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FROM ROCHDALE PRINCIPLES TO LLCs: THE ONGOING EVOLUTION OF THE COOPERATIVE STRUCTURE

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The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser.

In a world where large corporations were all subject to two levels of tax, the passthrough treatment of cooperatives was anomalous. As a result, commentators and the IRS often subjected cooperatives to attack. This article traces the development of the taxation of cooperatives and reviews some of the attacks that have been leveled at cooperatives. In the current world of LLCs, the tax treatment of cooperatives no longer seems as strange as it once did, and the benefits of the cooperative form are less clear. Cooperatives have responded with revised structures (New Generation Cooperatives) and a push for more flexibility in state laws governing cooperatives (allowing cooperatives to form as LLCs). The article describes these changes and suggests how the tax law may react to them.

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Nestled quietly on the continuum of entities from general partnerships to C corporations is the cooperative. Long before LLCs, the cooperative provided a type of passthrough treatment for owners of an entity that was generally a corporation in form. The tax treatment of cooperatives has been criticized in the past, in part because it was misunderstood. Cooperatives have also faced resistance from the IRS. Lately, business considerations have transformed the operation and organization of cooperatives, while significant changes have been made in the classification of entities for tax purposes. As a result, the tax treatment of cooperatives may be more readily understood by those who don't deal with them regularly, while proponents of cooperatives wonder whether the entities that now call themselves cooperatives fit the traditional mold.

In this report, I identify three types of cooperatives, with a description of the history that led to their slightly different tax regimes. I also set out some attacks that have been leveled at the tax treatment of cooperatives, and some positions the IRS has taken regarding the taxation of cooperatives. I show how the courts and Congress have often, but not always, stepped in to mitigate the IRS's positions. Finally, I discuss the development of ''New Generation Cooperatives'' (NGCs) and the potential that now exists for LLC cooperatives that have been authorized by recent changes in state law.

I. Categories of Cooperatives Under the Code

There are three categories of cooperatives under the Internal Revenue Code:

A. ''Exempt'' farmers cooperatives, described in section 521;

B. Certain mutual or cooperative entities described in section 501(c)(12), which are ''exempt from taxation'' pursuant to section 501(a);[1] and

C. ''Taxable'' cooperatives, governed by subchapter T of the code (sections 1381-1388).[2]

Despite the labels given to some cooperatives, no cooperative is ''exempt'' from tax any more than a partnership is exempt from tax.[3] To the extent cooperatives do not pay tax, they operate as passthrough entities, and their patrons generally include the cooperative's income in their income.[4] When the tax law drew a sharper distinction between corporations and passthrough entities, the ability of cooperatives to get passthrough treatment on their income fostered the ''exempt'' characterization, since cooperatives are often corporations in form.

While the code continues to refer to some cooperatives as ''exempt,'' a cooperative's income is taxed either to the entity itself or to its members — in the case of nonpatronage income of a nonexempt cooperative, it is taxed to both.[5] Moreover, when the cooperative is allowed a

[1] Commentators often ignore the separate existence of this category of cooperative, although two relatively recent articles have discussed the tax treatment of rural electric cooperatives. Clayton S. Reynolds, ''Tax-Exempt Electric Cooperatives: A Discussion of Issues Relating to the 85 Percent Member Income Requirement,'' 55 *Tax Law.* 585 (2003); Cliff Massa III and Sean P. Clancy, ''When Should an Exempt Electric Cooperative Become a Taxable Business?'' *Tax Notes*, July 21, 2003, p. 379; *see also* Clayton S. Reynolds, ''Tax Issues Raised for Rural Electric Cooperatives by the Advent of the Non-Bypassable Charge,'' 52 *Tax Law.* 335 (1999). Some of this recent attention was stirred by controversy surrounding the sale by rural electric cooperatives of propane to their customers as part of their cooperative activities. The cooperatives lost this battle when the IRS concluded that this was not an activity described in section 501(c)(12). Rev. Rul. 2002-54, 2002-37 IRB 527, *Doc 2002-20107, 2002 TNT 170-8*.

[2] The Internal Revenue Code has special rules that apply to housing cooperatives. Section 216. Housing cooperatives are cooperatives under subchapter T. *Trump Village v. Commissioner,* 69 T.C.M. (CCH) 2985, *Doc 95-6276* or *95 TNT 122-34* (1995), *acq.* 1995-44 IRB 4, *95 TNT 212-41*. However, the focus of this article is the cooperative as a business entity, so the special rules that apply to housing cooperatives are not discussed here.

[3] In the 1950s and 1960s, taxwriters who believed that cooperatives were ''exempt'' questioned whether they should be. *See* Caplin, ''Taxing the Net Margins of Cooperatives,'' 58 *Geo. L.J.* 6 (1969) (cited hereafter as Caplin); Warren, ''Taxation of Cooperatives,'' (cited hereafter as Warren) in 3 House Comm. on Ways and Means, *Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base* 1879 (Comm. Print 1959) (cited hereafter as *Tax Revision Compendium*); Magill, ''The Exemption of Cooperatives From Income Taxation'' (cited hereafter as Magill), *id*. at 1927; Peel, ''The Taxation of Cooperatives,'' *id*. at 1867. The better view is to treat cooperatives as passthrough entities, not exempt organizations, with a few significant differences from more familiar passthroughs (such as partnerships and S corporations) relating to the timing of income items and the failure to pass through the character of income to recipients. As Professor Bittker and George Rahdert observed over 25 years ago:

> The 'exemption' conferred by section 521 on many of these marketing cooperatives is something of a misnomer; they are treated much like conduits through which the members sell their goods, patronage dividends being excluded from the organization's income but taxed to the members. Because the basic statutory principle is 'conduit' treatment rather than true tax exemption, these cooperatives are comparable to trusts and Subchapter S corporations, and the statutory rules effectuating this basic policy are outside the scope of this article [which dealt with nonprofit entities].

Boris Bittker and George Rahdert, ''The Exemption of Nonprofit Organizations from Federal Income Taxation,'' 85 *Yale L.J.* 299, 351 n.140 (1976). A similar point is made in Henry Hansmann, *The Ownership of Enterprise* 131-132 (1996).

[4] As a concession to the practicalities of running a cooperative, members are not taxed until the income is distributed to them. The distribution can be made up to 8½ months after the close of the cooperative's tax year. Sections 1385(a) (inclusion by patron in year received), 1382(d) (payment period for cooperative). Partners and patrons of cooperatives may also be treated differently when the partnership/cooperative provides to the partner/patron a benefit that is not business-related. Patrons of cooperatives generally do not include in income patronage refunds that relate to personal expenditures. Section 1385(b)(2). In the case of a partner, section 707(a) would probably require inclusion of those items in income. Whether this inclusion would occur absent a statutory provision is unclear. *Compare Benjamin v. Hoey*, 139 F.2d 945 (2d Cir. 1944) (not included) *with Wegener v. Commissioner*, 119 F.2d 49 (5th Cir. 1941) (included).

[5] Section 1388(a)(3) (patronage dividend determined only with reference to ''business done with or for its patrons''). ''Exempt'' farmers' cooperatives have some tax advantages: for example, they can deduct income from transactions with nonmembers that are distributed to members. Section 1382(c)(2). However, based on IRS figures, the number of exempt farmers' cooperatives has steadily decreased — there were 2,129 in 1991 but only 1,330 in 2000. *See* IRS 1996 Data Book, at http://www.irs.gov/taxstats/article/0,,id=97216,00.html (1991-1996); IRS 2002 Data Book, at http://www.irs.gov/taxstats/article/0,,id=102174,00.html (1999-2002). The number increased slightly to 1,347 in 2002. IRS 2002 Data Book, *id*. The number of taxable farmers' cooperatives went from 3,219 in 1991 to 2,537 in 1994, increased to 3,407 in 1997, and decreased to 3,096 in 2001 (2002 data not available). *Id*. and IRS 1999 Data Book, at http://www.irs.gov/taxstats/article/0,,id=102173,00.html (1996-1999). Figures from the Department of Agriculture show the number of farmer cooperatives decreasing steadily from 1993 (4,244) to 2001 (3,651). These figures are available through a ''State Data'' link available as a spreadsheet at http://www.rurdev.usda.

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deduction for patronage dividends, there is a reasonable argument that these amounts are not its income under general tax principles. Analogous items paid by noncooperative entities would be deductible.[6]

I will first describe the history of the taxation of cooperatives to help explain the way the three categories of cooperatives are taxed under current law.

II. History of Cooperative Taxation

The 1913 tax law exempted ''agricultural, or horticultural organizations'' from tax.[7] The 1916 tax act exempted agricultural cooperatives more explicitly, although it did not use the word ''cooperative.''[8] The 1926 tax act made explicit that the exemption was limited to ''associations organized and operated *on a cooperative basis*.''[9] This exemption continued into the 1939 code.[10] Administratively, the Treasury allowed all cooperatives (exempt and others) to exclude from gross income patronage dividends that were distributed pursuant to a preexisting legal obligation,[11] and allowed exempt cooperatives to make deductible distributions of income from transactions with nonmembers.[12] In addition, before 1951, ''exempt'' cooperatives could deduct amounts allocated to ''reserves'' and no one was taxed on those amounts. On the other hand, patrons of cooperatives, exempt or not, were always required to include patronage dividends in income.[13]

In 1951, Congress attempted to write clear rules governing the tax treatment of cooperatives. Cooperatives were given a statutory deduction for patronage dividends (which may be nothing more than evidence of the allocation of the cooperative's income to its patrons), while patrons were expected to include the dividends in income.[14] Exempt cooperatives were no longer allowed to take deductions for amounts allocated to reserves.[15] But in a series of taxpayer victories,[16] courts held that Congress mandated only the deductibility of patronage dividends by cooperatives, but allowed patrons to exclude from income the face amount of some of the paper distributed to them by the cooperative. The courts allowed patrons to defer the recognition of income until the cooperative actually paid the promised amount, even though this eliminated the symmetry between the deduction by the cooperative and the inclusion by the patron. Congress changed the result in 1962, requiring patrons of

gov/rbs/coops/data.htm (data for odd years only). IRS data do not identify filings of non-farmers' cooperatives. Such cooperatives file a regular corporate tax return, with no indication that the taxpayer is operating on a cooperative basis. E-mail from Tracy Holtslag, cooperatives technical adviser, IRS, to author (December 9, 2003).

[6] *See* discussion in section V, *infra*.

[7] Revenue Act of 1913, section II G(a). I have relied for some of the early history of the tax treatment of cooperatives on Magill, note 3 *supra*, and Donald Frederick, ''Subchapter T: Where We've Been and What Is the Future,'' 54 *The Cooperative Accountant* 23 (Fall 2001) (cited hereafter as Frederick).

[8] Revenue Act of 1916, section 11(a)(Eleventh) had an exemption for:

> Farmers', fruit growers', or like association, organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; . . .

The Revenue Act of 1921, section 231(11), added an exemption for purchasing agents that acquire supplies for farmers.

[9] Revenue Act of 1926, section 231(12) (emphasis supplied).

[10] 1939 Code, section 101(12).

[11] Magill, at 1928 n.6, cites T.D. 1996 (1914); T.D. 2737 (1918); O.D. 64, 1 C.B. 208 (1919); I.T. 1499, I-2 C.B. 189 (1922); I.T. 1566, II-1 C.B. 85 (1923); S.M. 2288, III-2 C.B. 233 (1924); S.M. 2595, III-2 C.B. 238 (1924); A.R.R. 6967, III-1 C.B. 287 (1924); G.C.M. 12393, XII-2 C.B. 398 (1933); G.C.M. 17895, 1937-1 C.B. 56; I.T. 3208, 1938-2 C.B. 127.

[12] Before Congress added explicit rules for cooperatives to the code, only administrative practice prevented nonexempt cooperatives from deducting distributions of nonpatronage income to patrons. According to Magill and Merrill, nonexempt cooperatives that paid taxes on income from nonmember transactions did so on a ''voluntary'' basis. Magill and Merrill, ''The Taxable Income of Cooperatives,'' 49 *Mich. L. Rev.* 167, 190 (1950) (hereafter Magill and Merrill).

[13] I. Packel, *The Organization and Operation of Cooperatives* 258 (4th ed. 1970). This result is implicit in the government's reasoning in its early rulings allowing cooperatives to exclude patronage dividends. *E.g.*, I.T. 1499, I-2 C.B. 189 (1922) (''In the case of sales of produce . . . the refunds . . . are in reality only part payment for the produce furnished.'') This result did not necessarily follow when the patronage dividend was not paid in cash but was simply distributed to patrons with non-interest-bearing cooperative obligations. Nevertheless, it appears that patrons of cooperatives were expected to take paper distributions of the cooperative's income into their own income at face value. 1951 Senate Hearings, note 77 *infra*, at 1250 (testimony of Mr. Colin Stam, Chief of Staff of the Joint Tax Committee) and 1251 (excerpt from report of Joint Tax Committee). Before 1951, many members of cooperatives apparently failed to include in income patronage dividends distributed in noncash form. Income tax information release No. 2, April 13, 1950, 5 *CCH 1950 Stand. Fed. Tax Rept.* 6111, cited in Magill, note 3 *supra* at 1929 n.10.

[14] S. Rept. No. 781, 82d Cong., 1st Sess., *reprinted in* 1 *Seidman's Legislative History of Federal Income and Excess Profits Tax Laws, 1953-1939* at 1498:

> . . . [A]ll earnings or net margins of cooperatives will be taxable either to the cooperative, its patrons or its stockholders. . . . With this exception [payments in respect of purchases of personal items by patrons], funds which are allocated to the accounts of patrons, or paid in cash or merchandise, are taxable to them.

[15] *See* S. Rept. No. 781, note 14 *supra* at 1498-99.

[16] *Long Poultry Farms Inc. v. Commissioner*, 249 F.2d 726 (4th Cir. 1957); *Commissioner v. Carpenter*, 219 F.2d 835 (5th Cir. 1955), *aff'g* 20 T.C. 603 (1953), *acq*. 1958-1 C.B. 4; *Caswell's Estate v. Commissioner*, 211 F.2d 683 (9th Cir. 1954). Because cooperatives were allowed to deduct the patronage dividends they were paying, *e.g.*, *Farmers Cooperative Co. v. Commissioner*, 288 F.2d 315 (8th Cir. 1961), Congress had to act.

cooperatives to take into income the amounts for which the cooperative received a patronage dividend deduction.[17]

III. Cooperatives Under Current Law

''Taxable'' cooperatives deduct payments that qualify as patronage dividends. The patronage dividend must be profit from patronage activities,[18] and it must be distributed pursuant to a preexisting legal obligation. The dividend may be paid in cash, in property, or in some categories of ''cooperative paper''[19] that reflect the cooperative's commitment to pay amounts in the future.[20] It is generally included in the patron's income.[21] Cooperatives may also distribute ''nonqualified'' paper. Cooperatives may not deduct distributions of nonqualified paper, and patrons do not take those amounts into income at the time of distribution. When the paper is redeemed for cash or property, the cooperative gets a deduction (or, in effect, a credit for the taxes the cooperative would have saved by deducting the dividend when it was distributed, if that results in a lower tax liability), with income to the patron.[22]

''Exempt'' farmers' cooperatives operate under a regime that has rules similar to the rules for taxable cooperatives. However, they can distribute and deduct more items than nonexempt cooperatives. Specifically, they deduct some dividend payments and they deduct profits earned from nonmembers (including profits from income earned in transactions with the United States).[23]

The cooperatives described in section 501(c)(12) continue to operate under the rules that governed cooperatives from 1951 to 1962.[24] That means they can take a deduction for any paper they distribute, even though their patrons will not take the patronage dividends into income until the paper is redeemed for cash. Like all cooperatives since 1951, they are not allowed deductions for reserves that they create, and they can not get the special deduction for dividends on preferred stock and distributions of nonmember earnings that ''exempt'' cooperatives get.

An overarching principle that applies to all cooperatives is that the cooperative be operated ''on a cooperative basis.''[25] The regulations do not explain what that phrase means, but they do add that the cooperative must allocate amounts to patrons ''on the basis of the business done with or for such patrons.''[26] A central court decision in the development of the tax treatment of cooperatives traced the guiding principles underlying current cooperative operation to the rules of the Rochdale cooperative, a consumers' cooperative formed by textile weavers in England in 1844.[27] The three attributes identified by the Tax Court were subordination of capital (benefits of the enterprise do not flow mainly to suppliers of capital); democratic control (often applied as a one member-one vote structure[28]), and allocation of profits in accordance with patronage. The IRS in the past devoted significant attention to the Rochdale principles, although they have been cited much more sparingly of late.[29] As we will see below, cooperatives recently have moved away from strict adherence to those principles.

IV. Do Cooperatives Have a Business Advantage?

A. Past Discussions

The fact that a cooperative may not be subject to tax caused consternation to some in the past. A notable example is Mortimer Caplin, who was commissioner of Internal Revenue from 1961 until 1964. In a 1969 article,[30] Caplin complained heatedly about the special treatment given to cooperatives, characterizing it as a windfall for cooperatives that allows them to compete unfairly with

[17] Section 1385.

[18] For a discussion of what constitutes patronage income, see section VI.I *infra*.

[19] Section 1388(c) defines a ''qualified written notice of allocation.''

[20] Sections 1388(a) (definition of patronage dividend), 1382(b) (categories of deductible patronage payments).

[21] Section 1385(a); *but see* section 1385(b) (certain patronage dividends excluded from income).

[22] Sections 1383 and 1385(c). As is true of regular patronage dividends, the income is generally recognized by the patron in the year *after* the cooperative gets the deduction. *See* note 4 *supra*.

[23] Section 1382(c). Thus, as the court said in *Farmers Cooperative Co. v. Commissioner*, 85 T.C. 601, 602 n.3 (1985), *aff'd* 822 F.2d 774 (8th Cir. 1987):

> 'Exempt' in this context is somewhat different from its use in sec. 501 because farmers' cooperatives which meet the requirements set out in sec. 521 are subject to the normal tax, surtax, and alternative tax imposed upon corporations in general by sec. 11, except that in computing taxable income they are given the advantage of deductions which are not shared by cooperatives that do not meet the requirements (sec. 1381).

[24] This was made clear in the legislative history to the 1962 Act. *E.g.,* H. Rept. No. 1447, reprinted in 1962-3 C.B. 402, 483:

> . . . The tax treatment outlined here . . . does not . . . apply to exempt mutual ditch, irrigation, or REA [Rural Electrification Act] cooperatives, . . . It also does not apply to presently taxable organizations which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. These will continue to be treated the same as under present law.

[25] Sections 521(b)(1) and 1381(a)(2).

[26] Treas. reg. section 1.1381-1(a).

[27] *Puget Sound Plywood Inc. v. Commissioner,* 44 T.C. 305, 308 (1965).

[28] *See* section VI.H *infra* for a fuller discussion of this principle.

[29] From 1975 to 1980, eight GCMs cited Rochdale: 36268 (May 14, 1975), 37442 (March 6, 1978), 37578 (June 16, 1978), 37751 (November 4, 1978), 37857 (February 2, 1979), 38061 (August 22, 1979), 38217 (December 21, 1979), 38595 (December 29, 1980). Since then, only one GCM has cited Rochdale principles, GCM 39610 (March 5, 1987). The most recent private letter ruling to cite the Rochdale principles allows democratic control to be exercised through voting by written consent (ballot) in lieu of a meeting, as well as by proxy, noting a bit dismissively that ''Communications have changed greatly since the days of the Rochdale Cooperative.'' LTR 200210033, *Doc 2002-5773, 2002 TNT 47-77*.

[30] Caplin, note 3 *supra*.

taxable corporations. Caplin was concerned about business advantages that cooperatives may have because special tax rules apply to them. We first consider whether cooperatives really have business advantages compared to other entities because of their tax treatment. In the next section we consider whether the tax rules applied to cooperatives are special.

Caplin argues that cooperatives compete unfairly with other corporations. Caplin does not explain exactly how this happens, but it is clearly an important basis for his criticism of the tax treatment of cooperatives. At the beginning of his article, he writes:

> Today, cooperative corporations, although nominally subject to the corporate income tax, may deduct those earnings distributed to patron-owners in the form of patronage dividends, thus in effect avoiding tax liability. Additionally, if 20 percent of these dividends is paid in cash and the balance in the form of paper allocations, cooperatives can retain and invest earnings for expansion and other business purposes on a tax free basis. Thus, cooperatives virtually are exempt from the corporate income tax. In contrast, ordinary business corporations currently pay a tax of over 50 percent on their taxable income in excess of $25,000, whether that income is distributed to stockholders or retained for use in the business.
>
> Cooperatives originated as simple agency arrangements among farmers, who joined together in order to market their produce more profitably. Today, however, having capitalized upon their ability to generate tax-free earnings they have become large corporate enterprises engaging in multiline business activities in all segments of the economy. In almost every area of their operations, cooperatives wage aggressive and effective competition with taxpaying businesses. Indeed, cooperatives generally have grown more rapidly than business corporations and in many instances have acquired substantial corporations and converted them into cooperatives.[31]

Caplin's arguments echo previous claims about cooperatives.[32] Presenting testimony to Congress in 1959, Professor William C. Warren wrote:

> Expansion and integration of cooperatives, coupled with the special tax benefits which they enjoy, have placed them in a position to compete on an unfair basis with the ordinary corporations which do not enjoy these special tax prerogatives. . . .
>
> For example, if both a cooperative and a taxpaying corporation had profits of $10 million before taxes, the ordinary corporation would be able to retain only $4,800,000 for reinvestment, while the cooperative could have as much as $10 million available. The cooperatives would be able to expand and improve [their] facilities much more rapidly than [their] taxpaying competitor, thus acquiring a greater share of the market.[33]

Roswell Magill said, at the same time:

> Many cooperatives have become multimillion-dollar enterprises engaged in a wide variety of activities such as marketing, purchasing, manufacturing and processing. As a result of their growth, largely through the retention of untaxed earnings, cooperatives have been competing effectively with even the largest private business corporations.[34]

B. Do Cooperatives Compete Unfairly?

The critics appear to make two arguments based on the fact that cooperatives may not pay any corporate tax. First, not having to pay a tax allows them to ''wage aggressive and effective competition with taxpaying businesses.'' Second, cooperatives can grow more rapidly than taxable corporations ''largely through the retention of untaxed earnings.''

The first argument — tax exemption allows for aggressive competition — applies equally to other business entities that get passthrough treatment, which is the only sense in which cooperatives are exempt from tax. The issue has been discussed in connection with the tax treatment of partnerships compared to that of corporations, but recent works suggest that tax considerations do not, in the main, determine whether capital flows to the partnership sector.[35]

Even if cooperatives were tax-exempt entities, there seems to be no incentive for tax-exempts to use their exemption to gain a competitive advantage over others in their industries.[36] To the extent its income is not taxed, why should a tax-exempt entity accept any less of a profit than a similarly situated taxable entity? The tax-exempt

[31] *Id.* at 7-8 (footnotes omitted).

[32] Those criticisms have continued into the present. Letter of Wayne Valis to Treasury Secretary Paul O'Neill, *Doc 2002-12310, 2002 TNT 100-31* (cooperatives have ''unfair competitive advantage''); Massa and Clancy, note 1 *supra*; Donald C. Haley, ''The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem to Be Headed?'' 7 *Akron Tax J.* 61, 84 (1990) (unfair competition from telephone cooperatives).

[33] Warren, note 3 *supra* at 1883.

[34] Magill, note 3 *supra* at 1934.

[35] Roger H. Gordon and Jeffrey K. MacKie-Mason, ''Tax Distortions to the Choice of Organizational Form,'' 55 *J. Pub. Econ.* 279 (1994); Jeffrey K. Mackie-Mason and Roger H. Gordon, ''How Much Do Taxes Discourage Incorporation?,'' 52 *J. Finance* 477 (1997); Austan Goolsbee, ''Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax,'' 69 *Journal of Public Economics* 143 (1998); *but see* Jane Gravelle and Laurence Kotlikoff, ''Corporate Tax Incidence and Inefficiency When Corporate and Noncorporate Firms Produce the Same Good,'' 31 *Economic Inquiry* 501 (1993).

[36] Susan Rose-Ackerman, ''Unfair Competition and Corporate Income Taxation,'' 34 *Stan. L. Rev.* 1017 (1982) (cited hereafter as Rose-Ackerman); Henry Hansmann, ''Unfair Competition and the Unrelated Business Income Tax,'' 75 *Va. L. Rev.* 605, 610-611 (1989) (cited hereafter as Hansmann).

entity should charge the same price as its taxable competitor — its beneficiaries will just keep more of that profit than the owners of a comparable taxable entity.[37]

C. Do Cooperatives Accumulate Capital Unfairly?

Comparing the ability of regular corporations and cooperatives to retain capital is complicated.[38] We will consider the issue at three levels: the taxation of the entity, the taxation of the patron or shareholder, and the investment that is made by the patron or shareholder.

1. Taxation of the entity. Cooperatives avoid paying income taxes by distributing their earnings to patrons. Regular corporations do not have that option. However, a cooperative does not retain all of its income for reinvestment. To deduct patronage dividends, cooperatives must distribute at least 20 percent of the patronage dividend in cash.[39] Thus, in determining the advantage a cooperative has in accumulating capital (because it can deduct patronage dividends for tax purposes), the maximum benefit is not the full tax on its income. Instead, it is a percentage of the cooperative's profits that is 20 percentage points less than the tax rate to which a corporation would be subject.[40]

In fact, cooperatives have difficulties raising capital through conventional sources that other corporations do not have.[41] To counterbalance this, cooperatives might be expected to distribute as little as possible to their patrons. Yet there are pressures to distribute funds, because a cooperative's members want to receive cash so they can pay their own expenses. Therefore, cooperatives on average don't pay only the minimum 20 percent of their earnings as patronage dividends. The average is closer to 40 percent. This is about the same as the percentage of profits that regular corporations pay to their shareholders from before-tax income; the figure for after-tax income is now only a little more than 50 percent.[42]

[37] Rose-Ackerman at 1020. Rose-Ackerman believes a tax-exempt entity might harm taxable competitors. If tax-exempt entities enter particular industries disproportionately, because they are restricted in the businesses in which they can profitably engage, they may reduce the profits of others in those industries that do not have the mobility to move into another business. Perhaps the unrelated business income tax forces tax-exempts into "related" businesses, so for-profit entities in those areas may suffer accordingly. *Id*. at 1038-1039. For possible examples of this, see Lewis E. Harris, "Tax Exempt Organizations," 3 *Tax Revision Compendium,* 2101 (1959) (tax-exempt research institutes); Scott Dunham, "Business Activities of Exempt Scientific Research Organizations," *id*. at 2127. On the other hand, Hansmann argues that there may be economic efficiencies in tax-exempts operating in areas related to their exemption. Hansmann, note 36 *supra* at 626-633.

[38] Donald Sharpe, who considers cooperatives to be true tax-exempt entities, argues that tax-exempt entities have advantages in accumulating capital. Donald L. Sharpe, "Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later," 3 *Fla. Tax Rev.* 367, 386 (1996) (suggesting that tax-exempts who have this advantage should spend on their charitable purposes the amounts they would otherwise pay as taxes); Rose-Ackerman, note 36 *supra* at 1023. But those advantages are at least partly offset by the higher cost of capital that they face, since lenders have more difficulty monitoring the behavior of a nonprofit than the behavior of a for-profit business. *Id*. at 1029. For a fuller explanation of the problem cooperatives have in raising capital from members, see Bacchiega and de Fraja. "Constitutional Design and Investment in Cooperatives and Investor-Owned Enterprises" 75 *Annal of Public and Cooperative Economics* 265 (2004).

[39] Section 1388(c)(1).

[40] David Cobia and Thomas Brewer, "Equity and Debt," in Cobia, ed., *Cooperatives in Agriculture* 243, 246 (1989) (cited hereafter as *Cobia*). Under current law, any cooperative whose taxable income is less than $100,000 would pay out more by complying with the 20 percent rule than it would pay in taxes, because the rate of tax on corporate income under $100,000 is less than 20 percent. The maximum benefit for cooperatives with more than $100,000 of what otherwise would be taxable income is 15 percent of that amount, 20 percentage points less than the maximum corporate tax rate of 35 percent.

(Footnote continued in next column.)

[41] Cobia and Brewer, *id*. at 256 (emphasis in original):

> Cooperatives do have *disadvantages* when borrowing long-term capital. Most lending agencies do not compete for this segment of the market, nor are they particularly receptive when approached because they do not understand cooperatives or how they operate.

Cobia and Brewer point out an offsetting advantage: Cooperatives can borrow from banks for cooperatives. The theoretical advantages cooperatives have in raising capital because they pay no corporate tax are discussed in Richard Caves and Bruce Petersen, "Cooperatives' Tax 'Advantages': Growth, Retained Earnings, and Equity Rotation," 68 *Am. J. Agr. Econ.* 207 (1986) (cited hereafter as Caves and Petersen). Even under their theoretical model, which reflects the advantages cooperatives have in retaining capital because they pay no corporate tax, cooperative growth ultimately slows significantly once a cooperative begins redeeming its retains for cash.

[42] Information on this issue on the cooperative side is generally available for agricultural cooperatives only. In 1991-92, the average cash patronage payment of agricultural cooperatives was 38 percent of distributed net income. Robert C. Rathbone and Roger A. Wissman, Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives, ACS Research Report No. 124, Agricultural Cooperative Service, U.S. Dept. of Agriculture at 6 (October 1993), available at http://www.rurdev.usda.gov/rbs/pub/rr124.pdf (cited hereafter as Rathbone and Wissman). It seems reasonable to compare this to the payout ratio for S&P 500 companies, rather than all corporations, because cooperatives are likely to act more like publicly traded companies than closely held companies. The figure for S&P 500 payouts has varied quite a bit in the past 40 years — it was close to 60 percent in 1960-1964, but dropped to 35 percent or less in the years after 1995. It is likely that the reduction of the tax rate on dividends that was made in 2003 will cause that ratio to rise. *See* Treasury Office of Economic Policy, "The Jobs and Growth Tax Relief Reconciliation Act and the Increase in Dividends" (July 30, 2003, available at http://www.ustreas.gov/offices/economic-policy/dividends.pdf, which includes five year averages of the S&P 500 payout ratio since 1950; comparable arguments about dividend payouts can be found in Caves and Petersen, note 41, above at 208; William Bratton, "The New Dividend Puzzle," 93 *Geo. L.J.* ___ (2004) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=535462): The use of the 40 percent figure is probably correct currently, but it clearly changes over time. It is hard to know if the same is true for cooperatives — there are no comparable series for cooperatives that extend over such a long period. The payout figure for all corporations may be roughly the same, although the available figures include loss corporations that should perhaps be excluded from the comparison. *See* summary data on this issue,

(Footnote continued on next page.)

Accordingly, if we look just at the consequences at the entity level, a simple comparison between cooperatives and taxpaying corporations shows a benefit for cooperatives:

> Cooperatives must pay 20 percent of net margins to patrons. Corporations pay about 35 percent of their taxable income in taxes.[43] Thus, cooperatives get to keep 80 percent of their profits, while taxable corporations keep only 65 percent.

If we take the next step, and look at the average amounts paid to owners by cooperatives and taxable corporations, the comparison would be:

> Cooperative earns $100, which it can deduct as a patronage dividend. Average cooperative pays out $40 and retains $60.
>
> Taxable corporation earns $100 and pays $35 tax. Average corporation pays out 50 percent of the $65 of after-tax income[44] to shareholders, retaining about $33.

Accordingly, at this stage of the analysis, we conclude that the average cooperative initially retains more capital than the average corporation because patronage dividends can be deducted without actual distribution. Under this analysis, which ignores all issues of distributions, the advantage equals about 27 percent of the total profit from patronage.

2. Taxation of shareholders and patrons. The tax consequences to the shareholders of a corporation are not the same as the consequences to patrons of a cooperative. The detriments suffered by patrons of cooperatives when compared to shareholders of corporations should also be determined in comparing corporations and cooperatives because they affect the willingness of patrons to participate in a cooperative. The claimed advantages of the cooperative form in raising capital are not so significant if they arise because the cooperative's patrons must make contributions to the entity that shareholders don't make.

First, consider taxes paid. Under current law, an individual shareholder pays tax only on dividends actually received, generally at a 15 percent rate. Assuming the average 40 percent payout, this adds an additional 6 percent (15 percent of 40 percent) to the shareholder's tax cost of the corporation's earnings. The shareholder also has a deferred tax of 15 percent on the remaining 60 percent, or 9 percent (15 percent times 60 percent is 9 percent). The present value of that 9 percent cost is generally less than 9 percent, its precise value depending on when the additional amount is realized. If the owner dies before the additional dividend is paid, the additional amount could escape tax if the stock is sold after the basis of the stock is stepped up under section 1014.[45]

On the other hand, the patron of the cooperative will pay an immediate tax on the full amount that the cooperative deducts. The patron of the cooperative will pay perhaps 28 percent[46] of the total taxable patronage dividend in taxes. Net, there is an immediate additional cost of 22 percent for the patron of a cooperative (who pays 28 percent) compared to corporate shareholders

available from the Bureau of Economic Analysis of the Department of Commerce. E.g., http://www.bea.gov/bea/newsrelarchive/2004/gdp403f.xls. If cooperatives treat their patrons like regular corporations would treat their customers, payout figures for cooperatives and regular corporations are comparable. Where cooperatives compete directly with other purchasers of patrons' products, this could be the case. *See generally* Murray Fulton and Konstantinos Giannakas, "Organizational Commitment in a Mixed Oligopoly: Agricultural Cooperatives and Investor-Owned Firms," 83 *Am. J. Agr. Econ.* 1258 (2001) (discussing theoretical model). If cooperatives pay their patrons less for the patrons' products (or charge them more for what they sell to patrons), the cooperative's profits are inflated, so that when they pay out a percentage of those profits, they keep a larger percentage of the "real" profits of the enterprise than they would otherwise. For example, if a regular corporation earns $40 from a transaction, but a cooperative shows a $50 profit, the regular corporation will be left with $24 after paying out 40 percent of its profits to shareholders, while the cooperative will be left with $30 after paying out 40 percent to its patrons. Patrons might accept smaller payments from cooperatives than they get from other buyers because they know that the cooperative will also be distributing net margins to them. How comfortable they may feel about getting a lower price might depend on the percentage of net margins that a cooperative normally distributes in cash, the length of time before the unpaid net margins are actually paid, and the general relationship between the cooperative and its members. It has been asserted that most cooperatives in the United States set prices so as to maximize net income. This increases the patronage dividend ultimately paid to patrons, while minimizing the fears of potential competitors that the cooperative is being too competitive. David W. Cobia and Bruce Anderson, "Product and Pricing Strategies," in Cobia, note 40 *supra* at 174, 184 (1989).

[43] The comparison assumes that net margins are the same as taxable income. As just indicated, this depends on whether cooperatives pay the same amount to patrons as patrons would get from an equivalent taxable entity. *See* discussion in note 42 *supra*.

[44] The text's simple model comes into conflict with the averages used earlier. The averages show corporations paying 20 percent of profits in taxes. If we use these figures, the regular corporation pays $20 tax, $40 of dividends, and has $40 left. That would leave the advantage calculated below at 20 percent, not 27 percent of profits.

(Footnote continued in next column.)

[45] Note that, in any event, a sale results in a reduced rate of tax (like the reduced rate on dividends) since the gain is given favorable capital gain tax treatment.

[46] It is not clear what marginal tax rate to use for members of cooperatives. For farmers' cooperatives, a report of the Department of Agriculture's Economic Research Service shows that half of taxpayers with farm income are in the 15 percent marginal tax bracket. 22 percent are in the 28 percent bracket, but roughly the same number are in a 0 percent bracket. *See* http://www.ers.usda.gov/Briefing/FederalTaxes/TaxesSummary.htm (a summary of the report). However, many taxpayers with farm income are likely not primarily farmers. A more detailed study published by the Economic Research Service has the following information as of 1998 for the three categories of taxpayers with farm income who are likely to have farming as their primary occupation (*See* Ron Durst and James Monk, "Effects of Federal Tax Policy on Agriculture," United States Department of Agriculture, Agricultural Economic Report No. 800, at 7 (Table 6) (April 2001), available at http://www.ers.usda.gov/publications/aer800/aer800.pdf.):

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(who pay 6 percent), with the shareholders possibly paying an additional amount with a present value of up to 9 percent depending on when and how they reap the benefits of the corporation's undistributed earnings.

The difference between the tax cost of dividends to patrons and the cost to shareholders should reduce the 27 percent advantage for cooperatives that we calculated earlier and, under some assumptions, eliminate it.[47]

3. Earnings on investment. When we compare the cooperative to the corporation, we should also consider how the entity's decision to retain funds affects patrons and shareholders. The comparison is complicated by inherent differences between a cooperative and a regular corporation. The voting common stock of a cooperative is normally sold for a nominal amount and serves mainly to evidence membership in the cooperative.[48] It is often held in equal amounts by members of the cooperative. A major source of cooperative capital is ''retains'' — profits from transactions with patrons that are distributed as paper to the patrons, to be redeemed at some time in the future. That is the form of the patron's investment in the cooperative when the cooperative does not immediately distribute its profits in cash to its patrons. On one hand, this investment has significant aspects of equity.[49] On the other hand, whatever its categorization for tax purposes, in form the patron makes what is, in effect, an interest-free loan to the cooperative. That loan is made from the patron's after-tax income. For example, suppose $100 of a patron's dividend is not paid in cash. If the $100 had been paid in cash, the patron would have paid $28 in tax and would have kept $72 after tax. To allow the cooperative to have a full $100 in its possession, the patron would contribute an additional $28 to the cooperative, along with the $72 of after-tax income. Equivalently, under current law, the patron pays the $28 in taxes from other assets and the cooperative retains the $100, which it must ultimately pay out to the patron. In contrast, when a corporation does not distribute its profits, the retained earnings are, in effect, a further equity investment made by the shareholder with the shareholder's before-tax income (although it is the after-tax income of the corporation).[50]

Note how different the two investments are. Corporate stock is unambiguously an equity investment, offering the potential for appreciation in value. Cooperative retains have equity elements, but they appear to offer no benefit beyond receipt of their face amount when they are redeemed. Beyond receipt of these amounts on redemption, the patron's future return from the cooperative is generally a function only of the patron's future patronage *of* the cooperative, not of the patron's investment *in* the cooperative.[51] Moreover, given the average period (14

	Primary Occupation Farm Sales ($1,000)		Large Family Farms
	<$100	$100-$250	
Number	336,498	151,970	82,865
Percent of total	15.2%	6.8%	3.7%
Share by Bracket Within Group	**Primary Occupation Farm Sales ($1,000)**		**Large Family Farms**
	< $100	**$100-$250**	
Not taxable	31.2%	30.7%	21.5%
15%	65.2%	58.0%	41.8%
28%	3.3%	10.0%	23.9%
31%	0.1%	1.1%	7.5%
36%	0.1%	0.1%	2.9%
39.6%	0.1%	0.0%	2.4%
Federal Income Tax Paid ($1,000)	865,727	466,087	1,560,277

Clearly many more farmers are in the 15 percent bracket (or are not taxable) than are in higher brackets. However, it seems likely that a substantial percentage of the *income* earned by farmers is taxed at rates above 15 percent. It is even harder to get figures for nonagricultural cooperatives and their patrons. *See* S. Bhuyan, F. Leistritz, and D. Cobia, ''Non-Agricultural Cooperatives in the United States: Roles, Difficulties, and Prospects,'' Agricultural Economics Report No. 388 (N. D. State University, Dept. of Agricultural Economics), available at http://agecon.lib.umn.edu/cgi-bin/pdf_view.pl?paperid=632&ftype=.pdf at 2 (''relatively little has been written concerning non-agricultural cooperatives''). An indication that nonagricultural cooperatives may be as significant as agricultural cooperatives comes from the National Cooperative Bank's listing of the 100 ''top revenue generating cooperatives in America,'' available at http://www.co-op100.coop/coop100/index.htm. Forty-one of those top 100 cooperatives are agricultural cooperatives, and they generate $58 billion of revenue. The 59 nonagricultural cooperatives generate $61.3 billion. Many of those cooperatives have corporate members, but I have found no data that would suggest an appropriate figure to use for the members' marginal tax rate. In the text I have used a 28 percent marginal rate for the examples. I believe this is a conservative estimate of the average marginal rate at which cooperative income is taxed.

[47] To summarize, out of $100 of earnings, the cooperative gets to keep $27 more than a regular corporation. The shareholder of the corporation pays a 6 percent tax immediately and may pay up to 9 percent more later, a total of between $6 and $15. The patron in the 28 percent bracket pays $28 immediately (a patron in the 15 percent bracket pays $15).

[48] *See, e.g.,* U.S. Department of Agriculture, Rural Business and Cooperative Development Service, Cooperative Information Report 1, Section 9, at 6 (1981, Revised 1995) (''Many cooperatives require members to purchase a small initial amount of capital stock as proof of their membership''), available at http://www.rurdev.usda.gov/rbs/pub/cir1sec9.pdf.

[49] The Service has held that revolving fund credits are equity for purposes of the reorganization provisions. Rev. Rul. 70-298, 1970-1 C.B. 82. The Tax Court reached the same conclusion in *Atwood Grain and Supply Co. v. Commissioner*, 60 T.C. 412 (1973), and a holding that such paper is like equity was made by a state court in *In re Voluntary Dissolution of Kitsap-Mason Dairymen's Association*, 497 P.2d 604 (Wash. Ct. App. 1972). The AICPA audit guide for farmers' cooperatives treats retains that contain typical provisions (no fixed maturity date, subordinated to all debt instruments) as equity. AICPA, *Audits of Agricultural Producers and Agricultural Cooperatives,* par. 11.24 (2003). I have found no case that holds that such paper should be treated as debt.

[50] Of course, under current law, the tax paid on dividends is at a reduced rate. Section 1(h)(11) in effect imposes a reduced 15 percent rate on many dividends.

[51] *See* the discussion of ''New Generation Cooperatives'' in section VII *infra* for one context in which the patron may profit

(Footnote continued on next page.)

years) during which this interest-free ''loan'' will remain outstanding, the actual value of the paper retains would seem to be between half and a quarter of their face amount (using discount rates of 10 percent and 5 percent, respectively).[52] Confronted with those practical consequences of cooperative membership, the patron may choose to take its business instead to a taxable entity that could ultimately pay it less, but makes all its payments immediately in cash.[53]

However, this analysis is incomplete, because patrons do get a return on their retains, although it is not easy to measure that return for any particular patron. Compare a cooperative with an average 40 percent cash payout to one that pays 100 percent of net margins to its patrons in cash. If the patrons' earnings do not remain with the cooperative, the cooperative must find funds elsewhere to satisfy its capital needs. As a result, the cooperative that pays out 100 percent of its earnings to its patrons will have interest expense in respect of the 60 percent that it does not retain for its own needs, since it will have to borrow those amounts from third parties. That will be an added cost of operating the cooperative in the future, reducing the profits it makes for its patrons in later years.

We can measure the cost to a particular patron of that additional borrowing only under simplifying assumptions. If the cooperative has a single activity that is wholly patronage-based, and if the percentage of patronage activity of each patron remains at the same level in the future, the willingness of the patron to leave part of a patronage dividend with the cooperative, which appears to be an interest-free loan, is, in fact, an investment in the equivalent of interest-bearing debt.[54] Under that analysis, the difference between the investment made by the patron of the cooperative and the investment made by the shareholder of the corporation is the difference between an investment in equity and an investment in debt.

That picture is clouded when we examine the simplifying assumptions. Most importantly, patrons do not generally maintain patronage at the same percentage of the cooperative's business from year to year. To the extent a patron's patronage increases, the patron obtains the benefit of the capital that has been left in the cooperative by others. To the extent the patron's patronage declines, the patron won't get the full return on the amounts the patron has left with the cooperative.

Second, if the patron is using the co-op for personal purchases or for assets whose costs will not be deducted immediately, the amount of income that comes through the cooperative as an economic matter as a result of the patron having to leave part of the patronage dividend in the cooperative will not become additional taxable ordinary income in the year the patronage dividend is taken account of for tax purposes.[55]

Accordingly, there seems to be no benefit to patrons or shareholders from the nature of the investment each makes when the entity does not distribute all its earnings — they are simply making different investments. So, as was concluded in the previous section, the patrons of a cooperative who are below the 28 percent marginal tax bracket appear to gain a benefit from the cooperative structure. However, most, if not all, of that advantage disappears if the patron is in a 28 percent or higher tax bracket.

V. Do Cooperatives Have a Tax Advantage?

Although Caplin argues otherwise, it is not clear that the special provisions of subchapter T provide benefits to cooperatives and their patrons that they would not otherwise have under general tax principles. Consider the tax treatment that a noncooperative would receive if it were governed by contractual provisions similar to those that govern the operation of cooperatives.

A. The Entity

The description of cooperative taxation that we have given was based on the code, but there are decisions that allow deductions for payments analogous to patronage dividends even absent special statutory provisions.[56]

from an investment in a cooperative. Generally, when the cooperative has assets that appreciate and that can be sold without undermining the continued operation of the cooperative, the patrons may obtain an additional benefit from ownership of an interest in the cooperative.

[52] In fiscal 1991, 86 percent of agricultural cooperatives reported that their equity was subject to redemption. Those whose equity was not subject to redemption were generally small, low-equity cooperatives. 89 percent of those with equity subject to redemption had active programs of redemption, 92 percent of them with revolving fund programs (redemption of oldest equity first, generally on a regular basis). The average revolving fund period, weighting the data based on total equity used, is 14 years (the nonweighted average is 16 years). Rathbone and Wissman, note 42 *supra* at 11 (Table 7). At a 5 percent discount rate, the present value of $1 in 14 years is about $0.50. With a 10 percent rate, the present value is about $0.25.

[53] *See* David W. Cobia, ''Distribution of Net Income,'' in Cobia, note 40 *supra* at 221, 231 (1989) (''[p]utting a high percentage of refunds in the cash form . . . may encourage patronage and membership'').

[54] Consider a patron with fixed percentage patronage of the cooperative. In Year 1, the patron's patronage dividend is $1,000, but $600 is left with the cooperative. Suppose that in Year 2 the patron's patronage dividend were $800. If the cooperative did not have the patron's $600, it would have had to borrow $600, on which it would have paid, say, $60 interest. Since we are assuming that the patron's patronage is constant from year to year, that $60 of interest would have been a cost that would have reduced the patron's patronage dividend in Year 2 to $740. Hence, under these simplified assumptions, the ''interest-free'' loan that the patron makes by paying tax on the portion of the patronage dividend that the patron does not receive, is, in actuality, a loan that while compelled, does produce as a return the amount that the cooperative would otherwise have had to pay to a commercial lender.

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[55] Section 1385(b) (patronage dividend not included in income if it is properly treated as an adjustment to basis or is attributable to a personal item).

[56] *E.g.*, *Uniform Printing & Supply Co. v. Commissioner*, 88 F.2d 75 (7th Cir. 1937); *Greene County Farmers Sales Association v. United States*, 55 F. Supp. 123 (Ct. Cl. 1944) (Taxpayer, not governed by special cooperative tax rules, allowed deduction for profits earned from some patrons to be distributed to other patrons because obligation to make such a distribution was enforceable). For a very recent review of some of the issues that

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They focus on the binding legal obligation of an entity (not necessarily an entity that is treated as a cooperative for tax purposes) to make a distribution of profits to its patrons. The obligation must be in place before the entity transacts business with its customer. The obligation is to return to the customer a portion (generally all) of the profit from the transaction as determined at the end of the year.[57]

However, Caplin argues that, under the assignment of income doctrine, a corporation recognizes income that it has earned even if it diverts the income to its shareholders.[58] If the income is truly income of the cooperative rather than of its member-patrons, a contractual arrangement to shift the income to the patrons will not succeed.

Is the income the cooperative's or its members'? Cooperatives have advanced two arguments to support their tax treatment. First, cooperatives argue that they are merely agents of their members. Relying on the standard set forth by the Supreme Court in *National Carbide Corp. v. Commissioner*,[59] Caplin shows that cooperatives do not act as agents for tax purposes. In general, Caplin says, cooperatives purchase assets directly from, or sell assets directly to, patrons, and they hold the assets in their own name. An agency relationship is not usually created in a cooperative's documents. Moreover, the acts of a cooperative do not bind its members. Thus the cooperative cannot be said to function as agent with respect to the assets in question and does not hold itself out as agent in its dealings with third parties. Accordingly it fails the Supreme Court's tests of agency.

Second, cooperatives argue that patronage dividends are merely deductible price adjustments. That is harder to refute. Caplin tries by first noting a basic principle of corporate taxation:

> When benefits are given to stockholders because they are owners, such benefits are considered dividends, regardless of how they are labeled and whether or not they are distributed in proportion to stockholdings.[60]

The application of that principle to the cooperative and its patrons is not so clear, since patronage dividends don't fit comfortably in his description. A cooperative is not generally organized like a regular corporation. The benefits patrons get relate more directly to their patronage of the cooperative than to their membership in the cooperative, which, in many cases, involves very little commitment on the part of the patron.

Caplin concedes that regular price rebates are deductible by businesses, but argues that patronage dividends do not fit the description of regular price rebates.

First, he argues that those expenses lack a profit motive. He claims that, given the nature of cooperatives, patronage dividends are paid ''to *eliminate* rather than to *increase* profits.''[61] However, viewing a cooperative as a self-interested entity, patronage dividends do have a profit motive, since the promise of patronage dividends attracts potential members who would otherwise market their goods through regular commercial channels. The patronage dividend structure also serves as an attractive source of capital for cooperatives when a large portion of the dividend is issued, as it usually is, in the form of an unsecured, non-interest-bearing promise to pay in the indefinite future.[62]

Caplin also argues that patronage dividends have additional requirements attached to them that are not applied to regular price rebates.[63] For example, they must

apply to sales price adjustments of this sort, see Michael Baillif, ''Sales Price Adjustments: The Continuing Conundrum,'' 57 *Tax Law.* 571, 575-576 (2004). There is not much case law on this issue as it applies to cooperatives because the tax authorities early on granted cooperatives the right to exclude or deduct patronage dividends without any specific statutory basis for doing so. *E.g.*, I.T. 1566, II-1 Cum. Bull. 85 (1923) (deduction); I.T. 1499, I-2 Cum. Bull. 189 (1922) (deduction); G.C.M. 17,895, 1937-1 Cum. Bull. 56 (exclusion); I.T. 3208, 1938-2 C.B. 127 (exclusion when from patronage activity). Few noncooperatives fit this structure. For a general review of the early history of the taxation of cooperatives, see *Farmers Cooperative Co. v. Birmingham*, 86 F.Supp. 201, 212-37 (N.D. Iowa 1949).

[57] The ''year'' is not necessarily a calendar year. The marketing of some agricultural products may lead to pools that extend beyond the close of a calendar year.

[58] *See* Caplin, note 3 *supra; see also* Warren, note 3 *supra*; Magill, note 3 *supra*. Caplin cites cases such as *Lucas v. Earl*, 281 U.S. 111 (1930) (assignment from individual); *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir.), *cert. denied* 335 U.S. 867 (1948) (assignment from corporation).

[59] 336 U.S. 422 (1949). Since Caplin's article was written, the Supreme Court reexamined the agency issue in *Commissioner v. Bollinger*, 485 U.S. 340 (1988). The Court, *id.* at 346-347, quoted the ''six *National Carbide* factors'':

> [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent. [336 U.S.] at 47 (footnotes omitted).

The Court then expanded on the fifth factor, as follows, 485 U.S. at 349:

> It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.

(Footnote continued in next column.)

Caplin's analysis appears to be consistent with the *Bollinger* version of the agency test also.

[60] Caplin, note 3 *supra* at 29 (footnotes omitted).

[61] *Id.* at 30 (footnote omitted).

[62] *See* the discussion of retains in Rathbone and Wissman, note 42 *supra* at 1; for a comprehensive earlier discussion, see Farmer Cooperative Service, U.S. Department of Agriculture, *Legal Phases of Farmer Cooperatives*, 483-84 (1976).

[63] Caplin, note 3 *supra* at 31-32.

be distributed in accordance with a preexisting legal obligation, and they must be attributable to business done with the patron who receives them.[64] Yet, the noncooperative cases that allowed deductions comparable to deductions for patronage dividends involved arrangements with similar requirements. Moreover, because the rules of subchapter T treat patronage dividends in a manner unlike regular price rebates (for example, the rules allowing deduction — and inclusion — of the full face amount of a notice of allocation), there is a separate reason for extra requirements applied to patronage dividends. The presence of those requirements does not mean that patronage dividends would not be deductible at all absent those requirements.

Caplin does not accept the argument made by cooperatives that patronage dividends, unlike regular corporate dividends, are based on patronage rather than investment.[65] In a cooperative, after all, like other mutual organizations, the essence of ownership is normally patronage, and hence the distinction between ownership and patronage is blurred. However, cooperatives argue that this difference underlies the different tax regime under which they operate. The profit distributed to the patron from this year's earnings does not depend at all on what portion of the cooperative the patron ''owned'' in the past, but only on patronage in the current year. Caplin's argument ignores this distinction.

Even if we accept Caplin's conclusion that patronage dividends are not like regular price rebates, we might still allow cooperatives to deduct a portion of patronage dividends. The patronage dividend structure allows cooperatives to recalculate the price paid on a transaction with a patron. With that in mind, cooperatives may not pay full value to their producing patrons in the first instance, and may overcharge their consuming patrons. To the extent cooperatives act in this way, it is appropriate to treat part of a patronage dividend as a price adjustment. William Warren, who critically reviewed the taxation of cooperatives in 1959, noted this problem explicitly:

> One of the difficulties with [taxing cooperatives like other corporations] is that not all cooperatives deal with their members on the basis of current market values. In these instances the cooperatives' net trading margins might not be comparable to ordinary corporate profits. Accordingly, it may be desirable to enact special provisions for taxing cooperatives which would avoid these difficulties.[66]

So, even if we accept Caplin's arguments, a portion of patronage dividends paid to a cooperative's owners could be considered deductible costs. Cooperatives would be prevented from deducting only the part of patronage dividends that reflects entity profits.

In any event, subchapter T makes other changes in the rules that apply to cooperatives and their patrons. Cooperatives deduct a full patronage dividend when they distribute 20 percent of it in cash if they distribute the rest in obligations of the cooperative.[67] If any cooperatives are on the cash basis, this may give them a greater benefit than they would have otherwise.

Moreover, the cooperative is allowed 8½ months after the close of the tax year to make its distributions. The deduction for a distribution generally relates back to the prior tax year of the cooperative.[68]

Although Caplin identified two arguments made by cooperatives in favor of the prevailing treatment of patronage dividends, one court has identified four such arguments that have been accepted by the courts.[69] Whatever the theory, the longstanding practice, antedating subchapter T, is that cooperatives exclude patronage dividends from income.[70] The arguments in favor of exclusion (or deduction) are strong enough so that, even absent the statutory provisions, I think a court would be hard pressed to require a cooperative to include in income the amounts it pays out in patronage dividends.

B. The Patrons

To what extent would members of cooperatives be subject to different rules if subchapter T were not in the code? One benefit to members — the right to defer the recognition of income in respect of a patronage dividend until it is received — would be the rule for cash-basis members in any event. Accrual-basis taxpayers might have been required to take patronage dividends into income in the year of the underlying transaction.[71] Thus, subchapter T grants a benefit through its rules for the timing of income only for accrual-basis members.

On the other hand, a cash-basis member of a cooperative suffers a detriment from cooperative tax treatment. Absent an explicit provision in subchapter T, a cash-basis patron would include in income only the value of obligations received from a cooperative.[72] Because obligations of cooperatives generally are interest-free and unsecured,[73] their value is less than their face amount.

[64] Section 1388(a).

[65] Caplin, note 3 *supra* at 31.

[66] Warren, note 3 *supra* at 1884-85 (footnote omitted).

[67] Section 1388(c)(1).

[68] Sections 1382(b) and (d). There would be no relation back if the distribution were made in the year the amount was earned.

[69] *Stevenson Co-Ply Inc. v. Commissioner*, 76 T.C. 637, 644-645 (1981), suggests that cooperatives may be merely ''conduits of income,'' *citing United Cooperatives Inc. v. Commissioner*, 4 T.C. 93, 105 (1944), and that they are essentially like a large partnership, *citing Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201, 218 (N.D. Iowa 1949).

[70] Before subchapter T was added to the code, there was some controversy as to whether the patronage dividend should be considered an exclusion or a deduction. Frederick, note 7 *supra* at 27-28. Section 1382(b) says patronage dividends ''shall not be taken into account.'' Nevertheless, discussions of patronage dividends often speak in terms of whether they are deductible.

[71] *Cf.* AICPA, *Audits of Agricultural Producers and Agricultural Cooperatives*, par. 11.15 (2003) (circumstances under which patron would recognize patronage dividend in year of patronage).

[72] See note 16 *supra* and text there.

[73] See note 62 *supra* and text there.

Subchapter T requires patrons to include the face amount in income if the cooperative is to get a full deduction.[74]

As to the timing of patronage dividends, the distribution is taxable to the member only when received by the member.[75] This may be a favorable result for an accrual-basis member, depending on when the ''all events'' test is otherwise satisfied. Although most farmers use the cash method of accounting, some farm operations with corporate owners are required to use the accrual method of accounting.[76]

VI. The Service's Approach to Cooperatives

Perhaps because Congress seemed to be concerned that cooperatives may have advantages when compared to conventionally taxed entities,[77] the IRS has maintained a somewhat adversarial attitude towards cooperatives.[78] The IRS approach has had some success in the courts, but the IRS has lost a number of important arguments. Moreover, the IRS has taken positions in private rulings that do not have clear and direct judicial support and, significantly, are inconsistent with prevailing cooperative practice. In this section, we review a number of the major issues that have been a source of controversy between taxpayers and the IRS.

A. 'Substantially All' Requirement

Under section 521(b)(2), ''substantially all'' of an exempt cooperative's stock must be owned by ''producers who market their products or purchase their supplies and equipment through the association.'' The statute does not provide a standard for what constitutes ''substantially all'' of the stock. The term ''substantially all'' is found elsewhere in the code, with varying standards.[79]

In Rev. Rul. 73-248,[80] the Service held that producers need to own at least 85 percent of the stock of the cooperative to satisfy this test. While the rule is arbitrary, it has been upheld by the courts. In *West Central Cooperative v. Commissioner*,[81] the court found that the Service's rule was a reasonable interpretation of the statute. Accordingly, a cooperative in which producers owned only 83.75 percent of the entity's stock was held not to qualify as an exempt cooperative.

B. Percentage Limits of Nonpatron Activities

Section 521(b)(4), which applies to exempt farmers' cooperatives, provides that exemption shall not be denied a farmers' cooperative if its *nonmember* business does not exceed its *member* business, as long as *purchases* for those who are neither members nor producers do not exceed 15 percent of all *purchases*. No comparable limitations are given in the provisions of the code that apply to nonexempt cooperatives. However, in Rev. Rul. 72-602,[82] the IRS suggested that a nonexempt cooperative had to do more than 50 percent of its business with members. It based this requirement on the general statement in section 1381(a)(2) that a cooperative is an entity ''operating on a cooperative basis.'' The IRS stated:

> Fundamental to 'operating on a cooperative basis' is a mutual joinder of interests in the risks and benefits of the organization. . . . If . . . a cooperative does operate on a for-profit basis with its nonmembers then in order for it to be considered a corporation 'operating on a cooperative basis' for purposes of section 1381(a)(2), it must do more than 50 percent in value, of its business with members.

The courts did not accept this argument. Influenced partly by the fact that exempt cooperatives that have explicit rules regarding the nature of the business they can conduct, are also required to operate ''on a cooperative basis,''[83] both the Eighth Circuit and the Claims Court held that Rev. Rul. 72-602 was an unreasonable interpretation of the statute.[84] The Service ultimately conceded the point.[85]

C. Application of Section 277

Section 277 limits the use of excess losses of membership organizations. While it allows losses from membership activities to be carried forward as losses from membership activities in the following year, it does not allow the membership organization to carry losses back into prior years. In all events, membership losses may not

[74] Sections 1385(a), 1388(c)(1)(B). Note that section 267 would generally not apply to prevent a mismatch between an accrual-basis cooperative and a cash-basis patron, since the cooperative and the patron are not in a relationship described in section 267(b).

[75] Section 1385(a).

[76] Section 447.

[77] The bill that reached the Senate did not contain any provisions relating to cooperatives. Revenue Act of 1951, Hearings before the Committee on Finance, United States Senate, 82d Cong. 1st Sess. on H.R. 4473 (1951 Senate Hearings), Part 1, pp. 1-54 (1951) (text of bill). However, the claimed competitive advantage that cooperatives had over other corporations was discussed by a number of witnesses. 1951 Senate Hearings, Part 2, pp. 415, 442-443, 481-489, 490-491, 533, 618, 1015-1019; Part 3, pp. 1217-1437, 1473, 2622-23. The Senate added section 314 to its bill, which prevented exempt cooperatives from taking deductions for reserves that were not distributed to specific patrons. This effectively eliminated the exemption from ''exempt'' cooperatives.

[78] Revenue Ruling 2002-54, discussed in note 1 *supra* may be viewed as an example of that attitude. In contrast to the statement in the text, earlier commentators argued that the IRS treated cooperatives perhaps too kindly in the early days of the income tax. Magill and Merrill, note 12 *supra* at 177.

[79] *E.g.*, section 368(a)(1)(C) (interpreted, for rulings purposes, to mean 90 percent of net assets and 70 percent of gross assets, Rev. Proc. 77-37, 1977-2, C.B. 568, 569 section 3.01, and otherwise dependent on facts and circumstances, Rev. Rul. 57-518, 1957-2 C.B. 253).

[80] 1973-2 C.B. 295.

[81] 758 F.2d 1269 (8th Cir. 1985); *see also Farmers Cooperative Co. v. Commissioner*, 822 F.2d 774 (8th Cir. 1987), which considers who should be treated as a stockholder for this purpose.

[82] 1972-2 C.B. 510.

[83] Section 521(b)(1).

[84] *Conway County Farmers Ass'n. v. U.S.*, 588 F.2d 592 (8th Cir. 1978), *rev'g* 78-1 U.S.T.C. (CCH) para. 9334 (E.D. Ark. 1978); *Columbus Fruit & Vegetable Co-op Ass'n. Inc., v. U.S.*, 7 Cl. Ct. 561, 85-1 U.S.T.C. (CCH) par. 9314 (1985).

[85] Rev. Rul. 93-21, 1993-1 C.B. 188, *93 TNT 76-15*.

be offset against nonmember income. The Service concluded that this provision applied to cooperatives.[86]

In *Buckeye Countrymark Inc. v. Commissioner*,[87] a nonexempt cooperative incurred losses both from transactions with members and from transactions with nonmembers. The cooperative carried back the losses, offsetting the nonmember loss against nonmember income and offsetting the member loss against member income that had not been reduced by deductions for patronage dividends. The Service allowed the nonmember loss to be offset against prior nonmember income, but did not permit the member loss to be carried back, arguing that section 277 does not allow such a carryback. The court disagreed with the Service's analysis. Among other things, the court argued that cooperatives were already prevented from offsetting losses from member activities against nonmember income. In addition, section 1388(j)(1) assumes that section 172, dealing with net operating losses, will apply to the member income of cooperatives. Under section 277, no net operating loss can be created, because excess member deductions are carried forward into the following year as member deductions. The IRS has acquiesced in *Buckeye Countrymark*.[88]

D. Dividends on Capital Stock

When a nonexempt cooperative has patronage and nonpatronage profits, the distribution of dividends on capital stock affects the funds available for patronage dividend distributions. The funds used to pay those dividends are funds that, in accounting for the cooperative's available resources, are not available for other purposes.[89] Does the dividend paid on capital stock reduce the amounts that the tax law considers available to the cooperative in making its patronage distributions?

An example should help explain the issue. Suppose a cooperative has profit of $60 from member transactions and $40 profit from nonmember transactions. It also is required to pay a nondeductible dividend of $10 on its preferred stock. Assume that the cooperative's governing documents indicate that the dividend should come first out of profits from nonmember activities. That would leave $60 of profits to be distributed to patrons pursuant to a preexisting legal obligation. That $60 would appear to be excluded from the calculation of the cooperative's taxable income as a patronage dividend under the code.

However, the regulations have long taken the position that, in determining the amount that can be considered a patronage dividend, a portion of the dividends paid on capital stock had to be allocated to patronage income to determine the maximum deductible patronage dividend.[90] The result, in this example, is that the total amount of cooperative profits available is $90, rather than $100, and only 60 percent of that, or $54, could be treated as a patronage dividend.[91]

The first court to consider this issue rejected the Service's position. In *Mississippi Chemical Corp. v. United States*,[92] the court held that the basis for excluding patronage dividends from income was inconsistent with the regulation. If patronage dividends are excluded because they do not belong to the cooperative, since they are subject to the obligation to return them to the patron, then that rule of exclusion should apply to whatever belongs to the patron under the patron's agreement with the cooperative. Because the cooperative had agreed to make patronage refunds without diminution by the amount of the dividend paid on capital stock, it followed that the full amount due under the agreement should be treated as a patronage dividend.

However, later courts, relying on the longstanding administrative position of the Service on this matter, held for the government.[93] They reasoned that, before the statutory changes in 1951 and 1962, cooperative tax treatment was a function of administrative action, including the rule set forth above for allocation of dividends on capital stock. Because there was no indication that Congress intended to change that rule, the administrative rule should be upheld.

This issue has not been resolved finally by the courts or Congress.[94]

E. Patronage Losses and Nonpatronage Income

When a membership organization loses money on its member activities and makes money on nonmember activities, the profit from the nonmember activities can be used to subsidize the member activities. If the tax law allowed the organization to net the profit and loss for tax purposes it would, in effect, allow the profits from the nonmember activities to be distributed to the members with no one being subject to tax on the income. To prevent that from happening, Congress in 1969 added section 277 to the code. That section requires the organization to carry forward any loss on membership activity and to use that loss against membership activity income in later years.

As described in part C above, the courts have ruled that section 277 does not apply to cooperatives. However, the logic of section 277 leads to an analogous argument in

[86] LTR 8641003.

[87] 103 T.C. 547, *Doc 94-10148, 94 TNT 221-5* (1994). The Court of Claims had earlier reached a similar conclusion favoring the taxpayer. *Landmark Inc. v. United States,* 25 Cl. Ct. 100 (1992).

[88] 1997-1 C.B. 1, *Doc 97-12260, 97 TNT 86-12*.

[89] The issue does not arise in the case of exempt cooperatives because they are allowed to deduct those dividends in any event. *See* section 1382(c)(1).

[90] *See* Treas. reg. section 1.1388-1(a)(1).

[91] *See* Rev. Rul. 68-228, 1968-1 C.B. 385; *modified on another issue* RR 72-602, 1972-2 C.B. 510, *modified by* RR 93-21, 1993-2 C.B. 188.

[92] 197 F. Supp. 490 (S.D. Miss. 1961), *aff'd, United States v. Mississippi Chemical Company*, 326 F.2d 569 (5th Cir. 1964).

[93] *Union Equity Cooperative Exchange v. Commissioner*, 58 T.C. 397 (1972), *aff'd*, 481 F.2d 812 (10th Cir. 1973), *cert. denied* 414 U.S. 1028 (1973); *FCX Inc. v. United States*, 209 Ct. Cl. 145, 531 F.2d 515 (1976); *Des Moines County Farm Service Co. v. United States*, 448 F. 2d 776 (8th Cir. 1971), *aff'g,* 324 F. Supp. 1216 (S.D. Iowa).

[94] A legislative solution, under which dividends paid on stock would not reduce the amount deductible as a patronage dividend, is being considered by Congress. *See, e.g.,* section 648 of a substitute for S. 1637 (JOBS Act), *Doc 2004-7532, 2004 TNT 67-38*.

the case of nonexempt cooperatives. Allowing a nonexempt cooperative to net member losses against nonmember income has the effect of allocating the nonmember income to members of the cooperative.[95]

However, nonexempt cooperatives are not permitted to deduct the distribution of nonpatronage income, and are not permitted to deduct profits from nonmember activities (unless there is a preexisting legal obligation to distribute those profits to the nonmembers, in which case the nonmembers are being treated as members). Therefore, if the nonexempt cooperative is permitted to offset member losses with nonmember profits, that would indirectly give the nonexempt cooperative the benefit of distributing nonmember profits as patronage dividends to members.

Nevertheless, in the first case to consider the issue, the Tax Court held that a cooperative could offset member losses with nonmember income.[96] The government argued that the cooperative should be prevented from offsetting member losses with nonmember income under section 277.[97] Without considering whether section 277 should apply to cooperatives, the Tax Court reasoned that section 277 was intended to prevent ''sham losses, those losses that were constantly and intentionally generated in dealings with members so that the profits from commercial ventures . . . could be passed on to such members free of tax.''[98] Because the court found that the cooperative had not run its membership activities with this intention, it refused to apply section 277 or the concept underlying it. The Court of Appeals reversed this decision, holding that a nonexempt cooperative must keep its patronage and nonpatronage activities separate.[99] The Tax Court ultimately came around to this view also.[100]

F. Gains and Losses in Different Pools

Cooperatives may engage in more than one business activity, operating each on a cooperative basis. For example, it may market cattle for one group of patrons and purchase fuel for another. Or, it may market cotton for one group and chickens for another. When one activity is profitable but another incurs a loss, may the cooperative net the profit of one activity against the loss of another? Clearly, if we view the cooperative like any corporation, it could offset the losses of one division against the profits of another. However, if the cooperative has agreed to return to its cotton patrons the profits from its cotton activities, can it instead use those profits to subsidize the chicken producers? Would that be ''operating on a cooperative basis''? Does the result change if the patrons have consented to the offset?

In the early 1970s, the Service concluded that a cooperative could not net the losses of one ''function'' against the income of another.[101] (The two ''functions'' cooperatives may have are purchasing and marketing.) In the Service's view, that netting would run afoul of the requirement that a cooperative operate ''at cost.'' The IRS was also concerned that cooperatives would net income from one ''allocation unit'' against losses of another ''allocation unit'' in the same function.[102] If one of its allocation units had more members than the other, the majority group could run the cooperative to their benefit, generating losses by overpaying their members, while making profits on the members of the other allocation unit.

This internal position of the IRS was never tested directly in the courts, although the Service took this position in at least one private letter ruling.[103] In 1986, Congress added section 1388(j) to the code. Under that section, cooperatives are permitted to net losses and gains of any group of patrons, whether the netting was functional or merely among allocation units, as long as the patrons are informed of the netting. The Service's loss was fairly severe. Not only did Congress include in the legislative history the usual language to the effect that the legislative change was not intended to imply that the law was different previously, but it made the effective date of the legislation 1962 — when the current version of subchapter T came into effect. The legislative history pointed out that the Service had lost analogous issues in a number of Tax Court decisions. In *Associated Milk*

[95] Suppose a marketing cooperative loses $5 in transactions with members. That means that it paid the members $5 ''too much'' when it purchased goods from its members, because it lost money when it resold those goods. However, that extra $5 is recorded as income by the members, since it is reflected as increased proceeds from their sale of the items that the cooperative markets. Suppose the cooperative also makes $5 in transactions with nonmembers. If it offsets the income from the nonmember transactions with the loss from the member transactions, it will have no taxable income. Alternatively, it could have planned its member transactions more carefully and not recognized a loss on those transactions. It then would have paid its members $5 less, and they would have had $5 less taxable income. However, the cooperative would then have $5 of taxable income (from its nonmember activities). An exempt cooperative could deduct the $5 if it distributes it to its members. The result is the same as in the case of netting — the cooperative has no taxable income and the members have an additional $5 of income.

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

[97] The government also argued that cooperatives do not operate with a profit motive, and hence their losses are not operating losses that should be offset against business income of the cooperative. The government had lost that issue before the Tax Court not long before in *Associated Milk Producers Inc. v. Commissioner*, 68 T.C. 729 (1977), which allowed cooperatives to make use of the net operating loss provisions of the code.

[98] The case that served to motivate Congress to pass section 277 was *Anaheim Union Water Co. v. Commissioner*, 321 F.2d 253 (9th Cir. 1963), *rev'g. in part* 35 T.C. 1072 (1961).

[99] *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980).

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

[101] G.C.M. 34935 (July 3, 1972).

[102] For example, the marketing of cotton and the marketing of chickens would be two allocation units within the marketing function of a cooperative. This issue is raised, with the argument made in the text, in G.C.M. 38217 (December 21, 1979).

[103] LTR 8521003.

Producers Inc. v. Commissioner,[104] the Tax Court allowed a cooperative to offset income in the current year with a loss carryover from a prior year. The Service's concern had been that the patrons in the two years were not identical. The Service had earlier ruled that a loss carryover does not affect the amount payable as a patronage dividend.[105] In *Ford-Iroquois FS Inc. v. Commissioner*,[106] the court allowed a cooperative to offset income from a farm supply operation with losses from prior years that had been generated by marketing and storage operations, where there was substantial overlap of the patrons in the operations. In *Lamesa Cooperative Gin v. Commissioner*,[107] the Tax Court did not accept the Service's claim that an exempt cooperative could not offset income from its purchasing operations with losses from its marketing operations, when the purchasing operations were sufficiently small that accounting for them separately would have been difficult.

The Service's loss here would seem to have broader import. Particularly in light of the retroactive effective date, it can be read as a signal from Congress that the Service should be circumspect before attempting to influence a cooperative's internal operations. At least as long as the patrons of the cooperative are aware of the cooperative's arrangements, Congress seems willing to allow cooperatives to conduct their internal operations unfettered by the Service's oversight.

G. Qualified Written Notices of Allocation

As explained above, cooperatives are permitted to allocate their income using ''qualified written notices of allocation,''[108] which are non-interest-bearing obligations that will not necessarily include a fixed redemption date. While the value of those notices may therefore be substantially less than face, the code allows the cooperative to deduct the face amount of the notice while requiring the patron to take the full face amount of the notice into income.[109]

Cooperatives may permit patrons to redeem these notices before their due date under certain circumstances.[110] Depending on the circumstances (and the cooperative), the redemption may be at face, or it may be at the value at the time of the early redemption. When the redemption is at less than face, the patron takes a loss for the difference between basis (which will normally be face) and the amount actually paid on redemption.

The cooperative's treatment of the redemption was not initially clear. After the Supreme Court's reexamination of the ''tax benefit'' doctrine in *Hillsboro National Bank v. Commissioner,* 460 U.S. 370 (1983), the Service took the position that the redemption of the notices at less than face was ''fundamentally inconsistent'' with the original deduction and thus that the cooperative should take the difference into income.[111]

In *Gold Kist Inc. v. Commissioner*, 110 F.3d 769, *Doc 97-12670* or *97 TNT 89-11* (11th Cir. 1997), *rev'g.* 104 T.C. 696, *Doc 95-6352* or *95 TNT 124-6* (1995), the Eleventh Circuit ruled to the contrary. It held that the tax benefit rule does not require a cooperative to take into income the difference between the face of a qualified written notice of allocation and the amount for which it was actually redeemed. The Eleventh Circuit emphasized that the legislative history of subchapter T treats the patron as having received the full patronage distribution and then reinvested it in the cooperative. Accordingly, the failure of the cooperative to pay the face amount of the written notice of allocation relates to the reinvestment by the patron, not the deduction of the patronage dividend. The Tax Court, in contrast, read the legislative history as emphasizing that the cooperative should get a deduction only if it actually pays the amount to the patron. It viewed the discussion in the legislative history that describes the patronage dividend as if it were paid out to the patron and then reinvested as merely a justification for taxing the patron before the patron receives an actual distribution.

There have been no further decisions on this issue.

H. Democratic Control — One Member, One Vote

The Service relies heavily for its application of the rules governing cooperatives on *Puget Sound Plywood v. Commissioner*.[112] That is a bit ironic, because the Service lost in *Puget Sound* on the issue of whether a workers' cooperative could get the advantages of treatment under subchapter T.

Puget Sound was an important case for the development of the tax law governing cooperatives. The taxpayer cooperative recognized the importance of the issue, and brought forward, as its expert witness, Dr. Edwin G. Nourse, the first chairman of the Council of Economic Advisers. Prof. Nourse had published the first significant article by an American economist analyzing cooperatives.[113] The resulting opinion takes a comprehensive view of what constitutes a cooperative, and contains general statements about cooperatives that the Service, and the courts, have quoted liberally since.

Nevertheless, it is not clear that the statements are exclusive statements of the law governing cooperatives. In particular, the description of the pristine cooperative,

[104] 68 T.C. 729 (1977).

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

[106] 74 T.C. 1213 (1980).

[107] 78 T.C. 894 (1982).

[108] Section 1388(c).

[109] Sections 1382(b)(1) and 1385(a)(1).

[110] Special situations that lead to such redemptions include patrons' estates, patrons who achieve a certain age, patrons no longer farming or retired from farming, patrons who move out of the trade territory, and patrons claiming certain hardships. *See* Rathbone and Wissman, note 42 *supra* at 16.

[111] Besides the fact that this position is reflected in the *Gold Kist* litigation, it can be found in LTR 9249005.

[112] 44 T.C. 305 (1965).

[113] ''The Economic Philosophy of Co-Operation,'' 12 *American Economic Review* 577 (1922). The importance of Dr. Nourse's testimony can be seen in the attention it is given in his biography, Knapp, J.G., *Edwin G. Nourse — Economist for the People* 419 (1979) (his testimony in *Puget Sound* and a similar case tried at around the same time, *Linnton Plywood Association v. United States*, 410 F. Supp. 1100 (D. Or. 1976), was ''Nourse's last major contribution to cooperative theory and development'').

which the Service sometimes takes as the only description of cooperatives, does not describe the full gamut of entities that are generally considered cooperatives.

That can be seen in one of the provisions that the decision highlights, the democratic control of a cooperative. The opinion describes this in terms of a one-member/one-vote structure. That certainly describes the classic structure of a cooperative, and, indeed, the prevailing structure of cooperatives. It reflects a major contrast with regular corporations, where control is a function of capital investment.

However, the IRS seems to treat this as the sole method of control in a cooperative. The IRS position on voting is expressed, for example, in LTR 9219030:

> a corporation seeking to be treated as a cooperative must be organized on a democratic model in which each member has one vote regardless of the size of its investment or the amount of business it does with the cooperative.[114]

The Service generally articulates two separate principles in discussing democratic control. One is that democratic control requires one-member, one-vote structures. The other speaks more generally of the need for patrons — as opposed to others — to control the co-op. Regarding the strict one-member, one-vote rule, no court decision has held that an entity is not a cooperative because it varied from the one-member, one-vote paradigm. Important cooperative theorists and academics, including Prof. Nourse, have made clear that other forms of voting, including voting by patronage, are acceptable.[115] Indeed, government studies confirm that many cooperatives employ other voting procedures.[116] Hence, it is unlikely that the Service's position requiring a one member, one-vote structure would be upheld by the courts, and, indeed, there is no evidence that the Service wishes to challenge the significant number of cooperatives that currently use methods other than one-member, one-vote.[117]

I. Identifying Patronage Income

Part of the definition of a patronage dividend is that it must be ''determined by reference to the net earnings of the organization from business done with or for patrons.''[118] Business done ''for'' patrons is apparently something beyond business done ''with'' patrons. However, it cannot include all business done by the cooperative. If it did, there would be no special benefit for ''exempt'' cooperatives from the fact that they can distribute deductible patron dividends from business done with the United States and from nonpatronage sources.[119]

The line drawing that is involved here is not necessarily a matter of strict rules, although the Service has attempted to set down some hard and fast rules in this area. The regulations state that

> income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.[120]

The courts have not accepted this rule as a hard and fast principle, in part because the Service itself did not apply it without qualification. An important case on this issue, in which the Service has acquiesced, is *Farmland Industries Inc. v. Commissioner*.[121] In *Farmland*, the taxpayer purchased stock of corporations that were sources for the supply of materials for the cooperative. The cooperative was able to sell the stock at a profit, and the question was whether the profit was patronage-sourced.

The IRS pointed to the regulation quoted above, in which it had long taken the position that income from both investment in securities and the sale or exchange of capital assets should never be treated as patronage-sourced income. The gains on those sales seemed to fall directly under the language of the regulations.

[114] A slightly more flexible standard can be found in some later rulings, e.g., LTR 9742030, *Doc 97-28730, 97 TNT 202-38*, which says (emphasis supplied): ''Democratic control of the cooperative . . . is *typically* achieved by voting on a one-member, one-vote basis.''

[115] *E.g.*, Nourse, ''The Economic Philosophy of Co-operation,'' 12 *Am. Ec. Rev.* 577, 588 (1922) (''The fundamental principle of 'one man-one vote' is sometimes modified so that voting is in proportion to patronage''); Martin A. Abrahamsen, *Cooperative Business Enterprise* 56-57 (McGraw-Hill 1976) (''In response to member desire to achieve control in proportion to the business they do with their cooperative, laws in a dozen or more states sanction proportional voting in local associations. . . . [P]ure democracy (one member, one vote) may be difficult to maintain and not even desirable unless a high degree of homogeneity exists in member needs and operations.''); Emelianoff, Ivan, *Economic Theory of Cooperation* 198 (1948) (reprinted by the Center for Cooperatives, University of California 1995) (''Both equal and unequal voting power are inherent in cooperative associations, provided that they are based on proportionality of economic participation of the individual members''); David Barton, ''What Is a Cooperative?'' in Cobia, note 40 *supra* at 1, 2 (1989) (''Control of a cooperative is *typically* democratic, meaning that each person has only one vote regardless of the amount that the person has invested in the cooperative or volume of business transacted. . . . Voting in cooperatives may also be proportional to use or to equity investment'') (emphasis supplied).

[116] Bruce Reynolds, Thomas Gray, and Charles Kraenzle, ''Voting and Representation Systems in Agricultural Cooperatives'' (RBS Research Report 156) (June 1997), available at http://www.rurdev.usda.gov/rbs/pub/rr156.pdf. As of 1995, more than 18 states allowed proportional voting in cooperatives. In Illinois, 54 of 87 cooperatives surveyed in the study used proportional voting, and 19 of 69 used it in California.

[117] For a more extensive discussion of this issue, including a thorough examination of the IRS's position and the judicial decisions in this area, see Clayton S. Reynolds, ''Cooperative Democracy,'' 78 *Taxes* 19 (2000). Reynolds also concludes that voting based on patronage should be permissible.

[118] Section 1388(a)(3).

[119] Section 1382(c)(2)(A) and Treas. reg. section 1.1382-3(c).

[120] Treas. reg. section 1.1382-3(c)(2). By its terms, this regulation applies only to ''exempt'' cooperatives. However, the regulation is applied generally to determine whether income is patronage-sourced, whether the cooperative is an exempt or a nonexempt cooperative. *See, e.g.*, *CF Indus. Inc. v. Commissioner*, 995 F.2d 101, 102, *Doc 93-6344, 93 TNT 120-9* (7th Cir. 1993).

[121] 78 T.C.M. (CCH) 846, *Doc 1999-37627, 1999 TNT 229-7* (1999), *acq.* 2001-1 C.B. *xix*, *Doc 2001-8566, 2001 TNT 58-9*.

However, the court rejected that argument. Based on case law and the Service's own pronouncements, the court found that the test of whether income is patronage-sourced is whether:

> the income at issue is produced by a transaction which is directly related to the cooperative enterprise, such that the transaction facilitates the cooperative's marketing, purchasing or service activities. . . .

It pointed out that earlier cases had rejected the Service's position in connection with the types of income mentioned in the regulation.[122] Moreover, in the Service's own pronouncements, the rule that capital gains are not patronage-sourced income had twice been contradicted.[123] Accordingly, it allowed the cooperative to treat gains on the sale of stock as patronage-sourced income. The Service acquiesced in this decision, indicating that it would treat the examples in the regulations ''as instructive, but not controlling.''[124]

J. Summary

Some observations about the above issues may be worth making. One of the few IRS victories (interpretation of ''substantially all'' in section 521(b)(2)) is the one issue discussed here that involves ''exempt'' cooperatives only. If courts continue to treat the fairly complete passthrough nature of exempt cooperatives as a major benefit (even after the check-the-box regime has become entrenched), it can be expected that they will support attempts by the IRS to limit access of cooperatives to that perceived benefit. In any event, note that cooperatives appear to be moving away from exempt status.[125]

The three issues that apply to cooperatives generally (redemption of qualified notices, democratic control, and identifying patronage income) suggest that the IRS might not have much success when it tries to push a restrictive view of the essential nature of cooperatives. The issue has been litigated most frequently in connection with identifying patronage income. Despite the fact that the IRS had a regulation supporting its restrictive view of patronage income, it has generally lost on the issue.

A pattern emerges from the case law discussed above. The courts and Congress are relatively sympathetic to the IRS's position when the issue involves the separation of patronage activities from nonpatronage activities. Thus, cooperatives can't offset patronage losses against nonpatronage income because that essentially expands the passthrough structure beyond patronage income. Similarly, shareholders of exempt cooperatives must be producers — because exempt cooperatives get passthrough treatment for amounts paid on capital stock, allowing nonproducers to hold that stock would expand the passthrough structure beyond those for whom the statute was intended. When cooperatives attempt to allocate their cost of capital solely to nonpatronage activities, some courts have supported the IRS's limitation. This is not to say that in light of the changing structure of the income tax, in particular the sharply reduced significance of the double-tax regime, there is an important boundary here to protect. However, the courts appear willing to leave it to Congress to revise that dividing line.

On the other hand, when the IRS attempts to limit how cooperatives allocate benefits among members, the courts have reversed the IRS's positions. The courts generally appear to believe that Congress intended cooperatives to have the flexibility to regulate themselves. When the issue has been passed back to Congress before the courts could resolve the issue, as was true with the netting issue, Congress's only concern was that the members be aware of what the cooperative's board was doing. Once that was assured, Congress allowed benefits to be shifted from one group of patrons to another.

VII. New Generation Cooperatives

As agricultural products in the United States have generated progressively smaller returns to farmers,[126] farmers have looked for ways of capturing the greater profits available from the processing of their products. One notable approach to this issue is the ''new generation cooperative'' (NGC).

In an NGC, ownership of an equity interest in the cooperative involves obligations as well as benefits. Each ownership unit carries with it an obligation to deliver a certain amount of product to the NGC. In return, the owner of the unit will share in the profits of the entity. Because each unit reflects the same amount of patronage, the distribution of profits is proportional both to patronage and to ownership.

The operation of the NGC is based on principles that have been used by cooperatives in the past. Specifically, the strict connection between stock ownership and patronage is a characteristic of so-called ''base capital'' plans that some cooperatives use.[127]

However, this structure is particularly suited to a cooperative that runs a plant that processes the product supplied by the patrons, because NGCs typically operate with closed membership — new members can join the

[122] *St. Louis Bank for Cooperatives v. United States,* 624 F.2d 1041 (Ct. Cl. 1980) (interest); *Cotter and Company v. United States,* 765 F.2d 1102 (Fed. Cir. 1985) (rents and interest); *Illinois Grain Corp. v. Commissioner,* 87 T.C. 435 (1986) (rents and interest).

[123] Rev. Rul. 74-24, 1974-1 C.B. 244; Rev. Rul. 71-439, 1971-2 C.B. 321.

[124] AOD CC-2001-03, *Doc 2001-8881, 2001 TNT 60-6*.

[125] *See* note 5 *supra*.

[126] Between 1910 and 1990, the farmer's share of every dollar generated in agriculture went from $0.41 to $0.09. I. Kotov, ''New Generation Cooperatives: A Short History of the Idea and the Enterprise,'' in M. Holmes, N. Walzer, and C. Merrett, *New Generation Cooperatives: Case Studies, Expanded 2001* 19, 20 (2001), available at http://www.iira.org/pubsnew/publications/IVARDC_CS_198.pdf.

[127] In a traditional base capital plan, a member's equity obligation is determined annually, and is a function of the cooperative's need for capital and the member's uses of the cooperative. The member's equity obligation may be based on the average of a few years' prior patronage. D. Cobia, J. Royer, and G. Ingalsbe, ''Equity Redemption,'' in Cobia, note 40 *supra* at 267, 274-275. In the standard NGC model, the connection between patronage and equity ownership is maintained strictly from year to year.

cooperative only if they purchase stock from existing members. If the plant has a particular capacity, then this form of stock ownership — if the number of ownership units remains limited — will provide the cooperative's plant with the optimal amount of product for it to process during the year.[128] Moreover, because an ownership interest in the cooperative carries with it specific rights to market a fixed amount of produce through the cooperative, the cooperative can sell its stock (which embodies the right to do business with the cooperative) for significant amounts of money, and members will sell their shares rather than redeeming them. Both those facts alleviate the normal problems cooperatives have in raising capital.[129] Note that if a patron does not produce the amount of product reflected in its stock ownership, it is obligated to supply the product in any event, perhaps by going out and buying it in the market.

In terms of cooperative theory, closed membership is not part of the ideal.[130] Moreover, if the NGC is successful, the ownership units will become valuable. This will give members of the cooperative a profit that is not necessarily related to their own production that is channeled through the cooperative.[131]

While those issues may give pause to cooperative theorists, they do not appear to interfere with the tax treatment of the cooperative. As long as the cooperative's obligation is a ''preexisting legal obligation,'' the patronage dividends will be deductible. There is no indication that the IRS will challenge NGCs on the basis that they are not ''operating on a cooperative basis.''

VIII. Cooperatives as LLCs

More confusing to the tax system is a cooperative that is formed as an LLC. Such a structure, which might have been possible in the past, is now a clear reality thanks to new cooperative laws that have been passed in a number of states, notably Wyoming and Minnesota. A committee of the National Conference of Commissioners on Uniform Laws is currently drafting an ''Agricultural and Agricultural Related Cooperative Act.''[132] The laws that are already in effect allow cooperatives to form as limited liability companies rather than corporations. If a cooperative forms as an LLC, but elects to be treated as a corporation for tax purposes, it can continue to qualify as a cooperative under subchapter T.[133] However, the flexibility that those laws give to cooperatives, including an increased ability to raise capital from outside investors, may mean that some cooperatives formed under these laws fail to qualify as cooperatives under the code. This apparently is acceptable to those looking to use these new structures, because the entities can be partnerships for tax purposes, and thus will naturally get passthrough treatment.[134]

The possibility that a cooperative could be an LLC that is taxed as a partnership emphasizes that the essential tax nature of a cooperative is a passthrough entity. However, a partnership is a passthrough for all its income. Thus, the cooperative LLC that is treated as a partnership should get standard passthrough treatment for its nonpatronage income. On the other hand, it appears unlikely that any one of the three categories of cooperative identified at the beginning of this article could be taxed as a partnership and also get the benefits of subchapter T. A nonexempt cooperative must be a ''corporation,''[135] which this entity will not be, and an exempt cooperative

[128] It has been shown that establishing a closed membership is one way a cooperative can successfully integrate vertically. Royer, J.S., and S. Bhuyan, ''Market Incentives for Cooperative Forward Integration Into Processing Activities,'' in R. W. Cotterill, ed., *Competitive Strategy Analysis for Agricultural Marketing Cooperatives* 35-57 (Westview Press, Boulder, Colo. 1994).

[129] A. Harris, B. Stefanson, and M. Fulton, ''New Generation Cooperatives and Cooperative Theory,'' 11 *J. Cooperatives* 15, 19 (1996); J. Royer, ''Finance and Taxation,'' in C. Merrett and N. Walzer, eds., *Cooperatives and Local Development* 123, 137 (2004). As these articles point out, the NGC structure eliminates the ''free rider'' problem for cooperatives: In a regular cooperative, there is no incentive for the patrons to invest in the cooperative and to leave their investment in place.

[130] ''Unlimited membership'' is one of the most common characteristics mentioned in connection with cooperatives, I. Emelianoff, *Economic Theory of Cooperation* 29 (Center for Cooperatives, University of California 1995) (reprint of 1948 edition), and it is emphasized in Nourse's classic article on cooperatives. E. Nourse, ''The Economic Philosophy of Cooperation,'' originally published in 12 *The American Economic Review* 577 (1922), *excerpted in* Abrahamsen and Scroggs, eds., *Agricultural Cooperation* 160, 171 (1957) (''cooperative organization requires a membership list open at all times''); *see also* Randal E. Torgerson, ''A Critical Look at New Generation Cooperatives,'' 54 *The Cooperative Accountant* 3, 6 (2001) (discussing exclusivity of NGCs).

[131] A. Harris, B. Stefanson, and M. Fulton, ''New Generation Cooperatives and Cooperative Theory,'' 11 *J. Cooperatives* 15, 19 (1996) (increase in share price may keep new members out and reduce profits of those who can buy shares of the NGC). For an NGC whose stock ownership has remained stable for a long time, the increase in share value could be said to match patronage, since the level of patronage is a function of stock ownership in the NGC structure. However, since stock of an NGC normally can be transferred, the value that may have been created will all go to the owners in the year the value of the stock increases.

[132] Some of the information in this paragraph, including descriptions of state cooperative laws, comes from the committee's draft prepared for the annual meeting, July 30-August 6, 2004, with prefatory note and preliminary comments (Thomas E. Geu, reporter), which can be found at http://www.law.upenn.edu/bll/ulc/uaarca/2004AnnMtgDraft.htm.

[133] LTR 200119016, *Doc 2001-13346, 2001 TNT 93-87*.

[134] In a private ruling, the IRS has held that a cooperative organized under such a statute can check the box like regular LLCs. LTR 200139020, *Doc 2001-24960, 2001 TNT 190-27*. The entity was reportedly formed under the Wyoming statute. *See* M. Hanson, ''Legal Framework of Cooperative Development,'' in C. Merrett and N. Walzer, eds., *Cooperatives and Local Development* 95, 110 (2004).

[135] Section 1381(a)(2).

is described as an ''association,''[136] which would normally mean that it is an entity that is treated as a corporation for tax purposes.[137] A cooperative qualifying under section 501(c)(12) is not definitionally required to be a corporation, although it seems odd to imagine a rural electric cooperative organized as a partnership.[138] Even if the entity does not qualify as a cooperative under the code, it might still receive some of the nontax benefits of being a cooperative.[139]

The cooperative LLC structure leaves some cooperative analysts puzzling over whether the entity that is created should be considered a cooperative.[140] From the standpoint of the tax law, the question may not matter, since the benefits of subchapter T and section 521 probably won't be available for a cooperative that elects to be treated as a partnership.

IX. Conclusion

There are times when nontax events overtake tax controversies. To a significant extent, that may have occurred regarding the tax treatment of cooperatives. The passthrough treatment that was so troubling to commentators 50 years ago is now a simple reality for cooperatives (and, indeed, most other business entities). As cooperatives adopt LLC status, the arguments that they have special benefits because of their tax treatment are mooted by the reality that their treatment is the same passthrough treatment that other LLCs receive. Fights over the definition of patronage income fade into the background, because all income of a passthrough is allocated to its owners. Similarly, arguments over whether the cooperative is ''operating on a cooperative basis'' no longer loom large.

These conclusions assume that the cooperative is prepared to forego the benefits of subchapter T. Those benefits relate to the flexibility of patronage dividends — the right to take a deduction for paper that may not have an ascertainable value and to defer allocation decisions for 8½ months — and the power to make distributions of nonqualified paper whose final tax consequences can be determined only after the paper is redeemed. Cooperatives that are prepared to go that route will face the daunting task of complying with subchapter K.[141] However, they will find that most of the legal and policy issues raised in this article — issues that have been major concerns in cooperative taxation — will not apply to them.

[136] Section 521(b)(1).

[137] Section 7701(a)(3) (definition of corporation includes an association); Treas. reg. section 301.7701-3(a). In the past, cooperatives were virtually all incorporated. Donald A. Frederick and John D. Reilly, ''Income Tax Treatment of Cooperatives: Background,'' in *USDA Cooperative Information Report* 44, pt. 1, at 29 (Nov. 1993), available at http://www.rurdev.usda.gov/rbs/pub/cir441.pdf.

[138] Because rural electric cooperatives are currently treated as earning nonpatronage income when they sell propane to their patrons, *see* note 1 *supra*, they may wish to consider electing to be a partnership under the code to get passthrough treatment for that income. It seems mechanically possible to have both subchapter T and subchapter K applied to a section 501(c)(12) cooperative, with the deduction allowed under subchapter T for patronage dividends treated as a section 707(a) transaction between the partnership and the partner/patron not acting as a partner. That could give the patron normal passthrough treatment in respect of nonpatronage income and a year's deferral on patronage income distributed to the partner/patron that is subject to the rules of subchapter T. However, at first blush this seems bizarre conceptually, because the patronage income would seem to be exactly the type of income that the partner/patron is earning in its role as a partner. Perhaps a court would choose to treat the patronage dividend under subchapter T rather than under subchapter K, on the theory that it is a more specific passthrough regime applicable to the cooperative. However, if the cooperative is able to use subchapter K to get the benefits of passthrough treatment for its nonpatronage income, and has no problem complying with the time constraints of subchapter K (which are stricter than the 8½ month delay allowed by subchapter T), a court might be unsympathetic to allowing the patrons to get the benefit of deferral for patronage income, and may decide to impose the rules of subchapter K rather than those of subchapter T to patronage income.

[139] The Capper-Volstead Act gives protection from antitrust attack to cooperatives (defined slightly differently from the way they are defined in subchapter T of the code). 7 U.S.C. section 291. The Farm Credit Act allows entities ''operated on a cooperative basis'' to borrow (under favorable conditions) from banks for cooperatives. Whether these and other nontax benefits will be available to LLC cooperatives is discussed in Donald A. Frederick, ''The Impact of LLCs on Cooperatives: Bane, Boon, or Non-Event?'' 13 *J. Cooperatives* 44, 47-48 (1998), and Randall E. Torgerson, ''Commentary, States Need to Carefully Consider New 'Cooperative' Laws,'' 69 *Rural Cooperatives* 2 (July/August 2002), available at http://www.rurdev.usda.gov/rbs/pub/jul02/jul02.pdf (hereafter Torgerson).

[140] *See, e.g.*, Torgerson, note 139 *supra*; J. Gary McDavid, ''Evolving Cooperative Structures,'' 55 *The Cooperative Accountant* 4 (2002); *but see* Donald Frederick, ''Agricultural Cooperatives in the 21st Century: Issues and Recommendations,'' 56 *The Cooperative Accountant* 6, 11 (2003) (cooperatives should continue to ''make decisions based on cooperative principles'').

[141] For example, whether retains are debt or equity becomes important under subchapter K, under which debt gets special treatment under section 752, and the amount of equity a partner has in the partnership may affect what the tax law will consider an allocation that is in accordance with the ''partner's interest in the partnership.'' Section 704(b); Treas. reg. section 1.704-1(b)(3).