INCOME TAXATION OF EXEMPT FARMERS' COOPERATIVES

RICHARD R. MURPHEY, JR.*

The purpose of this article is to survey generally the conditions that must be met in order for a farmers' cooperative organization to achieve a so-called "tax exempt" status under section 521 of the 1954 Internal Revenue Code, and to consider the income tax advantages which result once such status is achieved.[1] Because of the broad brush that must be applied in sketching these points within the limits of a single article, no attempt has been made to do more than touch on the various factors which sometime pose tax problems in the operation of farmers' cooperatives.

All cooperatives have as their primary purpose the rendering of services to their patrons at cost. The services rendered by a farmers' cooperative, whether exempt or not, commonly fall into two categories; marketing of the products produced by its patrons, and purchasing on their behalf supplies and equipment used by them in their everyday living and in the operation of their agricultural pursuits. The operations of an exempt cooperative engaged in marketing can be briefly described as follows. The producers deliver their products to the exempt cooperative for sale by it, usually receiving at the time of delivery a substantial advance on the amount expected to be realized on the sale. When the total amount received from such sales is realized, the expenses of sale are deducted and the remaining proceeds, less prior advancements, are allocated to the producers as a patronage dividend[2] in proportion to the quality or quantity of products supplied by each of them. An exempt purchasing cooperative buys on behalf of its patrons those items they desire to acquire, receiving from each patron the estimated purchase price at time of delivery. At the close of the year's operations, the excess of the amounts paid to the exempt cooperative by its patrons over the cost to the exempt cooperative of the items furnished plus operating expenses is distributed as a patronage dividend in proportion to the amount of business done with each patron.

Since these patronage dividends are considered for tax purposes as the profit to the producer on the sale of his products in the case of an exempt marketing cooperative and a return of excess payment made by a patron of an exempt purchasing cooperative, they are not included as taxable income to the exempt cooperative, although such patronage dividends

*Of the firm of Dunbar, Dunbar & Kienzle, Columbus, Ohio.

[1] In order to simplify the necessarily repeated references to farmers' cooperative organizations, such organizations exempt under INT. REV. CODE OF 1954, §521 will hereinafter be referred to as "exempt cooperatives." Cooperatives not exempt under section 521 will be referred to as "taxable cooperatives."

[2] U. S. Treas. Reg. 118, §39.101(12)-2(b)(4) (1953), Proposed Reg. §1.522-1 (b)(4) (1956).

do constitute taxable income to the patron to whom they are paid or allocated.[3]

At the outset, it should be pointed out that all cooperatives, whether or not coming within the provisions of section 521, are required to file federal income tax returns which call for much of the same information as is required by the regular corporate income tax return. While the special deductions permitted under section 522 with respect to the computation of net income will, in most cases, cause the exempt cooperative to be relieved of the payment of any substantial amount of tax, the use of the term "tax exempt" as applied to such a cooperative has been inaccurate since passage of the Revenue Act of 1951, as failure to allocate all of its income on the basis of patronage or shareholdings will result in taxation of such unallocated income on the same basis as a corporation for profit.[4]

The statutory basis for special federal income tax treatment of exempt cooperatives[5] is presently found in INT. REV. CODE OF 1954, SECTIONS 521 and 522, which furnish a clear outline for this article.[6]

---

[3] Rev. Rul. 10, 1954-1 CUM. BULL. 24.

[4] U. S. Treas. Reg. 118, §39.101(12)-2(a) (1953), Proposed Reg. §1.522-1(a) (1956).

[5] Farmers' cooperatives have been afforded special tax treatment since the passage of the first income tax law in 1913. At that time they were exempted from tax by regulation on the ground that they fell within the classification of exempt "agricultural" organizations. The first direct reference to them in the income tax law appeared in the Revenue Act of 1916, §11(a)(12), 39 STAT. 766. The presently applicable statutes spring directly from this source, although in considerably amplified form.

[6] INT. REV. CODE OF 1954, §521. EXEMPTION OF FARMERS' COOPERATIVES FROM TAX.

(a) EXEMPTION FROM TAX. A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) APPLICABLE RULES.

(1) EXEMPT FARMERS' COOPERATIVES. The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) ORGANIZATIONS HAVING CAPITAL STOCK. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly in

Section 521 treats of the standards that must be met by a farmers' cooperative organization in order to be exempt from income taxation except to the extent provided in section 522. Section 522 deals with those special deductions from gross income afforded such an exempt cooperative

---

the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) ORGANIZATIONS MAINTAINING RESERVE. Exemption shall not be be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) TRANSACTIONS WITH NONMEMBERS. Exemption shall not be denied any such association which markets the products of nonmembers in an amount of value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) BUSINESS FOR THE UNITED STATES. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

INT. REV. CODE OF 1954, §522. TAX ON FARMERS' COOPERATIVES.

(a) IMPOSITION OF TAX. An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) COMPUTATION OF TAXABLE INCOME.

(1) General rule. In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter)—

(A) amounts paid as dividends during the taxable year on its capital stock, and

(B) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) PATRONAGE DIVIDENDS, ETC. Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

which serve to relieve it from the full brunt of the regular income and capital gains taxes levied by INT. REV. CODE OF 1954, SECTIONS 11 and 1201, respectively. Sections 521 and 522 are, except for editorial revision, almost identical with INT. REV. CODE OF 1939, SECTION 101 (12), as last amended.[7] Because treasury regulations with respect to sections 521 and 522 have not been finalized as of the time of the preparation of this article and since there are no substantive statutory changes from the 1939 Code, reference is made throughout this article to the regulations applicable to INT. REV. CODE OF 1939, SECTION 101 (12).[8]

In keeping with the rather elementary approach which must be taken in such a general survey as is attempted here, it seems advisable to set out a few general definitions classifying the persons who deal with exempt cooperatives, particularly since most of the articles and cases dealing with the subject assume that the reader is acquainted with such terminology.

The word "patron," which is specifically defined in the Regulations,[9] means any person, whether an individual or an artificial entity, with whom or for whom an exempt cooperative does business on a cooperative basis, regardless of whether such person is or is not a member of the exempt cooperative. The relationship between an exempt cooperative and its patrons is the keystone of the tax status afforded it, and any discrimination among patrons, regardless of their member or nonmember status, will expose an exempt cooperative to a disallowance of its tax excemption.[10]

The word "producer" means a person, whether an individual or an artificial entity, who is engaged in the production of either farm products or products so closely allied to the farming industry as to constitute, in the eyes of the Treasury, a proper commodity for marketing by an exempt cooperative.

The word "member" means a person, whether an individual or an artificial entity, who, because of ownership of stock or a certificate of membership, or for some other reason, is entitled to participate in the management of an exempt cooperative.[11]

A "nonmember" is a patron of an exempt cooperative who has no direct voice in its management.

A farmers' cooperative organization establishes its right to special

---

[7] Rev. Act of 1951, 65 STAT. 490.

[8] The proposed Regulations to sections 521 and 522 promulgated in 21 FED. REG. 418, et seq. (1956) are almost identical with the Regulations applicable to section 101(12) of the 1939 Code.

[9] U. S. Treas. Reg. 118, §39.101(12)-2(b)(2) (1953), Proposed Reg. §1.522-1(b)(2) (1956).

[10] U. S. Treas. Reg. 118, §39.101(12)-1(a)(1) (1953), Proposed Reg. §1.521-1(a)(1) (1956).

[11] U. S. Treas. Reg. 118, §39.101(12)-1(a)(2) (1953), Proposed Reg. §1.521-1(a)(1) (1956).

tax treatment under section 522 by filing a two-page exemption application (Form 1028) with its local district director of internal revenue. The application includes a number of questions the answers to which determine whether the applicant meets the requirements of section 521. If the applicant satisfies such requirements, an exemption letter is issued, after which the cooperative is authorized to file its income tax returns on Form 990-C and to take the deductions permitted under section 522 in determining net income.

As the foregoing paragraph indicates, the standards for determining the tax exempt status of a farmers' cooperative organization are set out in section 521. More specifically, they are contained in subsection (b) thereof which contains five subparagraphs. The first of these states the purposes for which exempt cooperatives may be operated, while the succeeding subparagraphs spell out various operating techniques which may be utilized without endangering the exempt cooperative's status.

Exempt Activities

The types of farmers' cooperatives that are exempt from taxation except as provided under section 522 are defined in section 521(b)(1) as being "farmers', fruit growers', or like organizations." Neither the Internal Revenue Service nor the courts have clearly indicated what tests must be met to constitute a "like association" within the above quoted language. It has been determined by the courts that such organizations as cooperative advertising associations[12] and scavenger service cooperatives[13] are outside the tax exempt pale. These decisions rejected the inclusion of billboard advertising and garbage collection, respectively, within the "like association" category on the basis of the doctrine of *ejusdem generis*. This principle was set out by the Treasury with respect to farmers' cooperatives as early as 1922,[14] and was recently repeated in a 1955 revenue ruling.[15] This ruling considered requests by a fishermen's cooperative association and an oyster-growers' cooperative association that they be considered exempt farmers' cooperative purchasing associations within the meaning of 521(b)(1). In spite of the fact that under the applicable state laws the fishermen's association had been held to be an "agricultural association" and fish "agricultural products," it was ruled that such activities could not qualify an association for exemption.[16]

12 National Outdoor Advertising Bureau, Inc., v. Helvering, 89 F. 2d 878 (2d Cir. 1937), 19 A.F.T.R. 619, 37-1 U.S.T.C. ¶9289.

13 Sunset Scavenger Co. v. Comm'r, 84 F. 2d 453, 17 A.F.T.R. 1319, 36-2 U.S.T.C. ¶9366 (9th Cir. 1936).

14 I. T. 1312, I-1 Cum. Bull. 263 (1922).

15 Rev. Rul. 611, 1955 Int. Rev. Bull. No. 41, at 10.

16 Ohio Rev. Code §1729.01, which deals with agricultural cooperative organizations includes in its definition of "agricultural products" such farm activities as beekeeping, vitaculture, and forestry. However, under the rule set out in Munroe L. Lyeth v. Hoey, 305 U. S. 188 (1938), provisions of state laws are not controlling in determining federal income tax status.

A treasury regulation[17] has included dairying and livestock growing[18] in the types of businesses that may be conducted by exempt cooperatives. The same regulation also provides that "cooperative organizations engaged in occupations dissimilar from those of farmers, fruitgrowers, and the like, such as marketing building materials, are not exempt." In practice, the Treasury has generally approved as being within the proper scope of operations of exempt cooperatives all activities which are normally considered connected with the farming industry. This includes going so far as approving the operation of a market place for farmers to sell their products as a proper exempt cooperative endeavor.[19]

Subparagraph (b)(1) also requires that such activities be conducted on a cooperative basis. Any failure to distribute the proceeds of sale or the savings on purchases in any manner other than in proportion to the quality or quantity of products supplied by each producer, or the amount of purchases made by each patron, will result in loss of exemption.[20] Discrimination between member and nonmember patrons in distribution of proceeds or savings remaining after payment of stock dividends is strictly forbidden. However, an exempt cooperative may credit the patronage dividends due to nonmembers toward purchase of a share of stock or a membership in the cooperative, rather than distribute such dividend in cash, without losing its exempt status. The Regulations require every exempt cooperative to retain permanent records of all business done both with members and nonmembers in order to establish its compliance with the requirement that it operate on a cooperative basis. Considerable leeway is granted the exempt cooperative with respect to the manner in which such records are to be kept, but their preparation and retention in permanent form is an absolute requirement.[21]

Ohio, like many states,[22] has enacted a rather comprehensive statute with respect to the organization and conduct of farmers' cooperatives.

---

[17] U. S. Treas. Reg. 118, §39.101(12)-1(a) (1953), Proposed Reg. §1.521-1(a) (1956).

[18] The acquisition of grazing lands by a cooperative for use by its members on the basis of the number of head of stock they wish to graze has been approved by the Treasury as being an activity of a type to which former section 101 (12) applied. The grazing lands were considered "supplies" acquired by a purchasing cooperative for its members. G.C.M. 22364, 1941-1 CUM. BULL. 296; see also S.M. 2288, III-2 CUM. *BULL.* 233 (1924) which approved purchase of timberland in order to supply crates to citrus growers.

[19] I. T. 2720, XII-2 CUM. BULL. 71 (1933).

[20] Rev. Rul. 141, 1955 INT. REV. BULL. No. 11, at 21, permits the retention by an exempt cooperative of all patronage and other dividends of less than one dollar and of all cents payable in excess of whole dollar amounts in order to defray record maintenance expenses without losing its exempt status. Such amounts retained are taxable to the cooperative as unallocated income.

[21] U. S. Treas. Reg. 118, §39.101(12)-1(a) (1953), Proposed Reg. §1.521-1(a) (1956).

[22] OHIO REV. CODE, c. 1729. See Jensen, *The Bill of Rights of U. S. Co-*

However, organization under such a statute is not a determining factor in securing exemption under section 521. Such exemption will be granted even if the cooperative association is organized under general corporation laws and has charter powers permitting it to engage in business for profit, providing the Commissioner is satisfied that such association actually conducts its business as a cooperative.[23] It is not even necessary that the word "cooperative" appear in the name of the cooperative in order to claim the exemption.[24]

Purpose of Operation

Having established the type of association that is eligible for special treatment, the statute next sets out the purposes for which such associations' activities may be conducted. These purposes are two. The first is the marketing of the products of its members or of other producers, and the distribution of the proceeds of sale, less expenses, to such producers, on the basis of the quality or quantity of the products furnished by them. Such expenses must be directly connected with the exempt cooperative's marketing operations.[25] While outright purchase of products by a marketing cooperative without any obligation to turn over to the producer the proceeds of such sales exposes the cooperative to loss of exemption, emergency outright purchases by an exempt cooperative to satisfy its contractual obligations, when its members were unable to supply sufficient products have been held not to cause loss of exemption.[26] The second is the purchasing of supplies and equipment for its members or, within certain limits, for other persons, at cost, plus necessary expenses. Many exempt cooperatives perform both the these functions. In determining whether a cooperative engaging in both such functions is entitled to exemption, the Treasury requires that it satisfy the provisions of section 521 on both counts.[27] It is not the purpose of this article to discuss the broad permissive scope of such marketing and purchasing activities. One important facet of marketing operation which should be mentioned in passing in the processing, warehousing, and distribution of farm products, which is often undertaken by exempt cooperatives, in order to

---

operative Agriculture, 20 Rocky Mt. L. Rev. 3, at 13 (1948) for a then current collection of state cooperative statutes.

[23] I. T. 1914, III-1 Cum. Bull. 287 (1924); Eugene Fruit Growers Ass'n v. Comm'r, 37 B.T.A. 993 (1938); United Cooperative, Inc., 4 T. C. 93 (1944).

[24] Rev. Rul. 26, 1955 Int. Rev. Bull. No. 3, at 64.

[25] The Treasury has recently ruled that the purchase by an exempt cooperative of insurance on the lives of its members, the cooperative being the beneficiary of such policies, would result in a loss of exemption on the ground that the purchase of such insurance is not a proper marketing expense and would constitute a failure to turn back to producers all of the proceeds of sale less marketing expenses. Rev. Rul. 558, 1955 Int. Rev. Bull. No. 36, at 10.

[26] Producers Produce Co. v. Crooks, 2 F. Supp. 969, 12 A.F.T.R. 621 (W.D. Mo. 1932); I.T. 1598, II-1 Cum. Bull. 159 (1923).

[27] U. S. Treas. Reg. 118, §39.101(12)-1(c) (1953), Proposed Reg. §1.521-1(c) (1956).

provide a cheaper and more highly integrated service. Typical of such operations are dairy processing and canning factories. The types of purchases that may properly be made by an exempt cooperative encompass virtually the whole range of human needs, since the Regulations specifically state that they include all goods and merchandise used in the operation and maintenance of the farm or of a farmer's household.[28] The purchasing activities of exempt cooperatives include such diverse activities as oil refining, automobile repairing, fertilizer processing, and financing.

The requirements described in the foregoing paragraphs are those that are essential in qualifying a farmers' cooperative organization for special tax treatment under section 522. The following provisions deal primarily with approved methods of operation. These provisions, which are incorporated in subparagraphs (2), (3), (4) and (5) of section 521 (b) were first added by the Revenue Act of 1926,[29] and gave congressional approval to practices previously accepted by the Treasury. Their addition is evidence of the success and growth of exempt cooperatives which has required the adoption of formal business practices not needed in the operation of the simple agency form followed in the early stages of farmers' cooperative development.

Issuance of Stock

Exempt cooperatives may issue capital stock without limitation as to classification and may pay dividends thereon at a rate not to exceed the greater of the legal rate of interest in the state of incorporation or eight percent per annum, such rate to be based on the value of the consideration for which the stock was issued.[30] The limitation contained in the last clause of the foregoing sentence serves as a deterrent to issuance of stock dividends since the maximum permissive dividend rate of eight percent of the consideration for which the stock was issued might then be exceeded so as to cause the cooperative to lose its exempt status.[31]

Nonvoting preferred stock may be issued by an exempt cooperative to any persons, regardless of their status as producers. However, "substantially all" of the stock, other than nonvoting preferred, must be owned by producers who market their products or purchase their supplies and equipment through the cooperative. Both at the time of applying for exemption, and thereafter, the cooperative must be prepared to show that ownership of such stock has been limited to producers, as far as possible, and to explain the ownership of such stock by nonproducers. One explanation which the regulation indicates is acceptable is the

---

[28] U. S. Treas. Reg. 118, §39.101(12)-1(b) (1953), Proposed Reg. §1.521-1(b) (1956).

[29] 44 Stat. 39.

[30] Int. Rev. Code of 1954, §521(b)(2). Ohio Rev. Code §1729.10 specifically limits dividends on stock of agricultural cooperatives to eight percent per annum.

[31] Farmers' Mutual Cooperative Creamery of Sioux Center, Iowa, 33 B.T.A. 117, 125 (1935).

issuance of voting stock to a nonproducer in order that he may meet the statutory qualifications for holding office in the exempt cooperative.[32]

In considering language similar to that now found in section 521(b)(2), the Tax Court held in 1930 that exemption was not lost where nine percent of the voting stock of the cooperative was held by nonproducers.[33] In an earlier ruling,[34] which has not been overruled, the Treasury held that exemption was lost where twelve percent of the stock of a cooperative was held by persons who were nonproducers in the taxable year in question and where more than nine percent thereof was originally issued to nonproducers. In light of the foregoing, it would appear that an exempt cooperative might sell some of its voting stock to nonproducers without losing its exemption, particularly if such nonproducers have some special relationship to the cooperative, such as attorney or financial advisor, which might make their participation of particular benefit to the cooperative. However, the cooperative should endeavor to limit as much as possible such stockholdings by nonproducers, including those persons who were producers when purchasing the stock but who have ceased to be such.

As can be seen from the foregoing paragraph, it is important that the by-laws of an exempt cooperative contain provisions for acquiring the stock of a person who has become a nonproducer and that funds be made available for such acquisition. It is true that the Regulations provide that in the event stockholders cease to be producers and the cooperative, because of some reason beyond its control, is not able to acquire their stock, the ownership of a "small amount of the outstanding capital stock" by such nonproducers will not destroy the cooperatives' exemption.[35] However, over a period of time, the normally steady withdrawal of stockholders from the status of producers may cause the Treasury to consider the amount of stock which must be reported on the cooperative's tax return as belonging to nonproducers to be more than a "small amount."

MAINTENANCE OF RESERVES

Section 521(b)(3) approves the creation and maintenance of certain types of reserves. Exempt cooperatives are permitted to accumulate and maintain any "reasonable reserve for any necessary purpose," as

---

32 U. S. Treas. Reg. 118, §39.101(12)-1(a)(2) (1953), Proposed Reg. §1.521-1(a)(2) (1956). OHIO REV. CODE §§1729.09 and 1729.10 prohibit the grant of membership or the issuance or transfer of common stock to persons other than cooperative marketing associations or persons engaged in the production of agricultural products for the market.

33 Farmers' Co-operative Creamery v. Comm'r, 21 B.T.A. 265 (1930), non-acq., X-1 CUM. BULL. 79.

34 G.C.M. 557, V-2 CUM. BULL. 71 (1926).

35 U. S. Treas. Reg. 118, §39.101(12)-1(a)(2) (1953), Proposed Reg. §1.521-1(a)(2) (1956).

well as any reserve required by state law.[36] Because of the cyclical nature of the farming industry and because of the large permanent investment which must be made to properly carry on many of the activities of a cooperative, maintenance of adequate reserves is as essential to the continuity and success of cooperative activities as to any other business venture. The relevant regulation mentions as proper subjects for reserves the erection of buildings and facilities required in the cooperative's business, the purchase and installation of machinery and equipment, and the retirement of indebtedness.[37] In addition to these examples, any type of reserve that constitutes an acceptable corporate deduction for federal income tax purposes will be permitted exempt cooperatives, providing a showing can be made of the necessary business purpose for such reserve. Amounts retained in such reserve need not be allocated among patrons. Of course, in the event that the necessity or reasonableness of any reserve is questioned, the burden of showing necessity or reasonableness is on the exempt cooperative.[38]

While the maintenance of necessary reserves in reasonable amounts will not result in a denial of exemption, amounts set aside in reserves, other than those deductible as necessary business expenses, constitute taxable income to the exempt cooperative in the year such amounts are earned, unless such amounts are allocated to patrons. This treatment, which was introduced in the Revenue Act of 1951, is intended to tax either the exempt cooperative or its patrons on all income earned annually by the cooperative. Therefore, all amounts allocated to patrons, whether or not actually distributed to them in cash, constitute taxable income to such patrons, while all amounts not so allocated and not subject to deduction as necessary business expenses under sections of the law relating to corporations for profits, are taxable to the exempt cooperative. However, despite the natural desire of most exempt cooperative managements to incur as little tax as possible at the cooperative level, the basic purpose for creating and maintaining reserves is to have money available to meet contingencies or clearly forseeable expenditures when they arise. To allocate this money to patrons means that the management of the exempt cooperative may not have complete control over the disposition thereof at the time when it is actually needed by the cooperative. It is for this reason that amounts credited to reserves are not

---

[36] Exempt cooperatives are often authorized by state law to maintain so called "educational" reserves for the purpose of publicizing farm cooperative organizations and doing research on farm problems. However, since the maintenance of such reserves is permissive rather than required, they do not meet the test set out above. Mim. 3886, X-2 CUM. BULL. 164 (1931).

[37] U. S. Treas. Reg. 118, §39.101(12)-1(a)(2) (1953), Proposed Reg. §1.521-1(a)(2) (1956).

[38] Fertile Co-operative Dairy Ass'n v. Huston, 119 F. 2d 274, 27 A.F.T.R. 95, 41-1 U.S.T.C. §9433 (8th Cir. 1941).

generally allocated to patrons, even though such retention results in income tax liability to the exempt cooperative.

It was pointed out earlier that permanent records must be maintained by every exempt cooperative clearly indicating the amount of business done with each patron. This means that the amounts held in reserves must be apportioned among the patrons even if no allocation of such amounts is made to the patrons and, consequently, no deduction allowed the exempt cooperative with respect thereto. However, if at any time it is determined to be no longer necessary to hold part or all of the amounts in a given reserve, the exempt cooperative may proceed to allocate that unneeded portion of the reserve which has been held longest among its patrons in proportion to the amount of business done by such patrons in the taxable year or years in which such released amounts were received by the exempt cooperative and may thereupon deduct such amounts from net income in the year when allocation actually takes place.[39]

Pending their use for the purposes for which they are set aside, reserves may be invested in such manner as the exempt cooperative see fit. Income earned from such investments constitutes nonpatronage income.

Transactions With Nonmembers

The principal function of any exempt cooperative is to act for its members in marketing their products or in purchasing supplies and equipment for them. However, most cooperatives also undertake to serve nonmembers who have some community of interest with its members. Not only is the extension of the exempt cooperative's facilities to such nonmembers of considerable benefit to them, but it affords the cooperative a broader source of supply than that offered by the members, if the activities are involved in marketing. A purchasing cooperative can effect savings for its members by including nonmembers in the purchasing group so as to warrant larger quantity discounts from sellers. Often an equally important factor is the good will that is created and the valuable public relation benefit that results from sharing the fruits of cooperation with others.

However, statutory restrictions are imposed limiting the proportionate amount of business which an exempt cooperative may conduct on behalf of nonmembers. These restrictions on nonmembers dealings constitute the principal reason for the failure of many cooperatives to apply for exempt status under section 521.

Section 521(b)(4) permits a marketing cooperative to retain its exemption so long as the total value of products marketed on behalf of nonmembers does not exceed the total value of products marketed

---

[39] U. S. Treas. Reg. 118 §39.101(12)-4(a) (1953), Proposed Reg. §1.522-3(a) (1956).

for members.[40] The law further requires that the proceeds of sale of products, less operating expenses, must be returned to the producer thereof, whether he is a nonmember or not, if the cooperative is to remain exempt.[41] Therefore, the sale by a cooperative on behalf of its members of products not raised by them but purchased by them from other producers constitutes a basis for loss of exemption.[42] But an exempt cooperative may market for members products produced by nonmembers if the cooperative is aware that the member is acting only as the agent of the nonmember and is legally bound to turn over to the nonmember the proceeds of sale of his products, less necessary marketing expenses.[43] That portion of products sold which were produced by the nonmembers will, however, be counted as sales on behalf of a nonmember in determining the total values of nonmembers' products marketed.

Exempt cooperatives may also purchase supplies and equipment for nonmembers whether such nonmembers are producers or not, so long as such purchases do not exceed fifty percent of its total purchases and so long as not more than fifteen percent of its total purchases are made for persons who are neither members nor producers. However, the Treasury has permitted exempt cooperatives some leeway with respect to the nonmembership-dealing restrictions. Sales by an exmpt purchasing cooperative engaged in refining petroleum products of certain by-products not usable by farmers have been disregarded in determining whether the fifteen percent limit on purchases for patrons who are neither producers or members has been exceeded.[44] In order that the volume of member, nonmember, and nonproducer dealings can be determined, the permanent records maintained by an exempt cooperative must classify patrons as to their status as members, nonmembers, producers, and nonproducers. Failure to do this can cause a denial of exemption.[45]

Business for the United States

A final but exceedingly valuable statutory provision[46] in this age of governmental involvement in the farming industry is that one which permits an exempt cooperative to disregard business done with the United States or any of its agencies in determining the volume of business done with nonmembers or nonproducers. The profits realized from such transactions constitute nonpatronage income.[47]

---

40 Producers Livestock Marketing Ass'n of Salt Lake City, 45 B.T.A. 325 (1941).

41 Int. Rev. Code of 1954, §521(b)(1).

42 I. T. 3853, 1947-1 Cum. Bull. 42; Dr. P. Phillips Cooperative, 17 T.C. 1002 (1951).

43 Rev. Rul. 496, 1955 Int. Rev. Bull. No. 32, at 8.

44 Rev. Rul. 12, 1954-1 Cum. Bull. 93.

45 Farmers Union Co-operative Gas & Oil Co., P-H 1941 B.T.A. Mim. Dec. ¶41,556, aff'd 45 B.T.A. 1160 (1941).

46 Int. Rev. Code of 1954, §521(b)(5).

47 U. S. Treas. Reg. 118, §39.101(12)-3(d) (1953), Proposed Reg. §1.522-2(d) (1956).

INCOME TAX DEDUCTIONS

The preceding paragraphs of this article have dealt with the purposes and operating techniques which may be followed by exempt cooperatives. The remaining portion will treat of the deductions available to exempt cooperatives for federal income tax purposes.

Except with respect to certain special deductions, exempt cooperatives, taxable cooperatives, and corporations for profit are all governed income tax wise by the same general provisions. All three are subject to tax at the rates set out in section 11 and section 1201 of the Code. All three are subject to the same limitations with respect to accounting periods, valuation of inventories, and net operating loss carry-overs and carry-backs. However, exempt cooperatives are not entitled to file consolidated returns,[48] and their shareholders and patrons are not permitted any individual[49] or corporate[50] deductions for stock or patronage dividends received. On the other hand, exempt cooperatives are favored over the other two entities, in that they need not file their income tax return until the fifteenth day of the ninth month following the close of the taxable year.[51]

Three major differences, with respect to computing taxable income, do exist between exempt and taxable cooperatives, on the one hand, and corporations for profit on the other. Two of these, the deduction for stock dividends paid and the deduction for allocation of income not derived from patronage, are allowed exempt cooperatives only, while the third, the exclusion from gross income of dividends, rebates, or refunds to patrons based on income derived from business done with or for such patrons[52] (herein called "patronage dividends"), is available to both exempt and taxable cooperatives.

Section 522(b)(2) provides that patronage dividends allocated by an exempt cooperative "shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521." No statutory authority exists which expressly provides for eliminating from net income patronage dividends allocated or paid by a taxable cooperative. However, the long-standing administrative practice of the Treasury has been to eliminate amounts refundable by cooperatives to patrons in connection with transactions conducted on their behalf. The basis for this practice, which has been consistently recognized by the courts,[53] has been described as follows:[54]

---

[48] U. S. Treas. Reg. §1.1502-2 (1955).

[49] INT. REV. CODE OF 1954, §§34 and 116(b).

[50] INT. REV. CODE OF 1954, §246.

[51] INT. REV. CODE OF 1954, §6072.

[52] U. S. Treas. 118, §39.101(12)-4 (1953), Proposed Reg. §1.522-3 (1956).

[53] Midland Cooperative Wholesale, 44 B.T.A. 824 (1941); Farmers' Cooperative Co. v. Birmingham, 86 F. Supp. 201, 38 A.F.T.R. 606, 49-2 U.S.T.C. ¶9400 (N.D. Iowa, 1949). The latter case considers fully the federal tax treatment of patronage dividends, as well as containing useful information regarding the development of farmers' cooperatives.

> Under long established Bureau practice, amounts payable to patrons of cooperative corporations, as so-called patronage dividends, have been consistently excluded from the gross income of such corporations. The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation or an additional consideration due the patron for goods sold by him through the corporation. As such amounts are not includible in gross income of the corporation, they are obviously not deductible by it, though, where they have been erroneously included in gross income in the first instance, the correcting adjustment is sometimes loosely termed a deduction. Where patronage dividends are payable only to members or stockholders (or the members receive larger patronage dividends than nonmember patrons on identical transactions), the excess of the payments over the amounts due them on a patronage basis represent ordinary income to the corporation from business carried on by it for the joint profit of the members and, consequently, distributions thereof to the members are essentially ordinary dividend payments.

As the foregoing quotation indicates, patronage dividends are treated as exclusions from gross income rather than as deductions therefrom.[55]

Three tests must be satisfied in order that patronage dividends may be excluded from gross income. First, the allocation or payment must be based on a valid obligation of the cooperative to the patron which existed prior to receipt of the amounts constituting the dividend.[56] This preexisting obligation may be based on the by-laws or articles of incorporation of the cooperative, or on contracts between it and its patrons.[57] However, an informal understanding will not satisfy this requirement.[58] An exclusion may also be granted in the absence of any corporate provision or contract if the state statute under which the cooperative is organized provides that all amounts received by it belong to its patrons.[59]

A second requirement is that amounts allocated or paid as dividends must be based on proceeds received or savings realized during the taxable year for which the exclusion is taken or in a preceding taxable year.[60] It should be noted, however, that in order for any allocation of

---

54 I. T. 3208, 1938-2 CUM. BULL. 27.

55 G.C.M. 17895, 1937-1 CUM. BULL. 56.

56 U. S. Treas. Reg. 118. §39.101(12)-4 (1953), Proposed Reg. §1.522-3 (1956); Beaver Valley Canning Co., P-H 1950 T.C. Mem. Dec. ¶50312.

57 Sumner Rhubarb Growers' Ass'n, P-H 1951 T.C. Mem. Dec. ¶51,146, C.C.H. ¶18,324.

58 American Box Shook Export Ass'n v. Comm'r, 156 F. 2d 629 (9 Cir. 1946).

59 San Joaquin Valley Poultry Producers Ass'n v. Comm'r, 136 F. 2d 382, 31 A.F.T.R. 161, 43-1 U.S.T.C. ¶9484 (9 Cir. 1943). This case involved the question of whether amounts held by the cooperative in reserves were deductible from its net income.

60 INT. REV. CODE OF 1954, §522(b)(2).

income derived in a prior year to be excluded, it must be allocated in accordance with the amount of business done with or for each patron during the taxable year in which such income was derived. This requirement applies with equal force to both patronage and nonpatronage dividends. For example, if capital gains are realized from property held by the exempt cooperative over a number of years, the gains must be allocated, insofar as possible, among those persons who were patrons in the years in which the asset was owned, on the basis of their patronage during such taxable years. By the same token, if income derived from patronage has been held in a reserve rather than allocated in the year derived and it is determined in a later year that such reserve is unnecessary and that the amount constituting it should be allocated, such allocation must be among those persons who were patrons during the year the income was derived on the basis of their patronage in that year.

The third requirement is that patronage dividends must actually be allocated to patrons in order to qualify as exclusions. The regulation[61] defines allocation as follows:

> The term "allocation" includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving funds certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron, is not an allocation.

It is essential in satisfying the allocation requirement that documentary notice be given to each patron of the amount being credited in his favor on the books of the exempt cooperative. Actual distribution of cash is not required. Allocation of income without distribution thereof enables a cooperative to retain sufficient working funds to finance its operations from year to year without exposure to tax thereon at corporate levels. Of course, patrons receiving documentary evidence of the allocation in their favor must report the face amount of such documents as income in the year received.[62]

In addition to the exclusions from gross income of patronage dividends, exempt cooperatives are permitted to deduct amounts allocated to its patrons which are not derived from patronage.[63] The term "income not derived from patronage" is defined by the Treasury in a "catch-all" definition[64] to mean "incidental income derived from sources

---

[61] U. S. Treas. Reg. 118, §39.101(12)-2 (1953), Proposed Reg. §1.522-1 (1956).

[62] Rev. Rul. 10, 1954-1 CUM. BULL. 24. But see Comm'r v. Carpenter, 219 F. 2d 635, 46 A.F.T.R. 1743, 55-1 U.S.T.C. ¶9259 (5th Cir. 1955).

[63] INT. REV. CODE OF 1954, §522(b)(1)(B).

[64] U. S. Treas. Reg. 118, §39.101(12)-3(d) (1953), Proposed Reg. §1.522-3(d) (1956).

not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage." In addition, as has been noted earlier, income from business done with the United States or its agencies also constitutes nonpatronage income. The conditions which must be met by an exempt cooperative in order to deduct nonpatronage income largely parallel those set up with respect to the exclusion from gross income of patronage dividends. Such income must be allocated in a nondiscriminatory manner among the exempt cooperative's patrons on the basis of the patronage business done with or for such patrons. The allocation test must be met, and the amounts allocated must have been derived during the taxable year in question or some previous year. One distinction is that the Regulations do not require that allocation of nonpatronage income be based on a pre-existing obligation of the exempt cooperative. However, since the by-laws or contracts which control the allocation of dividends to patrons do not generally distinguish between patronage and nonpatronage dividends, this distinction is often not significant.

Another special deduction available only to exempt cooperatives is the right to deduct dividends paid on capital stock.[65] In order to claim this deduction, two requirements must be met in addition to those set out in section 521 and referred to earlier. First, the deduction is available only to the extent that such dividends are actually paid in cash. Second, such payments must be distributed within sufficient time to reach the shareholders before the end of the taxable year in the normal course of events.[66] While an exempt cooperative may claim a deduction or exemption if it allocates nonpatronage or patronage dividends to its patrons within eight and one-half months after the close of the taxable year, no reversion back of dividends paid after the close of such year is permitted.

As a result of the exclusions and deductions discussed above, an exempt cooperative is required to pay income taxes only on those amounts which it fails to allocate and continues to hold in some form of reserve or temporary surplus which is not subject to direct claims of ownership by its patrons.

---

[65] INT. REV. CODE OF 1954, §522(b)(1)(A).

The term "capital stock" includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidences of a proprietary interest in a cooperative association. U. S. Treas. Reg. 118, §39.101(12)-3(c) (1953).

[66] U. S. Treas. Reg. 118, §39.101(12)-3(c) (1953), Proposed Reg. §1.522-2(c) (1956). See also Rev. Rul. 141, 1955, INT. REV. BULL. No. 11, at 21.

Conclusion

As is indicated by the foregoing paragraphs, the federal income tax provisions present no serious obstacles to the successful operation of an exempt cooperative. The governing statutes and the applicable administrative rulings and court decisions have been developed in a deliberate but uninterrupted manner and the present state of the law is relatively free of complications attributable to "growing pains."

In keeping with the framework of the symposium of which this article is a part, it should be pointed out that membership in and operation through an exempt cooperative offers the farmer not only a "tailor-made" tax-exempt merchandising arm, but provides him with what can be an efficient and flexible device for combatting the adage that farmers "sell at wholesale and buy at retail."