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George E. Couper

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Recommended Citation
George E. Couper, The Farmer, the Cooperative, and the Commissioner, 7 Hastings L.J. 143 (1956).
Available at: https://repository.uchastings.edu/hastings_law_journal/vol7/iss2/2

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THE FARMER, THE COOPERATIVE, AND THE COMMISSIONER

By GEORGE E. COUPER*

A recent report of the United States Department of Agriculture indicates that there are 10,114 active farmer cooperatives in the United States. Memberships in these groups total seven and one-half million. More than 130,000 of these memberships are California farmers who did a net business of $803,256,000 with their organizations.¹ That figure is almost one-third of the value of all farm produce marketed in California.² These statistics indicate that almost every attorney except the most specialized will eventually have some contact with a farmer cooperative. It is reasonable to assume that one of his problems will involve the special rules of Federal taxation of these organizations and their patrons.

A true agricultural cooperative is a farmer owned and controlled business organization which markets the produce or purchases the supplies used in agricultural production for the mutual benefit of its farmer members. An agricultural cooperative does business on a cost basis returning to the farmer all sums realized in excess of expenses of operation and maintenance and other authorized retentions. The organization may issue capital stock but the primary financial benefit is intended for the agricultural producer who buys from or sells through his organization. Patronage, not money invested in the enterprise, determines the distribution of benefits.³

Farmer cooperatives, frequently called associations or mutuals, are generally incorporated. There are agricultural cooperative association acts in all forty-eight states⁴ and the National Conference of commissioners on Uniform State Laws adopted a uniform agricultural cooperative corporation act.⁵ In addition, the courts have recognized enterprises organized under general business corporation laws as cooperatives.⁶

If a farmer sells his produce to or through his cooperative, the marketing organization is required to seek the best price available for him. It returns to the farmer all it receives less expenses and retentions. The member purchasing farm supplies and machinery from his association pays

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* A.B., University of California, 1947; LL.B., Hastings College of Law, 1953. Assistant Counsel, California Farm Bureau Federation.

¹ U. S. DEPT. OF AGRICULTURE, STATISTICS OF FARMER COOPERATIVES 52 (1955).

² CALIFORNIA DEPT. OF AGRICULTURE, BULL. NO. 3 (1954).

³ "The individual farmer is ordinarily both an investor in, and a patron of, the cooperative association of which he is a member. His contribution to the success of the venture is, therefore, a two-fold one, involving both his capital and his patronage. As an investor in the association, he is promised a limited return on his equity in the association. As a patron he is promised his proportionate share in the savings made possible by his contribution to the pooling of purchases or sales and in any income which the association may derive from its activities." Hearings Before the House Ways and Means Committee, 80th Cong., 1st Sess., at 3135 (1947).


⁵ PROCEEDINGS OF NATIONAL CONFERENCE OF COMMISSIONERS 180 (1936).

cost plus estimated expenses of the organization. Both types of cooperatives are obligated to return to their members at the end of the fiscal period their pro rata share of the surplus based on the amount of their patronage. This rule was affirmed by the Court of Appeals for the Ninth Circuit in an opinion which read in part:

"In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis all funds received in excess of the cost of goods sold. Such an obligation may arise from the association’s articles of incorporation, its by-laws or some other contract."

With one exception the mere fact that an enterprise is organized as a cooperative is not sufficient to create the obligation to return patronage dividends. The obligation of a California agricultural association to return surplus to members based on their patronage was held to arise from the law under which it was organized. Several writers have criticized the decision; and it would appear that a more concrete contract to return surplus to patrons is required for Federal Income Tax purposes.

In addition to the articles of incorporation and by-laws mentioned by the court in the American Shook Box Export case above, agreements to pay patronage dividends are commonly found in the marketing contracts which most cooperatives execute with their producer members.

Voting control, in most associations, is vested in farmers who produce or consume the commodity handled. Members may have one vote only, or may vote in proportion to their patronage in the prior year. In any event, capital stock ownership is not the criterion for voting control in cooperatives. On dissolution, net assets are distributed to patrons on the basis of their patronage.

From this general description of cooperatives, it is easy to predict that they would have peculiar tax problems not faced by the ordinary incorporated enterprise.

I. The Cooperative and the Commissioner

The pro rata share of cooperative profits which is allocated to the farmer at the end of the fiscal period is called a patronage dividend. This

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7 American Shook Box Export Assn. v. Commissioner, 156 F.2d 629, 630 (9th Cir. 1946). See also United Cooperatives, 4 T.C. 93 (1944).
8 Farmers Union State Exchange, 30 B.T.A. 1051 (1943); Fountain City Cooperative Creamery Assn. v. Commissioner, 172 F.2d 666 (7th Cir. 1949).
9 American Shook Box Export Assn. v. Commissioner, 156 F.2d 629, 631 (9th Cir. 1946), referring to San Joaquin Valley Poultry Producers Assn. v. Commissioner, 136 F.2d 382 (9th Cir. 1943). See Agricultural Code of California, §§ 1190-1221.
10 Jensen and Others, op. cit. supra note 4, at 88; Davis, An Economic Analysis of the Tax Status of Farmer Cooperatives 54 (1950); Hensel, Digest of Selected Cases and Rulings on Federal Income Taxation of Farmer Cooperatives 92 (1950).
11 Davis, op. cit. supra note 10.
return may take many forms but in any form it represents the farmer's share of the profits based on the business he has done with his association. Patronage dividends or patronage refunds as they are sometimes called will be more fully explained later, but for present purposes it is sufficient to know that they may be cash dividends or they may be in documentary form evidencing a debt of the cooperative or indicating the patron's share of some capital item or fund.

In 1914 the Treasury Department ruled that a patronage dividend was in effect a refund of a part of the association's gross income and as such, for purposes of tax accounting, it could be treated as a reduction of gross income. This ruling has been criticized by the United States Ninth Circuit Court on at least two occasions as overly liberal. Despite the criticism, the Internal Revenue Service has not changed its position materially since the initial finding. The Commissioner once insisted that patronage dividends gave rise to an exclusion from gross income not a deduction. Apparently the reasoning behind the continued favored treatment was that the pre-existing obligation to pay patronage dividends took those sums out of the constitutional definition of income. However, the terms deduction and exclusion are used interchangeably in the cases in this field of law. The courts seem to prefer to call this accounting peculiarity a deduction. Congress refers to a deduction in considering this problem and recent Revenue Rulings have acceded to this usage. It has been pointed out that regardless of the term used, the result is the same.

While the Treasury Department has consistently granted the cooperative the right to exclude patronage dividends, extensive fringe litigation has occurred over the deduction. The Commissioner has questioned whether there was a pre-existing obligation to pay patronage dividends; whether

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13 "The Congress has not legislated the deduction, and the courts cannot usurp that function. Whether the respondent should have allowed the deduction he did allow is a question upon which we express no opinion. "We know of no manner in which such liberality may be reviewed by the court." Cooperative Oil Assn. v. Commissioner, 115 F.2d 666, 668, 669 (9th Cir. 1940). See also Riverdale Cooperative Creamery v. Commissioner, 48 F.2d 711 (9th Cir. 1931).
15 "Exclusion of patronage dividends from taxable income is not limited to cooperatives. In the case of both cooperatives and ordinary corporations, patronage dividends or price rebates are excludable if paid in accordance with a contractual obligation in effect at the time of the transaction. To the extent, however, that patronage dividends represent non-income businesses or evidences of capital contributions of patrons—their exclusion from taxable income of the cooperatives confers no special tax advantage." Hearings Before the House Ways and Means Committee, 80th Cong., 1st Sess., at 3142 (1947). But see Farmers Union Co-op. of Guide Rock v. Commissioner, 90 F.2d 488 (8th Cir. 1937) where that theory was disapproved.
nonmember patrons received equal treatment; and whether patronage dividends were actually allocated to patrons.

A limited exemption was provided in the 1916 Revenue Act for associations acting as sales agent for members and turning back proceeds less expenses on the basis of quantity of produce delivered. This exemption was extended in the Revenue Act of 1921 to include organizations which purchased supplies as agents for the producer. In 1926 the Revenue Act contained the first comprehensive tax exemption for farmers' cooperatives. The report of the Senate Finance Committee of that year indicates that the exemption granted merely confirmed part of the fundamental policy of the Treasury Department toward these organizations.

The 1926 Revenue Act contained the following language:

The following organizations shall be exempt from taxation under this chapter . . . (12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made

20 Farmers Union Co-op of Guide Rock v. Commissioner, 90 F.2d 488 (8th Cir. 1937).
22 39 STAT. 766, § 11.
23 42 STAT. 253, § 231.
24 "The committee amendment does not broaden the scope of nor even include all the provisions of the Treasury regulations but only incorporates certain provisions adopted by the Department as fundamental in allowing exemptions to cooperative marketing and purchasing associations. The amendment will assure associations, now exempt, that the liberal construction, by the Department, of existing law is sanctioned by Congress and if enacted will prevent a valid, but perhaps sudden or drastic, restriction upon exemptions, such as is now possible under existing law." S. Rpt. 69th Cong., 2nd Sess. 13 (1926).
for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases.\textsuperscript{25}

In 1936 Congress added:

"Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph.\textsuperscript{26}

The language of the 1926 cooperative exemption with the noted addition has appeared in every subsequent revenue act and even survived the changes in the 1954 Internal Revenue Code, although broken down into numbered paragraphs.\textsuperscript{27}

The quoted section of the 1926 Revenue Act prescribed eight rules for determining whether an association was entitled to exemption. These conditions were:

1. The association must be formed by producers.
2. It must be obligated to operate on a nonprofit basis.
3. The cooperative must purchase supplies or sell produce.
4. Substantially all capital stock (if any) must be in the hands of farmers except nonvoting nonparticipating preferred stock, dividends on which do not exceed 8 per cent or the legal rate in the State of incorporation.
5. Reserves must be reasonable and necessary or required by state law.
6. All patrons must be treated alike whether members or not.
7. Nonmember business cannot exceed member business.
8. Nonmember nonfarmer business cannot exceed 15 per cent in purchasing cooperatives.

Failure to meet the test of any one of the eight conditions precluded exemption. However, the nonexempt cooperative was still allowed to deduct amounts properly paid as patronage dividends as a result of the rulings already mentioned. In order to be deductible the profit participation had to be by all patrons, whether members or not, as a result of a pre-existing obligation on the association to pay. If the cooperative did nonmember business but only members shared in profits, the amount attributable to nonmember business was not allowed as a deduction.

The formula for computing net taxable income of a cooperative was set forth in Ruling 6967.\textsuperscript{28} After taking apparent net income, amounts paid as true patronage dividends could be further excluded before computing the amount of profit subject to tax. Though sounding simple, the computation is quite complicated where preferred stock dividends are paid and that fact was pointed out by the Board of Tax Appeals in a case in which the Commissioner had erred in favor of the association.\textsuperscript{29}

Dividends paid on capital stock and Federal Income Tax are generally

\textsuperscript{25} 44 STAT. 39, § 231(12) (1926).
\textsuperscript{26} 48 STAT. 700 (1936).
\textsuperscript{27} INT. REV. CODE OF 1954, § 521.
\textsuperscript{28} 31-4 COM. BULL. 287 (1924).
\textsuperscript{29} Farmers Union Cooperative Exchange, 42 B.T.A. 1200 (1940).
paid out of profits and would not figure in apparent net income. Yet the amount available for patronage dividends cannot be computed until these two items are known. As long as a nonexempt cooperative pays preferred stock dividends it will also be liable for Federal income taxes since it cannot distribute all income in patronage dividends. In addition, since the amount of the tax is not an amount paid in patronage dividends, the nonexempt cooperative cannot deduct the amount of the tax from apparent net income and therefore pays a tax on the amount of the tax. A simultaneous equation is required to compute the actual tax liability and the amount available to patrons as patronage dividends.

The special advantage given to associations in the Revenue Act of 1926 and subsequent years came under a great deal of fire. They were competing with retail enterprises, produce houses, processors and buyers. The cooperative gave the farmer big buying power and stabilized the price he received for his crops or livestock. He generally received better prices when he sold through his organization and this necessarily increased the cost of goods to the retailer.

The cooperatives were not entirely blameless. Many took advantage of the benevolent tax laws to create huge reserves and distribute profits improperly. Activities of the associations were investigated by the Committee on Small Business of the House of Representatives and their favored tax status discussed by the American Bar Association's Section on Corporation, Banking and Mercantile Law.

These inquiries culminated in 1951 in changes to the Revenue Code which had far reaching effects on some cooperatives. In that year, Congress amended section 101(12) to provide that cooperatives exempt under that section would be subject to corporate normal and surtaxes. In one breath they said the associations were tax exempt and in the next they made the associations subject to taxes. When the term tax exempt is applied to cooperatives it must be considered in a qualified sense. Despite the withdrawal of fully exempt status, cooperatives still enjoyed a favored position. The amendments granted them special deductions not allowed the ordinary corporation.

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2 PROCEEDINGS, 181-185, 1946.
3 An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15, or section 117(c)(1) except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under section 23)—
   (i) amounts paid as dividends during the taxable year upon its capital stock, and
   (ii) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that
dividends, exempt associations were allowed to deduct from taxable income amounts paid as capital stock dividends and amounts distributed on a patronage basis derived from nonpatronage income.

An exempt co-op which paid out all of its net income in stock dividends or patronage dividends was in no worse position than it had been prior to the amendment. But the organization which accumulated surplus other than reasonable and necessary business reserves found itself facing a tax burden. This liability, however, was not as staggering as that of the unfavored corporation which had to consider in addition the excess profits tax and the tax on accumulated earnings.

The accumulation of unreasonable reserves was one of the charges most often levelled at cooperatives during the congressional hearings and it is likely that Congress intended these changes to be fair warning to all farmers' cooperatives to mend their ways or face further stringent legislation. The 1951 revision places the exempt and nonexempt association in a more analogous situation. The exempt organization now is forced to allocate all income to patrons or preferred shareholders to avoid taxation. The non-exempt co-op may avoid taxation on its patronage income by allocating it to patrons. The basic distinction between the two is that the exempt association may deduct from gross income stock dividends and amounts allocated to patrons not derived from patronage. The nonexempt co-op which incurs nonpatronage income must pay taxes on this profit. Payment of stock dividends out of income will also subject the nonexempt association to taxes as pointed out earlier in this article.

It is interesting to note that the 1951 legislation contained the first legislative recognition of the Treasury Department's long standing practice of allowing nonexempt cooperatives to deduct patronage dividends from gross income. The same language appears in the 1954 code.

Despite the obvious advantages of securing exemption, many cooperatives prefer to remain nonexempt. In the case of an association which pays no capital stock dividends and distributes all income to patrons there is no tax advantage to exemption unless the organization realizes non-
patronage income. Other cooperatives prefer to restrict the distribution of patronage dividends to members though they may do nonmember business—a practice which prevents qualifying for exemption.

The exempt cooperative makes an annual return on form 990-C. The Tax Court ruled in Automobile Club of Michigan v. Commissioner, that the filing of "Forms 990" by a nonprofit organization did not start the Statute of Limitations running against assessment of delinquent taxes because these forms did not require the taxpayer to furnish sufficient information to make a determination of tax liability. While form 990-C requires more detailed information than required by the form filed by the Auto Club, the cited case has created grave doubts in the minds of the users of all exempt organization returns. In a field of law which is so unsettled, the protection of the Statute is a very practical consideration.

At least one major cooperative found that it paid to give up its exempt status and pay taxes because it did not have to keep detailed records on nonmember business. Secondly, by surrendering its exemption, the association was free to create permanent reserves out of surplus for later capital expansion.

II. The Farmer and the Commissioner

The term patronage dividend has been used in a general sense and not fully defined in this article. Dividends are generally thought of as payments of money, or occasionally of goods, capital items or capital stock. Patronage dividends may be paid in money, but as often as not they will take the form of retain certificates or similar documents. These hybrid securities are also called advice letters, revolving fund certificates or indebtedness certificates. Strictly speaking, they are not bonds or notes, nor do they come within the definition of true capital stock certificates. Some retain certificates bear interest and others do not. Often ownership is restricted to members or patrons of the association, but some certificates circulate freely with other commercial paper. These documents may bear a maturity date or not depending on the needs of the individual association.

Davis, op. cit. supra, note 10, at 49.
20 T.C. 1083 (1953). See also John Danz, 18 T.C. 454 (1953).
Jensen and Others, op. cit. supra, note 4, at 582, speaking of a large New York co-op known cryptically as G.L.F.
20 T.C. 1033 (1953). See also John Danz, 18 T.C. 454 (1953).
Jensen and Others, op. cit. supra, note 4, at 582, speaking of a large New York co-op known cryptically as G.L.F.
20 T.C. 1033 (1953). See also John Danz, 18 T.C. 454 (1953).
Jensen and Others, op. cit. supra, note 4, at 582, speaking of a large New York co-op known cryptically as G.L.F.

41 This variance in method of making patronage refunds is recognized by Congress. Int. Rev. Code of 1954, § 522(b) (2) provides:
Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund or rebate) shall be taken into account in computing taxable income.

43 By whatever name known, certificates evidencing patronage dividends are not regulated under California Corporate Securities Act. See Agricultural Code of California, § 1220.
By whatever title they are called, the retain certificates advise the patron that his share of the income of the cooperative for the year based on the amount of his patronage is a certain amount and that that sum has been allocated to his credit on the books of the corporation. Generally these certificates or letters are serially numbered by years. The sums retained are debited to revolving funds which bear the designation of the year of operations in which earned. In the case of a marketing cooperative handling different classes of produce, the fund may be broken down into sub-funds indicating the pool to which they are applicable.\(^4\)

The cooperative may apply the patronage dividend toward the purchase of its capital stock and thus retain the profits on a permanent basis. The reason for the cooperative retaining income and issuing certificates or exchanging patronage dividends for capital stock in lieu of cash is obvious. Like all businesses it constantly needs operating capital. Unlike the usual corporation, there are unfavorable tax consequences in retaining even a small amount of unallocated surplus. Therefore the cooperative sets up a fund shared in by patrons from which it can draw operating capital. Assuming all the other conditions mentioned earlier, if the cooperative allocates the share of each patron to him on its books within eight and one-half months of the end of its fiscal year, it may include that sum in its patronage dividend deduction.\(^4\)

In part I of this article the treatment of patronage dividends by the paying cooperative has been considered. There is another side to this story which must be considered. The Treasury Department has taken the position for some time that the recipient of a patronage dividend must include it in his gross income. If the dividend is paid in cash, the full amount is reportable. If the dividend is in kind, such as merchandise, then the patron must report its fair market value. If the patronage dividend consists of capital stock or retain certificates, the face amount must be included in gross income.\(^4\)

The reasoning behind the Treasury’s position is that if patronage dividends are paid by a marketing cooperative, they constitute additional compensation for produce sold. If the refund is from a purchasing association, it is held to be a reduction of operating costs. The farmer may reduce his expenses by the amount of the dividend from a purchasing co-op rather than report an additional sum in his gross income. When the patronage dividend takes the form of capital stock, retain certificates or merchandise,

\(^4\) Davis, op. cit. supra, note 10, at 41-47, contains an excellent discussion of this field of cooperative accounting.

\(^4\) Int. Rev. Code of 1954, § 522(b) (2).

\(^4\) Letter from T. C. Mooney, Deputy Commissioner of Internal Revenue, to National Council of Farmer Cooperatives, November 23, 1943.
the recipient must add to his gross income or reduce expenses because of the fiction of constructive receipt of cash.\textsuperscript{46}

In 1948 the Bureau of Internal Revenue began a vigorous campaign of enforcement directed toward the distributee of patronage dividends. For the first time Form Number 1040F, the individual income tax return used by farmers, contained a space specifically for inclusion of patronage dividends. The instructions pointed out that refunds from a purchasing co-op for which the farmer had taken no expense deduction did not constitute income. That instruction is consistent with the theory that the patronage dividend arising from deductible purchases is a reduction of operating costs.

The first decisive opinion arising under the "new look" in the treatment of recipients of patronage refund certificates was \textit{Caswell v. Commissioner}.\textsuperscript{47} Petitioners were members of the Turlock Cooperative Growers Association through which they marketed their peaches. Their produce was pooled with other peaches of the same kind and quality. Expense records were maintained for each pool and after settlement of bills growers were paid their pro rata share of the profits of the pool less an authorized retain. Retains were credited to a capital account and members received retain certificates which they were free to sell.

Petitioners had not included the 1945 retain certificates in their gross income for the year and deficiencies were assessed. Petitioners had two arguments. In the first place, they reasoned, they hadn't received or been entitled to receive payment for the certificates during the year. They were on the cash basis and therefore they did not receive income constructively or otherwise. In any event, they maintained, the certificates had no fair market value when issued and accordingly they realized no income under section 111(b) of the Internal Revenue Code of 1939.\textsuperscript{48}

The court admitted that some earlier decisions involving cooperatives had rested on the theory of constructive receipt by the member of retained surplus. The court dismissed the first of petitioner's arguments saying:

"In the instant cases the respondent [Commissioner] does not rely on the conduit theory nor any other variation of the theory of constructive receipt but has determined and contends that the Caswells in payment for their peaches, and in addition to the cash distributed received other property, namely, the certificates, and under section 111(b) supra, received and realized income to the extent of the fair market value of the certificates at time of issue, and further that the fair market value of the certificates was equal to face."\textsuperscript{49}

\textsuperscript{46}Ibid.
\textsuperscript{47}17 T.C. 1190 (1952).
\textsuperscript{48}§ 111(b) Amount Realized—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.
\textsuperscript{49}17 T.C. at 1198.
Petitioner's second argument received more attention. The court refused to make an analogy between the retain certificates and more commonly known commercial documents. Judge Murdock pointed out that the certificates could be sold and in some instances were sold, the only restriction being that transfers be listed on Turlock's records. He mentioned that they bore interest at 6%, and that Turlock had redeemed certificates for other years without undue delay. Turlock Growers' sound condition, good reputation and the values reflected in its books were also considered. The testimony of two Turlock bankers that the certificates were not marketable, that their purchase was speculative and that they were not accepted as primary collateral was not given much weight. The court concluded by saying:

"In such circumstances we think it clear that the certificates from the date of their issuance not only had fair market value but the record gives no leeway for saying that such fair market value was less than face."

On appeal, the Court of Appeals for the Ninth Circuit reversed the Tax Court. They considered certain provisions of Turlock Growers' marketing contracts which were not considered by the Tax Court and which provided:

"From this Association charge, organization and other general Association expenses shall be deducted, and with the balance a commercial reserve shall be created. Whenever any commercial reserve is no longer needed for Association purposes, the Association shall distribute it among the Growers in the proportions to which they are entitled. . . ."

The court also referred to the cooperative's by-laws which required distribution of the commercial reserves to members upon dissolution.

The court held that the certificates received by appellant were mere evidences of their contingent rights in the commercial reserve. The certificates did not give Caswells any new right or any greater right than they had before the certificates were issued. Under the contract and the by-laws the reserves were distributable only upon the happening of certain contingencies which were either that there was no further need for the funds or that the cooperative was dissolved. Neither of these contingencies occurred during the taxable year. The certificates were not sold during that time and nothing was received on account of them. Therefore, the court held, the certificates did not constitute income in the year received.

Hard on the heels of the Caswell case in the Tax Court were two other cases involving retain certificates. The first of these was Phillips v. Commissioner. The Phillips Cooperative was a nonexempt association. It received

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50 Id. at 1199.
51 Caswell v. Commissioner, 211 F.2d 693 (9th Cir. 1954).
52 Id. at 695.
54 17 T.C. 1027 (1952).
income from marketing members’ fruit and for caretaker services it performed in members’ groves. The marketing contracts were separate from the caretaking agreements and only the latter contained a clause requiring that overages be prorated back to members in revolving fund certificates if cash were not paid. The marketing contracts were silent on the question of patronage refunds, and there was no provision for them in the articles of incorporation or the by-laws.

In 1946 the co-op realized profits on both its marketing and caretaking activities. In prior years it had distributed cash refunds but that year decided to place the funds in reserve. In place of cash, Phillips Cooperative issued to its members revolving fund certificates which were nonassignable, nonnegotiable and bore no interest. These documents were payable only at the discretion of the Board of Directors. Respondents were members of the cooperative who did not include these revolving fund certificates in their gross income and the Commissioner assessed deficiencies.

The Tax Court decision by Judge Murdock distinguished between the profits from marketing and caretaking. As to the former, the court pointed out that there was no obligation on the part of the association to make a refund. That surplus was its taxable income. The court said:

"Those certificates had no fair market value and did not represent income to the recipients on that basis. The Cooperative never made the funds themselves subject to the demand of any member so that constructive receipt might apply."

The decision went on to point out that if the certificates representing reserved marketing profits were redeemed in later years, the amount realized would be includable in gross income in the year received. The Commissioner’s contention that these sums were includable in 1946 gross income was rejected.

The situation with respect to the amounts retained by the cooperative from its 1946 caretaking activities was different, according to the court. The association was obligated to issue revolving fund certificates. The amounts retained by the caretaker organization did not belong to it because, the court said, these sums had always belonged to the members who paid for the services. Logically, if the retained sums had belonged to members continuously they could not be profits. However, the Commissioner’s assessment was sustained. The members were assumed to have deducted the amount paid for caretaker services in 1946. The court held that they should have decreased this deduction by the amount of the applicable retain certificate, and it assumed they had not done so.

The court’s holding was consistent with a prior decision in which

65 Id. at 1029.
Phillips Cooperative was allowed to deduct the income from caretaking for which it issued certificates, but was denied a deduction for its marketing income allocation.

Shortly after the Phillips case was decided, the Tax Court announced its decision in Joplin v. Commissioner. Taxpayers were members of a tax exempt cooperative and reported their income on the cash basis. For the year in question, the cooperative allocated part of its net income to members in the form of credits to a capital reserve account, and in addition issued its preferred stock having a par value of $25.00 a share. Members were not advised of their credits to the capital reserve.

Taxpayers reported neither the credits nor the preferred stock in their gross income for the year. They contended that the income of a tax exempt cooperative was cooperative income and a cash basis taxpayer realized no income from capital reserve credits or a preferred stock distribution until cash was received. They argued as an alternative that if the preferred stock represented income when received it was only income to its fair market value. They offered proof that the fair market value was half of the face value.

The court disposed of the preferred stock question by citing its earlier decision in the Caswell case to the effect that the stock was income in the amount of its fair market value. The taxpayers' evidence of the fair market value of the preferred shares was rejected, and the court held the fair market value to be face value. Regarding the capital reserve credits of which taxpayers were not advised, the court said they could only constitute income to members on the theory of constructive receipt.

"Since the cooperative had a right under its charter and its by-laws, and under the provisions of section 101(12) of the Code, to retain a portion of the net earnings for operating capital reserve, such retained reserves were its income, although exempt from tax, and not income to the patrons until actually distributed or made available to them.

"We do not think that the taxable or nontaxable status of the cooperative determines the tax liability of the patrons on such nondistributable profits. In no case should the constructive receipt theory apply, we think, unless at some time the earnings of the cooperative were made available to or were subject to the control of the patron.

"Therefore, with respect to the amounts credited to capital reserve we hold that the taxpayers received no taxable income."  

The opinion does not mention whether the co-op's articles of incorporation or by-laws required ultimate distribution of capital reserve credits to members. Outwardly, however, the reserve credits here involved appear to differ little from the usual cooperative retain except that the members

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57 17 T.C. 1526 (1952).
58 Id. at 1531, 1532. See also Farmers Grain Dealers Association of Iowa v. U. S., 116 F. Supp. 685 (S.D. Iowa 1953), where the same decision was reached on similar facts.
were not advised of the allocation. Apparently the failure of the association to notify taxpayers was the determining factor in the *Joplin* decision.\(^5\)

to the extent the determination that the preferred stock certificates were includible in taxpayers gross income at face value rested on the *Caswell* case, the *Joplin* decision is open to question since the Tax Court was reversed in the *Caswell* case as noted earlier.\(^6\)

The facts in *Carpenter v. Commissioner*\(^7\) differ materially from those in the prior cases. The taxpayer was a member of a tax exempt cooperative which distributed its net income in retain certificates and by purchase of the stock of a packing company. The shares of packing company stock were purchased in the names of individual members of the cooperative but the members were not advised of this fact until the following year when the shares were issued to them. Carpenter reported his income on the cash receipts basis and included the packing company stock in his gross income in the year in which he received the certificate. He did not include the retain certificates in gross income that year, but did report receipt of cash in partial redemption of the certificate in later years.

The Revenue Service took the position that the retain certificates were income when issued and the stock was income in the year purchased. The Commissioner argued that the retain certificates were to be included in gross income at face value regardless of whether or not they had any fair market value at all when issued. In addition he claimed that since the cooperative was allowed to deduct the amount of net income allocated in certificates, consistency required that the amount of each allocation should be taxable to the recipient. This argument he based on a theory of constructive receipt and reinvestment since each member had assented to the by-laws which required the issuance of retain certificates.

In its findings of fact the Tax Court noted that the retain certificates were redeemable in the sole discretion of the association’s Board of Directors. The court found that they bore no interest, were transferable only on the books of the co-op after permission of the Board, were junior to all other debts and earlier certificates, and that the taxpayer had been unable to sell or borrow on his certificates. Evidence was also received that there had never been a transfer of certificates on the association’s books. Finally the court found that the certificates had no fair market value when issued.

Judge Tietjens, speaking for the court, acknowledged that the consistency sought by the Commissioner might have virtue but went on to say that the co-op and its patrons were different entities and that it did not

\(^{58}\) *But see* B. A. Carpenter, 29 T.C. 603 (1953), where the failure to notify taxpayer of the allocation was held immaterial.

\(^{59}\) *Caswell v. Commissioner*, 211 F.2d 693 (9th Cir. 1954).

\(^{60}\) 20 T.C. 603 (1953).
necessarily follow that what was excludable by the cooperative was automatically taxable to the patron.

Since the court had already found that the certificates had no fair market value, the judge ruled that they were not income when issued. To the Revenue Service's contention for the constructive receipt theory the court answered that there was no better case for it here than in the Phillips case. The taxpayer had no dominion over the funds and the decision to retain them lay with the association's directors.

Turning to the question of the proper year for reporting the packing company stock, the court ruled that the taxpayer's knowledge of the purchase in his name was immaterial. The association was his agent for the purchase and his rights accrued as of the date of purchase. The court then ruled that the taxpayer had not shown the Commissioner's determination to be incorrect, and held that the stock constituted income to Carpenter in the year purchased for him and not the later year when he was advised of the purchase.

The government appealed that part of the ruling concerning the fair market value of the retain certificates. The Court of Appeals affirmed the Tax Court in a brief decision that gave weight to the lower court's decision but added nothing new to the field of tax law.62

The Tax Court reached a similar decision in Howey v. Commissioner.63 They rested their ruling in favor of the taxpayer on their finding that the retain certificates had no fair market value. The court made only casual reference to the fact that the cooperative was not obligated to issue retain certificates. Under Phillips v. Commissioner any prorated surplus would have been taxable to the association since it had no pre-existing obligation to issue the certificates and the amounts shown on these documents would not be includable in the member's income.

Following the Fifth Circuit's decision in the Carpenter case a summary of the positions of the agencies concerned revealed traces of distinguishable patterns. The Commissioner had adhered to his ruling that retain certificates were reportable in the gross income of the recipient in the year received at their face value without regard to the basis on which the recipient reported his income.64 However, the fiction of constructive receipt and reinvestment, argued by the Commissioner in the Phillips and Joplin cases, had been sidelined in favor of the theory that retain certificates constituted other property received in payment for produce sold.65 He continued to rule that if allocation of a pro rata share of a cooperative's overage to a patron

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62 Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955).
63 13 T.C.M. 899 (1954).
was an obligation created by contract or by-laws, then retain certificates representing these allocations were reportable in the year received whether the patron was notified or not. 66

The Tax Court accepted, in the Caswell and Joplin cases, the Bureau's contention that the taxpayer's basis for reporting was immaterial. They had, however, rejected the government's ruling that retain certificates were reportable at full face value. The court said that these documents were reportable at fair market value. 67 That determination was consistent with the reasoning that retain certificates constituted "other property" received under section 111(b) of the 1939 Code. Had the court followed the constructive receipt and reinvestment theory they would logically have been bound to rule that full face value was reportable.

The Tax Court in the earlier cases paid scant attention to evidence as to fair market value, ruling that the market value and face value were the same. 68 Later decisions from this court indicated they would look into the question of a fair market value different from face. 69

The theory of constructive receipt had been firmly rejected by the Tax Court throughout the line of cases concerning taxation of retain certificates. 70 In the Phillips case the court had apparently adopted the commissioner's view, commonly referred to as the rule of consistency, that if the allocated patronage dividends were rightfully excluded from the cooperative's gross income they were necessarily includable in the income of the recipient of the retain certificate representing the allocation. But in the Carpenter case the court specifically rejected the consistency theory pointing out that the patron and the cooperative were two different tax reporting entities.

The Courts of Appeal had neither accepted nor rejected the commissioner's determination that the taxability of retain certificates did not depend upon the recipient's reporting on the accrual basis. The Carpenter decision was predicated on a lack of fair market value and the Caswell case on the fact that the allocation by the co-op was subject to contingencies. Neither court considered the method of reporting. 71 Cases in other fields of tax law had held that cash basis taxpayers must include certain items in income which had not been reduced to possession. 72 But the fiction of constructive receipt was involved. As seen above, constructive receipt was rejected by the Fifth and Ninth Circuits in cases involving retain certificates.

67 Ibid; and Wallace Caswell, 17 T.C. 1190 (1952).
69 B. A. Carpenter, 20 T.C. 603 (1952); Mary G. Howey, 13 T.C.M. 399 (1954).
70 B. A. Carpenter, supra note 69; D. Phillips, 17 T.C. 1027 (1952).
71 Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955); and Caswell v. Commissioner, 211 F.2d 693 (9th Cir. 1954).
72 Burns v. Commissioner, 31 F.2d 399 (5th Cir. 1929).
Receipt of income by a cash basis taxpayer was mentioned in the Carpenter case by the Fifth Circuit but its brief decision relied on a determination that the revolving fund certificates had no fair market value when issued. What the appellate courts would have held if the question had been presented squarely to them is a matter for conjecture. By finding that the retain certificate had no fair market value, the Court of Appeals had rejected the Treasury Department's ruling that the face amount was reportable.\(^7\)

The most recent case on the tax question under discussion added chaos to confusion! Moe v. Earle\(^7\) involved an Oregon farmer who had been a member of the Apple Growers Association as far back as 1929. He had been a party to the Association's standard marketing contract during the entire span of his membership. The contract provided for payment of advances to growers and payment of net proceeds within 30 days of the closing of the pool from which his produce was marketed. The by-laws of the Association contained provisions for deductions from amounts paid growers to be credited to a Building and Equipment Fund. Deductions were made in 1930, 1931, 1935, 1936 and 1937. Growers received Pool Closing Statements which indicated amounts received by the co-op from the sale of produce, the expenses and deductions and the net credit to be paid to them.

Until 1940 the cooperative's by-laws contained no requirement that retain certificates be issued to evidence the Building and Equipment Fund deductions. In that year, however, the Fund was made a part of a revolving fund and provision made for the issuance of certificates. In 1942 the Association completed the computation of the amounts due each grower and issued certificates. These documents were entitled Certificates of Contribution to Revolving Capital Fund. They included a statement to the effect that they did not constitute debts of the Association, were null and void if the membership of the recipient was cancelled and were not negotiable. Their redemption was at the sole discretion of the Association's Board of Directors, and they bore no interest. Each year after 1942 the Cooperative issued a similar certificate to growers representing the prior year's deduction.

In 1949 the Association revolved out the amount of the 1930 and 1931 "contributions." Taxpayer, who had not filed returns during the 1930's and had not included any part of the certificates in gross income for 1942 or subsequent years, reported the amounts revolved out to him in 1949 in his gross income. Additional sums were revolved out to Moe in 1951 and these too were reported in his gross income for the year. The taxpayer thereafter filed a claim for refund of taxes, based on the argument that the

\(^7\) Letter from T. C. Mooney, supra note 45.
\(^7\) 5 CCH 1955 STAND. FED. TAX REP. ¶ 9130 (D. Ore. 1954).
amounts received in 1949 and 1951 were returns of capital and constituted income only in the 1930's when they were contributed to the Association.

In the meantime the Bureau of Internal Revenue had conducted a field audit of Moe's 1949 return and had added to his gross income the face value of the 1949 Contribution Certificates and assessed a deficiency in that amount. This audit was subsequent to the Treasury Department's announcement in 1950 that the face amount of retain certificates was includable in gross income in the year received. The taxpayer's 1951 return included the amount of that year's certificate. The claim for refunds for both years were denied.

The taxpayer brought suit against the Collector of Internal Revenue at Portland, Oregon. The basis of his suit was that the sums deducted in the 1930's by the cooperative had been constructively received and had been contributed back to the Building and Equipment Fund. The complaint pointed out that the standard growers contract called for payment of net proceeds without deductions within 30 days of the closing of the pool to which their crop was assigned.

In an unwritten opinion the trial court concluded that the cash received by the taxpayers in 1949 and 1951 was income then and held that the sums deducted in the 1930's were neither income then nor in 1942 when certificates representing the retains were issued. Thus in reporting the cash received in 1949 and 1951 taxpayer had been correct and was not entitled to refunds. The court relied on Caswell v. Commissioner in support of its ruling that the certificates issued in 1942 did not constitute income then and that the deductions made in the 1930's did not constitute constructive receipt of income.

On appeal the Government as appellee was on the horns of a dilemma. It had to rely on the Caswell case to support the decision in its favor in the District Court; but, the holding in the Caswell case was contrary to the position of the Treasury Department on the general problem of taxation of retain certificates; and the Moe case was being appealed to the same court that had decided Caswell. A decision denying the refund would strengthen the Caswell case, but if the court reversed itself and overruled Caswell, the Government would lose the Moe case.

In this unenviable position the appellee's brief made no attempt to distinguish the cases on the facts. It merely agreed with appellant that the trial court’s decision in Moe v. Earle and the Caswell case were both contrary to "... long established practice of the Internal Revenue Serv-

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78 211 F.2d 693 (9th Cir. 1954).
The invitation was certainly implied for the court to reverse itself and overrule Caswell.

The court refused the invitation. In a per curiam decision they said:

"This appeal raises complicated questions in regard to the withholding of a portion of the proceeds derived from handling and marketing of apples by a cooperative organization... The judgment is affirmed without a reasoned opinion because we adhere to the general principles expressed in the case of Caswell v. Commissioner, 211 F.2d 693." 77

That the court should stand on its prior decision is not surprising. That the Revenue Service should allow itself to be placed in such a position is surprising. The explanation may lie in Revenue Ruling 54-10,78 which was issued after adoption of regulations regarding tax treatment of recipients of retain certificates.80 There the Service instructed its employees that if the period of limitations had not expired, the face amount of the certificate allocated to the cooperative patron should be included in his gross income in the year of allocation. On the other hand if the statute had run the Service is instructed to include the amount of cash received by the patron in gross income of the year of redemption which was not reported in the year of allocation. The taxpayer in Moe v. Earle received the certificate in 1942. The statute of limitations for a deficiency assessment against that year's return had run81 and apparently the Treasury followed the alternative course of including the 1949 and 1951 redemptions in Moe's income for that year.

The Ninth Circuit's decision in Moe v. Earle raises questions which cannot be answered at the time of this writing. It is unlikely that the Service will now acquiesce in Caswell. They will probably stand by their regulations. In view of this probable stand, how shall farmers report their retain certificates? If they report these documents in the year allocated, will the Revenue Service use the Moe and Caswell cases to tax cash redemptions after the period of limitations has run on refunds for the year of allocation? The answers may differ from circuit to circuit since only the Fifth and Ninth Circuits have been heard on the subject. However, with the Tax Court decisions in Carpenter and Howey and the Southern District Court of Iowa's opinion in the Farmers Grain Dealers case82 allied against them, the Treasury has a decreasing number of untried courts.

In oral arguments before the appellate court in Moe v. Earle, the government suggested that the court should adopt two rules. One would apply

77 Brief for the Appellee, Moe v. Earle, No. 14623 (9th Cir. 1955).
78 Moe v. Earle, No. 14623 (9th Cir. 1955). The court also cited Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955).
to retain certificates received prior to 1951; the other to those documents received thereafter. The request for a different rule for 1951 and thereafter was supported by quotations from the Senate hearings which led to the 1951 amendments to section 101(12) of the Internal Revenue Code discussed earlier. According to the government's oral arguments the Treasury Department understood at these hearings that there was no opposition to their rule of consistency which would tax retain to the patron if exempted from the co-op's gross income.

The answers to the farmers' question of how to report retain certificates may come from the legislative body. The simplest solution to the problem would be for Congress to yield to pressure from other business groups and restrict the cooperative's tax exemption. It would be easier to collect the tax at the organization level; and the Ninth Circuit by citing Eisner v. Macomber in support of its decision in Caswell cast advance constitutional doubts on any law attempting to tax all retain certificates in the hands of patrons. On the other hand federal income taxation of net earnings of a cooperative has already passed one constitutional barrier.

Another possible course of action is a withholding tax levied on each patron's retains at the cooperative level. That plan would also be easy to administer from the government's point of view. It would remove the question of fair market value of certificates from most of the cases. A withholding tax on retain certificates would place the burden on the farmer to claim a bad debt or capital loss in later years.

It is possible however that nothing will be done about the problem in the next session of Congress. In a period of falling farm prices Congress may hesitate to enact such legislation, particularly since it is an election year.

In the meantime, the safest course of action appears to be to report retain certificates when received and to keep an eye on the period of limitation on refund claims. Congress may come to the rescue before the statute runs on current years returns.

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84 INT. REV. CODE OF 1939, § 101(12) (B).

85 Letter from Secretary of the Treasury George Humphrey to Representative Jere Cooper, July 26, 1955. In that letter the Secretary states that Congress assumed in 1951 that the Treasury's regulations would be upheld and intended that cooperative income should be taxed either to the organization or to its members.

86 252 U.S. 189 (1920). The case held that a stock dividend did not fall within the definition of income in the Sixteenth Amendment.

87 In Farmers Union Co-op of Guide Rock v. Commissioner, 90 F.2d 488 (8th Cir. 1937), the court held that net earnings of a cooperative constituted taxable corporate income under the Sixteenth Amendment.

88 Letter from Secretary of the Treasury, supra note 85.