

1994

## Agricultural Cooperatives: An Update

James B. Dean

*Dean McClure Eggleston & Husney*

Follow this and additional works at: <https://digitalcommons.unl.edu/nlr>

---

### Recommended Citation

James B. Dean, *Agricultural Cooperatives: An Update*, 73 Neb. L. Rev. (1994)

Available at: <https://digitalcommons.unl.edu/nlr/vol73/iss1/12>

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Nebraska Law Review by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

# Agricultural Cooperatives: An Update

## TABLE OF CONTENTS

I. Backup Withholding on Cooperative Patronage .....	228
II. Operating on a Cooperative Basis .....	229
III. Interest Income as Patronage Sourced .....	231
IV. Industry Specialist and Cooperative Audit Hotline .....	231
V. Nonqualified Notices of Allocation .....	233
VI. Use of Subsidiaries by Cooperatives .....	234
VII. Mergers .....	235
VIII. Implied Duty of Fair Dealing with Members .....	236
IX. Statute Revisions .....	237

This Article will present a number of occurrences and developments in the area of agricultural cooperatives from 1991 until the present. Many of the legal developments which affect cooperatives occur in the tax arena because of the tax treatment afforded cooperatives and their patrons. For this reason, a number of the matters noted in this Article will be drawn from tax materials.

### I. BACKUP WITHHOLDING ON COOPERATIVE PATRONAGE

Backup withholding on patronage dividends is a complicated area of the law. What follows is a general summary of its current application.

Section 3406 of the Internal Revenue Code authorizes backup withholding on certain reportable payments.<sup>1</sup> For 1992 and prior years the backup withholding rate was twenty percent.<sup>2</sup> The Energy Policy Act of 1992 raised the backup withholding rate to thirty-one percent on amounts paid after December 31, 1992.<sup>3</sup> As applies to co-

---

Copyright held by the NEBRASKA LAW REVIEW.

\* Attorney at Law and Partner, Dean, McClure, Eggleston & Husney, Denver, Colorado.

1. I.R.C. § 3406 (1988).

2. *Id.* § 3406(a).

3. Pub. L. No. 102-486, 79 Stat. 445, § 1992 (codified at 42 U.S.C. §§ 13201-13356 (Supp. IV 1992)).

operatives, there are four alternative criteria for reportable payments under section 3406.

1. The patron has failed to furnish the cooperative with his or her taxpayer identification number (TIN).
2. The Internal Revenue Service (IRS) has notified the cooperative that the patron has furnished the cooperative an incorrect TIN.
3. The patron has under-reported his or her income and the IRS has notified the cooperative to withhold on future payments.
4. The patron has failed to certify to the cooperative that he or she is not subject to backup withholding.<sup>4</sup>

Criteria three and four apply only to patronage dividend payments which are made fifty percent in cash with the withholding rate applied only to the cash portion. If the patronage dividend is not paid at least fifty percent in cash, then for situations covered by criteria three and four, no withholding is required. Should the patronage dividend be in the form of a redemption of a non-qualified allocation, which is usually one hundred percent in cash, then the total amount would be subject to backup withholding.

If a cooperative withholds from a patron under the third criterion, the cooperative must notify the patron that the withholding will be required in the future.<sup>5</sup>

If criteria one or two applies to a patronage dividend payment, backup withholding is only applied to the cash portion of the patronage dividend.<sup>6</sup> If the cash portion of the patronage dividend is ten dollars or less, it is quite possible no withholding is required.<sup>7</sup> The regulations define "reportable payments" as that part of a patronage dividend paid in money.<sup>8</sup>

## II. OPERATING ON A COOPERATIVE BASIS

For a number of years the IRS took the position that a cooperative taxable under subchapter T of the Code<sup>9</sup> would not be operating on a cooperative basis if more than fifty percent of its business was with non-members.<sup>10</sup> In *Conway County Farmers Ass'n v. Commis-*

---

4. I.R.C. § 3406 (West 1993).

5. *Id.* § 3406(c).

6. *Id.* § 3406.

7. *See* I.R.C. § 3406(b)(5) (West 1993) (excluding certain small payments from backup withholding).

8. I.R.C. § 35a.3406-1(a)(2)(B) (West 1993). It is worth noting that the regulations at § 35a.9999-3, Question 49, seem to require backup withholding from subsequent payments where a payer failed to withhold on previous payments even though the conditions for imposing backup withholding do not exist when the subsequent payments are made.

9. *Id.* §§ 1381-1388.

10. *E.g.*, Rev. Rul. 72-602, 1972-2 C.B. 511.

sioner,<sup>11</sup> the Eighth Circuit ruled that there was no statutory basis for imposing the fifty percent test and that business done with patrons could be treated under the provisions of Subchapter T while the non-member business could be treated under general corporate tax rules.<sup>12</sup>

On October 22, 1991, the IRS distributed a revised Action on Decision which acquiesced to the result in the *Conway* case. The IRS stated it will no longer assert that an organization is not "operating on a cooperative basis" solely because it does more than fifty percent of its business with nonmembers.<sup>13</sup> The IRS will consider all facts and circumstances, including the nature and value of business conducted with nonmembers, in determining whether the organization is operating on a cooperative basis.<sup>14</sup>

The IRS listed seven factors which it asserts must be considered in determining whether an organization is "operating on a cooperative basis" under section 1381(a)(2).<sup>15</sup>

The IRS relied on *Puget Sound Plywood, Inc. v. Commissioner*,<sup>16</sup> as requiring three fundamental factors:

1. Subordination of capital: The organization must limit the financial return it pays on its contributed capital.

2. Democratic control: Each member must have one vote regardless of the size of the member's investment or the amount of business the member does with the cooperative.

3. Operation at cost: At least annually, the organization must return the excess of its revenues over its related costs to its patrons in proportion to the volume or value of business done with each patron.

The IRS has also espoused four additional factors which it contends should be considered in determining whether an organization is "operating on a cooperative basis."<sup>17</sup>

4. Joint effort: The organization must be engaged in some joint effort actively with, for, or on behalf of its members.

5. Minimum number of patrons: There must be a minimum number of patrons; the organization must have sufficient membership to form a "mutual joinder of interest" in the risks and benefits of the cooperative effort.

6. Limited business done with nonmembers: The amount of business done with nonmembers must be limited.

---

11. 588 F.2d 592 (8th Cir. 1978).

12. *Id.* at 598-600.

13. 1991 AOD Lexis 38, \*2.

14. *Id.*

15. Priv. Ltr. Rul. 92-19-030 (Feb. 7, 1992).

16. 44 T.C. 305, 308 (1965).

17. Priv. Ltr. Rul. 92-19-030 (Feb. 7, 1992).

7. Liquidating distributions: Upon liquidation, present and former members must participate on a proportionate basis in any distribution of the organization's assets.<sup>18</sup>

### III. INTEREST INCOME AS PATRONAGE SOURCED

Another tax issue which has plagued cooperatives in recent years has been the efforts by the IRS to treat interest income on temporarily invested excess funds as nonpatronage sourced income and, therefore, subject to tax at the cooperative level.

In 1991, the United States Tax Court ruled that based on the projected need for funds by a cooperative, any interest on funds invested for thirty days or less would be treated as patronage sourced but income on longer term investments would be nonpatronage sourced.<sup>19</sup> The Seventh Circuit Court of Appeals modified the decision of the Tax Court saying its finding based with regards to thirty day investments "makes no sense."<sup>20</sup> The court of appeals held that the cash management practices of the cooperative were justified because they were integrally associated with the bona fide business dealings of the cooperative and the returns on the investments should be considered patronage sourced.<sup>21</sup>

There is no reason to believe the IRS will not continue to challenge the earnings made by cooperatives on investments of excess or reserve funds. It is clear the IRS is looking for a test case which can be taken to the United States Supreme Court. Cooperatives that invest excess or reserve funds in a manner which will produce a return should be exceedingly careful that there is a justifiable business reason for the investment which relates to the ordinary business of the cooperative.

### IV. INDUSTRY SPECIALIST AND COOPERATIVE AUDIT HOTLINE

Following the appointment by the IRS of the new Farmer Cooperative Industry Specialist, it appeared to the National Council of Farmer Cooperatives that cooperative audits resulted in more requests for technical information, less autonomy on the part of auditors, and uniform refusal to settle certain cooperative issues.<sup>22</sup> According to the

---

18. For a discussion and critique of the four additional factors, see HAYES AND MAGNUSON, NAT'L COUNCIL ON FARMER COOPERATIVES, REPORT OF SUBCOMMITTEE ON OPERATING ON A COOPERATIVE BASIS, INCLUDING SECTION 521, REPORTS OF SUBCOMMITTEES OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE 15, 16 (1992).

19. *CF Industries, Inc. v. Commissioner*, 62 T.C.M. (CCH) 1249, 1256 (1991).

20. *CF Industries, Inc. v. Commissioner*, 995 F.2d 101, 103 (7th Cir. 1993).

21. *Id.* at 104.

22. Memorandum from Leslie Mead, Associate General Counsel, National Council of Farmer Cooperatives, to LTA Committee, Re: Cooperative Audit Hotline (Mar. 22, 1991).

IRS Manual, the cooperative industry specialist is to provide "assistance and coordination of large farmer cooperative examinations."<sup>23</sup> In addition, the specialist is to "help ensure uniform and consistent treatment of issues nationwide and provide better identification and development of issues."<sup>24</sup>

Partially in response to the appointment of the industry specialist, and in an effort to coordinate the responses of the farmer cooperative community to audit issues and provide assistance to cooperatives under audit by the IRS, the National Council of Farmer Cooperatives and the National Society of Accountants for Cooperatives established a Cooperative Audit Hotline in early 1991.<sup>25</sup>

The Hotline is intended as a clearinghouse for exchange of information regarding cooperative audit activity. The information provided is general in nature and does not constitute the rendering of legal, tax, accounting, or other professional advice.<sup>26</sup>

An important part of the industry specialization program has been the selection of coordinated issues. The IRS defines coordinated issues as "major issues of particular importance to an industry that have been selected for industry-wide coordination."<sup>27</sup> The following issues have been selected for farmer cooperatives:

- (1) the application to cooperatives of I.R.C. 277 dealing with netting expenses of non-member business against member business income;
- (2) payment of patronage dividends on the basis of book income, rather than on the basis of tax income;
- (3) characterization of certain items of income as patronage sourced (available for distribution as a patronage dividend) versus nonpatronage sourced;<sup>28</sup> and
- (4) operating on a cooperative basis.<sup>29</sup>

If one works with a cooperative which has one of these issues, care should be taken to examine all precedent and commentary available with respect to the approach taken or to be taken by the cooperative with respect to the issue.

---

23. *Id.* (quoting I.R.S. Manual).

24. *Id.* (quoting I.R.S. Manual).

25. *Id.*

26. *Id.* The hotline can be contacted at 1-800-786-TAXX. Where professional services are needed, they should be sought directly.

27. *Id.* (quoting I.R.S. Manual).

28. *See supra* Part III.

29. *See supra* Part II.

## V. NONQUALIFIED NOTICES OF ALLOCATION

There appears to be a growing awareness of the possible uses of nonqualified notices of allocation in the financial planning of cooperatives.<sup>30</sup> When the investment credit could offset income taxes, many cooperatives would issue nondeductible nonqualified notices of allocation in allocating year end earnings or patronage to members and patrons. They would then offset the tax which the cooperative would otherwise have paid by investment credits generated from capital construction projects. With the elimination of the investment credit, this use of nonqualified notices of allocation was no longer applicable.

With a growing concern from many cooperative members and patrons for the redemption of equities distributed through qualified written notices of allocation on which the members and patrons have been taxed, a number of cooperatives have examined the use of nonqualified written notices of allocation as a means of allocating earnings or patronage while not imposing the tax burden on their members. Some cooperatives, in studying their financial condition, believe that the retention of allocated earnings net of income tax payable on them makes for a stronger capital base and provides for more flexibility in future planning than does the use of the more traditional qualified notices of allocation.

In a survey taken by a subcommittee of the Legal, Tax and Accounting Committee of the National Council of Farmer Cooperatives, several reasons were given for using nonqualified written notices of allocation. These included:

- (1) to create "permanent" capital;
- (2) to allocate nonqualified allocations received from another cooperative;
- (3) to allocate income sheltered from tax by investment tax credits, net operating loss carryovers, or losses from nonpatronage activity or of a noncooperative subsidiary, or tax exempt income;
- (4) to allocate income which might result from disallowed losses or reclassifications of income as nonpatronage;
- (5) to avoid current tax at the membership level;
- (6) to conserve cash by not having to make at least the twenty percent cash payment required for qualified written notices; and

---

30. A "nonqualified written notice of allocation" is a written notice of allocation which is not qualified. I.R.C. § 1388(d) (West 1993). A "qualified written notice of allocation" is a written notice of allocation which the distributee has agreed to take into income at its stated amount. If paid as part of a patronage dividend, 20% or more of the patronage dividend must be paid in money or by a qualified check. I.R.C. § 1388(c) (West 1993). For a comprehensive analysis of nonqualified notices, see Royer and Wissman, *Nonqualified Notices: An Alternative for Distributing Cooperative Earnings*, SEPT. 1989 AGRIC. COOPERATIVE SERVICE RES. REP. No. 80.

(7) to avoid or minimize alternative minimum tax.<sup>31</sup>

## VI. USE OF SUBSIDIARIES BY COOPERATIVES

As cooperatives of all kinds seek to conduct their business in the most up to date manner, consideration is more and more being given to the use of subsidiaries (wholly owned or jointly owned with other entities) as a means through which some portion of the cooperative's business may be conducted. There are a variety of reasons why a subsidiary might be employed.

In some cases, if properly handled, a subsidiary may shield the cooperative parent from environmental liability. In some cases, to pursue profitable operation of a particular business segment, it may prove advantageous to place the segment in a separate corporation. This can be especially true in the case of a joint venture with another organization to operate the segment. It may be possible to raise capital in the subsidiary for a particular business segment when it would not be possible to raise money by direct investment in the cooperative parent.<sup>32</sup>

If a subsidiary is to be used by a cooperative and the cooperative desires to have the earnings of the subsidiary treated as patronage sourced income for the cooperative, great care must be taken to ensure that the subsidiary is properly organized to meet the requirements which will be imposed on the cooperative itself for income to qualify as patronage sourced. Some of the elements which must be in place are a pre-existing obligation to return patronage sourced income to the patrons, an agreement of the patrons to include allocated income in their income for tax purposes, and a proper mix of member and non-member business if non-member business is to be sought.

Additionally, the state cooperative statutes under which the cooperative parent is organized must be carefully examined to ensure there is no direct or subtle prohibition against the cooperative owning an interest in a subsidiary. For example, prior to the 1992 amend-

---

31. A. JAMES ROBERTS, III, NAT'L COUNCIL OF FARMER COOPERATIVES, CAPITAL FORMATION AND FINANCIAL STRUCTURES OF COOPERATIVES INCLUDING USE OF WRITTEN NOTICES OF ALLOCATION, REPORTS OF SUBCOMMITTEES OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, 21 (1992).

32. For an excellent review of the use of subsidiaries by cooperatives, see John D. Reilly, *An Overview of the Use of Subsidiaries by Agricultural Cooperatives*, 13 J. OF AGRIC. TAX AND LAW 197 (Fall 1991). See also TERRY D. BERTHOLF, NAT'L COUNCIL OF FARMER COOPERATIVES, USE OF SUBSIDIARIES BY COOPERATIVES, REPORTS OF SUBCOMMITTEES OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, 71 (1992); Charles A. Kraenzle and Dave Volkin, *Subsidiaries of Agricultural Cooperatives*, Cooperative Res. Rep. 4 (Act 4, USDA Economics, Statistics and Cooperatives Service) (1979).

ments to the Kansas Cooperative Act,<sup>33</sup> the power of Kansas cooperatives to utilize subsidiaries was thought to be substantially limited.<sup>34</sup>

Finally, Subchapter T cooperatives and non-cooperative subsidiaries may file federal income tax returns on a consolidated basis.<sup>35</sup>

## VII. MERGERS

On April 2, 1992, the United States Department of Justice ("Department") and the Federal Trade Commission ("Commission") issued the Horizontal Merger Guidelines ("Guidelines") revising the Department's 1984 Merger Guidelines and the Commission's 1982 Statement Concerning Horizontal Merger Guidelines.<sup>36</sup> While the guidelines are not legally binding, litigants and courts look to them for guidance in evaluating whether a merger has violated the antitrust laws. Because the Capper-Volstead Act<sup>37</sup> and section 5 of the Clayton Act<sup>38</sup> do not exempt cooperatives from violations of most aspects of the federal antitrust laws, cooperative lawyers should be aware of these Guidelines when structuring mergers for their cooperative clients.

The long-awaited Guidelines for the first time unified the two agencies' approach to antitrust law. The unification of approach has generally been considered a positive step because business participants and their counsel will be able to review their actions, or actions they are considering, under one set of standards instead of two as was previously necessary when both the Department and the Commission had separate sets of standards for evaluating mergers.

According to experts in the antitrust field, the Guidelines will probably not significantly change the government's analytical framework for reviewing mergers. Instead, the Guidelines codify several enforcement standards which have evolved since the issuance of the 1982 Guidelines. However, the Guidelines do introduce some changes

---

33. KAN. STAT. ANN. § 17-1601 (1986) (amended 1992).

34. See Bertholf *supra* note 32. A comprehensive comparison of the provisions in state cooperative statutes is contained in James R. Baarda, *State Incorporation Statutes for Farmer Cooperatives*, COOPERATIVE INFO. REP. 30 (USDA Agricultural Cooperative Service) (Oct. 1982). Mr. Baarda notes that the holding of an interest in other associations or corporations is specifically permitted by a majority of state cooperative incorporation statutes, but he also reported, "[t]he distinction between cooperative and non-cooperative ownership is not clear in most statutes" and many states do not specifically authorize cooperatives to invest in or own noncooperative enterprises. *Id.* at § 15.14, 116.

35. Priv. Ltr. Rul. 93-26-057 (1993).

36. For the text of the Guidelines and the introductory statement issued with the Guidelines, see Horizontal Merger Guidelines—1992, No. 26,569, Trade Reg. Rep. (CCH) ¶ 13,104 (May 5, 1992).

37. 7 U.S.C. §§ 291-292 (1988).

38. 15 U.S.C. § 12-44 (1988).

which should be noted. They also leave some unanswered questions in interpretation.<sup>39</sup>

### VIII. IMPLIED DUTY OF FAIR DEALING WITH MEMBERS

This writer believes courts may become more inclined than in previous times to impose an implied duty of fair dealing between the cooperative and its members. Although there are not a large number of reported cases which have reached a substantial decision point, several cases have been brought by members or former members of cooperatives based on breach of an implied duty of fair dealing or a closely related theory. There is some evidence that courts may find this theory appealing if they find that cooperatives have not dealt with their members in a fair and equitable manner.

The United States District Court for the Northern District of Illinois held that the bylaws of a cooperative are a contract between the members and the cooperative, and the contractual nature of the bylaws imposes on the cooperative an implied duty of good faith and fair dealing in its relationship with its members.<sup>40</sup> For this reason, the cooperative could not prevail on a motion to dismiss for failure to state a claim where a terminated member sought a declaratory judgment which would permit the member to sell the cooperative's merchandise in the former member's hands or compel the cooperative to repurchase it.<sup>41</sup>

In a class action brought by a dissolved former corporate member of a regional cooperative for recovery of equities in the regional cooperative, the class plaintiff alleged a variety of theories, but among them was the concept of a breach of a fiduciary duty of fair dealing.<sup>42</sup> Although the case was settled before judicial determination of all the theories, a review of the briefs of the parties in the case suggests that there are plausible bases upon which claims based on a duty of fair dealing can be presented in a way which could attract the attention of a sympathetic tribunal.

---

39. For discussions of aspects of the Guidelines, see LOYD W. McCORMICK, NAT'L COUNCIL OF FARMERS COOPERATIVES, REPORT OF THE SUBCOMMITTEE ON LEGAL AND TAX ASPECTS OF JOINT VENTURES, MERGERS, REORGANIZATIONS AND ACQUISITIONS, REPORTS OF SUBCOMMITTEES OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, 81 (1992); John Magney et al., *Merging of the Minds on Antitrust Policy*, TEX. LAW., August 1992 at 12; Mark Potts, *Justice Department, FTC Unveil Merger Guidelines; Unified Approach Taken for First Time*, WASH. POST, April 3, 1992, at B1.

40. *Quick Appliance Parts, Inc. v. Johnstone Supply, Inc.*, No. 91-C5204, 1991 WL 214066 (N.D. Ill. Oct. 16, 1991).

41. *Id.*

42. See Amended Complaint, *Consumers Gas & Oil, Inc. v. Farmland Indus., Inc.*, No. 92-F-1394 (D. Colo. 1992).

### IX. STATUTE REVISIONS

Several states have revised and modernized their cooperative statutes within the past few years including South Dakota, Kansas, Wisconsin, Iowa, and Minnesota. However, no national model cooperative statute has been drafted since the Bingham Act of 1923, which was a Cooperative Marketing Act for Kentucky and later used as a model by many states.