

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: October 23, 2009

to:
Internal Revenue Agent

from:
Senior Counsel
(Large & Mid-Size Business)

subject:
Patronage Dividend Deduction

This is in response to your request for our opinion as to whether, under the facts set forth below, _____ is entitled to the full amount of the patronage dividend deductions it claimed for its taxable years _____. This memorandum may not be used or cited as precedent.

Please be advised that this writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether the Taxpayer is entitled to patronage dividend deductions for the years in issue for amounts paid to its members out of earnings not attributable to corn purchases made pursuant to the Uniform Agreements it entered into with its members.

CONCLUSION

The Taxpayer is not entitled to patronage dividend deductions for the years in issue for amounts paid to its members out of earnings not attributable to corn purchases

made pursuant to the Uniform Agreements it entered into with its members. More specifically, the Taxpayer is not entitled to patronage dividend deductions for amounts paid to its members to the extent that such amounts are paid out of earnings attributable to purchases from nonmembers or purchases from members over and above such members' committed bushels.¹

FACTS

(hereafter "Taxpayer") is a non-exempt cooperative subject to Subchapter T. During the years in issue, the Taxpayer had over members. According to its financial statements, the Taxpayer was organized "to pool investors and provide a corn supply for a ethanol plant for commercial sales throughout the United States." The Taxpayer does not, however, directly own or operate an ethanol plant. The Taxpayer's principal asset and source of income is its investment in (hereafter "LLC"). The Taxpayer has a fiscal and taxable year ending

LLC owns and operates a plant that produces ethanol from corn. Prior to , LLC was owned approximately percent by the Taxpayer and percent by a third-party. On or about , LLC redeemed the third-party's interest. Thereafter, LLC was a wholly-owned subsidiary of the Taxpayer and was treated as a disregarded entity for Federal income tax purposes.

The Taxpayer and each of its members have entered into a (hereafter collectively the "Uniform Agreement"). The Uniform Agreement obligates the member to provide corn to LLC for LLC's use in the production of ethanol. Each year, the member is required to provide a set number of bushels of corn ("committed bushels). Specifically, paragraph of the Uniform Agreement provides, in part, that:

¹ As noted in footnote 2, below, references to corn purchased from nonmembers and corn purchased from members over and above such members' committed bushels do not include corn purchased for the corn pool and used to fulfill members' delivery obligations under the Uniform Agreements. We have assumed, without opining thereon, that earnings attributable to pool corn used to fulfill members' delivery obligations were properly treated as patronage-sourced income irrespective of the source of the pool corn.

Paragraph of the Uniform Agreement provides that the Board may increase or decrease the member's committed bushels, on a pro rata basis with all other members' committed bushels, if the total number of committed bushels exceeds or is less than the number of bushels needed to meet the processing requirements of the ethanol plant.

If a member cannot fulfill his corn delivery obligation by physically delivering corn, the member's delivery obligation will be fulfilled with corn purchased by LLC on the open market and the member will be charged a pool fee. Paragraph of the Uniform Agreement provides, in part, that:

Paragraph of the Uniform Agreement also provides that the Taxpayer has no obligation to accept for marketing any corn in excess of the member's committed bushels, regardless of whether the member's total corn production has increased.

During the years in issue, the committed bushels (including both committed bushels physically delivered by members and committed bushels procured from the corn pool) were insufficient to meet the production requirements of the ethanol plant. The Taxpayer was therefore required to procure additional corn above the committed bushels. These additional bushels were procured by (1) purchasing corn from nonmembers, and (2) purchasing corn from some members over and above such members' committed bushels. For the Taxpayer's year , members' committed bushels provided approximately percent of the corn used by LLC to produce ethanol. For the Taxpayer's year 2006, members' committed bushels provided approximately percent of the corn used by LLC to produce ethanol.

For both its taxable year , the Taxpayer distributed 100 percent of its net income to its members as a patronage refund (partly in cash and partly in qualified written notices of allocation), deducted the full amount distributed as a patronage dividend under section 1382, and reported zero taxable income for the year. No part of the Taxpayer's net income for its taxable years was distributed to the nonmembers that sold corn to LLC.

Section of the Taxpayer's by-laws provides, in part:

At no point during the years in issue did the Taxpayer obligate itself in writing to conduct any transaction outside of a Uniform Agreement on a patronage basis.

Section of the by-laws provides:

Section of the by-laws provides, in part:

Section of the by-laws provides that “

” Section provides that “

” (emphasis added).

Section provides, however, that the “

(emphasis added). Section provides that the board of directors “

added). ” (emphasis

LAW

Section 1382(a) provides that, except as provided in subsection (b), the gross income of any organization subject to Subchapter T, “shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization or by reason of any amount paid to a patron as a per-unit retain allocation (as defined in section 1388(f)).” Paragraph (b)(1) of section 1382 provides that in determining the taxable income of an organization subject to Subchapter T, there shall not be taken into account amounts paid “as patronage dividends (as defined in section 1388(a)).” Section 1388(a) defines the term “patronage dividend,” in part, as:

[A]n amount paid to a patron by an organization to which part I of subchapter T applies –

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

Treas. Reg. § 1.1388-1(a)(2) provides, in part, that the term “patronage dividend” does not include:

(i) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings not derived from business done with or for patrons.

(ii) An amount paid to a patron by a cooperative organization to the extent that such amount is paid out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

The term “patron” is not defined in the Code. Treas. Reg. § 1.1388-1(e), however, provides:

The term “patron” includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

Under the statutory scheme of Subchapter T, a non-exempt cooperative effectively functions as a hybrid between an exempt cooperative and an ordinary C corporation. As explained by the Eighth Circuit:

Because of this restriction on the scope of allowable deductions [i.e., limiting the deduction for distributions to patrons to amounts distributed as patronage dividends and per-unit retain allocations as provided in section 1382(b)], nonexempt cooperatives must separate patronage- from nonpatronage-sourced income. A nonexempt cooperative is a hybrid business organization, taxed like an ordinary corporation with respect to nonpatronage-sourced income (see subchapter C, I.R.C. § 301 et seq.), but like a partnership with respect to patronage-sourced income. [Citation omitted] That is to say, nonpatronage-sourced income is fully taxable to the cooperative and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxed only once, usually to the patron.

Farm Service Cooperative v. Commissioner, 619 F. 2d 718, 723 (8th Cir. 1980)(holding that a non-exempt cooperative could not use patronage-sourced net operating losses to offset non-patronage sourced income).

ANALYSIS

The Taxpayer claimed patronage dividend deductions for the full amount it distributed to members for the years in issue. It premises its entitlement to deduct such amounts in full on the ground that 100 percent of its income for such years constituted “patronage-sourced income.” However, the amounts the Taxpayer distributed to its members did not constitute patronage dividends to the extent such amounts were paid out of earnings not attributable to corn purchases made pursuant to the Uniform Agreements between the Taxpayer and its members. More specifically, the amounts distributed did not constitute patronage dividends to the extent that such amounts were paid out of earnings attributable to purchases from nonmembers or purchases from members over and above such members’ committed bushels.² Such amounts are

² The pool corn, like the additional corn procured to meet the production requirements of the ethanol plant, would have been comprised of corn purchased both from nonmembers and from members above such members’ committed bushels. Unlike the additional corn, however, the pool corn was used to meet the members’ delivery obligations under the Uniform Agreements. We assume, without opining thereon, that no distinction should be drawn between committed bushels physically delivered by a member and committed bushels procured on a member’s behalf through the corn pool. Thus, we treat all committed bushels as having been delivered by members pursuant to their obligations under the Uniform Agreements, irrespective of whether the obligation was met through the corn pool or physical delivery. Accordingly, for purposes of this memo, references to corn purchases from nonmembers and corn purchases from members above such members’ committed bushels do not include purchases made for the corn pool.

nondeductible because they were not paid out of “patronage sourced-income;” that is, they were not paid on the basis of “business done with or for” the patrons, they were not paid out of earnings from “business done with or for” patrons, but they were paid “out of earnings other than from business done with or for patrons.” I.R.C. § 1388(a).

Initially it should be noted that the term “patronage sourced-income” is not found in the Code or the regulations. The term, however, has become a short-hand expression for income from “business done with or for” patrons as that concept is used in section 1388(a), the provision that defines patronage dividends. To constitute a patronage dividend under section 1388(a), an amount must, among other things, be paid on the “basis of quantity or value of *business done with or for such patron*,” (see paragraph (a)(1)), be determined by reference to “the net earnings of the organization from *business done with or for its patrons*” (see paragraph (a)(3)), but not be “other than from *business done with or for patrons*” (see clause (A) in the flush language of subsection 1388(a)) (emphasis added). Thus, “patronage sourced-income” is, in general, income from business done with or for a patron, a patron for this purpose being a person with whom the taxpayer does business on a cooperative basis. See, Treas. Reg. § 1.1388-1(e).

Here, the Taxpayer was not doing business on a cooperative basis with respect to corn purchases made from nonmembers, or with respect to corn purchases made from members other than pursuant to a Uniform Agreement between the member and the Taxpayer. Each member of the Taxpayer was obligated to provide a set amount corn to LLC each year for LLC’s use in the production of ethanol (i.e., the member’s “committed bushels”). The member’s obligation to provide the committed bushels arose under the Uniform Agreement between the member and the Taxpayer. Under Section of the Taxpayer’s by-laws, all transactions between the Taxpayer and a member pursuant to a Uniform Agreement were “conducted on a patronage basis.” Section , on the other hand, provided that:

(emphasis added).

As noted, at no point during the years in issue did the Taxpayer obligate itself in writing to conduct any transactions on a cooperative basis other than those that it conducted pursuant to the Uniform Agreements between itself and its members. Thus, the Taxpayer’s earnings for the years in issue were attributable to business conducted on a cooperative basis only to the extent they were attributable to the corn purchases

made from members pursuant to the Uniform Agreements.³ Put another way, the Taxpayer's earnings were not attributable to business conducted on a cooperative basis to the extent they were attributable to corn purchases from nonmembers or corn purchases from members that were not made pursuant to a Uniform Agreement (i.e., purchases above the members' committed bushels, since only the purchases of committed bushels were made pursuant to the Uniform Agreements). And to the extent the Taxpayer's earnings were not attributable to business conducted on a cooperative basis, they were not attributable to "patronage-sourced income." This is so for two reasons: First, such earnings were not derived "from business done with or for" the members (as required by paragraph (a)(3) of section 1388), but rather were derived "other than from business done with or for" the members (as prohibited by clause (A) of the flush language of section 1388(a)). Second, such earnings were not paid "on the basis of quantity or value of business done with or for such patron" as required by paragraph (a)(1). Treas. Reg. § 1.1388-1(a) and Treas. Reg. § 1.1388-1(e).

To the extent attributable to corn purchases not made from members pursuant to the Uniform Agreements, the amounts paid the members also failed to meet the requirements of paragraph (a)(2) of section 1388 and Treas. Reg. § 1.1388-1(a)(ii). Treas. Reg. § 1.1388-1(a)(ii) provides that to constitute a deductible patronage dividend, an amount must be "paid to a patron by a cooperative organization . . . [u]nder a valid enforceable written obligation of such organization to the patron to pay such amount, which obligation existed *before* the cooperative organization received the amount so paid" (emphasis added). Under the provisions of sections _____ of its by-laws, the Taxpayer is obligated to distribute its net income from patronage business to its patrons at least annually. Under the provisions of sections _____ of the by-laws, however, a distribution to members of net income from *nonpatronage* business is at the *discretion* of the board of directors.

We are aware of no authority supporting the proposition that a patronage dividend deduction can be allowed for amounts paid to members out of earnings attributable to business conducted other than on a cooperative basis. Beyond the statute and the regulations, there is little authority directly addressing the issue of whether a patronage dividend deduction can be allowed for amounts paid out of

³ The Taxpayer's original Protest acknowledges that "[T]he Taxpayer has not conducted business *on a patronage basis* with any member in excess of committed bushels nor with any nonmembers . . ." (emphasis original). Protest dated _____, p. 4. Likewise, the Taxpayer's revised Protest states that "the *only* transactions that the Taxpayer conducts on a *patronage basis* are purchases of corn from members, and *only* to the extent of their [Uniform Agreement] bushel commitments. All other transactions, including purchases of corn from nonmembers and from members in excess of their [Uniform Agreement] commitments . . . are conducted on a *nonpatronage basis*, i.e., participants in those transactions do not share in the Taxpayer's earnings." Protest dated _____, p. 10 (emphasis added).

earnings attributable to business conducted on a noncooperative basis (presumably because the statute and the regulations settle the matter). The case most directly on point is Iberia Sugar Cooperative, Inc. v. United States, 360 F. Supp. 967 (W.D. La 1972), aff'd per curiam, 480 F. 2d 548 (5th Cir. 1973).

The taxpayer in Iberia Sugar was a nonexempt cooperative that processed and marketed sugar cane. The marketing agreements between the taxpayer and members required that all cane grown on a member's land be sold to the taxpayer. This included a nonmember tenant's share of cane in instances where a member landlord had a share-crop lease with a nonmember tenant. The taxpayer distributed all of its net earnings to its members as patronage dividends. No patronage dividends were paid to nonmembers. The court held that the amounts paid to members were not deductible patronage dividends under section 1388(a) to the extent attributable to the cane purchased from nonmember tenants. See also, Smith & Wiggins Gin, Inc. v. Commissioner, 341 F. 2d 341 (5th Cir. 1965) (materially identical facts, but years at issue preceded enactment of Subchapter T); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F. 2d 326 (8th Cir. 1961) (cooperative not allowed a patronage dividend deduction for amounts distributed to members to the extent such amounts were attributable to earnings from grain storage for the Commodity Credit Corporation and other nonmembers (years at issue preceded enactment of Subchapter T)).

That a patronage dividend deduction cannot be allowed for amounts paid out of earnings attributable to business conducted other than on a cooperative basis is also demonstrated by Rev. Rul. 74-20, 1974-1 C.B. 242, and Linnton Plywood Ass'n v. United States, 410 F. Supp 1100 (D. Ore 1976). Rev. Rul. 74-20 and Linnton Plywood both address the issue of how to allocate the earnings of a cooperative where the earnings are attributable in part to business conducted on a cooperative basis and in part to business conducted on a noncooperative basis.

The taxpayer in Rev. Rul. 74-20 was a workers' cooperative that employed both members (who received patronage dividends) and nonmembers (who received no patronage dividends). Apparently recognizing that it was not entitled to patronage dividend deductions for amounts paid to member workers out of earnings attributable to nonmember workers, the taxpayer calculated the portion of its net earnings that could be distributed as patronage dividends using a formula that allocated its net earnings between that part attributable to member workers and that part attributable to nonmember workers. The formula was based on a ratio of the number of hours worked by the member workers over the total hours worked by all workers, but it weighed member hours more heavily than nonmember hours. The revenue ruling found that the result was "to distribute to the member workers income of the taxpayer that is attributable in part to net earnings from the efforts of the nonmember workers." It then held that "patronage dividends computed by increasing the hours worked by member workers in determining the applicable percentage of net earnings available for

patronage distributions do not qualify as patronage dividends to the extent that such distributions are from income attributable to nonmember workers.” See also, Rev. Rul. 74-24, 1974-1 C.B. 244 (gain from timber cutting recognized by nonexempt workers’ cooperative that employed both members and nonmembers was patronage income to the extent attributable to members, but nonpatronage income to the extent attributable to nonmembers); Rev. Rul. 74-160, 1974-1 C.B. 245 (similar as to interest income from loans to supplier); and Rev. Rul. 74-84, 1974-1 C.B. 244 (similar as to ordinary gain from sale of section 1245 property).

Linnton Plywood Ass’n v. United States, 410 F. Supp 1100 (D. Ore 1976), addressed the same issue as Rev. Rul. 74-20 under materially identical facts. The court there came to opposite conclusion of Rev. Rul. 74-20, holding that the taxpayer could weigh member workers’ hours more heavily than nonmember workers’ hours in order to account for the member workers’ greater productivity.⁴ Nothing in the opinion suggests, however, that the taxpayer would be entitled to patronage dividend deductions for amounts paid to members out of earnings attributable to work done by nonmembers. To the contrary, the issue of the relative value of the members’ and nonmembers’ contributions arose only because the taxpayer was *not* entitled to patronage dividend deductions for payments made out of earnings attributable to the work of nonmember workers.

In this case, the Taxpayer conducted business with nonmembers (and with members to the extent of purchases made other than per the Uniform Agreements) in the same manner as would any for-profit C corporation. As such, it generated non-patronage sourced income that cannot be deducted as a patronage dividend.

For the reasons set forth above, the Taxpayer is not entitled to a patronage dividend deduction for amounts distributed to its members out of earnings attributable to purchases from nonmembers or purchases from members over and above such members’ committed bushels.

This advice has been coordinated with Branch 5, Passthroughs & Special Industries and with Cooperatives Industry Counsel Rogelio Villageliu. Please feel free to call me if you have any further questions respecting this matter.

Senior Counsel
CC:LM:

⁴ As the basis of patronage in the present case is the delivery of a commodity, the relative value of member and nonmember contributions is not an issue.