



COOPERATIVE TAXATION; TWO STEPS FORWARD AND ONE STEP BACK

I know of no single cooperative-related issue that has created more confusion and ill-will than "taxation." Even those close to cooperatives find it difficult to stay current and knowledgeable on the subject. They often fail miserably in their attempts to address the complex issue and convey to the general public a sense of logic and legitimacy. Anti-cooperative interest groups feast on this confusion and public misunderstanding. And to make matters worse, tax treatment of cooperatives is never a "static" relationship because the courts and the I.R.S. are constantly changing regulations and/or reinterpreting their content. Compliance is much like an attempt to shoot at a moving target. Tax attorneys, accountants, and cooperative managers can only grow increasingly depressed over their attempts to comprehend, document, and fulfill their objectives. It's not surprising, therefore, that the general public would grow suspicious of a cooperative's tax status.

It is not possible to review the entire history and treatment of cooperative taxation in this short newsletter. I assume you already are familiar with the fundamentals. Instead, my objective is to review the results of litigation, and the changes in regulations (rulings), which have impacted cooperative taxation in the past few years. Several long-held positions have changed in the past 3 years. Two such changes represent a reversal of an I.R.S. position long-regarded as detrimental to cooperative interests. A new I.R.S. ruling produced a third change, which most likely will have an adverse impact on cooperatives.

C.C.C. RESEAL FEE INCOME

In 1988 a U.S. District Court in Louisiana held that storage fees received by a cooperative from the C.C.C. were to be treated as patronage-sourced

income (Caldwell Sugar Co-op vs. U.S.). This court ruling was in opposition to a long-held position by the I.R.S.

Caldwell Sugar was a nonexempt, agricultural cooperative, which processed and marketed cane sugar for member-producers and patrons. During the year in question, Caldwell Sugar received storage and handling fees as part of a C.C.C. resale program which extended original maturity dates for price support loans made to producers.

Caldwell Sugar treated the income thereby generated as ordinary income and split the storage fee income between patronage and non-patronage income based on the ratio of member-patron to total business conducted by the firm. Caldwell Sugar then allocated that portion of the C.C.C. related income it deemed (via computation) patronage-sourced, and took a patronage dividend deduction on its tax return for the allocated amount, as per Section 1382 (b) (1) of the code.

Under this section of the code, patronage dividends are not included when determining the taxable income of a cooperative. But for this section to apply, Section 1388 (a) of the code requires that patronage dividends paid to a patron by his/her cooperative must meet the following criteria:

- 1) The dividend must be paid on the basis of quantity or value of business done with or for such patron;
- 2) The dividend is paid under an obligation of the organization to make the payment, where such obligation existed before the organization received the payment; and
- 3) That payment is determined by reference to the net earnings of the organization from business done with or for its patrons.

After reviewing Caldwell Sugar's filing, the I.R.S. denied the cooperative's patronage-sourced classification of the income received from the C.C.C. under this resale program was denied, as was the corresponding patronage dividend deduction. The I.R.S. concluded that income received under the resale program was non-patronage sourced even though: (1) there had been no default on the loans extended, (2) the C.C.C. had only extended the loan period, and (3) the property (sugar) collateralizing the loans remained under the ownership of the farmer.

The Louisiana court rejected the I.R.S. declaration based on an earlier (1959) Revenue Ruling 59-107 which held that storage fees received by a cooperative from the C.C.C. prior to default were patronage-sourced and did not constitute income received by the cooperative from business done with the government. In so ruling, the court held that the classification of storage fees received by a cooperative from C.C.C. depended on who owns the commodity. Hence, the "business done" remained that of the producer, the owner of the stored commodity, presuming of course that he/she was a member-patron of that cooperative. The I.R.S. later acquiesced to this decision.

OPERATING AS A COOPERATIVE

The Tax Court's decision in Farmer's Cooperative Co. vs. Comm'r. is another example of the I.R.S. changing its long-held position regarding cooperation taxation. This decision concerned the definition of a "producer" for purposes of accessing the exemption of cooperatives from taxation under Section 521 (b) (2) of the code.

Under this provision, a cooperative organization with capital stock cannot be denied exemption from tax if "substantially all" of such stock is owned by producers who market their products or purchase their supplies and equipment through the cooperative (provided, of course, owners of nonvoting preferred stocks are not entitled or permitted to participate directly or indirectly in the profits of the cooperative on its dissolution or otherwise beyond the fixed dividends affixed thereto).

As early as 1973, the I.R.S. stated that, for a shareholder of a cooperative operating under Section 521 to be a "producer," the shareholder must market more than 50% of his/her products or

purchase more than 50% of his/her supplies from that cooperative.

But in Farmers Cooperative litigation, the Tax Court found that any amount of patronage was sufficient for a shareholder of an exempt cooperative to be an active "producer." The court judged 50% concept was contrary to the intent of Congress and that, accordingly, the patronage requirement of Section 521 was a qualitative requirement not a quantitative one. Further, the court held that the "substantially all" language of the provision referred to the stock ownership and not to the patronage activity required to be deemed an active producer. This may seem to be little more than an exercise in "syntax," but a grammatical assessment of the language seems to agree with the Tax Court's findings. In 1988, the I.R.S. heeded the courts and applied a more reasonable interpretation of the code.

PACKAGE DESIGN EXPENDITURES

Most cooperative firms do not incur major expenses to develop a packaging design (label). However, Washington State fruit and vegetable marketing cooperatives may be an exception because these organizations often package their products under a cooperative-owned label. The cost of developing this label or design for a new line of product or a separate grade is considerable. This is especially true where commercial artists and related professionals create that design.

In 1989, the I.R.S. issued a ruling and two revenue procedures impacting the tax accounting treatment of expenditures resulting from creating of package designs. First, a "package design" is defined as an asset created by a specific graphic arrangement or design of, for example, shapes, colors, words, pictures, or lettering on a given product package or the design of a container with respect to its shape or function. Furthermore, the "package design cost" is defined as the cost of materials, labor, and overhead associated with the design's development. This includes all billings related to developing this design by an independent contractor.

In its Revenue Ruling 80-23, the I.R.S. ruled that such design expenditures incurred by a taxpayer after 1986 must be capitalized under Section 263A. Further, package design expenditures incurred prior to 1987 are also subject to

capitalization. Finally, the I.R.S. ruled that package design costs that are capitalized are not subject to amortization under Section 167.

In essence, package designs are judged to have an extended period of life and do represent an intangible form of improvement made to increase the value of the property. The I.R.S. noted that if an intangible asset has a known useful life, the length of which can be estimated with reasonable accuracy, the asset may be subject to depreciation. However, if the useful life cannot be estimated with reasonable accuracy, no depreciation is allowed. Only when that package design is actually abandoned are the costs of its development allowed as a deduction under Section 165.

Revenue Procedure 89-16 provides for a change in accounting procedures. Herein, the required change applies to all amounts previously deducted or amortized with respect to all designs still in use by the taxpayer. For such costs incurred prior to 1987, the adjustment generally will be recognized over a period not to exceed 6 years. A shorter period may be required if the adjustment is attributable to a shorter period; e.g., if the taxpayer has only been in existence for 4 years, the adjustment is recognized over a 4 year period. For costs incurred after 1986, the taxpayer should amend those prior returns to comply with Section 263A and capitalize such costs. For package designs placed in service in a tax year for which the taxpayer has filed properly as outlined in Revenues Ruling 89-23, as a matter of administrative convenience, the I.R.S. will allow amortization for certain package design costs over a deemed useful life of 60 months.

To access this proviso, the taxpayer must attach a statement to the return. This statement must indicate that the taxpayer is electing the 60-month useful life, and it must include a description of the particular package design, the date on which each design was placed in service, and the cost basis for each.

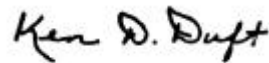
In summary, the I.R.S. has taken the position that all costs, whenever incurred, related to package designs still in use must be capitalized with all the associated adverse tax effects. Relief in the form of allowed amortization deductions over 60 months is available only for designs placed into service in tax years ending after March 5, 1989. Capitalized costs related to package designs placed in service before that date will only be

deductible when the package design is abandoned.

For impacted cooperatives, it would appear that this I.R.S. pronouncement opens all closed years back to 1913 for recapture of previously expensed package design costs and sidesteps the 3 year statute of limitations provided in Section 6501. How many cooperatives will be able to go back in their records 10 or 20 years to account for package design costs previously deducted? This would clearly seem to be an exercise in futility. Some reconsideration of this issue by the I.R.S. is expected and perhaps a more reasonable approach will soon surface.

SUMMARY

The issue of cooperative taxation remains complex. Changes such as those noted above serve only to add more confusion. Of these three changes noted, two represent steps forward and will prove beneficial to cooperatives. Only the last represents a step back into the morass of the ridiculous.



Ken D. Duft
Extension Economist