INCOME TAX TREATMENT OF COOPERATIVES: Internal Revenue Code Section 521

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Abstract

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

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

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Preface[1]

Agricultural marketing and supply cooperatives that have met certain prescribed organizational and operational standards have long enjoyed a special status under Federal income tax law. Until 1951, qualifying farmer cooperatives were truly exempt organizations. Since then, they have been subject to income taxation but able to take advantage of two deductions not available to other cooperatives. They can deduct a limited amount of dividends paid on capital stock and distributions of nonpatronage income made to patrons on a patronage basis.

The rules to qualify for these deductions are found in Internal Revenue Code section 521. As with any special tax status, the prerequisites to use of section 521 are strictly construed against the taxpayer. Restrictive rulings by the Internal Revenue Service (IRS), when upheld by the courts, have made it increasingly difficult for cooperatives to qualify for section 521 status. Even otherwise eligible cooperatives may voluntarily relinquish section 521 status when the cost of compliance exceeds the benefits of taking the two special deductions.

Although use of section 521 has fallen off in recent years, special rules tied to it may make section 521 status appealing in certain situations. For example, a limited exemption from Federal securities regulation is attracting the attention of marketing cooperatives that allow the transfer of delivery rights at more than their original cost.

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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 contains two chapters in USDA's series on Federal income taxation of cooperatives. Chapter 11 discusses the requirements to attain section 521 status. Chapter 12 reviews the special tax deductions available to these cooperatives and other tax and securities law treatments related to section 521 status.

Section 521 tax treatment reflects the Government's intention to support agriculture. A statutory exemption for qualifying farmer cooperatives was enacted in the Revenue Act of 1916. Although true exempt status was terminated in 1951, these associations have access to deductions not available to other cooperatives or noncooperative corporations. They may deduct (1) dividends paid on capital stock and (2) distributions of nonpatronage income to patrons made on a patronage basis.

Not all farmer cooperatives qualify for this tax treatment. Section 521 status is only available to farmer cooperatives that meet these organizational and operational tests:

1. Their primary activity must be to market the products of members and other producers and/or purchase supplies and other equipment for members and other persons.
2. They must pay patronage refunds to all patrons (members and nonmembers alike) on the same basis.
3. Dividends on capital stock may not exceed the legal rate of interest in the State of incorporation or 8 percent per year, figured on the value of the consideration for which the stock was issued, whichever is greater.
4. Substantially all voting stock (at least 85 percent) must be owned by producers who have used the cooperative's services during the past tax year.
5. Reserves must be required by State law or for a necessary purpose.
6. The value of products marketed for members must exceed that of products marketed for nonmembers.
7. The value of supplies and equipment sold to members must exceed that of such products sold to nonmembers. Also, the value of supplies and equipment sold to persons who are

neither members nor producers can't exceed 15 percent of the cooperative's total sales of supplies and equipment.

8. In the event of dissolution, assets remaining after debts are paid and equity redeemed must be paid to all patrons (member and nonmember alike) on the basis of patronage.

To qualify for section 521 status, a farmer cooperative must comply with all of these requirements. A cooperative with a marketing and a farm supply function must meet these tests for both.

While any corporation can claim general cooperative tax treatment on its tax return, section 521 status must be applied for and granted by IRS. The burden is on the cooperative to show continuous compliance with the requirements. IRS may revoke section 521 status at any time, retroactive to the time the cooperative first failed to meet all of the prerequisites.

Other important tax and business issues are related to section 521. These cooperatives are eligible for limited additional tax breaks. One benefit important to certain cooperatives is an exemption from the registration and prospectus requirements of the Securities Act of 1933 available only to section 521 cooperatives. Associations that promote agricultural interests may qualify for true tax exempt status under Code section 501(c)(5). The Code also contains several other sections providing special tax treatment for cooperatives that serve farmers but are not eligible for section 521 status.

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CHAPTER 11
SECTION 521 REQUIREMENTS

Farmer cooperatives meeting organizational and operational requirements detailed in Internal Revenue Code (Code) section 521[2] are given two special deductions in addition to those subchapter T affords all corporations operating on a cooperative basis. Section 521 cooperatives may deduct dividends paid on capital stock[3] and patronage-based distributions of nonpatronage income.[4]

While the Code refers to qualifying cooperatives as "exempt," this is a misnomer. Section 521 cooperatives must generally follow the rules and pay the same taxes applicable to other cooperatives, except for the two special deductions.[5] Because these cooperatives are not truly "exempt," the term is avoided in these reports.

A discussion of the legislative and regulatory history leading to current Code section 521 is provided in Chapter 3.[6] A review of that material might be useful in understanding Chapters 11 and 12.

Section 521 has two parts. Section 521(a) provides that a farmers' cooperative described in section 521(b)(1) shall be exempt from taxation *except as otherwise provided in part I of*

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[2] I.R.C. § 521.

[3] I.R.C. § 1382(c)(1).

[4] I.R.C. § 1382(c)(2).

[5] *See*, Farmers Cooperative Co. v. Commissioner, 85 T.C. 601, 602, (note 3) (1985); Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 408-411 (1972), *aff'd*, 481 F.2d 812 (10th Cir. 1973), *cert. denied*, 414 U.S. 1028 (1973).

[6] Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA, 2005), pp. 105-118.

Subchapter T and shall be considered an organization exempt from income taxes for purposes of any other law which refers to tax-exempt organizations.

Subsection 521(b) contains the organizational and operational rules a cooperative must meet to be eligible for section 521 status. Requirements for section 521 tax treatment are strict, and unless each is satisfied a cooperative may not be a "section 521" cooperative. This chapter explains each of these tests.

While any corporation can claim subchapter T status when filing its tax return, prior approval of the Internal Revenue Service (IRS or the Service) is necessary to claim the benefits of section 521. Chapter 12 explains the procedural requirements of applying for and maintaining section 521 status.

The tax rules specifically applicable to section 521 cooperatives are found in subchapter T.[7] These are also covered in Chapter 12.

UNDERLYING POLICY

This special tax treatment is only available to farmer cooperatives. As indicated in Chapter 3, a statutory exemption for farmer cooperatives dates back to the Revenue Act of 1916. The current rules have remained virtually unchanged since the Revenue Act of 1926.[8]

Prior to and during the Depression, farmers were under severe economic pressure. The farmer cooperative movement was enjoying a period of rapid growth. Farmers turned to cooperatives as a means of survival. Congress was sympathetic to the farmers' plight and strong public policy support existed for their

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[7] Most notably I.R.C. § 1382(c).

[8] Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005), pp. 113-116.

cooperatives. As the court explained in *Co-operative Grain & Supply Co. v. Commissioner*:

> The history of the development of farm cooperatives shows that they were organized primarily for the purpose of helping individual farmers to better their bargaining position in the sale of their products and the purchase of their supplies (citations omitted). In granting favorable tax treatment to certain farmer cooperatives Congress recognized their contribution to the agricultural community. Justification for bestowing upon them tax exempt status is based upon the policy that a strong and prosperous agriculture is necessary for the national welfare (citations omitted).[9]

Randolph Paul, in an article published shortly after he completed service as General Counsel to the Treasury and tax adviser to the Secretary of the Treasury, discussed several reasons justifying limited special treatment of certain farmer cooperatives. These included:

1. The national welfare depends on a strong and prosperous agriculture.
2. Individual farmers are at a great economic disadvantage when negotiating with buyers of farm products. Cooperatives help balance the marketplace.
3. Farmers have a limited ability to supply capital to their cooperative at any one time. The exemption helps cooperatives to build capital over time.
4. The exemption is strictly limited and narrowly circumscribed.
5. The benefit to farmers is much larger than the harm to competing for-profit organizations.

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[9] Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1162-63 (8th Cir. 1969), *rev'g* 26 T.C.M. 593 (1967).

6. The earnings are taxable income to the farmer-patrons, so they don't escape taxation.[10]

So the fact that section 521 tax treatment is limited to certain agricultural cooperatives reflects the desire of Congress to help farmers. It is based on economic and social concerns, not strictly tax policy.

An organization must satisfy a number of requirements to qualify as a section 521 cooperative. Qualification is judged by actual operation. The applicable Treasury Regulation (regulation) states "An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521."[11]

The IRS has determined that a cooperative whose articles of incorporation grant it powers which, if exercised, would disqualify it, nevertheless retains its section 521 status so long as it meets qualification criteria in its actual operations.[12] This is not to say that a cooperative's operations will be the sole criteria for section 521 qualification absent any consideration of articles of incorporation and bylaws.[13]

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[10] Randolph E. Paul, *The Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes*, 29 Minn. L. Rev. 343 (1945). At the time this article was written, farmer cooperatives meeting the tests currently codified in I.R.C. § 521(b) were totally exempt from Federal income taxation. The benefit of "exempt" status was reduced in 1951 when the exemption was replaced with the deductions for stock dividends and nonpatronage income distributed on a patronage basis.

[11] Treas. Reg. § 1.521-1(c).

[12] Rev. Rul. 68-496, 1968-2 C.B. 251. *See also* Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90, 91 (9th Cir. 1932), *aff'g* 21 B.T.A. 315 (1930).

[13] The importance of properly written documents is seen throughout this report. Any cooperative wishing to qualify for section 521 should review all relevant documents carefully.

REQUIREMENTS FOR SECTION 521 STATUS

Code sections 521(b)(1)-(4) contain several rules an organization must comply with to qualify for the special deductions accorded section 521 cooperatives:

1. The organization must be a farmers' cooperative.[14]

2. It must market the products of members and other producers[15] or purchase supplies and other equipment for members and other persons.[16]

3. Margins must be returned to all patrons (members and nonmembers alike) on a patronage basis.[17]

4. Dividends on capital stock may not exceed the legal rate of interest in the State of incorporation or 8 percent per year, whichever is greater.[18]

5. Substantially all (85 percent) voting stock must be owned by producers who use the cooperative's services.[19]

6. Reserves must be required by State law or for a necessary purpose.[20]

7. The value of marketing and purchasing transactions with members must exceed that of such transactions with nonmembers. Also, purchasing for persons who are neither members nor producers can't exceed 15 percent of total purchasing activity.[21]

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

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

[16] I.R.C. § 521(b)(1)(B) and Treas. Reg. § 1.521-1(b).

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

[18] I.R.C. § 521(b)(2) and Treas. Reg. § 1.521-1(a)(2).

[19] I.R.C. § 521(b)(2) and Treas. Reg. § 1.521-1(a)(2).

[20] I.R.C. § 521(b)(3) and Treas. Reg. § 1.521-1(a)(3).

[21] I.R.C. § 521(b)(4) and Treas. Reg. §§ 1.521-1(a)(3) and 1.521-1(b).

A cooperative must comply with each of these rules to qualify for section 521 status. The first part of this report explains how the IRS and the courts have interpreted them.

FARMERS' COOPERATIVE DESCRIBED

The first requirement for a cooperative to qualify for section 521 tax treatment is that its members be engaged in farming. The Code states that the only entities eligible for section 521 status are "farmers', fruit growers', or like associations organized and operated on a cooperative basis...."[22]

Statutory and Administrative Definitions

Neither Code section 521 nor the applicable regulations define "farmer." The only example mentioned in Code section 521 is a fruit grower. The section 521 regulations expand the list of examples to include livestock growers and dairymen.[23] The regulations also state "cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt."[24]

However, other regulations offer guidance as to the meaning of "farmer" in a tax context. The Service has referred to these definitions in limiting section 521 status to associations of traditional farmers.

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[22] I.R.C. § 521(b)(1).

[23] Treas. Reg. § 1.521-1(a)(1) (marketing associations) and § 1.521-1(b) (supply associations). Regulations implementing I.R.C. § 521 were issued as T.D. 6301, 1958-2 C.B. 197, 242-245 and amended to reflect changes made by the Revenue Act of 1962 by T.D. 6643, 1963-1 C.B. 148, 168-169.

[24] Treas. Reg. § 1.521-1(d).

Code section 61 provides the general definition of gross income. Under regulations associated with that section,[25] a farm is defined in the ordinarily accepted sense and includes livestock, dairy, poultry, fruit, and truck farms, as well as plantations and ranches. These regulations refer to those interpreting Code section 175 for more detailed rules to apply to determine whether an activity is farming.

Code section 175 provides for the deduction of soil and water conservation expenditures by a taxpayer engaged in the business of farming. Associated regulations state "the term 'farm' is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards."[26]

Section 180 of the Code provides for deduction of expenditures by farmers for fertilizer. The regulations state "land used in farming" means land used "for the production of crops, fruits, or other agricultural products or for the sustenance of livestock....The principles stated in §§ 1.175-3 and 1.175-4 are equally applicable under this section in determining whether the taxpayer is engaged in the business of farming...."[27]

Fishermen. Fishermen use cooperatives for marketing, supply, and service purposes. IRS has stated that whether fishermen qualify as farmers for section 521 purposes depends upon how the fish are grown. Raising fish on privately owned

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[25] Treas. Reg. § 1.61-4(d), *cited in* Rev. Rul. 73-570, 1973-2 C.B. 195 and Rev. Rul. 84-81, 1984-1 C.B. 135.

[26] Treas. Reg. § 1.175-3, *cited in* Rev. Rul. 73-570, 1973-2 C.B. 195 and Rev. Rul. 84-81, 1984-1 C.B. 135. Most of this regulatory language was published in T.D. 6235, 1957-1 C.B. 98, 101. References to fish farming were added by T.D. 6649, 1963-1 C.B. 49. An even more extensive list of examples of agricultural activities is found in the regulatory definition of "land used in farming" in Treas. Reg. § 1.175-4.

[27] Treas. Reg. § 1.180-1, *cited in* Rev. Rul. 84-81, 1984-1 C.B. 135. *See also* I.R.C. § 464(e)(1) for a similar definition of "farming," likewise *cited in* Rev. Rul. 84-81.

farms has been found to be an agricultural activity, while commercial fishing in open waters is not.

A cooperative formed to purchase supplies for marine fishermen and oyster growers was denied section 521 status, even though under applicable State law the term "agricultural products" includes fish and salt water seafood and the cooperative qualifies as an agricultural cooperative under State law.[28]

However, an association engaged in cooperatively marketing fish produced by its members and other patrons in privately owned waters was found to be eligible for section 521 status. IRS determined "farm-raised fish" are farm products and distinguished Revenue Ruling 55-611 on the basis that those persons weren't raising their fish on farms.[29]

These decisions are consistent with regulation 1.175-3, which states "a fish farm is an area where fish are grown and raised, as opposed to merely caught and harvested; that is, an area where they are artificially fed, protected, cared for, etc."[30]

Tree farming. The Service has taken a firm position that growing timber and other forestry activities are not farming for section 521 purposes. Access to section 521 was denied cooperatives engaged in marketing building materials produced by members[31] and a federated cooperative marketing newsprint and its member cooperatives supplying pulpwood cut from timber

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[28] Rev. Rul. 55-611, 1955-2 C.B. 270. Similarly, an organization formed to promote the commercial fishing industry cannot qualify for exempt status under I.R.C. § 501(c)(5) applying to agricultural organizations. Rev. Rul. 75-287, 1975-2 C.B. 211, *citing* Rev. Rul. 55-611.

[29] Rev. Rul. 64-246, 1964-2 C.B. 154. The production of fish on privately owned fish farms is also an agricultural activity under I.R.C. § 501(c)(5). Rev. Rul. 74-488, 1974-2 C.B. 166.

[30] Treas. Reg. § 1.175-3.

[31] Rev. Rul. 73-308, 1973-2 C.B. 193; Rev. Rul. 73-570, 1973-2 C.B. 194.

grown on members' land.[32] These rulings draw heavily on regulatory and statutory language stating forestry or the growing of timber is not a farming activity for tax purposes.[33]

Grazing. IRS has approved section 521 status for an association of cattle ranchers who leased grazing land cooperatively to provide feed for their livestock.[34] It also approved a cooperative formed by grazing landowners to market their range grass to cattle raisers.[35]

Other activities not farming. Early cases denied section 521 status to a federated cooperative whose membership included consumer cooperatives, cooperative publishing houses, and a cooperative bank;[36] a housing cooperative;[37] a cooperative whose members were advertisers who procured billboard space[38] and a garbage collector cooperative.[39]

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[32] Rev. Rul. 84-81, 1984-1 C.B. 135.

[33] Treas. Reg. § 1.175-3 provides in part that "A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming." This language is incorporated by reference in Treas. Reg. § 1.180-1(b). *See also* I.R.C. § 464(e)(1) which states in part that "trees (other than trees bearing fruits or nuts) shall not be treated as an agricultural or horticultural commodity." (farming syndicate).

[34] Rev. Rul. 67-429, 1967-2 C.B. 218, *superseding* Gen. Couns. Mem. 22,364, 1941-1 C.B. 296.

[35] Rev. Rul. 75-5, 1975-1 C.B. 166.

[36] Cooperative Central Exchange v. Commissioner, 27 B.T.A. 17 (1932).

[37] Garden Homes Co. v. Commissioner, 64 F.2d 593, 596 (7th Cir. 1933), *rev'g* 26 B.T.A. 441 (1932).

[38] National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937).

[39] Sunset Scavenger Co. v. Commissioner, 84 F.2d 453 (9th Cir. 1936).

Thus "farmers" as used in section 521 has the traditional meaning. It encompasses persons who raise food and fiber from the soil and tend to animals.

Like Associations

The phrase "farmers', fruit growers', or like association(s)" has continuously been used to describe "exempt" farmer cooperatives since the Revenue Act of 1916.[40]

In 1922, the Treasury Department said: "In framing the Statute, Congress appears to have had in mind agricultural, fruit growing, and similar occupations. Under the doctrine of ejusdem generis the term 'like association' should be confined to pursuits similar to farming and fruit growing."[41]

The current language "farmer', fruit growers' and like associations organized and operated on a cooperative basis..." was enacted as part of the Revenue Act of 1926.[42] Certain nonfarmer cooperatives have sought to have the courts expand the scope of "like associations" to include all cooperatives, not just farmer associations. They have been unsuccessful.

In *Garden Homes Co. v. Commissioner*,[43] the court relied on I.T. 1312 to deny "exempt" status to a housing corporation that leased dwellings to tenant stockholders. Another U.S. Circuit Court of Appeals similarly rejected "exempt" status for a cooperative of garbage collectors.[44]

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[40] Revenue Act of 1916, ch. 463, § 11(a) Eleventh, 39 Stat. 756, 767 (1916).

[41] I.T. 1312, I-1 C.B. 263 (1922).

[42] Revenue Act of 1926, ch. 27, § 231(12), 44 Stat. 9, 40 (1926).

[43] Garden Homes Co. v. Commissioner, 64 F.2d 593 (7th Cir. 1933).

[44] Sunset Scavenger Co. v. Commissioner, 84 F.2d 453 (9th Cir. 1936).

Revenue Ruling 73-308[45] concerned an organization marketing building materials on a cooperative basis. After quoting Code section 521(b)(1), the Service said:

> It is a well recognized rule of statutory construction that where general words follow the enumeration of particular classes of persons or things, the general words will be construed as applicable only to persons or things of the same general nature or class of those specifically enumerated. Applying this rule to the statute under consideration, it follows that the term 'like association' by reason of its association with the word 'farmers' and 'fruit growers' must be modified and limited by those words. In harmony with this rule of statutory construction, it is evident that section 521 of the Code and its predecessors were designed to exempt from Federal income tax cooperative organizations organized and operated for the purpose of marketing the products of farmers, fruit growers, or other engaged in like occupations."[46]

IRS then noted section 1.521-1(d) of the regulations provides that "cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt."[47] IRS denied section 521 status but indicated it might qualify as a cooperative for Subchapter T purposes.[48]

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[45] Rev. Rul. 73-308, 1973-2 C.B. 193.

[46] *Id*. at 194.

[47] Treas. Reg. § 1.521-1(d).

[48] Section 521 is more restrictive in its application than subchapter T. Regular cooperative tax treatment is available to section 521 cooperatives and to any other corporation operating on a cooperative basis (with certain listed exceptions). I.R.C. § 1381(a). Thus, disqualification from access to section 521 does not deny a taxpayer single tax treatment as a cooperative. It only deprives a firm of the additional deductions for stock dividends and nonpatronage income

Shortly thereafter, Treasury issued another Revenue Ruling updating and restating I.T. 1312 to reflect current statutes and regulations.[49] Using the example of a cooperative formed to sell the products of independent lumber producing companies, it again determined that "like association" means similar to farming and fruit growing. It cited section 1.61-4(d) of the regulations as defining "'farm' in the ordinarily accepted sense" (examples omitted)[50] and section 1.175-3, which states "a taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming."[51]

In summary, "like associations" means farmer associations, not all cooperative associations. Thus, only farmer cooperatives can qualify for section 521 tax treatment.

MARKETING FOR MEMBERS AND OTHER PRODUCERS

To qualify for section 521 tax status, a farmers' cooperative must be engaged in one of two specific activities. The first is "marketing the products of members and other producers, and turning back to them the proceeds of sale, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them...."[52]

Questions have arisen as to the meaning of "marketing," "member," and "producer," and over the proper expenses to deduct from sales proceeds.

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distributed on a patronage basis that are only available to section 521's.

[49] Rev. Rul. 73-570, 1973-2 C.B. 194.

[50] Treas. Reg. § 1.61-4(d).

[51] Treas. Reg. § 1.175-3.

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

Marketing Described

The Service discussed the meaning of "marketing" in Revenue Ruling 66-108.[53] This ruling involved the section 521 eligibility of a cooperative organized and operated solely to maintain and care for its patrons' orchards and to harvest their crops. In determining whether such activity constituted marketing, the Service said:

> The term "marketing" as used in section 521(b)(1) of the Code includes the sale of farm products by a farmers' cooperative for its patrons and other activities necessary in the sale of such products, such as processing, packing, shipping, etc. Grove caretaking and harvesting are farming activities, but they do not involve the sale or the processing for sale of agricultural products. Therefore, they do not constitute "marketing" as that term is used in section 521 of the Code.[54]

While the cooperative did not receive the desired determination in Revenue Ruling 66-108, other cooperatives have been more successful by establishing a direct relationship between their activity and "marketing" as defined in that ruling. In Revenue Ruling 67-430 the Service found a cooperative formed to operate a farmers' market was qualified for section 521 status. IRS said:

> Revenue Ruling 66-108 (cite omitted) defines "marketing" as used in section 521 of the Code to include not only the sale of farm products by a farmers' cooperative for its patrons but other activity necessary to the sale of such products. This definition is broad enough to include all activities which are an integral part of the

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[53] Rev. Rul. 66-108, 1966-1 C.B. 154.

[54] *Id.*

marketing function. Therefore, a cooperative may be exempt under section 521 of the code without actually handling the sale of a product.[55]

While the Service has stated that "'marketing' includes all activities that are integral to the marketing function,"[56] other rulings illustrate the need to establish the direct connection to marketing. Revenue Ruling 71-100[57] involved a cooperative that marketed grain for a number of years. Then, it leased its elevator and other equipment to a noncooperative corporation. The members began selling their grain to the lessee and the cooperative's sole source of income became rental payments from the lessee. While the members benefitted by receiving higher prices for their grain and patronage refunds from the rental based on grain delivered to the lessee, IRS still denied section 521 status to the cooperative. It said the cooperative was actually engaged in a rental operation and did not market the products of its members or other producers as contemplated by Code section 521.

In another instance, a section 521 marketing cooperative was establishing a commodity trading division to serve as a commodity broker and to facilitate hedging transactions for it marketing patrons. The cooperative showed this new service would enable patrons to obtain higher prices and more secure profits from their farming operations. IRS, in finding the activity did not jeopardize this cooperative's 521 status, said:

> The proposed hedging transactions do not, in and of themselves, constitute marketing since the vast majority of hedging transactions are not intended to be consummated

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[55] Rev. Rul. 67-430, 1967-2 C.B. 220, *supersedes* I.T. 2720, XII-2 C.B. 71 (1933).

[56] Tech. Adv. Mem. 8705091 (Nov. 7, 1986).

[57] Rev. Rul. 71-100, 1971-1 C.B. 159.

by delivery. However, hedging may be an activity that is incidental to the marketing function of the taxpayer. It is a method of guaranteeing that the producer will be protected from downward price shifts in the case of products that are marketed through the taxpayer.[58]

Value-Added Processing

IRS has also acknowledged that value-added processing is part of "marketing" for section 521 purposes. The applicable regulations begin with a statement that "...cooperative dairy companies which are engaged in collecting milk and disposing of it *or the products thereof*..." and returning margins to patrons on the basis of patronage are eligible for section 521 tax status (emphasis added).[59]

Revenue Ruling 77-384 refers to the Service's "long standing position of allowing associations, in connection with their marketing function, to manufacture or to otherwise change the basic form of their members' products."[60] In Revenue Ruling 77-384, IRS said both the canning and drying activities of a fruit marketing association and the textile mill activity of a cotton marketing cooperative are permissible under section 521. IRS has also stated that a cooperative that processes its members' agricultural products into alcohol meets the requirements of section 521.[61]

In 1969, Congress briefly considered eliminating single tax treatment of cooperative earning generated by value-adding

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[58] Rev. Rul. 76-298, 1976 C.B. 180. The Service noted the proposed hedging would be done exclusively with current and active patrons.

[59] Treas. Reg. § 1.521-1(a)(1).

[60] Rev. Rul. 77-384, 1977-2 C.B. 198, *restating* Mim. 3886, X-2 C.B. 164 (1931).

[61] Rev. Rul. 81-96, 1981-1 C.B. 360. See also, Tech. Adv. Mem. 8705091 (Nov. 7, 1986) ("'Marketing' as used in section 521(b)(1) includes activities necessary to the sale of producers' products, such as processing, packing, and shipping of these products.")

activity.[62] During debate on the Tax Reform Act of 1969, Senator Abraham Ribicoff introduced an amendment to Code sec. 1382 that would have limited the patronage refund deduction to earnings from what he described as activities "directly related" to "the basic agency activities of marketing and purchasing."[63]

Senator Ribicoff seemed at least as concerned about cooperatives manufacturing farm supplies as he was adding value to products they marketed. On the marketing side, he indicated that under his amendment cooperatives could deduct earnings from making frozen concentrated fruit juice, baling cotton, and canning peaches, but not from the manufacture of the can or box. On the supply side, cooperatives would be able to continue to deduct earnings from reselling fertilizer and petroleum products they bought in bulk but not earnings realized on manufacturing fertilizer or drilling for and refining crude oil.[64] The Ribicoff amendment was rejected on a vote of 81-11.[65]

Biological v. Manufacturing Processing

In the mid-1990s, IRS began challenging certain requests for determination letters approving a cooperative's access to section 521 tax status. These associations were organizing by growers of basic commodities to increase their income. Their plan was to add value to the grain they produced by feeding it to animals owned on a cooperative basis and selling livestock and livestock products. The challenged marketing plans included feeding corn to hogs and marketing the hogs, feeding soybeans to tilapia (a fish) and marketing the fish, and feeding corn to hens and marketing both eggs and chicken.

The Service took the position that producers were not using these associations to market grain they produced, but rather to

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[62] 115 Cong. Rec. 37056-37062 (1969).

[63] 115 Cong. Rec. 37057 (1969).

[64] 115 Cong. Rec. 37058 (1969).

[65] 115 Cong. Rec. 37064 (1969).

market a totally different agricultural product. IRS said that feeding a commodity to an animal involved a biological process, as opposed to a mechanical process, and would not be considered processing for purposes of section 521.

Cooperatives responded that, for tax purposes, this is no different than changing corn to ethanol or cotton to cloth. Cooperatives relied particularly on Revenue Ruling 75-5, in which the Service had found that a farmers' cooperative formed to produce and market range grasses by grazing its own herd of breeder cattle on the land qualifies for section 521 tax status.[66]

Cooperatives decided to seek a legislative clarification of the issue. Several bills introduced in successive Congresses, beginning in 1998, included a provision to make it clear that for purposes of section 521, the marketing of the products of members or other producers shall include feeding such products to animals and selling the resulting animals or animal products.[67]

In 2004, cooperatives achieved their objective. The American Jobs Creation Act of 2004 created a new I.R. Code subsection 1388(k). It provides that marketing products of members or other producers includes feeding those products to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.[68]

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[66] Rev. Rul. 75-5, 1975-1 C.B. 166.

[67] *See, e.g.*, S. 2498, 105th Cong., 2d Sess. § 1 (1998); H.R. 1469, 106th Cong., 1st Sess. § 1 (1999); S. 312, 107th Cong., 1st Sess. § 9 (2001); H.R. 2347, 107th Cong., 1st Sess. § 9 (2001); S. 665, 108th Cong., 1st Sess. § 9 (2003); S. 1637, 108th Cong, 1st Sess. § 307 (2003).

[68] American Jobs Creation Act of 2004, § 316, Pub. L. No. 108-357, 118 Stat. 1469 (codified at 26 U.S.C. § 1388(k)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2nd Sess. at 362.

Member Described

The regulations say, "Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 521."[69]

Thus a member is, generally, someone who receives a payment out of cooperative earnings and has a vote at membership meetings. Member status hasn't been an issue in interpreting eligibility in Code section 521(b)(1). However, it has been contentious in applying the "substantially all" test in Code section 521(b)(2). A detailed description of membership in that context is provided later in this report.[70]

Producer Described

Code section 521 states a qualifying cooperative may engage in marketing the farm products of "members or other producers."[71] The term "or other producers" was added by the Revenue Act of 1926[72] following prior administrative practice.[73]

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[69] Treas. Reg. § 1.521-1(a)(3).

[70] *See infra* pp. 57-71.

[71] I.R.C. § 521(b)(1)(A).

[72] Revenue Act of 1926, ch. 27, § 231(12), 44 Stat. 9, 40-41 (1926), *noted in* Tech. Adv. Mem. 8048018 (Aug. 27, 1980).

[73] S. Rep. No. 52, 69 Cong., 1st. Sess. 23, 24 (1926):

> The existing law, strictly construed, allows exemption only to those farmers', fruit-growers', or like associations which act as sales or purchasing agents for producer members which return to such members the entire proceeds of their operations, except necessary sales or purchasing expenses. However, in order that any such association, not operated for profit, and which is a true cooperative association, shall get the benefit of this exemption, the

The phrase "member or other producers" means all products marketed by a section 521 cooperative must be provided by the farmer producer of that product.[74] A marketing cooperative generally will not qualify for section 521 if it markets goods for a nonproducer, even when that nonproducer is a member.[75] After it is established that the product being produced and handled by the cooperative is a farm product, it is still necessary to be sure the cooperative patrons (members and nonmembers) are producers of that product.

Revenue Ruling 67-422 provides that:

> ...a person is a producer if, as an owner or tenant, he bears the risks of production, cultivates, operates, or manages a farm for gain or profit--in short, if he is engaged in the trade or business of farming," and a person "who merely purchases a ripe crop at harvest would not be a pro-

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> Treasury Department in its regulations has construed the existing law with great liberality, enlarging the term "member" to mean any producer whether or not a member, ...
>
> The committee amendment exempts not only associations acting as sales or purchasing agents but any association organized and operated on a cooperative basis, and specifically includes other producers as well as member producers.

[74] Limited exceptions to this rule are explained in a subsequent section of this report, pp. 27-38.

[75] Dr. P. Phillips Cooperative v. Commissioner, 17 T.C. 1002 (1951); Farmers Cooperative Creamery Ass'n of Cresco, Iowa v. United States, 1981-1 U.S.T.C. (CCH) ¶ 9457 (N.D. Iowa 1981); Land O'Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir. 1975), *cert. denied*, 423 U.S. 926 (1975), *rev'g* 362 F. Supp. 1253 (D. Minn. 1973); Rev. Rul. 69-222, 1969-1 C.B. 161; Rev. Rul. 75-4, 1975-1 C.B. 165; Tech. Adv. Mem. 8025168 (March 27, 1980); and Tech. Adv. Mem. 8047006 (July 29, 1980).

ducer...since he fails to take the risks and responsibilities of the owner of a growing crop.[76]

Examples in Revenue Ruling 67-422 make it clear an outside occupation unrelated to farming will not disqualify a person as a producer. Under the right facts, an insurance agent and a physician can be producers.[77]

On the other hand, a creamery that purchased milk from producers did not qualify as a "producer" for purposes of section 521.[78] In *Farmers Cooperative Creamery Association*, the court reasoned that a creamery was not a producer because it did not manage or operate a farm, and that while there are risks involved in processing cheese from raw milk, "those particular risks are not contemplated by the term producer" as used in section 521(b)(1).[79]

The farmers' form of business structure and the size of the farming operation are generally not relevant. A partnership or corporation can be a farmer member just as a sole proprietor. Another example in Revenue Ruling 67-422 said that a profit making corporation which manufactures fertilizer and maintains land devoted to raising farm products for sale at a profit is a producer.[80]

However, the Service has said that a shareholder of a farming corporation is not, in the capacity of shareholder alone, a producer. The corporation, as owner or tenant, bears the risk and responsibilities of a growing crop and therefore is the producer.[81]

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[76] Rev. Rul. 67-422, 1967-2 C.B. 217, 218.

[77] *Id*. *See infra* notes 78-79 and accompanying text.

[78] Farmers Cooperative Creamery Association of Cresco, Iowa v. United States, 1981-1 U.S.T.C. (CCH) ¶ 9457 (N.D. Iowa 1981).

[79] *Id*. at 87,322.

[80] Rev. Rul. 67-422, 1967-2 C.B. 217, 218.

[81] Rev. Rul. 72-589, 1972-2 C.B. 282.

Landlords and Tenants

The issue is commonly raised in analyzing landlord-tenant relationships. These relations are often noted in cooperative incorporation statute provisions on membership. A typical provision is: "Any person, firm, partnership, corporation, or association, including both landlords and tenants in share tenancy, who is a producer of agricultural products...may become a member of the association."[82]

An early Board of Tax Appeal decision set the stage for how the landlord-tenant situation would be treated. The case involved the status of a farm owner whose farm was operated by a tenant on a crop-sharing basis. The court held the owner was entitled to producer status, reasoning:

> He risks his capital, furnishes seed and takes his chances on profits in much the same manner as he would were he to hire the work done for wages. The fact that he receives a cropshare of produce...is persuasive that he is actually engaged in farming and is a producer of farm products.[83]

In Revenue Ruling 67-422,[84] IRS adopted a test focusing on how the landlord and tenant are compensated. It said, "A person who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming, and hence is a producer. Generally, a person who receives a fixed

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[82] *See* James R. Baarda, *State Cooperative Incorporation Statutes for Farmer Cooperatives*, ACS Cooperative Information Report 30 (USDA 1982) and James R. Baarda, *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises*, ACS Research Report 54 (USDA 1986).

[83] Farmers Cooperative Creamery Ass'n v. Commissioner, 21 B.T.A. 265, 268 (1930).

[84] Rev. Rul. 67-422, 1967-2 C.B. 217.

rental or other fixed compensation (without reference to production) is not a producer."[85]

Several examples in Revenue Ruling 67-422 illustrate this distinction:

(1) A land owner leases his land to a tenant farmer for a specified number of years. Under the terms of the lease agreement the tenant farmer agrees to farm the land and pay the land owner a rental based on a certain fixed percentage of the farm crops produced. The tenant farmer has the option of paying the land owner in farm crops or their equivalent value in cash. Both the landowner and the tenant farmer qualify as producers.

(2) A stockbroker owns pasture land which he rents to a dairy farmer who uses the land to graze his dairy cattle. The dairy farmer pays the stockbroker a periodic fixed rental fee. The rental activity by the stockbroker does not qualify him as a producer.

(3) An insurance agent is engaged in the business of raising and selling chickens on a part-time basis. He qualifies as a producer.

(4) A physician, actively engaged in carrying on a medical practice, is also engaged in the business of operating a dairy farm through a manager. The manager is paid a fixed salary and has authority to make most managerial decisions for his principal. The physician qualifies as a producer. The manager's employment does not qualify him as a producer.

(5) The facts are the same as example (4) except that the manager and the physician entered into a partnership arrangement for the operation of the farm pursuant to which the manager

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[85] *Id*. at 218. Presumably, a landlord who receives rent based on the land's production bears the risk of production because his only remedy is to look to the crop produced. In contrast, a landlord who receives a fixed rent or other fixed compensation without reference to crop production bears no risk of production because such a landlord may look to the tenant's other income and assets to satisfy the rental obligation.

receives a percentage of the net profit of the farm rather than a salary. Both the manager and the physician qualify as producers.

(6) A profit-making corporation which manufactures fertilizer also maintains land devoted to raising farm products for sale at a profit. The corporation qualifies as a producer.[86]

Purchaser-Reseller

In other situations, a direct connection must be established between the person whose status is in question and production for that person to be a farmer/producer.

The purchaser of a crop does not become, as the new owner, its producer.[87] Under some circumstances a member may purchase the product at some point during the production process and act as its producer for the remainder of its production cycle. Where the member is in a real sense the producer of that crop, the member will qualify as a farmer/producer.

Dr. P. Phillips Cooperative v. Commissioner[88] concerned cooperative members who occasionally purchased an entire on-tree crop from the grove owner. The court noted that where the on-tree crop was purchased long before harvest, the member might have taken some of the risks and responsibilities of a grower. The court, however, found that in a couple of instances the fruit was purchased at or after harvest. Even though the members were clearly producers, the court revoked the association's "exempt" status because some of the fruit was marketed by members in their role as reseller rather than as producer.

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[86] *Id.*

[87] Rev. Rul. 67-152, 1967-2 C.B. 147, *superseding* I.T. 3853, 1947-1 C.B. 42.

[88] Dr. P. Phillips Cooperative v. Commissioner, 17 T.C. 1002 (1951).

Agency Relationship

If the purchaser is legally obligated to account to the actual producer for proceeds received from its sale through the cooperative, the products delivered to the cooperative by the purchaser may be deemed to be products of a producer. In Revenue Ruling 55-496,[89] some members marketed fruit for nonmember producers as well as their own fruit through the association. Such fruit was handled by the member for the actual producers under a written agency agreement providing that all proceeds of the fruit marketed, less only actual expenses incurred in connection therewith, were to be paid to the actual producers. About 20 percent of the value of all products marketed by the association during the taxable year were produced by nonmembers.

Prior to marketing any fruit offered by a member on an agency basis, the cooperative required the member to sign a contract promising that all fruit delivered to the cooperative on account of other producers was the actual property of such producers and the agent member would return to the producers proceeds of sales of their fruit, less necessary expenses. The contract also provided that the agent member would furnish the association with a written authorization from each nonmember producer showing his right to represent such producer. In this instance, the Service permitted the cooperative to maintain its section 521 status.[90]

The Service has also permitted a section 521 cooperative to purchase product from nonproducer-agents acting on behalf of producers when the agents were another section 521 cooperative and a nonprofit organization that promotes collective marketing of farm products and markets for its members as their agent.[91]

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[89] Rev. Rul. 55-496, 1955-2 C.B. 268.

[90] *In accord*, Tech. Adv. Mem. 8750002 (July 23, 1987).

[91] Priv. Ltr. Rul. 9310031 (Dec. 15, 1992).

On the other hand, a processor of products not accounting to farmer producers for amounts received is not a producer.[92] This is true even where the processor is wholly owned by the cooperative that treats it as a patron.[93]

Multiple Owners

Ownership interests in an agricultural product may be shared by multiple participants in its production. Ownership interest, along with a requisite degree of risk sharing, may make all owners producers of agricultural products.

In Revenue Ruling 58-483,[94] the Service found that both contract poultry growers and feed dealers who furnished poultry and all necessary supplies to the growers were producers for section 521 purposes. IRS noted that they divided the net profit from poultry sales and the parties otherwise operated as tenants in common, with each having an undivided interest in the poultry.

De Minimis Nonproducer Activity

A strict application of the rule barring marketing for nonproducers occurred in a 1975 letter ruling.[95] In a few instances, member producers who delivered grain to a cooperative grain warehouse requested that negotiable warehouse receipts be issued to nonmember-nonproducers such as charitable institutions or family members. Title to the grain transferred to the recipient and upon marketing the cooperative paid them the sales proceeds. Though the total amount of such marketing was 0.001 percent of total sales, IRS said the cooperative marketed for nonproducers and could not qualify for section 521.

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[92] Farmers Cooperative Creamery Ass'n of Cresco, Iowa v. United States, 1981-1 U.S.T.C. (CCH) ¶ 9457 (N.D. Iowa 1981).

[93] Land O'Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir. 1975), *cert. denied*, 423 U.S. 926, *rev'g* 362 F. Supp. 1253 (D. Minn. 1973).

[94] Rev. Rul. 58-483, 1958-2 C.B. 277.

[95] Tech. Adv. Mem., December 29, 1975.

Subsequent letter rulings have taken a more flexible approach, although they do not define an exception to the general rule. In one, the Service "looked through" nonproducer suppliers to the ultimate producers to determine the cooperative could maintain section 521 status.[96] In another, the cooperative purchased a small amount of farm products from nonproducers for processing and resale. IRS determined that the nonproducer purchases "were not significant (less than 1.5 percent of product handled), they assisted other farmer cooperatives and their own organization in meeting government requirements, and [the cooperative] stopped the practice when it was suggested that such purchases could jeopardize its exempt status."[97] The cooperative's section 521 status was not revoked.

Exceptions Permitting Nonproducer Business

For a long time, the rule against marketing nonproducer items has been interpreted to permit such activity on a limited, justifiable basis. *Producers' Produce Co. v. Crooks*[98] involved a poultry and egg marketing cooperative that met all requirements for exempt status. However, members occasionally were unable to provide all the goods the cooperative had contracted to deliver within a certain time. In those instances the cooperative purchased product from nonmember producers and dealers to fulfill its contracts. The cooperative did not realize any profit on this business. The court found such contracts were necessary to successfully market members' production and held:

> Plaintiff made such purchases not with the idea of an investment or profit, but with the sole object of meeting a

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[96] Tech. Adv. Mem. 8048018 (August 27, 1980).

[97] Tech. Adv. Mem. 8626002 (March 4, 1986).

[98] Producers Produce Co. v. Crooks, 2 F. Supp. 969 (W.D. Mo. 1932).

contract obligation. Under these circumstances, there would be no reason for depriving the plaintiff of the exemption.[99]

Three exceptions to the prohibition on purchasing nonproducer goods for processing and/or resale are now accepted. They are emergency purchases, ingredient purchases, and incidental purchases.

Emergency Purchases

IRS adopted the emergency purchases exception in Revenue Ruling 69-222.[100] A fruit marketing cooperative was unable to meet reasonable contract obligations to deliver a minimum level of product because a freeze greatly reduced member production. The association purchased fruit from nonproducers to meet its commitments under the contracts. The Service found that "emergency purchases...made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and not for any purpose of investment or profit" will not adversely affect the cooperative's section 521 status.[101]

The Service issued a series of three letter rulings to a processing cooperative faced with greatly reduced member production for both 1990 and 1991 caused by unusually heavy and extended rains and related pestilence. The cooperative had pre-existing marketing contracts for reasonable amounts of product based on production estimates of a nonprofit association providing agronomic services to the industry. Relying on Revenue Ruling 69-222, the Service permitted the cooperative to make purchases

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[99] *Id*. at 970.

[100] Rev. Rul. 69-222, 1969-1 C.B. 161. The nexus between this ruling and Producers' Produce Co. v. Crooks is discussed in Tech. Adv. Mem. 8705091 (Nov. 7, 1986).

[101] *Id*. *See also*, Rev. Rul. 76-388, 1976-2 C.B. 180 and Priv. Ltr. Rul. 9034043 (purchases from foreign countries permitted).

from foreign nonproducer sources to fulfill its contracts without jeopardizing its Section 521 status in both years.[102]

IRS also allowed the cooperative to receive a drawback of import duties paid on the replacement raw product for refined product subsequently exported by the cooperative over the next three years. The cooperative accounted for the duty refunds as a partial recovery of previous marketing expenses and allocated the refunds to the patrons originally charged with the import duty expense in 1990 and 1991.[103]

The emergency purchases exception will only be available if conditions show the purchase is made in a bona fide emergency. If the cooperative is aware its contracted commitments exceed the normal production of its members, purchases from nonproducers cannot be considered "emergency" purchases. Frequent resort to nonproducer purchases may be an indication the cooperative is making nonemergency purchases.[104]

The Service requires a preexisting contractual commitment to substantiate an emergency purchase. This is true even if the crop failure is due to a Presidentially declared natural disaster. A co-op described in a letter ruling[105] processed and marketed cottonseed. Although it had no preexisting orders for its product, the co-op purchased from a nonproducer (a nonexempt cooperative) so it would not face a five-month period of fixed plant overhead costs and possible loss of established markets. The purchases were not considered emergency purchases because the cooperative had no contract to deliver product, and its section 521 status was revoked.

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[102] Priv. Ltr. Rul. 9034043 (May 29, 1990); Priv. Ltr. Rul. 9132038 (May 13, 1991).

[103] Priv. Ltr. Rul. 9309012 (Dec. 1, 1992).

[104] Tech. Adv. Mem. 8047006 (July 29, 1980). A dairy cooperative that made nonproducer purchases to cover contract commitments nearly every month for a three-year period found not to be making "emergency" purchases.

[105] Tech. Adv. Mem. 7812004 (Oct. 31, 1977).

Ingredient Purchases

When cooperatives process patrons' products, they may require other ingredients to produce the end product. Ingredient purchases may be made from nonproducers without violating section 521 restrictions on marketing nonproducer products.

Ingredients are materials used by a cooperative to transform its patrons' farm product into another marketable form. For example, a cooperative that produces ice cream from patrons' cream must obtain sugar and flavoring necessary for ice cream production. IRS has said that even though those ingredients are not purchased from producers of agricultural products, their purchase does not endanger the processing cooperative's section 521 status.[106]

However, ingredients necessary to put agricultural products of patrons into marketable or changed form may not include farm products of the kind supplied by patrons. In Revenue Ruling 75-4, the ice cream manufacturing cooperative also indicated an intent to purchase cream from nonproducers. As this was a product furnished by member-producers, the Service said its purchase from nonmembers could not be called an ingredient purchase. If it marketed ice cream products from cream purchased from nonproducers, it would lose its section 521 status.[107]

Incidental Purchases

In certain situations marketing cooperatives may make limited "incidental" purchases of nonproducer goods for resale to facilitate their marketing of member products. The incidental purchases exception was accepted by the Board of Tax Appeals[108] in *Eugene Fruit Growers v. Commissioner*.[109]

An exception for incidental nonproducer activity was first advocated by a cooperative that sold a small amount of supplies to

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[106] Rev. Rul. 75-4, 1975-1 C.B. 165.

[107] *Id. See also* Tech. Adv. Mem. 8705091 (Nov. 7, 1986).

[108] The early name for the United States Tax Court.

[109] Eugene Fruit Growers v. Commissioner, 37 B.T.A. 993 (1938).

nonproducers. During the years at issue, the applicable law--the Revenue Act of 1921--only mentioned an exemption for cooperatives "purchasing supplies and equipment for the use of members...."[110] The cooperative's argument was unsuccessful.[111]

The concept of an incidental purchases exception was incorporated in the arguments of a dairy marketing cooperative whose exemption was revoked for purchasing nonmember products and reselling them to compliment the marketing of member milk. The years in question were also controlled by the Revenue Act of 1921, which also provided exempt status to a cooperative "organized and operated as sales agent for the purpose of marketing the products of members...."[112]

The same court that rendered the opinion in *Fruit Growers' Supply* didn't flatly refuse to consider an incidental purchases exception this time. It ruled against the cooperative because it found the sales to outsiders to be "commercially desirable" rather than "absolutely necessary" to meet competition in the sale of members' products.[113]

Eugene Fruit Growers Association marketed fruits, vegetables, and nuts on a cooperative basis. The cooperative also engaged in several "commercial activities" IRS said exceeded permissible conduct for an exempt cooperative. The cooperative had purchased an ice cream factory adjoining its cannery. The plant's refrigeration equipment was used to refrigerate association

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[110] The Revenue Act of 1921, ch. 136, § 231(11), 42 Stat. 227, 253 (1921).

[111] Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90 (9th Cir. 1932), *aff'g* 21 B.T.A. 315 (1930). Current law permits cooperatives with section 521 status to do up to 15 percent of their farm supply business with persons who are neither members nor producers. *See supra* p. 13.

[112] The Revenue Act of 1921, ch. 136, § 231(11), 42 Stat. 227, 253 (1921).

[113] Burr Creamery Corp. v. Commissioner, 62 F.2d 407, 410 (9th Cir. 1932), *aff'g* 23 B.T.A. 1007, *cert. denied*, 289 U.S. 730 (1933).

products. The cooperative continued that facility's ice and ice cream businesses to reduce the refrigeration costs of its members. To make more effective use of the cannery machine shop, some custom work was done on a commercial basis.

The cooperative separated the modest earning of the commercial activity from its primary cooperative functions and paid tax on the former. Nonetheless, IRS challenged the cooperative's tax exempt status.

The court ruled for the co-op, stating, "...these 'commercial departments' were purely incidental to petitioners' principal purpose. They were conducted, not for their own sake, but as an adjunct and supplement to the cooperative marketing of farm products."[114]

The court took particular note of tax code changes enacted as part of the Revenue Act of 1926 and continued in the applicable law at the time of the events under review, the Revenue Act of 1932. It cited legislative history wherein Congress approved the liberal interpretations of earlier law.[115] The court noted:

> ...there is no statutory requirement that petitioner be engaged "exclusively" in cooperative marketing, as there was in some of the provisions construed by (earlier) decisions, but merely that it be "organized and operated on a cooperative basis (a) for the purpose of marketing the products of members...." We believe petitioner falls clearly within that definition.[116]

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[114] Eugene Fruit Growers Association v. Commissioner, 37 B.T.A. 993, 1001 (1938).

[115] S. Rep. No. 52, 69th Cong., 1st Sess., 23-24, *cited at* 37 B.T.A. 1003. For a discussion of the early legislative history leading to current I.R.C. § 521, *see* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005), pp. 113-116.

[116] 37 B.T.A. 1001. Identical statutory language is found today in I.R.C. § 521(b)(1).

In Revenue Procedure 67-37,[117] IRS established audit guidelines for determining the effect of retail sales of nonproducers' products on a cooperative's section 521 status. The Service said a 521 cooperative could resell products acquired from nonproducers "...as a necessary supplement or sideline to the efficient retail marketing of products for its producer patrons."[118] The ruling includes an example of a dairy cooperative that would find it difficult to market its patrons' milk products at retail unless it also offered nonproducer products such as fruit juice and eggs.

Revenue Procedure 67-37 creates a safe harbor for incidental sales of nonproducer items. Auditors are to disregard such sales where the dollar volume of such sales does not exceed 5 percent of the cooperative's total retail sales. IRS based the figure on its "audit experience," concluding sales below 5 percent "...are not indicative of a separate profit motive."[119] Where the sales of nonproducer sideline items exceed 5 percent, a "facts and circumstances" test is applied to determine if the sales are a necessary supplement to efficiently marketing producer goods.[120]

Revenue Procedure 67-37 was interpreted in *Land O'Lakes, Inc. v. United States*.[121] Land O'Lakes operated a chain of convenience stores that sold dairy products of member-producers and non-dairy items purchased from proprietary firms. It also sold both producer and nonproducer goods at wholesale.

Nonproducer items amounted to 17 percent of Land O'Lakes total retail sales. Nonetheless, the court held that the retail nonproducer sales did not jeopardize the cooperative's section 521 status. It found the purpose of such sales was to enhance the sales of producer items (by attracting more customers to the stores) and

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[117] Rev. Proc. 67-37, 1967-2 C.B. 668.

[118] *Id.*

[119] *Id.*

[120] *Id.*

[121] Land O'Lakes, Inc. v. United States, 362 F. Supp. 1253 (D. Minn. 1973).

therefore met the test of being "incidental to the effective marketing of producer goods."[122]

The court also held Land O'Lakes marketing of nonproducer goods at wholesale was permissible under Code section 521. The court was not persuaded by the Government's attempt to establish a bright line between retail and wholesale marketing. It noted that such sales totaled only 3.4 percent of the cooperative's wholesale business and were otherwise incidental to the marketing of producer goods.[123]

The court's ultimate finding, that Land O'Lakes was entitled to section 521 tax treatment, was overturned on appeal. However, the appellate court opinion only dealt with IRS challenges to the cooperative's purchasing activities and its payment of patronage refunds to the nonproducer furnishing the goods resold at wholesale.[124]

IRS has continued to take a restrictive view of the incidental purchases exception. For example, a cotton marketing cooperative lost its section 521 status when it purchased a wool processing company. While the acquisition was made pursuant to a plan to stabilize the cooperative's future by diversifying its business activity, IRS said it did not qualify as an incidental activity because it wasn't necessary to market member producers' cotton.[125]

In 1986,[126] IRS established tests to determine whether marketing nonproducer products is incidental to the marketing of producer products:

1. The marketing of nonproducer products must be necessary to market producer products.

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[122] *Id.* at 1257.

[123] *Id.* at 1258-59.

[124] Land O'Lakes, Inc. v. United States, 514 F.2d 134, 137 (8th Cir. 1975), *rev'g* 362 F. Supp. 1253 (D. Minn. 1973), *cert. denied,* 423 U.S. 926 (1975).

[125] Rev. Rul. 76-233, 1976-1 C.B. 173.

[126] Tech. Adv. Mem. 8705091 (Nov. 7, 1986).

2. The amount of nonproducer products sold must be insubstantial in relation to the amount of producer products measured, in part, by the relative level of gross receipts realized on each activity.

3. The marketing of nonproducer products must not generate substantial receipts or substantial profits. Substantial is measured by looking at the receipts and profits of the cooperative's competitors who are not exempt from taxation.

Relying on this standard, IRS revoked the cooperative's section 521 status because it resold relatively small amounts of processed products it purchased from major customers for its member products. IRS noted that some of the sales occurred at the wholesale level, an activity it has never approved. It also determined the cooperative failed to show that handling nonproducer items was essential to the marketing of producer products or that it was incidental in amount.[127]

A concluding tax planning note. The Service has determined that when nonproducer items are purchased for a fixed price, the nonproducers are not eligible to be patrons of the cooperative. Therefore, the cooperative need not pay patronage refunds to them. "Profits attributable to these transactions will be nonpatronage sourced earnings subject to section 521(b)(4) of the Code."[128]

In *Land O'Lakes* the court was even more forceful, holding the cooperative forfeited section 521 status by paying patronage refunds to a nonproducer subsidiary.[129]

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[127] *Id.*

[128] Rev. Rul. 76-388, 1976-2 C.B. 180. The nonproducer business involved purchases of sideline products and emergency purchases.

[129] Land O'Lakes, Inc. v. United States, 514 F.2d 134, 139-140 (8th Cir. 1975), *rev'g* 362 F. Supp. 1253 (D. Minn. 1973), *cert. denied,* 423 U.S. 926 (1975).

Necessary Marketing Expenses

Code section 521 provides that eligible cooperatives must return to marketing patrons the proceeds from selling their products, "less the necessary marketing expenses,...."[130] While the regulations don't explain the phrase, they do substitute "operating" for "marketing" when discussing the Code provision.[131]

Revenue Ruling 55-558[132] concerned a vegetable marketing cooperative with only five high-volume producer-members. In view of the impact the loss of a member's volume would have on the cooperative, it purchased a life insurance policy on the life of each member, named itself the beneficiary, and paid the premiums. The Service determined the insurance premiums were not a "marketing" expense and therefore the association was not turning back to its members and other producers the proceeds of sales less necessary marketing expenses. Section 521 status was denied.

IRS explained its interpretation of "necessary marketing expenses" in more detail in Revenue Ruling 76-233.[133] A marketing cooperative of cotton producers incurred consulting and legal expenses in acquiring a wool processing company. The purchase was part of a plan to broaden its economic base beyond the marketing of cotton. The Service said:

> Necessary marketing expenditures include expenses, necessary to prepare a product for its final sale, incurred from the time the product is turned over to the cooperative by the producer. Expenses such as grading, packing, crating, processing, canning, drying, freezing, evaporating, and wrapping, qualify as necessary marketing expenses. However, expenses not connected with the marketing of

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[130] I.R.C. § 521(b)(1)(A).

[131] Treas. Reg. § 1.521-1(a)(1).

[132] Rev. Rul. 55-558, 1955-2 C.B. 270.

[133] Rev. Rul. 76-233, 1976-1 C.B. 173.

the products of the members and other producers do not qualify as necessary marketing expenses within the meaning of section 521(b)(1) of the Code.[134]

The Service found that these consulting and legal fees were not "necessary marketing expenses." Because the payments reduced the amounts of patronage refunds (sales proceeds less expenditures) paid to the producers, IRS revoked the association's section 521 status. As any other payment reduces the funds available for patronage refunds, a farmers' marketing cooperative may jeopardize its section 521 status whenever it incurs expenses not connected to its marketing activity.

PURCHASING FOR MEMBERS AND OTHER PERSONS

The second permissible activity for a section 521 cooperative is "purchasing supplies and equipment for the use of members and other persons, and turning over such supplies and equipment to them at actual cost, less necessary expenses."[135] It should be noted that being able to provide supplies to members and other "persons" gives a cooperative more leeway than in its marketing function, where business can only be conducted for members and other "producers."[136]

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[134] *Id*. at 174.

[135] I.R.C. § 521(b)(1)(B). Research has not disclosed a ruling or decision discussing "necessary expenses" in the context of providing supplies. Presumably, IRS would argue they have to be connected to the supply function just as "necessary marketing expenses" must be connected to the marketing function under Rev. Rul. 76-233, 1976-1 C.B. 173.

[136] Limits on nonmember and nonproducer business are addressed *infra*, pp. 33-38.

Manufacturing

Code section 521 talks of eligible associations "purchasing" supplies and equipment for the use of members and other persons.[137] This is probably because at the time this language was first developed, cooperatives lacked the resources and expertise to manufacture farm supplies.

Over the years, farmers have pooled their capital and acquired fertilizer plants, petroleum refineries, feed mills, and other major facilities to produce their own farm inputs. IRS has recognized this change in the way cooperatives meet member needs and determined that "Where a farmers' cooperative purchasing association manufactures products supplied to the farmer patrons, such manufacture represents a part of the purchasing activity of the association."[138]

Household Items

Code section 521 focuses on business relationships, the marketing of farm products and purchasing of farm supplies and equipment. In a farm setting, differentiating business and household items purchased by producers from their cooperative would be very difficult.

A regulatory provision eliminates possible controversy in this area. It states: "The term 'supplies and equipment' as used in

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[137] *Id*. Unfortunately, the term "purchasing" is often used when discussing both marketing and supply functions. In the marketing context, it is used when a cooperative purchases product "from" someone, often nonmembers and/or nonproducers. In the supply context, it is used when a cooperative purchases supplies and equipment "for" someone, whether a member, nonmember or nonproducer.

[138] Rev. Rul. 69-417, 1969-2 C.B. 132, 133. For a discussion of the so-called Ribicoff amendment to deny cooperatives a patronage refund deduction for earnings on manufacturing farm supplies, *see* pp. 24-25 of this report.

section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household."[139]

This permits farmer-members to use their cooperative to purchase food and other household items for resale to them without jeopardizing its section 521 status. This can be an especially valuable service in sparsely populated areas that might not attract commercial grocery, drug, or hardware stores. It also means the cooperative includes sales of these items when computing its member, nonmember producer, and nonmember nonproducer supply activity when checking its compliance with limitations on nonmember business.

LIMITS ON NONMEMBER, NONPRODUCER BUSINESS

While section 521 cooperatives are permitted to do significant business with nonmembers and nonproducers, the Code contains specific limits on such activity. If a cooperative engages in both marketing and purchasing, the regulations state it must meet all Code requirements applicable to each function to qualify for section 521 status.[140]

The regulations also provide that "Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning

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[139] Treas. Reg. § 1.521-1(b).

[140] Treas. Reg. 1.521-1(c) states "An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code."

of section 521."[141] Thus, a cooperative counts as a member anyone who has a legal right to receive patronage refunds and to vote in cooperative affairs.

Marketing

The value of products marketed for members must exceed the value of products marketed for nonmembers.[142] This test has not been controversial, but a few questions have arisen concerning its application.

In one instance, a cooperative marketed fruit that was both produced by members and purchased by them on the open market. During the years in question, the value of fruit purchased by the members and marketed through the association exceeded the value of fruit marketed by the association that was grown or otherwise produced by the members. IRS stated that "member" products means products grown or otherwise produced by a member. Since products purchased were considered nonmember business, the association was in violation of the majority member business rule and not eligible for section 521 status.[143]

When one cooperative performs a mere administrative function for other cooperatives, IRS has stated the activities don't constitute marketing under section 521(b)(4). In a 1980 letter ruling,[144] three cooperatives combined grain shipments to take advantage of lower carlot rail rates. Commercial practice required that a single bill of lading be prepared in one cooperative's name and a single check issued. One cooperative received payment for all grain shipped by the three cooperatives and then wrote checks

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[141] Treas. Reg. § 1.521-1(a)(3). This definition is made applicable to supply cooperatives by Treas. Reg. § 1.521-1(b).

[142] I.R.C. § 521(b)(4) and Treas. Reg. § 1.521-1(a)(3).

[143] Rev. Rul. 67-152, 1967-2 C.B. 147, *superseding* I.T. 3853, 1947-1 C.B. 42.

[144] Tech. Adv. Mem. 8115011 (Dec. 18, 1980).

to the other cooperatives for their portion of the payment. The Service held this arrangement did not constitute marketing and the cooperative need not include the amount shipped by the others with whom it cooperated in its computation of nonmember business.

Under some circumstances a member, acting as an agent, may deliver another producer's product to the cooperative for marketing. The Service has determined that as long as nonmember producers are treated as patrons under the agency agreement, the association is eligible for section 521 status. But the product delivered is counted as nonmember business.[145]

Purchasing

Two limits apply to cooperative procurement of supplies for nonmembers:

1. The value of supplies and equipment purchased for members must exceed the value of such items purchased for nonmembers,[146] and

2. The value of supplies and equipment purchased for persons who are neither members nor producers may not exceed 15 percent of the value of all purchases.[147]

Most of the questions about these rules have concerned distinguishing producers from nonproducers for purposes of the 15-percent limitation on sales to persons who are neither members nor producers.[148] Sales to those who have no connection to

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[145] Rev. Rul. 55-496, 1955-2 C.B. 268; Priv. Ltr. Rul. 9310031 (Dec. 15, 1992).

[146] I.R.C. § 521(b)(4) and Treas. Reg. § 1.521-1(b).

[147] *Id.* The limitations on marketing and purchasing for nonmembers were first codified in the Revenue Act of 1926, ch. 27, § 231(12), 44 Stat. 9, 40-41 (1926).

[148] One cooperative did argue, unsuccessfully, that the term "supplies," as used in section 521(b)(4), does not include grain and feed

farming must clearly be considered nonmember, nonproducer sales. Examples include direct sales of petroleum products to the public[149] and sales by a federated cooperative to a member consumer cooperative whose patrons were consumers.[150]

IRS has stated that supplies sold to a farmer member, if used for a nonfarm purpose, must also be treated as nonmember, nonproducer business. Revenue Ruling 67-223[151] concerned a cooperative that sold gasoline to a member who was both a farmer and the owner of a trucking business. The member used the gasoline in both businesses. IRS noted that the purpose of Code section 521 is to assist farmers and other producers in their agricultural activities as producers. It permitted the cooperative to maintain its section 521 status, but required it to treat the purchases of gasoline for the member's use in his nonfarming business as purchases made for persons who are neither members nor producers for purposes of the 15-percent limit.

Exchanges of Like Items and Disposition of Byproducts

A series of three IRS revenue rulings addresses common situations in manufacturing farm supplies--exchanges of like products with nonmember nonproducers and the disposition of byproducts--in the context of the 15-percent limit on nonmember, nonproducer business. Revenue Ruling 54-12[152] described a cooperative that operated a petroleum refinery to provide light

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purchased by a cooperative for resale to member and nonmember patrons. Farmers Union Cooperative Ass'n, Fairbury, Neb. v. Commissioner, 44 B.T.A. 34 (1941).

[149] Central Co-operative Oil Ass'n v. Commissioner, 32 B.T.A. 359 (1935); Farmers Union Cooperative Oil Co. v. Commissioner, 38 B.T.A. 64 (1938).

[150] Cooperative Central Exchange v. Commissioner, 27 B.T.A. 17 (1932).

[151] Rev. Rul. 67-223, 1967-2 C.B. 214.

[152] Rev. Rul. 54-12, 1954-1 C.B. 93.

petroleum products required by its farmer members. The refining process also produced heavy fuel oils and distillates farmer patrons couldn't use.

At times, the cooperative exchanged light petroleum products for like products of other refineries, strictly to reduce transportation costs for both firms. It regularly sold the heavy byproducts on the open market to businesses, such as railroads and steel mills, that could use them. The Service, without any real analysis, found that both the exchanges of like products and the sales of byproducts not usable by farmer patrons could be disregarded in "determining whether the value of purchases made for persons who were neither members nor producers exceeded 15 percent of the value of all its purchases."[153]

Revenue Ruling 67-346[154] concerned a cooperative that exchanged a byproduct from its farm supply manufacturing operations that patrons could not use for an unlike product of a nonmember nonproducer its patrons could use. IRS said, "Such an exchange is in effect a sale by the cooperative of its products with the proceeds from the sale being used to acquire a different product for resale to the patrons of the cooperative."[155]

The Service required the cooperative to count the value of the byproducts exchanged against the 15-percent limit on nonmember, nonproducer business. It distinguished Revenue Ruling 54-12 on the basis that that ruling concerned the exchange of like products for the sole purpose of providing savings in transportation costs.

In Revenue Ruling 69-417,[156] IRS reviewed its findings in Revenue Ruling 54-12. It modified the earlier ruling, making it consistent with Revenue Ruling 67-346. The sale of byproducts to nonmember nonproducers must be counted against the 15-percent limit. However, the value of like products exchanged with

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[153] *Id.*

[154] Rev. Rul. 67-346, 1967-2 C.B. 216.

[155] *Id.* at 217.

[156] Rev. Rul. 69-417, 1969-2 C.B. 132.

nonmember nonproducers to save transportation costs would remain outside the scope of the limitation.

Use of Agents

A purchasing cooperative may sell supplies to an agent acting for producers rather than directly to producers. If the relationship is not found to involve a true agent, the sales will be treated as nonmember, nonproducer business.

In *Land O'Lakes v. United States*[157] the cooperative sold farm supplies (feed, seed, fertilizer) at wholesale to a number of retail agricultural supply stores. The stores were not members of the cooperative. They, in turn, sold the supplies to their farmer customers. By agreement between the stores and the cooperative, the retail store was designated an agent for the farmers who purchased the inputs. The agreement said the retail store would pass all patronage refunds from the cooperative on to farmer purchasers. The cooperative argued that the retail stores were agents for the ultimate farmer-purchasers and the sales should count as producer business for purposes of section 521(b)(4).

The Eighth Circuit Court of Appeals found the arrangement did not make farmer producers the purchasers rather than the nonproducer retail store. It said the cooperative sold its supplies unconditionally to the retail stores without knowing the identity of those who would receive the supplies as the stores' principals. The risks of loss remained with the retail store. The store remained free to set the retail price on its sales to customers and would gain the profit or bear the loss incident to the sale. The court found "The agent-buyer device must be disregarded as a legal fiction."[158]

The court then upheld IRS's denial of section 521 status for Land O'Lakes because including these items in the value of sup-

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[157] Land O'Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir. 1975), *rev'g* 362 F. Supp. 1253 (D. Minn. 1973), *cert. denied*, 423 U.S. 926 (1975).

[158] *Id.* at 139.

plies sold to nonmembers and nonproducers pushed such business by the cooperative over the permissible 15 percent.

UNITED STATES GOVERNMENT BUSINESS

The Code contains one additional rule pertaining to the business operations of a section 521 cooperative. Code section 521(b)(5) provides "Business done for the United States or any of its agencies shall be disregarded in determining" whether a cooperative is eligible for section 521 status.[159] A cooperative may do business, of either a marketing or purchasing nature, for or with the United States and not jeopardize its section 521 status. It may also disregard the value of such business when determining the percentage requirements of section 521(b)(4).

However, IRS has cautioned that a cooperative cannot be operated primarily to do business with or for the United States or one of its agencies. Revenue Ruling 65-5 concerned a cooperative that purchased grain from Commodity Credit Corporation (CCC) for use in both its supply and marketing activity. After acknowledging that section 521(b)(5) allowed the cooperative to disregard business with CCC in determining the percentage requirements under section 521(b)(4), the Service said:

> ...(T)hat provision should not be construed to mean that there is no limit on the amount of business a cooperative may do with the United States....(T)he farmers' cooperative in question will not jeopardize its exemption because of business done for or with the United States or an agency thereof...provided the organization continues to engage in marketing or purchasing activities for its patrons to the extent that it may properly be characterized as a far-

[159] I.R.C. § 521(b)(5). *See also* Treas. Reg. § 1.521-1(c).

mers' cooperative within the meaning of that term as defined in section 521 of the code.[160]

ORGANIZATIONS HAVING CAPITAL STOCK

A cooperative that meets the business conduct requirements of being a farmers' marketing or purchasing organization has only partially established its eligibility for section 521 status. It must also comply with certain additional organizational and operational requirements.

Cooperatives that issue capital stock must comply with two tests tied to that stock. First, the dividend rate on its stock may not exceed 8 percent per year or the legal rate of interest in the State of incorporation, whichever is greater. Second, substantially all voting stock must be owned by producers who market products or purchase supplies through the association.

These requirements exemplify the influence of cooperative principles over the tax law. They reflect the belief that cooperative members should own, control, and receive the benefits of cooperation. The limit on return on equity is to discourage attempts to operate the cooperative to generate earnings for investors, rather than to provide services and patronage refunds to its members. The limit on nonuser ownership of voting stock means member-users will always control a section 521 cooperative.

Research has not uncovered a definite explanation of why these limits only apply to cooperatives that issue stock. One possible answer is that nonstock associations were presumed not to pay a return on equity and therefore nonusers would have no interest in acquiring any voting interest. Early commentary suggests that if nonstock cooperatives did pay a return on equity,

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[160] Rev. Rul. 65-5, 1965-1 C.B. 244.

"the rate limitation applies to the interest paid or accrued on whatever form of capital shares exists."[161]

Limit on Stock Dividends

The Code provides that section 521 status shall not be denied a farmers' cooperative:

> ...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.[162]

The Revenue Act of 1916 and its successor tax laws in effect until 1925 made no mention of cooperative stock or dividends on equity. However, a series of administrative decisions by the Treasury Department between 1920 and 1924 authorized the issuance of capital stock and established the parameters on permissible returns.[163] These regulations were found to be valid and enforceable.[164] The Revenue Act of 1926 contained the first Code provision on dividends, the same as is now found in section 521.

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[161] George J. Waas and Daniel G. White, *Application of the Federal Income Tax Statutes to Farmers' Cooperatives*, Farm Credit Administration Bulletin No. 53, ¶ 521 (USDA 1942) p. 128.

[162] I.R.C. § 521 (b)(2) and Treas. Reg. § 1.521-1(a)(2)(I).

[163] These developments are outlined in Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) pp. 110-111.

[164] South Carolina Produce Ass'n v. Commissioner, 50 F.2d 742 (4th Cir. 1931), *aff'g* 19 B.T.A. (1930) (Exemption lost for paying a dividend of 10 percent during tax years 1923 and 1924, when the regulatory limit was 8 percent).

Rate of Return

The limit on the dividend rate, with its "whichever is greater" provision, is interpreted in a straightforward manner. If the legal rate of interest in the State of incorporation is greater than 8 percent, a cooperative can pay dividends at that rate with-out jeopardizing its section 521 status. If the legal limit on interest in the State is less than 8 percent, a section 521 cooperative can pay a return on capital of up to 8 percent without jeopardizing its section 521 status. The Code refers only to capital stock, so all classes of stock are included, whether common or preferred.

Valuing Consideration

Rate limits on capital stock are applied to "the value of consideration for which the stock was issued."[165] This value has been questioned in a few instances.

The value of consideration at original issue is the amount the member paid for the stock (and not the par value, if there is a difference). Certain stock transactions subsequent to original issue may draw into question the value of consideration against which a rate can be applied.

In *Farmers Mutual Cooperative Creamery of Sioux Center, Iowa v. Commissioner*,[166] members purchased capital stock that paid an annual dividend of 8 percent and received patronage refunds on their proportional share of the association's margins. The association had substantial dealings with and for nonmember producers. While nonmember producers received the same payments for product as members, they did not receive patronage refunds. (The court found this fact alone justified revocation of exempt status.) Earnings on nonmember business were placed into a reserve and additional stock allocations were made to members from this reserve. While the members paid nothing for this stock, it also returned an annual dividend of 8 percent.

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[165] I.R.C. § 521(b)(2).

[166] Farmers Mutual Cooperative Creamery of Sioux Center, Iowa v. Commissioner, 33 B.T.A. 117 (1935).

By the tax year in question, $27,140 of the outstanding capital stock of $45,680 had been issued as stock dividends from the reserve of earnings from nonmember business. The court held the value of the consideration for which the stock was issued was the amount each member paid for stock, which was often less than half the book value of the stock in that member's account. As all of the stock paid an 8 percent dividend, members were receiving a return from 12 to 18 percent on the amount they had actually invested in the cooperative. The court found this barred the cooperative from exempt status.[167]

In another situation, a general business corporation, which had conducted its business on a partially (unspecified) cooperative basis, reorganized as a cooperative. As part of the conversion, the firm replaced the common stock of the former corporation with one class of dividend-paying preferred stock. A second class of preferred stock was issued to shareholder-members to capitalize the earned surplus accumulated by the old corporation. This stock also paid dividends.

The court held the cooperative had received no consideration for the second preferred stock. It had, instead, simply changed the structure of the reorganized corporation's capital account. When the dividends on the two classes of stock were combined and compared to the amount the members had paid for the old corporation's common stock (now the first class of preferred in the cooperative), the dividend rate greatly exceeded the allowable limit of 8 percent of the value of the consideration. The cooperative was held ineligible for section 521 status.[168]

Shortly after the *Laura Farmers* opinion, the Service also expressed the view that when stock dividends are made for no additional consideration, the maximum annual dividend rate of the cooperative, if it is to establish section 521 status, may not exceed

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[167] *Id.* at 125.

[168] Laura Farmers Cooperative Elevator Co. v. United States, 273 F. Supp. 1019 (S.D. Ill. 1967).

the permissible percentage of the consideration paid for the original stock.[169]

A second example of the value of consideration question in a reorganization was addressed in *Etter Grain*.[170] A noncooperative business was allegedly converted into a cooperative.[171] As part of the reorganization, the former owners of the business had its assets appraised. They exchanged their stock in the old company for dividend-paying preferred stock in the cooperative. They assigned this new stock a par value far above their investment in the old firm, to capture its appreciation for themselves. The court said:

> The question of valuation would not be present if, as an example, a new cooperative corporation was formed and each stockholder invested cash for his preferred shares. But here, where stock is exchanged, the value to be used for Sec. 521 purposes is the investment value of each stockholder in the old corporation, not its re-evaluation as was used by [the cooperative] in this case.... To hold otherwise, would only open another door or afford another device and method for operating a co-op for the advantage of the stockholders rather than the member-producers.[172]

Substantially All Test

The section 521 requirement that ties use, ownership, and control together is the requirement that "substantially all" stock

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[169] Rev. Rul. 68-169, 1968-1 C.B. 286.

[170] Etter Grain Co. v. United States, 331 F. Supp. 283 (N.D. Tex. 1971), *aff'd*, 462 F.2d 259 (5th Cir. 1972).

[171] The new organization failed to qualify as a cooperative for a number of reasons.

[172] Etter Grain Co. v. United States, 331 F. Supp. 283, 286 (N.D. Tex. 1971), *aff'd*, 462 F.2d 259 (5th Cir. 1972).

evidencing membership be owned by producers who use the cooperative. The Code provides:

> Exemption shall not be denied any such association because it has capital stock...if substantially all such stock (other than nonvoting preferred stock...) is owned by producers who market their products or purchase their supplies and equipment through the association.[173]

The "substantially all" rule applies only to cooperatives with capital stock. "Membership" cooperatives having no capital stock are not subject to the test.[174]

"Substantially all" is not defined in the Code or regulations. However, inclusion of the modifier "substantially" indicates some stock may be owned by persons who are not producers marketing products and purchasing supplies through the cooperative.

The regulations require that any ownership of capital stock by nonproducers at the time the cooperative applies for section 521 status be justified and that ownership "has been restricted as far as possible to such actual producers."[175]

The regulations give examples where nonproducer stock ownership is permitted:

> If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is

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[173] I.R.C. § 521(b)(2).

[174] Tech. Adv. Mem. 7814002 (June 29, 1977). The Service notes, however, that if dividends can be paid on the basis of some equity ownership, though not capital stock, the test may be applicable.

[175] Treas. Reg. § 1.521-1(a)(2). *See* Rev. Rul. 67-204, 1967-1 C.B. 149.

> unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption.[176]

They do not, however, offer guidance as to the issues that became contentious in this area, (1) how do you identify "producers who market their products or purchase their supplies and equipment through the association," and (2) how do you measure "substantially?"

The Current Patronage Requirement

Section 521 requires that substantially all voting stock must be owned by "producers who market their products or purchase their supplies and equipment through the association."[177] Although this language has been part of the Code since 1926,[178] it was not presented to the courts for interpretation until the late 1960s.

In 1960, Co-Operative Grain & Supply Co., a grain marketing and farm supply cooperative in Roseland, Nebraska, applied for section 521 status. The district director denied the request on several grounds, including a determination that about 16 percent of the cooperative's stock was "in the hands of owners who are

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[176] Treas. Reg. § 1.521-1(a)(2).

[177] I.R.C. § 521(b)(2) and Treas. Reg. § 1.521-1(a)(2).

[178] Revenue Act of 1926, ch. 27 § 231(12), 44 Stat. 9, 40 (1926). For a summary of early rulings that are the foundation for the "substantially all" requirement, *see,* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) p. 110-111. *See also*, Gen. Couns. Mem. 33,981 (Nov. 20, 1968).

neither marketing or purchasing through the association."[179] He issued a notice of deficiency for taxes allegedly due and the cooperative sued in U.S. Tax Court.

The court found that substantially all, if not all, of the cooperative's shareholders were agricultural producers. However, it also determined that the cooperative was obligated to prove that "Substantially all of petitioner's shareholders were active producers, that is--producers who marketed their products or purchased their supplies and equipment through the association."[180]

The court ruled that since the cooperative made no attempt to show that its shareholder-producers were active patrons during the years at issue, it failed to meet the requirements of Code section 521(b)(2) and thus failed to show it qualified for section 521 status.

The cooperative appealed to the Eighth Circuit Court of Appeals. That court reviewed the underlying policy for special tax treatment, to improve the plight of farmers, and found this cannot occur unless the farmers patronize the association. The court concluded "substantially all of the shareholder-producers are required to market their products and purchase their supplies through the taxpayer on a current basis. That is our holding."[181]

While the 8th Circuit adopted the general position of the Tax Court, neither opinion provided guidance to cooperatives as to how much flexibility they had under the "substantially all" rule. The appellate court took two steps to remedy this. First, it noted IRS had asserted its national office had an ongoing project to pub-

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[179] Co-operative Grain & Supply Co. v. Commissioner, 26 T.C.M. (CCH) 593, T.C. Memo 1967-132 (1967).

[180] *Id.*

[181] Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1164 (8th Cir. 1969), *aff'g* 26 T.C.M. (CCH) 593, T.C. Memo 1967-132 (1967).

lish guidelines in this area. It urged the Service to issue appropriate administrative determinations.[182]

Second, the court ordered the case remanded to the Tax Court to give the cooperative an opportunity to produce additional evidence that it satisfied the current patronage test.[183]

On remand, the Tax Court interpreted "current" to mean "...actual yearly participation."[184] It held "substantially all" shareholders must market products or purchase supplies through the cooperative each year. A mere continuing business relationship is not sufficient. If a shareholder does not patronize the cooperative during the year, the shareholder may not be counted as a patron for purposes of meeting the "substantially all" requirement for that year.

The 85-Percent Rule

Several early decisions addressed the adequacy of a specific percentage of stock ownership by producers, presented by the facts at hand, but formulated no general quantitative measure. Ninety-one percent was held to be "substantially all",[185] but 72 percent was not.[186]

In 1973, IRS said for the first time that at least 85 percent of capital stock must be held by producers to meet the "substantially all" test.[187]

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[182] *Id.*

[183] *Id.* at 1165.

[184] Co-operative Grain and Supply Co. v. Commissioner, 32 T.C.M. (CCH) 795, 798 (1973), *on remand from* 407 F.2d 1158 (8th Cir. 1969).

[185] Farmers Cooperative Creamery Ass'n v. Commissioner, 21 B.T.A. 265 (1930).

[186] Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457 (1969).

[187] Rev. Rul. 73-248, 1973-1 C.B. 295. This ruling was noted in the Tax Court's opinion on remand in *Cooperative Grain & Supply Co*. The court declined to decide what percentage is sufficient, but held that

In 1974, 83.75 percent of the member-shareholders of West Central Cooperative in Ralston, Iowa, marketed some of their products or purchased some of their supplies through the cooperative. In 1978, the Service retroactively revoked the cooperative's section 521 status and accessed additional taxes for fiscal year 1974. The cooperative paid the assessment and sued for a refund in Federal District Court. The court determined that the 85-percent rule established in Revenue Ruling 73-248 was "reasonable and in keeping with the congressional mandate embodied in the language of § 521(b)(3)."[188]

The 85 percent figure has been applied strictly in a subsequent case,[189] and appears to be the established measure.

The "Ability-to-Vote-at-the-Next-Annual-Meeting" Test

If the current patronage test is applied too literally, it creates a dilemma for cooperatives. They have no way of determining how many members, and which specific members, will patronize the cooperative until after the end of the tax year.

At the same time IRS was challenging West Central Cooperative, it was also questioning the section 521 status of Farmers Cooperative Company, a grain marketing and supply cooperative in Platte Center, Nebraska. In 1982, the district director revoked the cooperative's section 521 status for all years after 1976 on the grounds that it had not sufficiently limited the ownership of its common stock to active producers to comply with the "substantially all" rule. The cooperative filed a petition for redetermination with the Tax Court.

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78 percent fell short. Co-operative Grain and Supply Co. v. Commissioner, 32 T.C.M. (CCH) 795, 797-798 n.4 (1973), *on remand from* 407 F.2d 1158 (8th Cir. 1969).

[188] West Central Cooperative v. United States, 607 F. Supp. 1 (N.D. Iowa 1983), *aff'd*, 758 F.2d 1269 (8th Cir. 1985).

[189] Farmers Cooperative Co. v. Commissioner, 85 T.C. 601 (1985), *aff'd on this issue, remanded on other issues*, 822 F.2d 774 (8th Cir. 1987)(84.78 percent insufficient).

During litigation, IRS argued that the current patronage requirement meant a section 521 cooperative had to do whatever was necessary to make sure at least 85 percent of its shareholders during the year did business with the cooperative. The cooperative asserted that it should be allowed to count as current shareholders nonmembers who patronized the association during the year and were entitled to, but had not by the end of the year, received their share of membership stock. It also said it should be able to disregard members who failed to patronize the association as its bylaws provided only producers who do business with the association each year may own common stock.

The Tax Court generally accepted the Service's arguments. First, it held that a cooperative whose annual shareholder patronage hit a peak of 84.75 percent was not in compliance with Section 521(b)(2).[190] The court did not permit the cooperative to count, as shareholders, producers who began patronizing the cooperative during the tax year but did not receive their stock certificates until after the end of that year. The cooperative was, however, required to count former patrons whose voting stock had not been redeemed by the end of the year. The court did suggest that a "facts and circumstances" approach would be appropriate to temper possible harsh results from a strict application of the 85-percent rule, as, for example, a cooperative that had 90 percent of its shareholders patronize it for 3 successive years and then saw that figure drop to 84.75 percent for one year.[191]

The cooperative appealed. In 1986, IRS issued a letter ruling that applied a "facts and circumstances" test to justify finding that

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[190] Farmers Cooperative Co. v. Commissioner, 85 T.C. 601 (1985), *remanded*, 822 F.2d 774 (8th Cir. 1987). The court noted that since an appeal of this opinion would go to the 8th Circuit, it was bound by that court's opinion in *West Central Cooperative*. Regardless, it stated that it also found the 85-percent test an appropriate measure for interpreting "substantially all." 85 T.C. at 613.

[191] *Id.* at 614-615.

although another cooperative did not meet the 85-percent rule, its section 521 status should not be revoked.[192]

In its litigation against Farmers Cooperative Company, the Service consistently argued that anyone holding a share of stock was a shareholder under Code section 521(b)(2), although the association's articles of incorporation and bylaws provided that "only producers of agricultural products...*who do business with the cooperative annually*, may own the common stock of the cooperative."[193] Yet in Technical Advice Memorandum 8626002, it applied a "facts and circumstances" test to disregard shareholders who ceased farming or moved from the area because they were no longer entitled to own stock in the cooperative.[194]

Although Technical Advice Memoranda cannot be cited as precedent, the Farmers Cooperative Company quoted extensively from this ruling in its brief to the 8th Circuit and argued to the court that this letter ruling states the law applicable to this specific issue.[195] There is no public record of whether this reference carried any weight with the court. However, the Service's inconsistency may have played a part in subsequent decisions favorable to Farmers Cooperative Company and to section 521 cooperatives in general.

In its review, the 8th Circuit Court of Appeals had to determine the status of two groups: (1) producers who began patronizing the cooperative during the tax year but did not receive their stock certificates until the following year, and (2) shareholders who did not patronize the cooperative during the year in question.

The cooperative asked the court to look beyond the actual shareholder lists. It argued that new producer patrons should be considered stockholders because they were automatically entitled

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[192] Tech. Adv. Mem. 8626002 (March 4, 1986).

[193] 85 T.C. at 604 (note 4) (emphasis added).

[194] Tech. Adv. Mem. 8626002 at 4.

[195] Brief for Appellant at 11-13, 822 F.2d 774 (8th Cir. 1987).

to a share of stock when they first used the cooperative's services, although the stock certificate was not presented until the annual meeting following the year of initial patronage. The cooperative also claimed inactive shareholders should not be counted because its articles and bylaws stated that only producers who did business with the cooperative on an annual basis could own common stock.[196]

IRS responded that the shareholder list on the last day of the tax year is the only appropriate basis for determining the cooperative's shareholder group. Because new patrons had not received their shares of stock, the Service said they should not be included in the calculation. The Service then argued that shareholders who were inactive during the year but still held their common stock at year-end should be counted in establishing the total number of shareholders.[197]

The court disregarded the nuances of corporate law involving stock ownership raised by both parties. It stated that accepting the cooperative's contentions would result in perpetual compliance even if no action was taken to make sure nonpatrons were indeed denied membership rights. It also noted that compliance with the Service's position, forcing the cooperative to revoke shareholder status before the end of the year (and thus before it knew for sure whether the patron would conduct any business that year) was a practical impossibility.[198]

The court devised its own method for applying the current patronage requirement. It said the purpose of the limitation was to restrict section 521 benefits to cooperatives organized and operated for the benefit of patrons as patrons and not for the benefit of investors. It explained that a share of common stock in

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[196] Farmers Cooperative Company v. Commissioner, 822 F.2d 774, 777-778 (8th Cir. 1987).

[197] *Id.* at 778.

[198] *Id.*

a cooperative is virtually worthless as an investment vehicle.[199] Thus the key determinate is not the actual ownership of the share of stock but the control, via the vote it symbolizes, over the direction and decision-making process of the cooperative.

The court concluded:

> ...although the right to vote may accrue or be lost during the tax year, it is normally exercised only at the annual shareholders' meeting that is ordinarily held several months after the close of the tax year.
>
> Thus, we hold that, for purposes of applying the 85% test, the relevant consideration is whether the right to vote has actually accrued or been terminated by the time of the annual shareholders' meeting following the close of the tax year.[200]

Thus, the proper test to determine if a person is a "member" for purposes of the "substantially all" requirement is whether that person *has the right to vote* at the annual stockholders' meeting following the close of the taxable year. A cooperative may count new patrons during the year who are actually entitled to vote at the subsequent annual meeting. And it can disregard inactive patrons only if their voting right has been terminated before that meeting.

The Aborted 50-Percent-Current-Patronage Rule

The "substantially all" rule requires that ownership of voting stock be limited to "producers who market their products or purchase their supplies and equipment through the association."[201] The test requires a cooperative to determine if each stockholder member markets through or purchases from the cooperative. Although this seems to be an easy determination, the second IRS

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[199] *Id.* (note) 6.

[200] 822 F.2d at 779.

[201] I.R.C. § 521(b)(2).

administrative action in 1973 interpreting "substantially all" cast compliance in doubt for many cooperatives. The rule was eventually rejected by the Tax Court and revoked by the Service.

IRS raised the issue of the amount of product that must be sold or supplies purchased through a cooperative by each patron in *Co-operative Grain & Supply Co. v. Commissioner*. The court noted that, in his brief, the Commissioner "assumes that *substantially all* of the shareholder-producers must market *substantially all* of their products and purchase *substantially all* of their supplies through the cooperative (court's emphasis)."[202]

The court refrained from discussing the issue as it wasn't before it on appeal, but suggested "imposition of the standard proposed here by the Commissioner could produce impractical and perhaps oppressive results. We believe the Tax Court, on remand, should resolve this issue, if it becomes an issue, by application of a reasonable and realistic standard."[203]

In Revenue Procedure 73-39[204], the Service said stockholder-members, to be considered current and active patrons, must market more than 50 percent of the farm products they produce through the cooperative or purchase more than 50 percent of their supplies and equipment of the type handled by the cooperative from the cooperative. The only exceptions were for persons who were unable to comply because of a disaster such as a crop failure or serious injury or if the cooperative dealt in high-priced items, like farm machinery, not normally purchased each year.

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[202] Co-operative Grain & Supply Co. v. Commissioner, 407 F.2d 1158, 1164 (note 10) (8th Cir. 1969), *remanding* 26 T.C.M. 593 (1967).

[203] *Id*. On remand, the Tax Court found the cooperative did not comply with the substantially all requirement without addressing the issue of the amount of business each member did with the association. Co-operative Grain & Supply Co. v. Commissioner, 32 T.C.M. (CCH) 795 (1973).

[204] Rev. Proc. 73-39, 1973-2 C.B. 502, *revoked by* Rev. Proc. 90-29, 1990-1 C.B. 533.

Revenue Ruling 77-440[205] elaborated on qualifications for active patronage, exploring the 50-percent marketing or supply rule. IRS described four "categories" of farmers, indicating in which categories the cooperative would be required to remove the farmers from its membership rolls to meet the requirements of section 521(b)(2).

In *West Central Cooperative*, the association argued that the 50-percent-of-production-and-purchases rule was unreasonable. The court responded by counting as patrons any shareholder who had done "some" business with the cooperative. As the cooperative was still short of the required 85 percent current patronage figure, the court did not address the legitimacy of Revenue Procedure 73-39.[206]

In *Farmers Cooperative Company*, the Service's proportion of business measure for counting stockholders as patrons was specifically rejected. In its initial decision, the Tax Court was not required to decide the proportion of business rule because it found, like the court in *West Central Cooperative*, that even without this rule the cooperative was still short of the required 85-percent current patronage. Nonetheless, the court commented:

> We note that consideration of this area is fraught with many difficulties and problems. Does [the Service] contemplate that cooperatives will keep track of shareholders' transactions outside the cooperative in order to police the 50 percent test of Rev. Proc. 73-39, 1973-1 C.B. 502? Would cooperatives effectively serve their congressionally intended purpose if patrons were required by con-

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[205] Rev. Rul. 77-440, 1977-2 C.B. 199. Similar facts were described in Tech. Adv. Mem. 7745007 (June 28, 1977).

[206] West Central Cooperative v. United States, 607 F. Supp. 1, 2-3 (note 2) (N.D. Iowa 1983), *aff'd*, 758 F.2d 1269 (8th Cir. 1985).

tract to transact a minimum amount of business with the cooperative?[207]

As noted previously, the Eighth Circuit, on appeal, expanded the category of shareholders the cooperative could count as current patrons. This meant that for one of the two years under review, the cooperative did qualify for section 521 status if the 50-percent-current-patronage rule was invalid. The appeals court remanded the case back to the Tax Court for review of the IRS requirement, noting its observations in *Cooperative Grain & Supply*.[208]

On remand, the Tax Court surveyed legislative history of the "substantially all" provision. It concluded:

> Petitioner's records reflect the amount of marketing or purchasing business transacted by each patron with petitioner each year, but not the amount of a patron's total marketing or purchasing business with or from all entities or sources for the same year. It would be impossible for petitioner to determine from its records whether any patron met the 50-percent test.[209]
>
> We are at a loss to understand [the IRS's] concern about the percentage or amount of their total business activity that each member or patron conducts with each cooperative. We are unable to perceive, and [IRS] has not suggested, any evil that may arise from patrons or members belonging to many cooperatives or only conducting a

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[207] Farmers Cooperative Co. v. Commissioner, 85 T.C. 601, 617 (note 11) (1985), *remanded*, 822 F.2d 774 (8th Cir. 1987).

[208] Farmers Cooperative Co. v. Commissioner, 822 F.2d 774, 781 (8th Cir. 1987), *remanding* 85 T.C. 601 (1985).

[209] Farmers Cooperative Co. v. Commissioner, 89 T.C. 682, 685 (1987), *on remand from* 822 F.2d 774 (8th Cir. 1987).

small portion of their total business activity with a cooperative."[210]

The Tax Court said any producer transacting any amount of business with the cooperative may be considered a currently active patron for purposes of the "substantially all" test. The Service acquiesced in that decision.[211]

The IRS Chief Counsel's Office examined the implication of *Farmers Cooperative Co.* and recommended revocation of Revenue Procedure 73-39 and Revenue Ruling 77-440. However, it noted that the "facts and circumstances" exception contained in Revenue Procedure 73-39 served a useful purpose and recommended the announcement revoking Revenue Procedure 73-39 preserve that exception.[212]

The Chief Counsel's recommendations were adopted. Both Revenue Procedure 73-39[213] and Revenue Ruling 77-440[214] were revoked.

The issue now seems settled. If 85 percent of the voting rights at the annual membership meeting are held by producers who did

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[210] *Id*. at 687.

[211] Action on Decision CC-1988-018 (August 8, 1988). "We accept the holding of the Tax Court that patrons currently transacting any amount of business with an exempt cooperative will be counted as active 'producers' in determining if 'substantially all' the cooperative's stock 'is owned by producers who market their products or purchase their supplies and equipment' through the cooperative within the meaning of section 521(b)(2). Rev. Proc. 73-39 is being revoked at the time this A.O.D. is issued." Formal acquiescence at 1988-2 C.B. 1.

[212] Gen. Couns. Mem. 39819 (July 7, 1989).

[213] Rev. Proc. 90-29, 1990-1 C.B. 533, *revoking* Rev. Proc. 73-39, 1973-2 C.B. 502. The exceptions for persons faced with a disaster or who patronized a cooperative for an item not normally purchased on an annual basis were retained.

[214] Rev. Rul. 90-42, 1990-1 C.B. 117, *revoking* Rev. Rul. 77-440, 1977-2 C.B. 199.

some marketing or purchasing through the cooperative during the previous tax year, the "substantially all" test is satisfied.

Compliance

These cases and rulings place an obligation on section 521 cooperatives to make sure that at least 85 percent of the persons entitled to vote at each annual meeting conducted some business with the cooperative during the previous tax year. Due diligence is required both when voting stock is issued and after each tax year is concluded.

Capital stock may be in the hands of nonproducers because the cooperative did not determine for itself the producer status of those to whom it issued capital stock. A cooperative must take active steps to avoid placing capital stock in the hands of nonproducers. It is not sufficient to automatically issue capital stock to all who patronize the cooperative with instructions that the certificate should be returned if the recipient is not actively engaged in farming.[215]

Cooperatives must also monitor the continued qualification of current holders of membership stock and purge from membership those who no longer qualify. Two events require action. The cooperative must terminate the memberships of persons who no longer (1) are producers of agricultural products or (2) use the cooperative.

To monitor "use," a cooperative must know who its members are, who patronizes the cooperative, and analyze membership and patronage data to determine who qualifies or does not qualify for ownership of voting stock. It must also establish and enforce procedures for purging membership rolls of those who do not qualify.[216]

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[215] Rev. Rul. 67-204, 1967-1 C.B. 149.

[216] Farmers Cooperative Co. v. Commissioner, 822 F.2d 774, 780-781 (8th Cir. 1987); Tech. Adv. Mem. 8205013 (Oct. 29, 1981) (2-year grace period without patronage unacceptable); Tech. Adv. Mem. 8252002 (March 25, 1980). For a discussion of other problems caused

Nonvoting Preferred Stock

The Code specifically provides that the requirement that "substantially all" stock be owned by producers who patronize the cooperative does not apply to "nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends."[217]

This language was discussed in General Counsel Memorandum 33,981.[218] It examines the legislative history leading up to enactment of the Revenue Act of 1926, including the language cited earlier. In his analysis, the Chief Counsel took the position that the limited exception was made to the "substantially all" test so that a section 521 cooperative could issue preferred stock as a part of an appropriate financing program.

While not stating what constitutes an appropriate financing program, the memorandum cautions that "Permitting a cooperative to issue an unlimited amount of nonvoting stock upon which dividends are paid to nonproducers could result in payment by the cooperative of a too substantial part of its profits to persons who are not patrons."[219] While there are no specific guidelines as to how much nonvoting stock nonproducers may own, IRS staff has noted that a section 521 cooperative that distributes too large a percentage of its earnings as stock dividends, rather than patronage refunds, is presumably no longer operating on a cooperative basis.

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by inactive memberships and guidance in purging membership rolls of inactive patrons, *see* Donald A. Frederick, *Keeping Cooperative Membership Rolls Current*, ACS Cooperative Information Report No. 37 (USDA 1989).

[217] I.R.C. § 521(b)(2). *See also*, Treas. Reg. § 1.521-1(a)(2).

[218] Gen. Couns. Mem. 33,981 (Nov. 20, 1968).

[219] *Id.*

TREATING MEMBERS AND NONMEMBERS EQUALLY

Embedded in the Code description of a cooperative eligible for section 521 status is a requirement that business with members and nonmembers must be conducted on a cooperative basis. In practice, this means that while other cooperatives need only make patronage refund allocations and distributions to members, section 521's must make them to nonmember users as well, and on the same basis as they are made to members.[220] This section discusses this requirement for equal treatment and notes several limited exceptions.

The General Rule

Code section 521 requires equal treatment of member and nonmember users in both marketing and supply operations. It provides a section 521 cooperative may be engaged in:

(A) "(M)arketing the products of members and 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,"[221] or

(B) "(P)urchasing supplies and equipment for the use of members and other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."[222]

The applicable regulation is more specific:

> If the proceeds of the business are distributed in any other way than on such a proportional basis, the associ-

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[220] *See, e.g.*, Priv. Ltr. Rul. 8025168 (March 27, 1980); Priv. Ltr. Rul. 8419060 (Feb. 8, 1984).

[221] I.R.C. § 521(b)(1)(A).

[222] I.R.C. § 521(b)(1)(B).

> ation does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.[223]

The rule requiring equal treatment was first codified in section 231(12) of the Revenue Act of 1926[224] and has been in effect continuously since that time. Once adopted, the rule was consistently applied by the courts[225] and is now generally accepted.

One way cooperatives have violated this rule is to charge or pay similar initial amounts to both members and nonmembers, but deny nonmembers any right to share in net margins by receiving patronage refunds.[226] In *Council Bluffs Grape Growers Ass'n*,[227] a section 521 cooperative marketed fruit for both member and

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[223] Treas. Reg. § 1.521-1(a)(1).

[224] Revenue Act of 1926, ch. 27, § 231(12), 44 Stat. 4, 40-41 (1926). For additional citations and a description of the legislative history of this rule, *see* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, Part 1 (USDA 2005) pp. 109-114.

[225] *See, e.g.*, Producers' Creamery Co. v. United States, 55 F.2d 104, 105-106 (5th Cir. 1932); Farmers' Mutual Cooperative Creamery of Sioux Center, Iowa v. Commissioner, 33 B.T.A. 117, 123 (1935); Farmers Union Co-op Co. of Guide Rock, Neb. v. Commissioner, 90 F.2d 488, 493 (8th Cir. 1937), *aff'g* 33 B.T.A. 225 (1935); Farmers Cooperative Co. of Wahoo v. United States, 23 F. Supp. 123, 127 (Ct. Cl. 1938).

[226] *See, e.g.*, Tech. Adv. Mem. 9114002 (No. 27, 1990).

[227] Council Bluffs Grape Growers Ass'n v. Commissioner, 44 B.T.A. 152 (1941).

nonmember producers. The bylaws provided that margins would be withheld from all patrons for a period of 5 years and placed in a working capital reserve. Members (but not nonmembers) were issued certificates for their proportional share of the margin, which said they would be paid off with margins earned 5 years after issuance.

The cooperative argued that members and nonmembers were treated equally in that neither got an immediate patronage refund. The court disagreed, finding the cooperative had no purpose or intent to return to nonmembers at any time any part of the earnings from the sale of their products. The Service's denial of Section 521 status was upheld.

A section 521 cooperative may maintain a reserve "for any necessary purpose."[228] However, the Code's permission to establish a reserve for any necessary purpose is "not intended as a waiver in any respect of that equality of treatment which is part of the necessary foundation" for section 521 status.[229] The reserve must be organized and operated in a manner that does not discriminate against nonmembers.[230]

The rule could also be violated if the cooperative makes an unequal payment such as a "bonus" only to members.[231]

Members and nonmembers must be treated alike regarding income from sources other than patronage.[232] This requirement

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[228] I.R.C. § 521(b)(4). The right of section 521 cooperatives to establish reserves is discussed in a subsequent section of this chapter.

[229] Fertile Co-operative Dairy Ass'n v. Huston, 119 F.2d 274, 277 (8th Cir. 1941), *aff'g* 33 F. Supp. 712 (N.D. Iowa 1940).

[230] *Id*. *See also* Farmers' Mutual Cooperative Creamery of Sioux Center, Iowa v. Commissioner, 33 B.T.A. 117 (1935); Council Bluffs Grape Growers Ass'n v. Commissioner, 44 B.T.A. 152, 155 (1941); Rev. Rul. 69-431, 1969-2 C.B. 133, 134.

[231] Producers' Creamery Co. v. United States, 55 F.2d 104 (5th Cir. 1932).

[232] Rev. Rul. 69-431, 1969-2 C.B. 133.

includes nonmember nonproducers for whom the cooperative provides supplies and other equipment.[233] Thus, if a cooperative exchanges a byproduct it produces for an unlike product processed by a nonmember nonproducer, the exchange is considered a sale of the byproduct to the nonmember nonproducer and that person is entitled to share in the net earnings of the cooperative on the same basis as all other patrons of the cooperative.[234]

Under some circumstances, it may be impossible to treat members and nonmembers alike. For example, the Packers and Stockyards Act (P&SA) prohibits the payment of patronage refunds to nonmembers.[235] In such cases, the cooperative must either not deal with nonmembers or not seek section 521 qualification.

One cooperative tried to avoid the P&SA problem by paying amounts equal to a patronage refund into a "patronage refund suspense reserve" for nonmembers. Even though it would have been possible at a later time to refund the amounts to nonmember patrons, the Service said there was no existing obligation to do so at the time amounts were deposited into the reserve, and in fact Federal law prohibited payment at that time. Section 521 status was denied.[236]

Many cooperatives do not market or purchase for nonmembers. If a section 521 cooperative only conducts business with or for members, the issue of treating members and nonmembers alike is not relevant. The cooperative is not required to have in place a mechanism for sharing patronage refunds with nonmembers.[237]

Equality of treatment requirements do not apply where permissible purchases of items to supplement marketing activity

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[233] Rev. Rul. 69-417, 1969-2 C.B. 132.

[234] Rev. Rul. 67-346, 1967-2 C.B. 216.

[235] Packers and Stockyards Act, 7 U.S.C. § 207(f).

[236] Rev. Rul. 73-59, 1973-1 C.B. 292.

[237] Eugene Fruit Growers v. Commissioner, 37 B.T.A. 993, 1002 (1938).

are made from nonmember nonproducers who do not qualify as patrons. Such circumstances may occur when a cooperative makes sideline product purchases and emergency purchases from nonmember nonproducers.

In Revenue Ruling 76-388, the Service said a patron bears the risk of loss from dealings with the cooperative, but nonmember nonproducers from whom sideline and emergency purchases are made at a fixed price bear no such risk. These commercial transactions do not involve "utilization of the cooperative function."[238] Nonmember nonproducers selling sideline and emergency products to the cooperative do not attain "patron status" and patronage dividends need not be paid to them.[239]

Cooperatives need not treat all patrons exactly the same. For example, a cooperative may determine patronage refund allocations based on quality of product, rewarding those patrons who deliver a higher quality product to the cooperative. In Revenue Ruling 75-110,[240] a milk marketing co-op proposed to adopt a quality bonus program to provide economic incentive for its members to produce higher quality milk. The payment was a premium above the Federal milk marketing order base price, directly attributable to providing a higher quality of milk.

The Service said the bonus plan was a permissible method of allocating income among the producer-members with which the cooperative did business and would have no adverse effect on the cooperative's section 521 status. It stated:

> Under the stated facts, the...bonus program meets the overall standard of the above sections of the Code[241] in that members similarly situated are treated equally. The quality standards established by the program represent a reason-

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[238] Rev. Rul. 76-388, 1976-2 C.B. 180, 181.

[239] *Id.*

[240] Rev. Rul. 75-110, 1975-1 C.B. 167.

[241] I.R.C. § 521(b)(1).

able method of differentiating between milk of varying quality and are equally applicable to all the members of the [cooperative].[242]

IRS also permitted a cooperative, for sound business purposes, to make larger advance payments to patrons who delivered their product early in the marketing year. The program was open to all patrons (member and nonmember) and the final payment to patrons was adjusted so the total price per ton paid to all patrons (adjusted for quality) was the same.[243]

Dual-Function Cooperatives

Code section 521(b)(1) describes separately the marketing and purchasing functions of eligible cooperatives.[244] The regulations also note a distinction between these two activities, stating, "An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code."[245]

IRS has asserted for a number of years that each function's activity must be separately accounted for and allocated to patrons of the respective function, almost as if two cooperatives exist.[246] In one letter ruling, a cooperative with both purchasing and marketing activity allocated patronage refunds on the basis of the association's overall net margin. In one year, purchasing constituted about 20 percent of the cooperative's sales but generated nearly 50 percent of the margin.

The Service stated section 521 cooperatives "...must deal at cost, not below or above cost, with the patrons of each

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[242] Rev. Rul. 75-110, 1975-1 C.B. 167, 168.

[243] Priv. Ltr. Rul. 9006024 (Nov. 9, 1989).

[244] I.R.C. § 521(b)(1)(A) and (B).

[245] Treas. Reg. § 1.521-1(c).

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

function....distributions must accurately reflect each patron's dealings with each function."[247] The Service found the cooperative did not qualify for section 521 status because the patrons of the purchasing department were not getting their fair share of patronage refunds and therefore not receiving supplies and equipment at cost plus necessary expenses as required by Code section 521(b)(1).[248]

The courts have been less demanding than the Service in requiring strict separation of marketing and supply activities. For example, in *Lamesa Cooperative Gin v. Commissioner*[249] a cooperative engaged primarily in marketing carried on a small supply function. It did not wish to set up a separate accounting system for the supply function, preferring instead to allocate its net margins as part of the primary marketing function.

The Tax Court held such a practice was permissible under the circumstances. It pointed out that "nothing in (the regulations)[250] explicitly refers to any separate accounting requirement for cooperatives engaged in both purchasing and marketing."[251] The court said it is obviously easier to determine if the allocation is fair to patrons of both functions if separate accounts are maintained, but the failure to account separately should not automatically cause a patronage deduction to be disallowed. Facts the court

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

[248] For other instances where IRS determines margins of each function must be returned to the patrons of that function, *see,* Priv. Ltr. Rul. 8025168 (March 27, 1980) and Tech. Adv. Mem. 8245082 (Dec. 31, 1981). The concept of equitable allocation of financial results between patrons of different functions will be explored in more detail in a section of a later report in this series covering handling of losses and netting losses and gains between functions.

[249] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

[250] Treas. Reg. § 1.521-1(c).

[251] Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894, 907 (1982).

cited in upholding the cooperative's method of allocation included significant overlap between patrons of the two functions, the small amount of purchasing done, and the membership's total acceptance of the system.[252]

Nonpatronage Income

One of the two special deductions available to section 521 cooperatives is for earnings derived from business with the United States or from other nonpatronage sources distributed to patrons on a patronage basis.[253] The proper allocation of nonpatronage income among patrons of different functions is necessary to qualify for the deduction.

Juniata Farmers Cooperative v. Commissioner[254] involved an interesting juxtaposition. Taxpayer was primarily a grain marketing cooperative with a modest farm supply business. The cooperative kept records for each function and allocated margins earned by each function separately to the patrons of that function.

In the tax years in question, a substantial portion of the cooperative's income came from Commodity Credit Corporation grain storage payments. The cooperative allocated this nonpatronage sourced income to the patrons of the grain marketing department on a patronage basis. IRS asserted that the cooperative should have allocated a prorata share of this nonpatronage income to the patrons of the purchasing department. The court summarily dismissed IRS's contention and held the cooperative's allocation fair and in compliance with section 521 requirements.

The Service subsequently stated that nonpatronage income and nonpatronage losses may be allocated to patrons of a department or departments to which the income or losses relate, rather than to

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[252] *Id.* at 910.

[253] I.R.C. § 1382(c)(2). The unique tax treatment of section 521 cooperatives is covered in Chapter 12, *supra*.

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

all patrons of the cooperative, "provided that the allocation is not discriminatory among patrons similarly situated."[255]

Expenses

In general, net margins to be allocated to patrons as patronage refunds are determined by reducing revenues by expenses. A section 521 cooperative that pays patronage refunds separately to its marketing and purchasing patrons must calculate the net margin for each function. Therefore, it must allocate its expenses (as well as revenue) between the two functions.

The Service has stated that when a section 521 cooperative allocates expenses to functions, it may not do so simply on the basis of gross sales by function. It must offset operating and other costs against the gross income of each function insofar as such costs are identifiable charges against the income of that function. Costs which cannot be reasonably identified as being attributable to a particular function may be apportioned between the functions on the basis of ordinarily accepted accounting principles.[256]

Exceptions

Section 521 cooperatives must make proportional allocations of earnings to member and nonmember patrons. However, limited variations on the equal treatment rule are permitted. These include applying a patronage refund toward a nonmember's membership investment, different forms of payment depending on consent, separate treatment for small refunds, and adjustments for nonqualified paper.

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[255] Rev. Rul. 67-128, 1967-1 C.B. 147. The cooperative was consistent in its practice and in each case could show that the particular nonpatronage income or loss was related to the department or departments to which it was allocated.

[256] Rev. Rul. 67-253, 1967-2 C.B. 214; Priv. Ltr. Rul. 8025168 (March 27, 1980).

Membership Investments and Fees

Normally, to join a cooperative the applicant must purchase a share of capital stock or, in the case of a nonstock cooperative, pay a membership fee. A cooperative may give new members options in meeting this financial obligation.

Nonmembers may meet this commitment with an up-front cash payment. They may also have their patronage refunds applied toward purchase of membership. The regulations provide this does not violate the section 521 equal treatment requirement.[257] However, they require permanent records that support the underlying patronage refund allocation and the application of the refund to satisfy the membership requirement.[258] They also note refunds applied toward membership are not "payment in money" for purposes of meeting the 20-percent cash distribution requirement to qualify written notices of allocation.[259]

To facilitate a base capital plan cooperative financing system, unequal amounts of equity investment may be required each year to achieve the desired proportion of equity contributed by each patron.[260] A cooperative on a base capital plan may adjust the cash portion of patronage refunds on an individual basis to bring each patron's equity contribution in line with that required under its plan.[261]

In Revenue Ruling 69-52, all members of the cooperative paid an annual membership fee. An amount up to the annual member-

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[257] Treas. Reg. § 1.521-1(a)(1).

[258] *Id.*

[259] Treas. Reg. § 1.521-1(a)(1); Treas. Reg. § 1388-1(c)(1).

[260] For a brief description of base capital financing plans, *see* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) pp. 79-80. For a thorough discussion, *see* Robert C. Rathbone & Donald R. Davidson, *Base Capital Financing of Cooperatives*, RBCDS Cooperative Information Report 51 (USDA 1995).

[261] Priv. Ltr. Rul. 7925114 (March 23, 1979).

ship fee was withheld from patronage refunds otherwise due each nonmember patron. The entire patronage dividend was withheld if the patronage refund due a nonmember patron was less than the annual membership fee.

IRS said this method of distributing patronage refunds was permissible under section 521. "The requirement that nonmembers pay a reasonable annual fee is no more than a requirement that those who avail themselves of the facilities offered by the cooperative pay their share of the cost of the operations of the organization."[262]

Consent

A section 521 cooperative may base some features of its patronage refund distribution on each patron's consent decision. A cooperative may make refund payments solely in nonqualified written notices of allocation to patrons who do not give qualification consent, but pay 20 percent in cash and the remainder in qualified written notices of allocation to patrons who do give statutory consent.[263]

Small Refunds

If small amounts are due patrons, record-keeping requirements become burdensome. Variances from the rule of equal treatment are permitted.

A cooperative issuing qualified written notices of allocation is generally required to pay at least 20 percent of the refund in cash.[264] The regulations provide that when the refund is for less than $5, a section 521 cooperative may make the entire payment

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[262] Rev. Rul. 69-52, 1969-1 C.B. 161, *superseding* Gen. Couns. Mem. 11,068, XII-1 C.B. 122 (1933).

[263] Treas. Reg. § 1.521-1(f).

[264] For requirements to qualify written notice of allocation, *see* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Distribution, Retains, Redemptions, and Patrons' Taxation*, RBS Cooperative Information Report 44, Part 3 (USDA 2005) pp. 31-51.

as a nonqualified written notice of allocation, even though the patron has consented to include the amount of the refund in taxable income. Other consenting patrons receiving a refund of $5 or more must receive at least 20 percent in cash and the remainder as a qualified written notice of allocation.[265]

The Service has also stated a section 521 cooperative may make full payment in money or qualified check to patrons entitled to patronage refunds of $10 or less, while patrons entitled to a refund of $10 or more receive $10 or 20 percent of their refund in cash, whichever is greater, thus eliminating the small written notice of allocation. This is a permissible discrimination among patrons.[266]

Also, again to reduce record-keeping costs, a section 521 cooperative may simply withhold refunds of less than one dollar, and all cents in excess of even dollars due patrons.[267] However, except for the variations described in Revenue Ruling 55-141, "administrative hardship" will not excuse strict adherence to accounting and allocation rules.[268]

Returns on Nonqualified Allocations

Although not a usual practice, cooperatives may pay interest or dividends on retained patronage refunds or per-unit retains. Written notices of allocation or per-unit retain certificates may be qualified or nonqualified depending on consent decisions by recipients, and the tax imposed on the cooperative will differ accordingly. The regulations permit a cooperative to pay a smaller amount of interest or dividends on nonconsenting recipients' nonqualified written notices of allocation and per-unit capital retains.

The reduction in interest or dividends must be "reasonable in relation to the fact that the association receives no tax benefit with

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[265] Treas. Reg. § 1.521-1(f).

[266] Rev. Rul. 66-152, 1966-1 C.B. 155.

[267] Rev. Rul. 55-141, 1955-1 C.B. 337.

[268] Tech. Adv. Mem. 8228008 (March 31, 1982).

respect to such nonqualified written notices of allocation (or such certificates issued to nonqualifying patrons) until redeemed."[269] If reasonable, the difference will not violate the equality of treatment requirement of section 521.

RESERVES

The Code provides that a section 521 cooperative may accumulate and maintain "a reserve required by State law or a reasonable reserve for any necessary purpose."[270]

The regulations give some examples of reserves considered to be for a necessary purpose. They are "...to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes...."[271]

IRS has not questioned the authority of section 521 cooperatives to have reserves, but has attempted to limit how those reserves are invested. Revenue Ruling 76-233[272] concerned a cotton marketing cooperative that wanted to broaden its economic base by purchasing a wool processing business. IRS said a section 521 cooperative may properly invest the reserves and incur expenses incident to such investment without jeopardizing its exempt status.

There are, however, limits on such investments. Investments must be "...incidental to the conduct of [the cooperative's] business on a cooperative basis. Investments...in noncooperative enterprises that are not merely incidental are inconsistent with" section 521 status.[273] The Service said the cooperative in this example

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[269] Treas. Reg. § 1.521-1(f).

[270] I.R.C. § 521(b)(3).

[271] Treas. Reg. § 1.521-1(a)(3) for marketing cooperatives, made applicable to supply cooperatives by Treas. Reg. § 1.521-1(b).

[272] Rev. Rul. 76-233, 1976-1 C.B. 173.

[273] *Id*. at 174.

would not qualify for section 521 status because the investment was not made to facilitate marketing cotton for members and other producers.[274]

OTHER ISSUES

The Service has raised other issues questioning the right of various farmer cooperatives to section 521 status. This section discusses those items.

Distributions Upon Dissolution

At dissolution, a cooperative may have a residual available for distribution after all obligations are paid and the equity is redeemed. An early 8th Circuit opinion stated that a section 521 cooperative must establish a legal obligation and keep adequate records to allocate and distribute that residual to all patrons whose business contributed to the residual, not just to member patrons.[275]

In Revenue Ruling 69-431,[276] the Service said that although the Code does not specifically cover the participation rights of stockholders in profits of a section 521 in the event of dissolution, it does require all net earnings from marketing and purchasing be returned to patrons on the basis of patronage. Such net earnings available for distribution at the cooperative's dissolution must be distributed to patrons on the basis of patronage rather than stockholders on the basis of their stock ownership. Thus, "although stockholders may share in the profits of an exempt

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[274] IRS staff has also questioned whether section 521 cooperatives, and other cooperatives as well, can accumulate unallocated reserves. *See, e.g.*, Gen. Couns. Mem. 38,099 (Sept. 18, 1979).

[275] Fertile Co-operative Dairy Association v. Huston, 119 F.2d 274 (8th Cir. 1941), *aff'g* 33 F. Supp. 712 (N.D. Iowa 1940).

[276] Rev. Rul. 69-431, 1969-2 C.B. 133.

farmers' cooperative, they may do so only on the basis of their patronage rather than on the basis of shares of stock that they may own. Neither common nor preferred stockholders may participate in the profits of an exempt farmers' cooperative, upon dissolution or otherwise, beyond the fixed dividends."[277]

Federated Cooperatives and "Look Through"

A federated cooperative is one whose members are other cooperatives rather than individual persons.[278] Section 521 contains no specific reference to federated cooperatives, but longstanding administrative practice has considered federated cooperatives eligible for section 521 status.[279]

IRS prescribed rules for the section 521 qualification of federated cooperatives in Revenue Ruling 69-651.[280] It applies what the Service calls the principle of "looking through" the member associations to the ultimate patrons in determining eligibility of the federated for section 521 status. The ruling states:

> Farmers' cooperatives may join together to form a federated cooperative to perform more efficient marketing or purchasing functions on behalf of the patrons of the member cooperatives. Since a federated serves the interests of the patrons of its member cooperatives, it is

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[277] *Id.* at 134.

[278] This is a generally accepted definition. Rev. Rul. 69-651, 1969-2 C.B. 135. The literature may also refer to a "mixed" cooperative as one with both individual farmers and other cooperatives as members. Although research has not uncovered a ruling on point, it is likely that a mixed cooperative would have to meet the same tests as a true federated to qualify for section 521 status.

[279] I.T. 2000, III-1 C.B. 290 (1924); S.M. 2288, III-2 C.B. 233 (1924).

[280] Rev. Rul. 69-651, 1969-2 C.B. 135.

> held that it is necessary to look to the patrons of the member cooperatives to determine whether the federated meets the requirements of section 521(b) of the Code. In making that determination, the federated is considered to be dealing directly with the patrons of its member cooperatives. Likewise, in determining control of the federated, it is held that it is necessary to consider the composition of membership of the member cooperatives.[281]

Rev. Rul. 69-651 illustrated the "look through" principle with four sample situations:[282]

1. When all members of the federated are section 521 cooperatives themselves, the federated will qualify for section 521 status.

2. When some of the members of the federated are not section 521 cooperatives and they pay patronage refunds only to their members, even though they do business with members and nonmembers, the federated does not qualify for section 521 status.

3. A federated with non-section 521 members must, in the aggregate, comply with the limitations on nonmember, nonproducer business applicable to section 521 cooperatives. The ruling provides that the value of supplies the members of a federated turn over to members must exceed that of supplies turned over to nonmembers.

Also, the value of the federated's supplies its members turn over to nonmember nonproducers may not exceed 15 percent of the value of its supplies turned over to all supply customers by its members. As the ruling also applies to marketing cooperatives, it infers that all products provided for marketing must be from mem-

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[281] *Id.*

[282] Although the situations in the ruling involve purchasing cooperatives, it states the conclusions are equally applicable to marketing cooperatives.

bers or other producers and the value of member products marketed must exceed that of products marketed for nonmembers.

4. Substantially all (at least 85 percent) of the voting control of the federated's members as a whole (indirect voting control of the federated) must be held by producers who currently patronize the federated's members.

The Service's "look through" theory produced controversy, some confusion, and numerous additional administrative decisions over the next few years. Rev. Rul. 69-651 was issued as a prospective decision with an effective date of the federated's tax year beginning on or after July 1, 1970. The first additional ruling postponed the effective date for situation 2 through 4 to tax years beginning on or after July 1, 1971.[283] This postponement was intended to give the Service time to develop compliance guidelines for Rev. Rul. 69-651.

In early 1972, the Service published five rulings[284] to clarify Rev. Rul. 69-651. Their holdings are summarized below.

Revenue Ruling 72-50 -- The purchase from other commercial sources and resale of farm supplies *not available from the federated* by a non-section 521 member of a federated can be disregarded in determining if the federated is eligible for section 521 status.[285]

Revenue Ruling 72-51 -- A federated supply cooperative does business with one nonmember, non-section 521 cooperative. It knows all of its member cooperatives have section 521 status and deal exclusively with producers. So long as its sales to the nonmember cooperative are less than 15 percent of total supply sales, it need not do the "look through" calculations as it will clearly still comply with the 15-percent limitation on nonmember, nonproducer business. If the federated isn't sure of compliance with the 15 percent limit, it may be able to look through the

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[283] Rev. Rul. 71-493, 1971-2 C.B. 240.

[284] Internal Revenue Bulletin, No. 1972-6 (Feb. 6, 1972).

[285] Rev. Rul. 72-50, 1972-1 C.B. 163.

nonmember to determine the level of purchases of its products ultimately made by producers. But to do this, the nonmember must be selling the supplies from the federated to both members and nonmembers at cost plus necessary expenses.[286]

Revenue Ruling 72-52 -- A non-section 521 cooperative is a member of a grain marketing federated with section 521 status. The local cooperative receives grain from both its member-producers and other nonmember producers. It sells grain to both the federated and to other commercial buyers. In computing its own compliance with the majority member business rule, the federated will allocate grain received from this member according to the same percentages as the member received grain from members and nonmembers.[287]

Rev. Proc. 72-16 -- This ruling sets out the information a federated cooperative must compile and provide IRS to establish and maintain section 521 status.[288]

Rev. Proc. 72-17 -- Outlines three methods available to a federated cooperative to establish and maintain its section 521 status when its taxable year differs from the taxable years of some of its members.[289]

Controversy over the "look through" rules continued, particularly Revenue Procedure 72-17. In early 1973, IRS suspended application of Situations 2 through 4 of Revenue Ruling 69-651 until a restudy of Rev. Proc. 72-17 was completed.[290]

In November 1973, the Service completed its consideration of the "look through" theory. It provided an additional method for a federated cooperative to treat members with tax years different from its own. A federated was permitted to take the taxable year

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[286] Rev. Rul. 72-51, 1972-1 C.B. 164.

[287] Rev. Rul. 72-52, 1972-1 C.B. 165.

[288] Rev. Proc. 72-16, 1972-1 C.B. 738.

[289] Rev. Proc. 72-17, 1972-2 C.B. 739.

[290] Rev. Rul. 73-138, 1973-1 C.B. 293.

of a member that ends within the federated's taxable year and consider it the same as that of the federated.[291]

The Service also revoked Revenue Ruling 73-138, which had suspended Revenue Ruling 69-651. This made Situations 2 through 4 in Revenue Ruling 69-651 applicable for all tax years beginning on or after December 17, 1973, the date these determinations appeared in the Internal Revenue Bulletin.[292]

The IRS position on "look through" has made it difficult for a federated cooperative to use section 521. If all cooperative members of a federated are section 521 cooperatives, and if the federated deals with its member cooperatives on a cooperative basis, the federated cooperative will qualify.[293] Otherwise the burdens of compliance discourage even trying to qualify.

Research has uncovered one additional ruling on federated cooperatives and section 521. Revenue Ruling 84-81[294] discussed a federated cooperative developed by persons who grew pine trees and cut them into pulpwood. They formed local cooperatives to market their pulpwood. The locals formed a federated cooperative that bought pulpwood from its cooperative members and processed it into newsprint. IRS said that because timber growers are not "farmers" for purposes of section 521,[295] the federated cooperative could not qualify for section 521.

Subsidiaries

Although the issue isn't addressed in the Code or regulations, farmer cooperatives can organize and use subsidiaries and still qualify for section 521 treatment. However, IRS has consistently

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[291] Rev. Proc. 73-38, 1973-2 C.B. 501.

[292] Rev. Rul. 73-568, 1973-2 C.B. 194.

[293] Rev. Rul. 69-651, 1969-2 C.B. 135 (situation 1).

[294] Rev. Rul. 84-81, 1984-1 C.B. 135.

[295] For a discussion of the IRS position concerning tree farmers and section 521, *see supra* pp. 16-17.

said that the subsidiary may only carry out activities the parent cooperative is allowed to conduct.

The IRS position was adopted in a series of rulings beginning with Revenue Ruling 69-575.[296] The Service offered two examples of cooperative purchasing associations that created subsidiaries to handle nonmember-nonproducer business. In the first, the subsidiary paid patronage refunds to its patrons, but the subsidiary's purchases for nonmember-nonproducers exceeded 15 percent of the combined purchasing business of the parent cooperative and the subsidiary. In the second, the subsidiary's purchases for nonmember-nonproducers were less than 15 percent of the combined purchases for the subsidiary and the parent cooperative, but no patronage refunds were paid to the patrons of the subsidiary. Instead, all earnings of the subsidiary were treated as taxable income and turned over to the parent cooperative as nonpatronage income. The Service stated:

> A farmers' cooperative association that is exempt under section 521 of the Code may establish and control a subsidiary corporation so long as the activities of the subsidiary are activities that the cooperative itself might engage in as an integral part of its operations without affecting its exempt status. However, an exempt cooperative may not utilize a subsidiary for the conduct of operations on an ordinary profitmaking basis.[297]

The Service then determined that neither cooperative was entitled to section 521 status. In the first example, the operations

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[296] Rev. Rul. 69-575, 1969-2 C.B. 134.

[297] *Id*., *citing* S. Rep. No. 52, 69th Cong., 1st Sess. (1939), *reprinted in* 1939-1 C.B. (Part 2) 332, 350. *See also* Rev. Rul. 76-233, 1976-1 C.B. 173, 174 (cotton marketing cooperative began investment plan including purchase of interest in wool processing company); Priv. Ltr. Rul. 9547015 (August 24, 1995) (Subsidiary conducted business with nonmembers on a nonpatronage basis).

of the subsidiary couldn't have been conducted as an integral part of the parent cooperative because such operations would have violated the 15-percent limit on nonmember-nonproducer purchasing business in Code section 521(b)(4). In the second, the operations of the subsidiary also couldn't have been conducted as an integral part of the parent cooperative because the subsidiary paid no patronage dividends as required by section 1.521-1(a) of the regulations.

Under Revenue Ruling 69-575, a subsidiary's operation may jeopardize its parent cooperative's section 521 status in two ways. First, limits placed on section 521 cooperatives regarding business conducted with nonmembers and nonproducers may be violated if the subsidiary's activities are attributed directly to the parent cooperative. Second, the subsidiary may deal with its patrons on a basis not permitted the parent if the parent dealt directly with those patrons.

One farm supply cooperative tried a novel organizational approach to avoid Revenue Ruling 69-575. The cooperative's directors and officers, acting on instructions of the cooperative's membership, established a separate supply association to handle nonmember, nonproducer business. The supply association paid patronage to all cooperative patrons. The cooperative's directors were original incorporators and sole stockholders of the supply association, each holding one share of common stock. If a cooperative director ceased being a director, that stock was sold at par value to the successor.

The supply association's purchases for nonmember, nonproducers exceeded 15 percent of the combined purchases of the cooperative and the supply association. IRS said "this relationship...results in effective ownership and control by [the cooperative] that is as significant as the ownership and control the parent cooperative had over its subsidiary in Revenue Ruling 69-575.

Accordingly, all business conducted by [the supply association], including nonmember-nonproducer business, will be

considered [the cooperative's] business."[298]

The Service treated the supply association as it would a true subsidiary. Its business exceeded the 15-percent limit on purchases for nonmember-nonproducers, so the cooperative was denied section 521 status.

The Service reached a similar conclusion in two virtually identical letter rulings concerning the acquisition of a food processing firm by a cooperative marketing association with section. 521 tax status. Before the acquisition, the firm had purchased all of the product marketed by the cooperative on behalf of its members. The acquired firm was reorganized as a wholly owned subsidiary of the cooperative. The acquired firm had conducted some business with nonproducers on a profit-making basis and conducted some business with growers who were not members of the acquiring cooperative on a nonpatronage basis. The acquired firm intended to continue both business arrangements. As both activities would disqualify the parent cooperative from section. 521 status, the Service said that conducting them through the subsidiary also caused the cooperative to lose its section 521 status.[299]

IRS did permit a section 521 cooperative to establish a wholly owned Domestic International Sales Corporation (DISC). IRS noted the DISC would perform foreign marketing functions that

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[298] Rev. Rul. 73-148, 1973-1 C.B. 294. The ability of the courts, and presumably the Service, to "pierce through the shell of separate corporate identity" and treat a cooperative and an affiliated firm "as a single entity" for tax purposes was noted as early as Burr Creamery Corp. v. Commissioner, 62 F.2d 407, 409 (9th Cir. 1932), *cert. denied*, 289 U.S. 730 (1933).

[299] Priv. Ltr. Rul. 9547015 and 9547016 (August 24, 1995). The cooperative anticipated this outcome. In these same rulings it did receive the findings it wanted, that the subsidiary could operate on a cooperative basis and, if it did so, transfer to the cooperative as tax deductible patronage refunds all of its earnings from processing and marketing products supplied by the cooperative.

the cooperative was already conducting as an integral part of its operations without affecting its section 521 status.[300]

Revenue Ruling 75-388[301] established that a subsidiary itself may qualify for section 521 treatment, if the subsidiary meets section 521 qualifications. The mere fact that its parent is a section 521 cooperative does not convey that status to the subsidiary. In this instance, the issue was whether substantially all of the voting stock of a wholly owned subsidiary of a section 521 cooperative was owned by producers as required by Code section 521(b)(2). The Service said it was, because the subsidiary served the interests of the cooperative members and since the cooperative had section 521 status, its membership satisfied the control requirements for the wholly owned subsidiary as well.

In summary, a section 521 cooperative may conduct business through a subsidiary. But, for the cooperative to maintain its section 521 status, the activities of the subsidiary must be activities that the cooperative itself might engage in as an integral part of its operations without jeopardizing section 521 status.

Access to Declaratory Judgments

Until recently, cooperatives were denied access to judicial review of disputes regarding their initial or continuing qualification to section 521 tax status until IRS asserted a tax deficiency or a tax had been paid and a refund claim filed. Available remedies were generally limited to filing a petition in U.S. Tax Court for relief following a notice of deficiency or to paying a tax and suing for a refund in a U.S. District Court or the U.S. Court of Federal Claims. This could delay resolution of disputed issues for several years.

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[300] Rev. Rul. 73-248, 1973-1 C.B. 294.

[301] Rev. Rul. 75-388, 1975-2 C.B. 227.

Code section 7428 provides that in other limited contexts, declaratory judgment procedures are available.[302] These permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to the payment of tax. Declaratory judgment relief is currently available to organizations engaged in an actual controversy with the Service over, among other things, their qualification as a religious, charitable, or educational organization under Code section 501(c)(3) or a private foundation under Code section 509. So, for example, when the IRS denies an organization's application for recognition as an exempt organization under Code section 501(c)(3), or fails to act on an application, or revokes or adversely modifies its tax-exempt status, the organization can seek a declaratory judgment regarding its tax-exempt status.

Legislation was introduced in several Congresses to extend this same procedural option to cooperatives in a dispute with the IRS over access to section 521 tax status.[303]

In 2004, cooperatives achieved this objective. The American Jobs Creation Act of 2004 created a new I.R. Code subparagraph section 7428(a)(1)(D). It permits a cooperative, when its application for Section 521 tax status is rejected, to seek judicial review of the denial without first creating a tax controversy. Such a case may be commenced in the U.S. Tax Court, the U.S. District Court for the District of Columbia, or the U.S. Court of Federal Claims. The court has jurisdiction to determine a cooperative's initial or continuing qualification as a farmers' cooperative described in Code section 521.[304]

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[302] 26 U.S.C. § 7428.

[303] *See, e.g.*, S. 2498, 105th Cong., 2d Sess. § 2 (1998); H.R. 1469, 106th Cong., 1st Sess. § 2 (1999); S. 312, 107th Cong., 1st Sess. § 10 (2001); H.R. 2347, 107th Cong., 1st Sess. § 10 (2001); S. 1637, 108th Cong, 1st Sess. § 308 (2003).

[304] American Jobs Creation Act of 2004, § 317, Pub. L. No. 108-357, 118 Stat. 1470 (codified at 26 U.S.C. § 7428(a)(1)(D)). *See also*, H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 363.

CHAPTER 12
SECTION 521 TAX TREATMENT

The Internal Revenue Code (Code) places section 521 cooperatives in a peculiar position. They are "exempt" organizations subject to taxation. Code section 521(a) states:

> A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation... except as otherwise provided in part I of subchapter T (sec. 1381 and following)....(S)uch an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.[305]

At one point, the regulations go so far as to state a section 521 cooperative will "be considered as an organization exempt under section 501."[306] However, this statement has its limits.[307] Differences in the tax treatment of a section 521 cooperative and a section 501 exempt organization are noted throughout this chapter.

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[305] I.R.C. § 521(a).

[306] Treas. Reg. § 1.1381-2(a)(1). *See also* Independent Cooperative Milk Producers Ass'n v. Commissioner, 76 T.C. 1001, 1008 (note 10) (1981).

[307] Farmers Cooperative Company v. Commissioner, 85 T.C. 601, 602-603 (note 3) (1985). *See also* Certified Grocers of California, Ltd. v. Commissioner, 88 T.C. 238, 249 (1987), where the Tax Court noted that it was the Service, not the Code, that assigned the 501 status. "Whatever the situation may be with respect to cooperatives exempt under 521--whether [the Service] may decree that such cooperatives are to be treated as exempt under section 501, the statute being silent, ... is a matter which we may leave to another day and another case."

BACKGROUND

Farmer cooperatives described in the current section 521 were, until 1951, truly tax exempt organizations.[308] The Revenue Act of 1951[309] retained the definition of a farmer cooperative previously exempt from taxation.[310] However, it ended the true tax exempt status of these associations and replaced it with deductions for stock dividends and patronage-based distributions of nonpatronage income.[311]

Section 522 was repealed and replaced by Subchapter T (Code secs. 1381-1388) in the Revenue Act of 1962.[312] This explains how tax rules for section 521 cooperatives were separated from the description of such an association in the Code.

Code section 521 is merely descriptive of an association that qualifies for section 521 status. It doesn't contain any tax rules.

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[308] At times, however, early courts seemed to impose taxation on some impermissible activities without explicitly revoking the organization's exempt status. In Fruit Growers' Supply Co. v. Commissioner, 56 F.2d 90 (9th Cir. 1932), *aff'g* 21 B.T.A. 315 (1930), income derived from selling surplus supplies to nonmembers constituted taxable gain to the cooperative. In Central Co-operative Oil Ass'n v. Commissioner, 32 B.T.A. 359 (1935), the cooperative was taxed on income derived from patrons to whom no patronage refunds were made.

[309] Revenue Act of 1951, ch. 521, § 314, 65 Stat. 452, 491-493 (1951). For a detailed description of the legislative history leading up to current Code section 521 and Subchapter T, *see*, Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, Part 1 (USDA 2005) pp. 83-129.

[310] This definition was designated § 101(12)(A) by the Revenue Act of 1951. It was recodified as § 521 in the Internal Revenue Code of 1954.

[311] Codified as § 101(12)(B) in the Revenue Act of 1951 and recodified as § 522(b)(1) in the Internal Revenue Code of 1954.

[312] Revenue Act of 1962, Pub. L. No. 87-834, § 17, 76 Stat. 960, 1045-1052 (1962).

The special tax treatment of section 521 cooperatives is set out in Subchapter T.

The primary tax advantages of Section 521 cooperatives are access to two deductions they may take in addition to those available to all other Subchapter T cooperatives. They can deduct dividends paid on capital stock, within limits, and nonpatronage sourced income paid patrons on a patronage basis.[313] In addition, other tax and nontax laws are based on a cooperative's qualification for section 521, something cooperatives may need to consider when making a decision to seek, maintain, or give up section 521 status.

SUBJECT TO TAXATION

The anomaly of considering section 521 cooperatives as exempt organizations is driven home by Code section 1381(b), which provides such associations "shall be subject to the taxes imposed by section 11 (corporate income taxes) or section 1201 (capital gains taxes)."[314] The regulations state this includes both normal tax and surtax, where applicable.[315]

The basic approach to section 521 cooperative taxation is similar to that of other cooperatives. Gross income is reduced on an item-by-item basis through the application of specific deductions described in the Code. Income remaining is taxable to the cooperative.[316]

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[313] I.R.C. § 1382(c) and Treas. Reg. § 1.1382-3.

[314] I.R.C. § 1381(b).

[315] Treas. Reg. § 1.1381-2(a)(1).

[316] *See* Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, 730 (note 2) (1978); Farmers Cooperative Co. v. Commissioner, 85 T.C. 601, 602 (note 3) (1985), *remanded*, 822 F.2d 774 (8th Cir. 1987).

Deduction for Dividends Paid on Capital Stock

Cooperatives are free to compensate members for the use of the capital they have in the cooperative by paying dividends on capital stock. As with any corporation, dividends are typically paid out of earnings on which the corporation has paid taxes.

The Code, however, provides special treatment for section 521 cooperatives. They are allowed to deduct "amounts paid during the taxable year as dividends on capital stock."[317]

The regulations describe capital stock broadly as including "common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association."[318]

The regulations also provide amounts paid as dividends on capital are to be considered "as a deduction from the gross income of a cooperative...."[319]

The proper time to recognize the deduction for dividends on capital stock differs from that of patronage-based distributions. The principle of "payment period" in which a cooperative may deduct patronage refunds paid up to 8½ months following the close of its taxable year does not apply to dividends on capital stock. Dividends on capital may only be deducted from gross income for the year they are paid out.[320] The regulations permit actual or constructive payment.[321]

Because the date of payment determines the year in which a deduction may be taken, IRS has said a cooperative may declare a dividend in a year it is not qualified under section 521 and take

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[317] I.R.C. § 1382(c)(1) and Treas. Reg. § 1.1382-3(b).

[318] Treas. Reg. § 1.1382-3(b).

[319] *Id.*

[320] I.R.C. § 1382(c)(1); Treas. Reg. § 1.1382-3(b).

[321] Treas. Reg. § 1.1382-3(b).

a deduction in the following year if it then qualifies for section 521 and makes payment of the dividend in that year.[322]

The regulations contain three additional guidelines pertaining to this deduction:

> 1. If the dividend is paid by a check bearing a payment date within the taxable year and it is mailed in a manner to reasonably assume it will arrive within the taxable year, a presumption arises that payment occurred within that year.
>
> 2. The determination of whether a dividend has been paid within a particular year is in no way dependent upon the cooperative's method of keeping its financial records.
>
> 3. For other rules on deducting dividend payments, under certain conditions, refer to Code section 561.[323]

The Subchapter T provision providing for the deduction of dividends on capital stock by section 521 cooperatives does not limit the rate of payment. However, to qualify for section 521 status, a cooperative may not pay a dividend that exceeds the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater."[324]

Thus, to determine the maximum rate at which dividends can be paid, a cooperative must look to both tax law and its own State cooperative incorporation statute. The payment of dividends above the permissible rate will result in the loss of section 521 status and all benefits thereof, not just the dividend payment deduction.[325]

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[322] Rev. Rul. 70-233, 1970-1 C.B. 180.

[323] Treas. Reg. § 1.1382-3(b). Code section 561 provides for the deduction for certain dividends distributions by a personal holding company and other types of businesses listed in Treas. Reg. § 1.561-1(a).

[324] I.R.C. § 521(b)(2).

[325] For a discussion of the permissible rate of dividends on capital stock, *see supra* pp. 54-57.

Deduction for Patronage-Based Allocations of Nonpatronage Sourced Income

The Code provides a second special deduction for section 521 cooperatives. They may deduct "earnings...derived from business done for the United States or any of its agencies or from sources other than patronage" paid to patrons on a patronage basis.[326] This includes both direct payments in cash and qualified written notices of allocation,[327] as well as payments to redeem nonqualified written notices issued to distribute earlier nonpatronage sourced earnings.[328]

The requirement that most cooperatives distinguish patronage and nonpatronage sourced income is the subject of Chapter 5 of these reports.[329] This is not a major issue with section 521 cooperatives. As both types of income are deductible when allocated to patrons on the basis of patronage, for the most part they simply combine the two and allocate them as other cooperatives do their margins on patronage business.

Nevertheless, a section 521 cooperative must be careful in handling its nonpatronage sourced income. It must be sure nonpatronage sourced income is not generated from activities in which the cooperative may not engage or somehow leads to unequal treatment of patrons, either of which may destroy the cooperative's section 521 tax status. It also needs to be sure the underlying funds qualify for a deductible distribution.

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[326] I.R.C. § 1382(c)(2)(A) and Treas. Reg. § 1.1382-3(c).

[327] *Id*.

[328] I.R.C. § 1382(c)(2)(B).

[329] Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, RBS Cooperative Information Report 44, Part 2 (USDA 2005) p. 27. This includes the definition of "income derived from sources other than patronage" at Treas. Reg. § 1.1382-3(c)(2).

Earnings

The distribution by the cooperative must be made "with respect to its earnings...."[330] If a cooperative receives income not classified as "earnings," it cannot receive a deduction when the money is distributed to patrons.

In one letter ruling,[331] a section 521 cooperative had issued qualified written notices of allocation in prior years as part of its patronage refund distribution. Responding to patrons' requests, the cooperative redeemed some of the nonqualified paper earlier than it would have under its regular equity redemption schedule. It redeemed this equity at a discount, paying only 50 percent of the original patronage refund amount. The cooperative accounted for the discounted amount as income and allocated it to current year's patrons on a patronage basis. It claimed a deduction for distribution of nonpatronage sourced income under Code section 1382(c).[332]

The Service held the income generated by discounting the equity certificates was not "earnings" for purposes of section 521 deductions. IRS said the amount realized must be recognized as income under the tax benefit rule. However, it found that classifying earnings as patronage or nonpatronage sourced "presupposes a transaction which gives rise to an amount which can legitimately be considered 'earnings.' It does not apply if the amount realized isn't 'earnings' in the first place. The amounts here in question are, in effect, merely amounts recovered which were previously deducted against 'earnings' of another taxable year."[333] The co-op was not permitted to deduct the distribution of income realized as a result of the discounted redemption.

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[330] I.R.C. § 1382(c)(2)(A) in the case of refunds paid and I.R.C. § 1382(c)(2)(B) in the case of redemptions of nonqualified allocations.

[331] Tech. Adv. Mem. 7840010 (June 22, 1978).

[332] The cooperative also argued that such income was patronage sourced. This approach was rejected by the Service.

[333] Tech. Adv. Mem. 7840010 (June 22, 1978).

U.S. Government Business

The Code specifically provides for the deduction of a proper distribution of earnings "derived from business done for the United States or any of its agencies."[334] Cooperatives may engage in numerous kinds of transactions with Government in which income is generated. For example, a marketing cooperative may store a commodity owned at some point by the Commodity Credit Corporation (CCC) and receive income for the storage service.[335] The storage function is business done for the Government and a section 521 cooperative may deduct the income when distributed to patrons on a patronage basis.

Other Nonpatronage Income

Section 521 cooperatives may have nonpatronage sourced income from purchases of sideline products, ingredients, or emergency purchases, if such purchases are otherwise permitted. The Service has said that if nonmember-nonproducer suppliers receive a fixed price for their products, a patronage relationship is not established. "The profits attributable to these transactions will be nonpatronage sourced earnings" and can be distributed to patrons, subject to the limitations of Code section 521(b)(4).[336]

Nonpatronage income may also be realized from investments, sales of assets, and other activities not directly related to or actually facilitating the cooperative's patronage operations.[337] Such income may be generated as part of the cooperative's ongoing business activity, such as a sale of property, or may be

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[334] I.R.C. § 1382(c)(2)(A), incorporated by reference in I.R.C. § 1382(c)(2)(B). *See also* Treas. Reg. § 1.1382-3(c)(1).

[335] *See supra* pp. 52-53.

[336] Rev. Rul. 76-388, 1976-2 C.B. 180, 181.

[337] Rev. Rul. 68-332, 1968-1 C.B. 383: Rev. Rul. 69-431, 1969-2 C.B. 133. *See* Treas. Reg. § 1.1382-3(c)(2) and the discussion of this language in Donald A. Frederick, *Income Tax Treatment of Cooperatives: Patronage Refunds*, RBS Cooperative Information Report 44, Part 2 (USDA 2005) pp. 39-81.

generated upon the sale of property at the cooperative's dissolution.[338]

Paid on a Patronage Basis

To be deductible, earnings from business done with the U.S. Government or from other nonpatronage sources must be distributed on a "patronage basis to patrons."[339] Under some circumstances a section 521 cooperative not only may, but must, distribute nonpatronage sourced income to patrons. Failure to do so will not simply cause loss of the deduction, it may cause the cooperative to lose its status under section 521.

In Revenue Ruling 69-431[340] a cooperative's nonpatronage income was placed in a reserve and paid to stockholders as an increase in the value of their shares of stock when redeemed. IRS said that "[S]ince an exempt farmers' cooperative is required to operate for the benefit of its patrons, earnings from nonpatronage sources (such as that derived from investments, the sale of assets, and business done with or for the United States) must also be distributed to the patrons on a patronage basis."[341] The cooperative was denied section 521 status.

A cooperative maintaining separate departments may allocate nonpatronage income (and losses) to the departments to which such income or losses are related and allocate the net earnings of each department to the patrons of that department on a patronage basis. IRS has said it is not necessary to allocate nonpatronage income to all patrons of the cooperative "provided that the

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[338] *See, e.g.*, Priv. Ltr. Rul. 8842018 (July 22, 1988).

[339] I.R.C. § 1382(c)(2)(A) in the case of refunds paid and I.R.C. § 1382(c)(2)(B) in the case of nonqualified written notices of allocation redeemed. The regulations provide the amount to be deducted must "be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for the patron during the period to which such income is attributable." Treas. Reg. § 1.1382-3(c)(3).

[340] Rev. Rul. 69-431, 1969-2 C.B. 133.

[341] *Id.* at 134.

allocation is not discriminatory among patrons similarly situated."[342]

Allocation Year

Generally, nonpatronage source income received in a taxable year, and not related to a multiple year event such as appreciation in value of a capital asset, must be allocated on a patronage basis to patrons of that year. There may be exceptions under some circumstances, as in the case where patronage patterns are highly unusual for that year. Revenue Ruling 55-591[343] involved a grain marketing cooperative that received substantial income from Commodity Credit Corporation storage fees in a year in which patronage was extremely low because of severe drought in its service area. The Service allowed it to allocate this nonpatronage source income on patronage of not only that year but the previous 4 years as well.

Capital Gains

The regulations recognize that in certain situations it may be very difficult to allocate nonpatronage income precisely on a patronage basis. They provide such payment must be on a patronage basis, "insofar as is practicable."[344]

The example used to illustrate when this flexibility can apply is capital gains realized from the sale or exchange of capital assets. The regulations provide that if a capital asset is acquired and disposed of within the same year, the income realized must be apportioned among that year's patrons on a patronage basis. If the assets is sold or exchanged in a tax year subsequent to the year of acquisition, then any gain "must be paid, insofar as is practicable,

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[342] Rev. Rul. 67-128, 1967-1 C.B. 147. "In each case the association is able to show that particular nonpatronage income or loss was related to the department or departments to which allocated."

[343] Rev. Rul. 55-591, 1955-2 C.B. 553.

[344] Treas. Reg. § 1.1382-3(c)(3).

to the persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years."[345]

Another complicating element was introduced in Revenue Ruling 68-322.[346] A cooperative sold property and elected to report the gain realized, for tax purposes, on the installment method under Code section 453. The Service permitted the cooperative to deduct the portion of the gain included in income in each taxable year, provided that income is allocated and paid on a patronage basis, insofar as is practicable, to the persons who were patrons of the cooperative during the years it owned the asset.[347]

The Refund Payment

The deduction for nonpatronage earnings distributed on a patronage basis is only available for amounts actually "paid" to patrons.[348] Payment may be in money, qualified written notices of allocation, or other property except nonqualified written notices of allocation.

Section 521 cooperatives have the usual period of time to allocate or distribute nonpatronage sourced income. It may be paid out anytime "during the payment period for the taxable year."[349] The payment period stretches from the first day of the tax year until 8 ½ months after the close of that tax year.[350]

Redemption of Nonqualified Written Notices of Allocation

When a section 521 cooperative has issued a nonqualified written notice of allocation representing earnings from business

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[345] *Id*. *See also* Priv. Ltr. Rul. 8952042 (Sep. 29, 1989).

[346] Rev. Rul. 68-332, 1968-1 C.B. 383.

[347] *See also* Priv. Ltr. Rul. 8819022 (Feb. 9, 1988).

[348] I.R.C. § 1382(c)(2).

[349] I.R.C. § 1382(c)(2) and Treas. Reg. § 1.1382-3(c)(1).

[350] I.R.C. § 1382(d) and Treas. Reg. § 1.1382-4.

done with the U.S. Government or from other nonpatronage sources, amounts paid to redeem it are deductible by the cooperative.[351] The redemption payment may be made in money or other property except written notices of allocation.[352]

The regulations somewhat limit the flexibility of the cooperative in determining the tax year that the deduction may be taken. They provide that if the amount is paid during the payment period of 2 or more years, it will be deductible only in the earliest of those years.[353] So, for example, if a cooperative is on a calendar tax year and paid an amount to redeem nonqualified allocations of nonpatronage income on January 15, 2005, it will be allowed a deduction for such amount only for its 2004 tax year.[354]

ADMINISTRATIVE PROCEDURES

Any corporation can assert a right to single tax treatment under Subchapter T simply by claiming the deductions authorized by Code section 1382(b) on its tax return. However, because section 521 cooperatives are treated as exempt organizations, section 521 status must be applied for and a letter of exemption received from the Service. The regulations state, "An organization is not exempt from taxation under this section merely because it claims that it complies with the requirements prescribed therein."[355]

This section of the report discusses obtaining, maintaining, and losing section 521 status.

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[351] I.R.C. § 1382(c)(2)(B) and Treas. Reg. § 1.1382-3(d).

[352] *Id.*

[353] Treas. Reg. § 1.1382-3(d).

[354] This is comparable to the treatment accorded redemption of patronage sourced nonqualified written notices under Treas. Reg. § 1.1382-2(c).

[355] Treas. Reg. § 1.521-1(e).

Obtaining Section 521 Status

Application for section 521 status is made on Form 1028. The regulations provide:

> In order to establish its exemption every organization claiming exemption under section 521 is required to file a Form 1028. The Form 1028, executed in accordance with the instructions on the form or issued therewith, should be filed with the district director for the internal revenue district in which is located the principle place of business or principal office of the organization.[356]

The procedures to apply for section 521 status are set out in Revenue Procedure 84-46.[357] If the cooperative is found eligible for section 521 status, IRS will issue a ruling or determination letter granting access to section 521. A cooperative need not be operational before applying for section 521 status. The Service will issue a determination letter in advance of a cooperative beginning its operations, provided the organizers show that the association is organized and will be operated according to the guidelines in section 521. Procedures to appeal an adverse determination are also provided.

The Service may require changes in the cooperative's organization and operation as a prerequisite to approving section 521 status. Sometimes this involves amending the bylaws.[358] Although section 521 status is usually only effective prospectively, the Service has granted section 521 status on a retroactive basis.[359]

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[356] *Id.*

[357] Rev. Proc. 84-46, 1984-1 C.B. 541.

[358] *See, e.g.*, Priv. Ltr. Rul. 9229011 (April 13, 1992).

[359] *Id.*

Special procedures and guidelines for federated cooperatives applying for section 521 status are found in several Revenue Rulings and Revenue Procedures.[360]

IRS charges a user fee to apply for section 521 status. In recent years, the Service has reviewed its fee schedule annually and published its charges for the year in Internal Revenue Bulletin No. 1 for that year. For 2004, the user fee structure for section 521 applications appears in Revenue Procedure 2004-8.[361] Persons applying for section 521 status in later years should check the fee schedule applicable at the time.

Maintaining 521 Status

Once a cooperative meets the requirements of section 521 and receives a letter of exemption, no further filing is required to maintain section 521 status. Section 521 status may be lost at any time, however, if a cooperative no longer meets the section 521 requirements.

The key to maintaining section 521 status is to continue to meet all qualifications. This responsibility falls on the cooperative. The entire range of qualifications are subject to continued maintenance. These include the specific percentages given in section 521 on such things as stock ownership by producers, nonmember business limits, nonproducer business limits, and limits on dividends on capital stock. They also include continuing to operate on a cooperative basis as required by Subchapter T of the Code.

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[360] Rev. Proc. 72-16, 1972-1 C.B. 738; Rev. Proc. 72-17, 1972-1 C.B. 739; Rev. Proc. 73-38, 1973-2 C.B. 501; Rev. Rul. 72-50, 1972-1 C.B. 163; Rev. Rul. 72-51, 1972-1 C.B. 164; Rev. Rul. 72-52, 1972-1 C.B. 165; Rev. Rul. 73-568, 1973-2 C.B. 194.

[361] Rev. Proc. 2004-8, § 6.09, 2004-1 I.R.B. 248.

Record Keeping

Accurate records are crucial to proving continued compliance with the requirements for section 521 status. The regulations provide:

> In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice.[362]

To establish that it is actually operated according to section 521 requirements, a cooperative with marketing and purchasing functions must maintain separate records of income and expenses for its marketing and purchasing departments, as well as records of business transacted with patrons of each department.[363]

Records may be needed for reasons other than those for which they were initially kept. As an example, a cooperative's records may show patronage for years in which gain in value of property occurred. When property is sold, the gain is often allocated on the basis of patronage during the years the cooperative owned the property. Prior year's patronage records, although kept for the pur-

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[362] Treas. Reg. § 1.521-1(a).

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

pose of properly allocating margins during those years, may be the basis for allocating the gain on the property sold later as well.

Loss of Section 521 Status

Section 521 status is a privilege granted by IRS. It can be voluntarily relinquished by a cooperative. The Service can revoke or modify the ruling or determination letter granting section 521 status.[364]

Cooperatives voluntarily surrender their section 521 status when they find the burdens of compliance outweigh the benefits. For example, a grain marketing cooperative may, at one time, have realized substantial income storing grain for the Commodity Credit Corporation. As a section 521 cooperative, it could deduct this nonpatronage income from its taxes if the margin was allocated and distributed to patrons on the basis of patronage. However, this business may have become much less important to the cooperative. The record-keeping burdens and the loss of capital from paying patronage refunds to nonmembers may now be greater than the tax benefit realized, leading the association to abandon section 521.

This status may be lost because the cooperative failed to qualify from the beginning[365] or it changed its structure or operations so as to fail to qualify. For example, IRS has said that a change in operation from marketing only for member-producers to including nonproducers (outside the scope of the limited exceptions to the rule barring such activity) is a change in method of operation that can cause revocation of section 521 status.[366]

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[364] Rev. Proc. 84-46, 1984-1 C.B. 541, 545 (Sec. 14).

[365] Etter Grain Company v. United States, 331 F. Supp. 283, 286 (N.D. Texas 1971), *aff'd*, Etter Grain Co. v. United States, 462 F.2d 259 (5th Cir. 1972).

[366] Tech. Adv. Mem. 8047006 (July 29, 1980).

Revocation may be retroactive to the time IRS believes the association was first in violation of any of the requirements.[367] The revocation may be retroactive, and back taxes collected, even though section 521 status was granted through the Service's error.[368]

The loss of section 521 status doesn't preclude an organization from continuing to operate on a cooperative basis under Subchapter T of the Code.[369] If otherwise eligible, it will still be allowed single tax treatment of its patronage refunds and per-unit retains.

OTHER ISSUES CONCERNING SECTION 521 STATUS

Other legal rights and responsibilities accrue to farmer cooperatives that successfully apply for section 521 tax status. Some of them are briefly described here.

Other Tax Consequences

A section 521 cooperative's quasi-exempt status impacts on other aspects of the organization's business and tax practices. Two restrictions are noted in the regulations. Provisions of section 243, providing a credit for dividends received from a domestic

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[367] Rev. Proc. 84-46, 1984-1 C.B. 541, 545 (Sec. 14); Tech. Adv. Mem. 8047006 (July 29, 1980) (applying earlier, but similar, rules to those in Rev. Proc. 84-46); Tech. Adv. Mem. 9114002 (Nov. 27, 1990)(request for relief from retroactive application under I.R.C. § 7805(b) rejected).

[368] Etter Grain Co. v. United States, 462 F.2d 259 (5th Cir. 1972), *aff'g* Etter Grain Co. v. United States, 331 F. Supp. 283 (N.D. Texas 1971).

[369] Tech. Adv. Mem. 9547015 (Aug. 24, 1995) and its companion ruling Tech. Adv. Mem. 9547016 (Aug. 24, 1995).

corporation subject to taxation, are not applicable to dividends received from a section 521 cooperative.[370] Nor are provisions of section 1501, relating to consolidated returns.[371]

Section 521 cooperatives are sometimes specifically named as sharing limited tax privileges with section 501(c) organizations. If an employee is paid less than $100 in a calendar year, the wages are not covered by the Federal Insurance Contributions Act.[372] Likewise, if an employee is paid less than $50 in any calendar quarter, the employee is not covered by the Federal Unemployment Tax Act.[373] Also, any drawing conducted by a section 521 cooperative is excluded from taxes on wagering, provided no part of the proceeds derived from selling tickets benefits specific shareholders or individuals.[374]

In other instances, section 521 cooperatives are not treated as exempt organizations. For example, under the accelerated cost recovery systems described in Code section 168 "a cooperative described in section 521" is not subject to rules for "tax exempt entities."[375]

Securities Law Consequences

The Federal Securities Act of 1933 contains an exemption for farmer cooperatives that qualify for section 521 treatment from its registration and prospectus requirements covering the initial offer and sale of securities.[376]

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[370] Treas. Reg. § 1.1381-2(a)(1). More specifically, *see* I.R.C. § 246(a)(1) and Treas. Reg. § 1.246-1(b).

[371] Treas. Reg. § 1.1381-2(a)(1).

[372] I.R.C. § 3121(a)(16).

[373] I.R.C. § 3306(c)(10)(A).

[374] I.R.C. § 4421(2)(B).

[375] I.R.C. § 168(h)(2)(A)(ii).

[376] 15 U.S.C. § 77c(a)(5)(B)(i). For a discussion of cooperative status under Federal securities regulation, *see*, John Noakes, Chapter

State securities regulations, often called "blue sky laws," may also rely on section 521 for identification of cooperatives eligible for special treatment. For example, Connecticut[377] and Georgia[378] bases their exemptions on section 521. Mississippi[379] modifies its restrictions on cooperatives having nonresident stockholders if the cooperative qualifies as a section 521 association in addition to meeting other listed requirements.

State treatment of cooperative securities varies widely. Many State blue sky laws do not provide a State securities exemption for section 521 cooperatives. However, they may have some form of cooperative exemption based on a different standard. All section 521 cooperatives are urged to have their legal counsel check to see if they are subject to State registration and prospectus requirements.

And even if a cooperative qualifies for general exemptions from registration at the Federal and State levels, cooperatives offering and selling securities may incur liability under Federal and State statutes for inadequate or misleading disclosure. As a result, it is advisable for cooperatives to prepare and distribute an appropriate disclosure document to potential purchasers of any securities they do sell.

Tax Exempt Agricultural Associations

Cooperative members may form other organizations to promote their common interests. If these organizations are agricultural in nature, they may seek tax exemption under Code

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136, *Agricultural Cooperative Securities*, in Neil Harl, Agricultural Law, Matthew-Bender: New York (1994).

[377] Conn. Gen. Stat. Ann. § 36b-21(a)(15).

[378] Ga. Code Ann. § 10-5-8(5).

[379] Miss. Code Ann. § 75-71-201(12).

section 501(c)(5).[380] Code section 501(g) defines "agricultural" as including "...the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock."[381]

The regulations state the organizations contemplated for exempt status under Code section 501©)(5) "are those which:

(1) Have no net earnings inuring to the benefit of any member, and

(2) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations."[382]

The regulations also provide these organizations are taxable on their unrelated business income.[383]

While a section 501(c)(5) association can't pay out earnings to members, if it should collect more in dues from its members than it needs to cover its costs, IRS has said it can refund those excess dues in the same proportion as they were received. The refunded money must have come from dues income. The amounts returned are considered a reduction in dues.[384]

The Service has issued several revenue rulings interpreting eligibility for Code section 501(c)(5) status. The first series, published during the time the regulations were being developed,[385] were quite favorable for producers.

Some granted tax exempt status to associations formed to educate producers on better methods of growing and marketing

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[380] I.R.C. § 501(c)(5). The brief Code section provides an exemption from taxes for "Labor, agricultural, or horticultural organizations."

[381] I.R.C. § 501(g).

[382] Treas. Reg. § 1.501(c)(5)-1(a).

[383] Treas. Reg. § 1.501(c)(5)-1(b).

[384] Rev. Rul. 81-60, 1981-1 C.B. 335.

[385] Treas. Reg. § 1.501(c)(5)-1 was proposed January 21, 1956 and adopted July 8, 1958 by T.D. 6301, 1958-2 C.B. 197, 203.

their products.[386] Others involved organizations more actively engaged in the production and marketing process.

Revenue Ruling 54-282[387] discussed a corporation formed by farm bureaus to test soil for farmers and other members of the community (members and nonmembers of the farm bureaus) and to educate community members on soil testing and conditioning. The Service said this organization qualified for exemption.

Revenue Ruling 57-466[388] concerned an association organized to provide a county-wide approach to improving and advancing agriculture. Its charter also authorized it to market farm products and provide farm supplies to producers. In addition to educational activities furthering agriculture, the organization purchased fertilizer and other supplies in bulk for resale to members and other producers. The Service said the organization was eligible for section 501(c)(5) tax exempt status but earnings on its farm supply operations were subject to tax under the unrelated business income provisions of Code section 511.[389]

Later rulings are more restrictive concerning the types of conduct an agricultural association may engage in and still qualify for tax exemption. An organization formed to carry out a livestock improvement program and promote sales of livestock also served as the sales agent for its members and operated a livestock auction. IRS found its principal activity was marketing livestock and determined it was not exempt under section 501(c)(5).[390] The Service has also denied exempt status to other

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[386] Rev. Rul. 55-230, 1955-1 C.B. 71 (Welsh ponies); Rev. Rul. 56-245, 1956-1 C.B. 204 (fur-bearing animals).

[387] Rev. Rul. 54-282, 1954-2 C.B. 126.

[388] Rev. Rul. 57-466, 1957-2 C.B. 311.

[389] The Service relied on section 39.422-3 of Regulations 118 concerning taxation of unrelated business income. Regulations 118 were made applicable to the Internal Revenue Code of 1954 by T. D. 6091, 1954-2 C.B. 47.

[390] Rev. Rul. 66-105, 1966-1 C.B. 145.

agricultural associations that it felt were providing direct business services to farmer-members, including arranging for transient farm laborers[391] and the management, grazing, and sale of cattle.[392]

Two rulings dealt with associations that keep records for use in improving milk production of member dairy herds. In the first, the association provided a report on how each member's cows compared with standards established by the State college of agriculture only to the farmer member. In denying except status, IRS said this activity did nothing to advance agriculture in general as required by the regulations, but "simply relieve(d) the individual farmer of work that he would either have to perform himself or have performed for him."[393]

On the other hand, the Service found a similar organization that takes part in the National Cooperative Dairy Herd Improvement Program qualified for section 501(c)(5).[394] The ruling noted the information collected from individual dairy producer members was used in a nationwide program to improve milk production and the overall quality of dairy products. IRS said:

> Since the data from the testing is made available to all dairy farmers for use in increasing production, the association has as its objective the betterment of the condition of those engaged in agricultural pursuits. Members of the association receive individual benefits when the computer center sends them the test results for their cows. However, these benefits are incidental to the objects of the program as a whole and are not inconsistent

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[391] Rev. Rul. 72-391, 1972-2 C.B. 249.

[392] Rev. Rul. 74-195, 1974-1 C.B. 135.

[393] Rev. Rul. 70-372, 1970-2 C.B. 118.

[394] Rev. Rul. 74-518, 1974-2 C.B. 166.

with those objectives. Accordingly, the association is exempt....[395]

Two other rulings, concerning aquiculture, set standards that parallel those for section 521 tax treatment. One concerned an association that encouraged better production methods and the overall interests of persons engaged in raising fish on private ponds. The Service found this association qualified for a section 501(c)(5) exemption.[396] But an association to promote the commercial fishing industry was held not exempt.[397]

Two additional rulings involved associations that negotiated with processors over the price to be paid members for their crops, sometimes called bargaining associations. In one instance bargaining was the organization's only function. IRS noted the organization performed no other activity that assisted the members in selling their crops. The ruling held that by negotiating the price of crops with processors, the organization's objective was the betterment of the conditions of the growers and producers. Therefore, it was found eligible for section 501(c)(5) status.[398]

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[395] 1974-2 C.B. 166, 167. The ruling is distinguished from Rev. Rul. 70-372, 1970-2 C.B. 118.

[396] Rev. Rul. 74-488, 1974-2 C.B. 166. *Relies on* Rev. Rul. 64-246, 1964-2 C.B. 154, holding that farm-raised fish are farm products for purposes of Code section 521. *See supra* pp. 9-10.

[397] Rev. Rul. 75-287, 1975-2 C.B. 211. *Relies on* Rev. Rul. 55-611, 1955-2 C.B. 270, holding an association that purchases supplies for oystermen and fishermen is not eligible for section 521 status. In this instance, since the fishermen were promoting a common business interest, the Service noted the association would be eligible for tax exempt status as a business league under I.R.C. § 501(c)(6).

[398] Rev. Rul. 76-399, 1976-2 C.B. 152. The ruling cited Rev. Rul. 74-118, 1974-1 C.B. 134, for the position that an organization of farm wives that supports higher prices for farm products is exempt and distinguished Rev. Rul. 66-105, 1966-1 C.B. 134 on the basis that the association discussed in that ruling went beyond establishing price to

In the second ruling, livestock producers in a particular geographic area were members of a national association that negotiated with processors over selling prices and other terms of trade with processors. The local group formed a corporation to buy land and build a gathering and shipping facility to facilitate the marketing of members' livestock under the national association's negotiated contracts. The Service found that this went beyond price negotiation to providing a service the farmers would otherwise simply have to perform themselves and denied access to section 501(c)(5) status.[399]

The Service has approved section 501(c)(5) exempt status for a local organization of farmers to promote more effective agricultural pest control. Although the organization's primary activity is to employ "scouts," who identify and count pests for farmer members, it also makes its data available to all local farmers through the local extension agent, farmers statewide through a local university, and nationwide through USDA programs. Thus, while the members receive individual benefits from the data collected in their own fields, the organization is still tax exempt because it shares its information for the overall advancement of agriculture.[400]

Other Cooperative Tax Exemptions

"Mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations" may qualify for exemption under section 501(c)(12).[401] The term "like

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acting as a sales agent.

[399] Rev. Rul. 77-153, 1977-1 C.B. 147. The ruling cites Rev. Rul. 74-195, 1974-1 C.B. 135, and Rev. Rul. 66-105, 1966-1 C.B. 145.

[400] Rev. Rul. 81-59, 1981-1 C.B. 334.

[401] I.R.C. § 501(c)(12) and Treas. Reg. § 1.501(c)(12)-1.

association" includes rural electric and water cooperatives[402] and cable television cooperatives.[403] IRS has said that while these organizations are not subject to Subchapter T, they still must meet basic requirements as cooperative organizations regarding interests of members in net margins in proportion to business, reasonable reserves, allocation of funds, treatment of members' interests and member rights on dissolution.[404]

State-chartered "Credit unions without capital stock organized and operated for mutual purposes and without profit" are exempt under Code section 501(c)(14)(A).[405] IRS has stated that in addition to being State chartered, exempt credit unions must operate without profit and for the mutual benefit of their members.[406]

Mutual insurance companies writing insurance at cost are tax exempt under Code section 501(c)(15).[407] The Service has said such companies must also give members the right to choose management, return premiums in excess of amounts needed to cover losses and expenses to members, and provide for a common equitable ownership of the assets by the members.[408]

Crop financing corporations organized by section 521 cooperatives or their members, operated in conjunction with such association, and meeting certain other tests consistent with section 521 cooperative tax status, are exempt under Code section

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[402] Rev. Rul. 67-265, 1967-2 C.B. 205, *restating and superseding* I.T. 1671, C.B. II-1, 158 (1923).

[403] Rev. Rul. 83-170, 1983-2 C.B. 97.

[404] Rev. Rul. 72-36, 1972-1 C.B. 151.

[405] I.R.C. § 501(c)(14)(A) and Treas. Reg. § 1.501(c)(14)-1.

[406] Rev. Rul. 69-282, 1969-1 C.B. 155, *clarified by* Rev. Rul. 72-37, 1972-1 C.B. 152.

[407] I.R.C. § 501(c)(15) and Treas. Reg. § 1.501(c)(15)-1.

[408] Rev. Rul. 74-196, 1974-1 C.B. 140.

501(c)(16).[409] The fact that such a corporation owns all of the stock of another business corporation will not disqualify it from exempt status.[410]

Cooperative hospital service organizations are exempt under Code section 501(e).[411] These associations may only perform a specific list of services spelled out in the Code.[412] In one of the rare instances of a cooperative tax case reaching the U.S. Supreme Court, the Court determined that because such an association provided linen and laundry service, admittedly "so essential to a hospital's operation" but not on the list of permissible activities, the association was not eligible for exempt status under section 501(e).[413]

Even though a cooperative is classified as tax exempt, it can still have a Federal income tax obligation. Code section 511 imposes a tax on the unrelated business taxable income of organizations otherwise exempt.[414] The unrelated business income concept for exempt organizations is similar to nonpatronage income of cooperatives. It is income that doesn't qualify for special tax treatment because it is generated by transactions that

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[409] I.R.C. § 501(c)(16) and Treas. Reg. § 1.501(c)(16)-1. The Service's rejection of one such corporations's claim to exempt status was upheld by the Tax Court on the basis that the corporation did not prove it was "organized" by a section 521 cooperative or that "substantially all" of its stock was owned by such association, or the members thereof, both requirements for exempt status under § 501(c)(16). Growers Credit Corporation v. Commissioner, 33 T.C. 981 (1960).

[410] Rev. Rul. 78-434, 1978-2 C.B. 179.

[411] I.R.C. § 501(e) and Treas. Reg. § 1.501(e)-1.

[412] I.R.C. § 501(e)(1)(A) and Treas. Reg § 1.501(e)-1(c).

[413] HCSC-Laundry v. United States, 450 U.S. 1, 5-6 (1981), *aff'g* 624 F.2d 428 (3rd Cir. 1980). *See also*, Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808 (11th Cir. 1996); Tech. Adv. Mem. 9542002 (July 18, 1995).

[414] I.R.C. § 511(a).

are merely incidental to the organization's activity that is favored under the Code.

For example, a credit union "exempt" under Code section 501(c)(14) realized income from the sale of credit life and disability insurance policies to its member borrowers. The policies provided that upon the death or disability of the borrower, the insurer will repay the loan balance. The credit union collected the premiums and received a commission on the premiums collected and a fee for its related administrative services from the insurer.

When IRS reviewed this arrangement, it stated that exempt income must come from a trade or business that is "substantially related to purposes for which exemption is granted" and "the service from which the gross income is derived must contribute importantly to the accomplishment of those purposes."[415]

IRS determined that the exempt purposes of a credit union were to hold members' funds on deposit and make loans to members. It said the sale of insurance policies was not substantially related to these functions and therefore the compensation received from the insurance company was subject to the tax imposed on unrelated business income.

[415] Tech. Adv. Mem. 9548001 (March 23, 1995).