 311(a), it said the cooperative did not have to recognize gain on the proposed redemption of "qualified" equity at less than face value. Code sec. 311(a) provides that, except for certain exceptions not relevant here, no gain or loss is recognized by a corporation on distributions regarding its stock of other stock, rights to acquire stock, or property.[134]

The Service also said patrons would not have to recognize gain, if any, in excess of the amount of cash received. Thus the 80 cents of every dollar of redeemed equity that the cooperative kept as unallocated equity escaped taxation.

In 1977, IRS changed its position. On essentially the same facts as the 1974 ruling, it said that the "tax benefit rule" prevails over Code sec. 311. The cooperative will recognize gain to the extent that its previous deductions for the retained allocations exceed the amount of money distributed to patrons at the time of redemption.[135]

The "tax benefit rule" has been in force in one form or another almost since enactment of the 16th Amendment and the decision to levy the income tax on an annual accounting basis. It was immediately recognized that some transactions would take 1 or more tax years to complete. When a taxpayer was able to deduct something in one year and recover the amount deducted in a subsequent year, the courts said taxpayer had to include the recovered amount in income in the year of recovery.[136]

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[134] I.R.C. § 311(a). "Property" includes "money," I.R.C. § 317(a).

[135] Priv. Ltr. Rul. 7743054 (July 28, 1977).

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

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

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

In 1942, the predecessor to current Code sec. 111 was enacted to protect taxpayers in this situation. Section 111 states that a taxpayer need not include in gross income "income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax" owed in the prior year.[137] Thus, while Congress didn't specifically codify the tax benefit rule, it implicitly recognized it and limited its applicability to the amount of tax savings realized in the earlier year.

Today, the tax benefit rule is characterized as one of inclusion and exclusion. "Recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded*."[138]

After 1977, the Service consistently relied on the tax benefit rule to require a cooperative that deducts a qualified allocation in the year of issuance to include the difference between the face value of the allocation and any lesser amount actually paid to redeem the allocation in income in the year of redemption.[139]

Gold Kist, a major cooperative in the Southeast, challenged the Service's position. When a membership in Gold Kist is terminated, the member may ask the cooperative to redeem its qualified retained patronage refunds. Gold Kist will normally

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[137] I.R.C. § 111(a).

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

[139] *See, e.g.*, Tech. Adv. Mem. 7840010 (June 22, 1978); Priv. Ltr. Rul. 8225100 (March 25, 1982); Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

honor the request, but will reduce the amount paid to reflect the present value of the retains. Gold Kist doesn't report as income the difference between the face value of the retains and the discounted amount paid the patrons.

In 1992, the Service, relying on the tax benefit rule, issued a letter ruling adverse to Gold Kist and informing the cooperative that when it redeemed qualified allocations for less than the amount of the deduction it claimed upon issuance, it must report the difference in taxable income for the year of redemption.[140] Gold Kist filed an appeal with the U.S. Tax Court.

Gold Kist raised two arguments. First, it said that the tax benefit rule did not apply in this case. Gold Kist relied on the U.S. Supreme Court's interpretation of the tax benefit rule in *Hillsboro National Bank v. Commissioner*.[141] In *Hillsboro,* the Court stated:

> Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed *fundamentally inconsistent* with the premise on which the deduction was initially based. (emphasis added)[142]

Gold Kist asserted that the transaction creating the patronage refund deduction at the cooperative level was completed when the allocation was made and the patron consented to include the amount of any retained allocation in its income. As Subchapter T didn't require that any amount ever be paid out in redemption of the retained allocation, there could not be a "fundamental inconsistency" between the original patronage refund distribution and the later redemption of the retained portion at less than face value.[143]

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[140] Tech. Adv. Mem. 9249005 (Dec. 4, 1992).

[141] Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

[142] 460 U.S. at 383.

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

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

The Tax Court rejected both arguments.[144] First, it held that the purpose of Subchapter T is to ensure that someone pays a tax on patronage earnings. When a cooperative redeems a qualified patronage refund for less than face value and treats the residual as unallocated equity, the retained portion is no longer a patronage refund. This is fundamentally inconsistent with the notion that patronage refunds are deductible at the cooperative level.

Second, the Tax Court found that while qualified written notices of allocation may be equity, they aren't "stock" as the term is used in Code sec. 311. Thus Code sec. 311 isn't applicable and the court concluded it didn't have to decide whether the tax benefit rule overrode sec. 311.[145]

The cooperative appealed and the U.S. Court of Appeals for the 11th Circuit reversed.[146] The appellate court determined that a patron's consent to include all of a qualified patronage refund in taxable income indicates constructive receipt of the entire refund and a reinvestment of the portion retained by the cooperative. A subsequent redemption is not connected to the original allocation, so the tax benefit rule can't apply. The court summarized:

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

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

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

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

> So, as the structure and legislative history of Subchapter T make clear, Gold Kist's deduction is premised on its patrons' consent to include the stated amount of the written notice in gross income. We cannot say that Gold Kist's redemption of qualified written notices of allocation for less than their stated amounts is fundamentally inconsistent with this premise. A tax year 1987 deduction, for example, is not initially premised on a commitment by Gold Kist to pay in real dollars the stated value of the qualified written notice of allocation; payment twenty years later of that amount is simply not the equivalent of the 1987 stated value.[147]

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

A simple example will illustrate the impact of this decision. Assume Cooperative (C) has a marginal tax rate of 34% and Patron (P) a marginal tax rate of 28%, the basic rates applied to middle-income taxpayers. Table 1 portrays a typical allocation decision by a cooperative. It then illustrates the different tax consequences under the IRS position and the *Gold Kist* decision when the qualified written notices of allocation are redeemed in a subsequent year at less than face value.

TABLE 1 -- ALLOCATION AND SUBSEQUENT REDEMPTION AT LESS THAN FACE VALUE

Year of Allocation. In 1992, C paid a patronage refund of $100 to P, consisting of $20 in cash and a qualified written notice of allocation for $80, which was credited to P's equity account in C.

- C acquired $80 of equity and had $0 tax liability on the $100 margin.

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147 110 F.3rd at 773.

- P received $20 in cash.

- P included the entire patronage refund in taxable income, so P had a tax liability of $28 ($100 x 28%).

- P acquired an ownership interest in $80 of C's equity.

Year of Redemption at Less Than Face Value, IRS Method. In 1998, C redeems P's 1992 equity allocation at 50 cents on the dollar.

- C reduces its member equity account by $80. C pays $40 to P.

- C recognizes the $40 of canceled equity as taxable income and pays federal income tax of $13.60 ($40 x 34%). The remaining $26.40 is accounted for as unallocated equity.

- P receives $40 in cash.

- P deducts the face value of the canceled equity, $40, from other taxable income and realizes a tax savings of $11.20 ($40 x 28%).

- Thus P receives a total of $51.20 for equity with a former book value of $80.

Year of Redemption at Less Than Face Value, *Gold Kist* Method. In 1998, C redeems P's 1992 equity allocation at 50 cents on the dollar.

- C reduces its member equity account by $80. C pays $40 to P.

- C does not recognize the $40 of canceled equity as taxable income and pays no additional Federal income tax. This leaves $40 to be accounted for as unallocated equity.

- Patron tax treatment appears to be unchanged. P receives $40 in cash. P deducts the face value of the canceled equity, $40, from other taxable income and realizes a tax savings of $11.20 ($40 x 28%). P still receives $51.20 for equity with a former book value of $80.

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

TABLE 2 -- WHERE DID THE MONEY GO?

IRS Method:

C	$26.40 in unallocated equity		
P	$43.20 cash	1992, $-8	($28 in taxes less $20 cash received)
		1998, $51.20	($40 cash from C and $11.20 tax savings)
IRS	$30.40 cash	1992, $28.00	(P's tax on the $100 qualified allocation)
		1998, $2.40	(C's tax of $13.60 less P's $11.20 savings)
	$100.00		

***Gold Kist* Method:**

C	$40.00 in unallocated equity	
P	$43.20 cash	Same as IRS method
IRS	$16.80 cash	(P's 1992 tax of $28.00 less P's 1998 savings of $11.20)
	$100.00	

First, the decision has no impact on members and other patrons. They can still deduct the difference between the face value of their equity and the amount of money received from the cooperative. See, e.g., that sample patron P winds up with $43.20 cash under either method.

Second, the cooperative has more money and IRS less. In this example, the difference is $13.60 for each $100 of margins. The $13.60 difference in the IRS take results from the fact that under *Gold Kist* the $40 now placed in unallocated equity has escaped taxation.

The more patronage equity converted to unallocated equity, the less money IRS ultimately receives. Now, here's some food for thought. Assume the members approve canceling all of their 1992 equity allocation. Table 3 shows the consequences.

TABLE 3 -- TOTAL CANCELLATION OF QUALIFIED ALLOCATION

- If the entire $80 in retained equity is converted to unallocated equity, P benefits from a tax savings in 1998 of $22.40 ($80 x 28%).

- C has $80 of tax-free unallocated equity.

- P has $14.40 ($20 cash received in 1992, less $28 tax obligation in 1992, plus $22.40 tax savings in 1998).

- IRS gets only $5.60.

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

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

Also, IRS is not likely to acquiesce in the *Gold Kist* decision. In a letter ruling issued after the decision, IRS said a corporation formed to provide network services to its members operated on a cooperative basis within the meaning of Code sec. 1382(a)(2). The cooperative's bylaws authorized it to redeem patronage equities of former members or other patrons, upon their request, at a discount. A footnote to the ruling states that "Co-op agrees that if it redeems a patron at discount, it will include the discounted amount in income (as nonpatronage sourced) pursuant to the tax benefit rule."[148]

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.

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[148] Priv. Ltr. Rul. 9742030, n.1 (July 21, 1997). The Service has also drafted a proposed coordinated issues paper under the Industry Specialization Program taking the position that the tax benefit rule requires a Subchapter T cooperative to recognize income if it redeems its qualified written notices of allocation at a discount and that such income is nonpatronage sourced. *See* TAXFAX, The Cooperative Accountant, Fall 1998, pp. 48-49.

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. The loss is carried over to other years at the cooperative level. It is offset against margins of other years, resulting in reduced patronage refunds for patrons of those years.[149]

An example is found in the leading case of *Associated Milk Producers*.[150] 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

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[149] 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.

[150] Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977).

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."[151]

Even as IRS was litigating to prevent loss carryovers, it issued an apparently conflicting letter ruling. The cooperative had two 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."[152]

After the *AMPI* decision and subsequent cases holding cooperatives could have losses for tax purposes,[153] 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.

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[151] *Id.* at 739.

[152] 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.

[153] *Supra*, pp. 21-25.

The Director of IRS's Corporate Tax Division referred the matter to the Office of General Counsel for review. After noting the Tax Court opinions in *AMPI*[154] and *Ford Iroquois*[155] 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.[156]

A letter ruling on the same facts and reaching the same conclusions was issued shortly.[157]

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.[158] In another, the terminating members of a cooperative with substantial losses had their equities 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

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[154] Associated Milk Producers v. Commissioner, 68 T.C. 729 (1977).

[155] Ford Iroquois F.S. v. Commissioner, 74 T.C. 1213 (1980).

[156] 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. 85-91.

[157] Tech. Adv. Mem. 8247011 (July 28, 1982).

[158] Priv. Ltr. Rul. 8540051 (July 3, 1985); Priv. Ltr. Rul. 8540056 (July 8, 1985).

taxable years.[159] 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.[160]

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 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

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[159] Priv. Ltr. Rul. 8812019 (Dec. 16, 1987).

[160] Priv. Ltr. Rul. 9021013 (Feb. 21, 1990).

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."[161]

The regulations likewise provide a section 521 cooperative can have a reserve.[162] 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)."[163] This suggests that the only time a section 521 cooperative 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.[164] 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."[165]

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

> ...(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

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[161] I.R.C. § 521(b)(3).

[162] Treas. Reg. § 1.521-1(a)(3).

[163] Treas. Reg. § 1.521-1(c).

[164] Ltr. Rul. 6503036020A (March 3, 1965).

[165] *Id.*

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."[166]

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.[167] 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 written that such a cooperative "may offset any deficit in operations by use of a reserve set up for such purpose."[168]

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.

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[166] *Id.*

[167] Tech. Adv. Mem. 8015048 (Dec. 31, 1979).

[168] Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

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 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 is 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."[169]

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[169] 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).

On appeal the 8th Circuit, while affirming much of the Tax Court opinion, reversed this holding.[170] 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.[171]

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:

> 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.[172]

In 1963, the IRS adopted the position taken by the Eighth Circuit Court of Appeals.[173]

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

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

[171] 288 F.2d at 332.

[172] 288 F.2d at 333.

[173] Rev. Rul. 63-58, 1963-1 C.B. 109.

activity. The bylaws required the cooperative to allocate margins and losses to the patrons of the function that generated them.[174]

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).[175]

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.[176] He concluded that while staff was literally 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.[177] 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.

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[174] Gen. Couns. Mem. 33,631 (Sept. 22, 1967).

[175] I.R.C. § 1388(a)(3).

[176] 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; Rev. Rul. 67-128, 1967-1 C.B. 147.

[177] Gen. Couns. Mem. 33,795 (April 11, 1968).

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.[178]

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 income from member payments in the following year(s).[179] The applicability of sec. 277 to cooperatives is explored in detail in the next section of this report. Also, the Service was developing its position that a cooperative simply couldn't have a loss for tax purposes.[180]

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.[181]

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

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[178] Rev. Rul. 67-253, 1967-2 C.B. 214.

[179] I.R.C. § 277.

[180] *Supra*, pp. 19-21.

[181] Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

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 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.[182]

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) Cooperatives, whether they had section 521 status or not, could not net earnings of one function against losses of the other function.

2) Cooperatives, whether they had section 521 status or not, could elect to net the results of different allocation units within a function.[183] If a cooperative wanted to net within a function, it would be required to notify the Commissioner and any change in the netting plan would require the Commissioner's approval.

3) Section 277 applied 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

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[182] 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).

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

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.[184] Also, the cooperative could carry the loss forward in the same allocation unit as a cost of operation in the succeeding year(s).

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.[185] 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.[186]

The Chief Counsel relied heavily on his belief that a cooperative 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.[187]

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[184] 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.

[185] Associated Milk Producers v. Commissioner, 68 T.C. 729 (1977); Farm Service Cooperative v. Commissioner, 70 T.C. 145 (1978).

[186] Gen. Couns. Mem. 37,578 (June 16, 1978).

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

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."[188]

In a second ruling,[189] 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* case[190] 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.

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[188] Tech. Adv. Mem. 7902004 (Sept. 27, 1978).

[189] Tech. Adv. Mem. 8245082 (Dec. 31, 1981).

[190] Ford-Iroquois FS v. Commissioner, 74 T.C. 1213 (1980).

The *Lamesa Cooperative Gin* case[191] 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 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."[192]

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.[193]

Any hope cooperatives had that IRS would permit greater flexibility in handling losses was shattered in early 1985 by the

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[191] Lemesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

[192] *Id.* at 907.

[193] *Id.* at 910.

issuance of a letter ruling revoking the section 521 status of Gold Kist Inc.[194]

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

[194] Tech. Adv. Mem. 8521003 (Jan. 25, 1985).

patronage refunds that the board had discretion to offset against losses in any other department.

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.

A Legislative Solution

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.[195] 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.[196]

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[195] 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.

[196] I.R.C. § 1388(j)(1).

Paragraph (2) makes clear that netting is also allowed after a cooperative acquires the assets of another cooperative through the 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.[197]

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.[198] 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.[199]

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

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[197] I.R.C. § 1388(j)(2).

[198] I.R.C. § 1388(j)(3).

[199] 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.[200]

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.[201]

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.[202]

Effective Dates

All of the provisions other than the notice requirements were made effective retroactive to tax years beginning after December 31, 1962.[203] 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.[204]

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 speci-

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[200] I.R.C. § 1388(j)(3)(B).

[201] I.R.C. § 1388(j)(3)(C).

[202] I.R.C. § 521(b)(6).

[203] 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.

[204] COBRA, § 13210(c)(2), 100 STAT. 324.

fically 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.[205]

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.[206]

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 nonpatronage income.[207] 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

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[205] COBRA, § 13210(c)(3), 100 STAT. 324. This language also was not codified.

[206] Gen. Couns. Mem. 39,587 (Dec. 3, 1986).

[207] Donald A. Frederick and John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds*, RBS Cooperative Information Report 44, Part 2 (USDA 1993, reprinted 1996) Chapter 5, pp. 18-49.

incidental to patronage activity, the loss is from nonpatronage sources.[208]

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.[209] 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.

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

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

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

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.[210] 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.[211]

A later letter ruling concerned a section 521 cooperative in the process of dissolution. It was permitted to carry forward a net operating loss and net it against nonpatronage income realized from the sale of assets during the dissolution period.[212]

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.[213]

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

[211] Ltr. Rul. 7202281240A (Feb. 28, 1972).

[212] Priv. Ltr. Rul. 9021013 (Feb. 21, 1990).

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

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,[214] 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.

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.[215]

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)

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

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

and may be carried back and forward to offset nonpatronage income in other years.[216]

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*[217] is an important decision 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).[218] (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.[219]

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[216] *Id.*

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

[218] 619 F.2d at 725, n. 16.

[219] For a thorough explanation of the cooperative perspective, *see* Clifford R. Fulton, *Relationship Netting Under Rev. Rul. 67-128: An End to*

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.[220] 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 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.[221]

Shortly after the taxpayer received this ruling, the U.S. Tax Court commented on the issue in *Certified Grocers of California, Ltd. v. Commissioner*.[222] 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

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the Isolation of Nonpatron Loss, The Cooperative Accountant, Summer 1986, at 55.

220 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).

221 *Id.*

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

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.[223]

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 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.[224]

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.

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[223] *Id.* at 251 n.21.

[224] Rev. Rul. 74-377, 1974-2 C.B. 274.

An early letter ruling concerned a wholesale grocery supply cooperative that divided its operations into five geographic divisions.[225] 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 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*.[226] 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 nonpatronage sources, such as gains on the sale of property, dividends on stock owned by the association, and incidental income.

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*,[227] 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

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[225] Tech. Adv. Mem. 7301319420A (Jan. 31, 1973).

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

[227] Associated Milk Producers v. Commissioner, 68 T.C. 729 (1977).

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 included offsetting the loss against otherwise taxable nonpatronage earnings.[228]

The Tax Court decision was reversed by the U.S. Court of Appeals for the 8th Circuit.[229] 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."[230]

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."[231]

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."[232]

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

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

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

[230] 619 F.2d at 727.

[231] 619 F.2d at 724.

[232] 619 F.2d at 727.

> nonpatronage-sourced income, then a (nonsection 521) cooperative could gain the tax advantages of a (section 521) cooperative without meeting the qualifications set forth in I.R.C. § 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.[233]

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."[234]

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 nonpatronage income and further that patronage losses may only be

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[233] *Id.*

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

carried forward to succeeding taxable years.[235] While the Service has accepted the Tax Court's rejection of its position that Code sec. 277 applies to nonsection 521 cooperatives,[236] the rule that patronage losses can't be netted with nonpatronage income remains firmly in place.[237]

A similar rule prohibits netting patronage-sourced expenses against nonpatronage income. *Certified Grocers of California v. Commissioner*[238] 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 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.

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

[236] 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. 85-91.

[237] 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).

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

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.[239]

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 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:

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[239] Treas. Reg. § 1.1502-80.

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.[240] Section 277 also provides that to the extent deductions from providing services and goods to members exceed member income in any year, the difference

[240] I.R.C. § 277(a).

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.[241]

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.[242]

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."[243]

On August 20, 1971, the Service's Regulations Policy Committee decided "Section 277 should be applied to cooperatives and should be vigorously enforced."[244] Yet, it was nearly 15 years before the Service began to routinely apply section 277 to cooperatives.

The first authoritative discussion of the applicability of section 277 to nonsection 521 cooperatives is in the Tax Court opinion in *Farm Service Cooperative*.[245] The Court held the

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[241] *Id. See also*, Tech. Adv. Mem. 8815001 (Nov. 3, 1987).

[242] 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).

[243] Gen. Couns. Mem. 34,334 (Aug. 17, 1970).

[244] Gen. Couns. Mem. 34,935 (July 3, 1972).

[245] 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.

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 the Service produced no evidence that the cooperative loss under consideration was a sham.[246]

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 ruling[247] 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.[248] 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.[249]

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.[250]

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.

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[246] 70 T.C. at 156-157.

[247] Priv. Ltr. Rul. 8233051 (May 19, 1982).

[248] Tech. Adv. Mem. 8247011 (July 28, 1982).

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

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

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 advise 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.[251]

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.[252] Landmark was a federated cooperative whose members were local grain marketing and supply cooperatives, also located in Ohio.

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

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[251] 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.

[252] Landmark v. United States, 25 Cl. Ct. 100 (1992).

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."[253]

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*.[254] While it never cited 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.

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[253] 25 Cl. Ct. at 108.

[254] Buckeye Countrymark v. Commissioner, 103 T.C. 547 (1994).

> 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.[255]

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 is not entitled to use nonpatronage income to subsidize its patronage activities.[256]

While this language was a disappointment to cooperatives that disagreed with the Eighth Circuit's opinion in *Farm Service*,[257] 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 6 years *Buckeye Countrymark* was under consideration, the Service raised the Code sec. 277 issue in numerous contexts.[258] But IRS did not appeal the decision and

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[255] 103 T.C. at 581-582.

[256] 103 T.C. at 570.

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

[258] Occasionally, a cooperative whose only concerns were having its losses recognized and carrying them forward, asked to be found subject

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.[259]

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.[260] 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.

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to § 277, Priv. Ltr. Rul. 8952019 (Sept. 28, 1989); or didn't object to having § 277 applied, Priv. Ltr. Rul. 9314013 (Jan. 6, 1993).

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

[260] I.R.C. § 216.

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).[261]

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.[262]

The housing cooperatives involved in these rulings obtained special legislative relief declaring the interest income was membership income.[263] 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.[264]

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

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

[262] Tech. Adv. Mem. 8532004 (April 17, 1985); Tech. Adv. Mem. 8532005 (April 17, 1985).

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

[264] 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).

certain reserve accounts was membership income under Code sec. 277. The court rejected the cooperative's position.[265]

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."[266]

But a concurring opinion, written by Judge Koener (and agreed to by 6 other judges), cited *Park Place* and *Concord Village* for 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)[267]

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).[268]

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

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[265] Concord Consumers Housing Cooperative v. Commissioner, 89 T.C. 105 (1987).

[266] 89 T.C. at 107, n.3.

[267] 89 T.C. 125, 126-127.

[268] Rev. Rul. 90-36, 1990-1 C.B. 59.

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.*[269] 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" within the meaning of Code sec. 1381(a)(2) and, as a Subchapter T cooperative, is not subject to Code sec. 277.[270] 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.

While *Trump Village* ignored Code sec. 216 a different Tax Court judge, in a subsequent decision involving similar facts, relied on it heavily.[271] 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 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.[272]

The court also addressed the nature of the interest income leading to the litigation. It found that the issue of whether it was

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[269] Trump Village Section 3 v. Commissioner, 69 T.C.M. (CCH) 2985 (1995).

[270] In late October the Service announced its acquiescence in *Trump Village.* The announcement referred to whether § 277 applied to a cooperative housing corporation described in § 216, which is also subject to subchapter T. 1995-44 I.R.B. 4 (Oct 30, 1995).

[271] Thwaites Terrace House Owners Corp. v. Commissioner, 72 T.C.M. (CCH) 578 (1996).

[272] 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.

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* appear to 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. Whether IRS will continue to force the issue is unclear. But certainly its burden, if it should do so, is substantial.

Rural Electric Cooperatives

In a 1991 letter ruling, the IRS applied Code sec. 277 to a "nonexempt" rural electric cooperative.[273] 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 downpayment 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 cooperative sold electricity to member-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

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[273] Tech. Adv. Mem. 9214009 (Dec. 13, 1991).

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.[274]

As all rural electric and telephone cooperatives are expressly excluded from Subchapter T coverage,[275] 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).[276] 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.[277]

This position was also rejected by the Tax Court.[278] 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

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[274] Announcement 96-24, 1996-16 I.R.B. 30, 45.

[275] I.R.C. § 1381(a)(2)(C).

[276] Buckeye Power, Inc., v. United States, 38 Fed.Cl. 154 (1997).

[277] Tech. Adv. Mem. 9124004 (March 13, 1991).

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

association "was not a membership organization for purposes of section 277."[279] 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.

[279] *Id.* at 663.

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Rural Business–Cooperative Service (RBS) provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

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