

1955

# Multiple Contractual Aspects of Cooperatives By-Laws

Charles E. Nieman

Follow this and additional works at: <https://scholarship.law.umn.edu/mlr>



Part of the [Law Commons](#)

---

## Recommended Citation

Nieman, Charles E., "Multiple Contractual Aspects of Cooperatives By-Laws" (1955). *Minnesota Law Review*. 1007.  
<https://scholarship.law.umn.edu/mlr/1007>

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact [lenzx009@umn.edu](mailto:lenzx009@umn.edu).

# MINNESOTA LAW REVIEW

Volume 39

January, 1955

No. 2

## MULTIPLE CONTRACTUAL ASPECTS OF COOPERATIVES' BY-LAWS

CHARLES E. NIEMAN\*

### I. RELATIONSHIPS BETWEEN FARMERS AND COOPERATIVES

At least three kinds of litigation involving cooperatives recurrently have presented problems peculiar to such organizations. In the past several years, numerous cases presented the question of whether a cooperative association was subject to corporation income tax on the net margins<sup>1</sup> which it distributed to its patrons.<sup>2</sup> Currently, a series of cases is developing involving the questions of whether and when a patron of a cooperative must pay individual income tax on the net margins which he receives in various forms from his cooperative.<sup>3</sup> It may be anticipated that the future will bring increased litigation between patrons and cooperatives with respect to the computation and distribution of net margins.<sup>4</sup>

---

\*A.B. 1928, Beloit College; L.L.B. 1937, University of Wisconsin. Member of the Minnesota bar.

1. "Net margins," in this article, connotes a cooperative's receipts (whether they be "income" to the cooperative or not) in excess of its costs, expenses and limited dividends on capital.

2. *E.g.*, Uniform Printing & Supply Co., 33 B. T. A. 1073 (1936), *rev'd*, 88 F. 2d 75 (7th Cir. 1937); Cooperative Oil Ass'n, Inc., 115 F. 2d 666 (9th Cir. 1940); Peoples Gin Co., Inc., 41 B. T. A. 343 (1940), *aff'd*, 118 F. 2d 72 (5th Cir. 1941); Midland Cooperative Wholesale, 44 B. T. A. 824 (1941); Peoples Gin Co., Inc., 2 T. C. M. 325 (1943); San Joaquin Valley Poultry Producers Ass'n, 136 F. 2d 382 (9th Cir. 1943); Greene County Farmers Sales Ass'n v. United States, 55 F. Supp. 123 (1944); United Cooperatives, Inc., 4 T. C. 93 (1944); American Box Shook Export Ass'n, 4 T. C. 758 (1945), *aff'd*, 156 F. 2d 629 (9th Cir. 1946); Fountain City Coop. Creamery Ass'n, 9 T. C. 1077 (1947), *aff'd*, 172 F. 2d 666 (7th Cir. 1949); Associated Grocers of Alabama v. Willingham, 77 F. Supp. 990 (N.D. Ala. 1948); Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201 (N.D. Iowa 1949); Colony Farms Coop. Dairy, Inc., 17 T. C. 688 (1951); Dr. P. Phillips Cooperative, 17 T. C. 1002 (1951).

3. For examples, see cases reviewed in parts VIII and IX, *infra*.

4. For example, in *Viker v. Halstad Elevator Co., Inc.*, not reported, (14th Dist. Minn. 1951), Mischler, *Summary of Cooperative Cases* 50, p. 24 (U. S. Dept. Agr., Coop. R. & S. Div., June, 1951) plaintiff-patron claimed a patronage refund computed by dividing net margins for year by bushels handled in year and multiplying that fraction by bushels delivered by plaintiff-patron, but defendant-association first made an extra payment to flax patrons

The cooperatives' income tax cases constituted a long course of administrative and judicial wallowing among various theories<sup>5</sup>

of first four months to distribute to them a large inventory gain realized on flax received in that period. Farmers who experienced market conditions before they had cooperatives realize that the existence of their cooperative and its effect on prices and practices are more important to them than patronage refunds. Consequently, they do not argue about their refunds. Younger farmers without that experience are more inclined to take the existence of their cooperative for granted and to place more importance on their patronage refunds. This change in attitude, increased volume and more exact accounting combine to produce more patron-cooperative litigation. Hence, it is important for lawyers and judges to learn about cooperative history, theory and practice.

5. "Let us first, for the moment, and with appropriate sympathy for them, consider the mental tortures which the Judges underwent when they first sought to analyze the cooperative corporation. At first blush, no particular problem was apparent. It was assumed that cooperatives were corporations just as any other incorporated business unit was a corporation. *Ergo*, by applying the law applicable to ordinary corporations, there should be no particular problem. But it was not long before the fallacy of this proposition began—and I say advisedly—to become apparent, although the fallacy is still deep-rooted and widespread among uninformed business men and lawyers. . . .

"The more closely the cooperative corporations were scrutinized through the judicial microscope, an unbelievable and almost horrifying fact began to dawn upon the judges. These cooperatives were neither fish, fowl, nor flesh—yet, they possessed some of the attributes of all three. . . .

" . . . [I]n applying the law of general corporations to cooperative corporations, the judiciary did not fare badly until they were confronted with the lethal 'patronage refund.' This was a new one. There was nothing in the books on the subject; yet, since the cooperative was a corporation, there just had to be some bolt in the corporate anatomy—since it is an inanimate entity—upon which this nut was to be screwed. As a flash from the blue finally came the answer to a perspiring and exhausted judiciary—why, it is merely a corporate dividend. Why, in the name of Heaven didn't we recognize this sooner? This opiate was shortlived.

"Corporate dividends were predicted upon investment by stockholders. These so-called 'patronage dividends' had no apparent relation to investment, but were anchored to something entirely new—volume of business done with the corporation—in other words, patronage. Then followed the second anguished effort to classify this elusive 'patronage refund' in normal and accepted corporate terminology. Again came the flash from the blue—these things are nothing more nor less than 'trade discounts.' Why didn't we think of that sooner?

"But the bliss did not last long, and the second opiate again wore off. Trade discounts as to the purchasing cooperatives were fine. The corporation had taken more from the patron than that which it had sold him was worth. But, what about the progressive payments to farmers for products which he sells through the association? And, here, again, the fog closed in. . . .

"Of only one thing may we be sure out of all the welter of the present confusion on this subject, namely, that the status of patronage refunds is governed by the law of contract and contract alone, except as positive statute law may control a cooperative business unit. As in the case of all contracts, the legal relationships created thereby depend upon the terms and provisions of each contract. Hence, abstract generalization on the subject is very difficult if not impossible, and this may be—and probably is—the chief reason for the present state of confusion.

"In earlier years, the Bureau of Internal Revenue was inclined to permit or allow exclusions or deductions, from gross income of non-exempt cooperatives, of patronage refunds actually paid before the close of the fiscal year. This rule was observed even though the cooperative was under no mandatory obligation to make such payments, and the payment or non-

before the mandatory obligation and reinvestment theory was firmly established.<sup>6</sup> Proper application of the same principles to the patrons' cases would produce sound and consistent results. However, the Tax Court too summarily dismissed the application of those principles to a patron's tax case.<sup>7</sup> As a consequence of failure to examine underlying principles, farmers and their lawyers are now confronted with at least three conflicting views concerning the taxability to patrons of net margins allocated to them by their cooperatives.<sup>8</sup> In order to determine satisfactorily disputes be-

payment of patronage refunds rested in the discretion of the board of directors.

"So far as ascertainable, no express negation of the earlier rules in this respect can be found. But, by implication, if not expressly, the Courts have discarded the proposition. . . .

"The rule today appears to be pretty firmly established that in order for a cooperative to exclude patronage refunds from gross income, the exclusion must be pursuant to a legal obligation to make the refund growing out of a pre-existing, enforceable contract creating the obligation. Such a mandatory obligation makes any income that of the patrons on a partnership basis rather than that of the cooperative corporation.

"Attention should be directed to the fact that a sharp distinction must be made between the terms deduction and exclusion. Legal deductions are permitted only pursuant to legislative grace granting the privilege. Exclusions of patronage refunds, under proper contractual obligations, are a matter of Constitutional right, under the Sixteenth Amendment." Hensel, *Taxation of Cooperatives*, Cooperative Law—1950 81-85 (Am. Inst. Coop., Wash., D. C., 1950).

6. United Cooperatives, Inc., 4 T. C. 93, 108 (1944): "The result of the procedure set up in petitioner's by-laws was as if the stockholder member who was under obligation to purchase additional stock had received, in cash, the 'patronage dividend' and had thereupon applied this sum to payment of stock. The stock, when thus paid and issued to him . . . represented an additional investment on his part to the capital of the corporation out of his savings from the annual transactions with petitioner."

7. B. A. Carpenter, 20 T. C. 603, 607 (1953): "We do not think that it necessarily follows that what is excludable from the income of the cooperative . . . automatically becomes income to the member." With no consideration of "why" or "why not," that statement explained nothing and produced only confusion. If net margins are excludable by a cooperative, it is only because the money in question is income to the patron rather than to the cooperative.

8. Kerner, *Taxability of Cooperative Retains*, 7 *Cooperative Accountant* No. 3, 11 (Fall, 1954).

"We are now faced with three views:

"The position of the Internal Revenue Service is that all retained non-cash allocations made to a patron of a farmer cooperative must be taken into account in computing gross income of such patron in the year in which the patron is notified of the apportionment of such item.

"The Tax Court (Howey v. Commissioner, T. C. Memo 1954 No. 19, and cases cited) has in a number of cases held such allocations to be taxable at their fair market value.

"The U. S. Court of Appeals for the Ninth Circuit has now said (Caswell v. Commissioner, 211 F. 2d 693) that such allocations are not taxable at the time evidence thereof is issued to the cooperative patron.

"Needless to say, cooperative patrons and their advisers find no area of certainty in this tax field. The answer to the important question of time of taxability will inevitably be given, but, as in the case of the question itself, no one can say when."

tween cooperatives and their patrons, the courts will have to realize the nature of that relationship. It is a contractual relationship. Frequently, the controlling terms of the contract are found in the cooperative's articles of incorporation, or by-laws, or both.<sup>9</sup> But there is too little realization that cooperatives' by-laws frequently include more than one kind of a contract<sup>10</sup> and give rise to more than one kind of legal relationship to the cooperative.<sup>11</sup> It is this writer's purpose to consider the nature of those contracts and relationships.

Different farmers stand in different legal relationships to the same cooperative; and any one farmer frequently stands in more than one legal relationship to the cooperative. One farmer may be a "member,"<sup>12</sup> but not a "patron," of a given cooperative. A second farmer may be a "patron,"<sup>13</sup> but not a "member," of the same cooperative. A third farmer may be both a "member" and a "patron" of that cooperative. In such a situation, the first and third farmers, as "members," have certain rights—such as the right to vote; but the second farmer, as a non-member "patron," has none of those rights. The second and third farmers, as "patrons," have certain rights—such as the right to a share of the net margins; but the first farmer, as a non-patron "member," has no such rights. The third farmer, being both a "member" and a "patron," possesses both kinds of rights; but he is entitled to some of them only in his capacity as a "member" and to others only in his capacity as a "patron." Clearly, "member" and "patron" are *not* synonyms.

Confusion triumphs when people refer to that third farmer as a "member" in discussing his rights and obligations as a "patron," or when they refer to him as a "patron" in discussing the rights and responsibilities which accrue to him only in his capacity as a "member." Consequently, it is important to realize that a farmer may stand in more than one legal relationship to a cooperative. Realizing that, it is important to refer to him in terms of the par-

---

9. For convenience, reference herein to "by-laws" is on the understanding that some of the considered provisions may be found in either the statute, the articles of incorporation, the by-laws, separate documents, or any combination of those sources.

10. For convenience, reference will be made to the "membership contract," the "patronage contract," and the "investment contract."

11. *E.g.*, the cooperative-member relationship under the "membership contract," the cooperative-patron relationship under the "patronage contract," and the cooperative-investor relationship under the "investment contract."

12. "Members," unless otherwise indicated connotes both "members" of non-stock associations and voting "shareholders" of stock associations.

13. A farmer becomes a "patron" of a cooperative by "patronizing" it, *i.e.*, by delivering commodities to be cooperatively marketed by it, or by receiving goods or services cooperatively furnished by it.

ticular relationship or capacity which gives rise to the particular rights and obligations under consideration.<sup>14</sup>

Confusion probably results, in part, from the fact that most cooperatives' by-laws<sup>15</sup> include provisions which constitute contracts and thereby create legal relationships which, in other kinds of corporations, usually arise out of other documents which are separate from the by-laws. As in other corporations, the applicable statutes, articles of incorporation, and by-laws of a cooperative constitute what may be termed a "membership contract" between the corporation and its members or shareholders for the government of the corporation.<sup>16</sup> Unlike other corporations, however, a cooperative's by-laws frequently include also a "patronage contract" between the cooperative and its patrons, and many times also include an "investment contract" between the cooperative and investors.

## II. THE "MEMBERSHIP CONTRACT"

The "membership contract" set forth in a cooperative's incorporation papers ordinarily does not differ greatly from those of other corporations with respect to form, subjects, and parties. In both kinds of corporations, that contract is between the corporation and its members or shareholders as such.<sup>17</sup> In both, provision ordinarily is made for the corporate name, purposes, place of business, capital stock or membership capital, board of directors, officers, stockholders' meetings, etc. The respective rights and responsibilities of the corporation and its members or shareholders must be

14. Too many accountants, lawyers and judges too often speak of "members" or "stockholders" when discussing the *patrons'* rights to a patronage payment, and too often refer to patronage margins as "earnings" and to patronage payments as "dividends." Is it any wonder, then, that laymen fail to discern the distinction between (1) patronage margins which a cooperative *owes* to its *patrons* as creditors and (2) earnings or profits which a corporation (either a cooperative or for profit) *owns* and may either retain for itself or pay over to its *stockholders* as owners? If lawyers drafting by-laws for cooperatives say "retain" instead of "pay" in connection with patronage margins and "pay" instead of "repurchase" or "retire" in connection with the repurchase or retirement of shares of stock or revolving fund credits, is it any wonder that judges as well as laymen gain the misimpression that the by-laws do not obligate the cooperative to pay the patronage margins to its patrons unless and until the cooperative repurchases or retires the shares of stock or revolving fund credits in which the stockholder or credit holder invested the proceeds of his patronage payment which was paid to him, as a *patron*, several years earlier?

15. See note 9 *supra*.

16. They also operate as a contract between the state and the corporation and a contract between the shareholders *inter sese*. *Somerville v. St. Louis M. & M. Co.*, 46 Mont. 268, 127 Pac. 464 (1912).

17. *Cf. ibid.*

spelled out from those "membership contract" provisions of the statute, articles, and by-laws.

In almost all corporations for profit and some cooperatives, those "membership contract" provisions constitute the entire by-laws. Subject to the rights of the state, the corporation and its shareholders or members are the only parties affected by them. While the corporation is bound by its articles and by-laws and its creditors were charged at common law and under some corporation statutes with notice of limitations of the corporation's powers,<sup>18</sup> the by-laws of most corporations do not spell out the terms under which they will do business with their customers. Their contracts with their customers, if written, are separate from their by-laws. Nor do the by-laws of most corporations spell out the terms of their bond issues and other investment securities other than capital stock or membership capital. The by-laws of corporations for profit almost invariably are neither a "patronage contract" between the corporation and its customers or patrons nor an "investment contract" between the corporation and investors in its securities other than capital stock or membership capital.

### III. THE "PATRONAGE CONTRACT"

The by-laws of early cooperatives were similar to those of other corporations in that they constituted only a "membership contract" between the cooperative and its stockholders or members. However, the very nature of cooperatives and their purpose to do business at cost<sup>19</sup> for the mutual benefit of their patrons necessarily introduced into their transactions with their patrons a contractual element

---

18. 13 A. J. Corporation § 745. Modern corporation statutes relax the common law rule of constructive notice. *E.g.*, Minn. Stat. § 301.11 (1953). By-laws as such generally bind only the members and officers and persons having or required to take notice of them. 13 A. J. Corporations § 161.

19. If an organization does *not* distribute net margins to patrons in proportion to patronage, it is not a cooperative. Nieman, *Imitation Cooperatives*, American Cooperation 1942-1945 86 (Am. Inst. Coop., Phila., 1945). "The primary object of a cooperative . . . is not returns on invested capital but service at cost." Fetrow, *Three Principles of Agricultural Cooperation* (F.C.A., U. S. Dept. Agr. Cir. E24, 1940). "An agricultural cooperative association . . . operates for the mutual benefit of its members or stockholders, as producers or patrons on a cost basis after allowing for the expenses of operation and maintenance and any other authorized deduction for expansion and necessary reserves." Hulbert, *Legal Phases of Cooperative Associations I* (F.C.A. U. S. Dept. Agr. Bull. 50, 1942). That the cooperative "must be organized in such manner as to legally bind it to operate on a cost or non-profit basis for the benefit of its patrons" has been described as one of "the federal statutory tests of a true cooperative." Jensen, *The Bill of Rights of U. S. Cooperative Agriculture*, 20 Rocky Mt. L. Rev. 193, 194 (1948).

which ordinarily is not involved in profit corporations' transactions with their customers. That new element is the necessity for adjusting to "cost" at the close of the fiscal year or some other period, the cooperative's payments to its patrons for their products and the patrons' payments to the cooperative for supplies or services furnished by it.

In rudimentary cooperative marketing transactions, the cooperative paid nothing to its patrons until after it had sold their products, collected the proceeds of such sales, and deducted its own costs and expenses. In those early, informal, cooperative transactions, there usually was no express, written "patronage contract" either in the by-laws or in any other document. Such a contract nevertheless existed. The parties understood and agreed, impliedly if not expressly, that the cooperative would pay over to the patrons in proportion to their patronage all marketing proceeds in excess of the cooperative's costs and expenses and sometimes a limited dividend on capital.

A variety of developments led to writing out those "patronage contracts." Those early written "patronage contracts" were separate and distinct from the by-laws. They generally were termed, "Marketing Agreements."<sup>20</sup> The mechanical difficulties and expense of periodically "signing up" all patrons, mostly the same ones, all over again and of keeping track of many separate, almost identical, documents, problems of enforcement of marketing contracts, the decline of the concept of "tying up" patrons' production so as to enable the cooperative to influence prices,<sup>21</sup> and the rise of the concept of maintaining an adequate volume of patronage by furnishing satisfactory services and prices led to the decline of separate "Marketing Contracts" and to the substitution of additional, new provisions in the by-laws—the insertion of the "patronage contract" in the by-laws.

Those provisions should set forth the cooperative's obligation to pay and the patrons' right to receive the net margins as well as provisions for the computation of the net margins. Such provisions spell out the terms on which the cooperative transacts business with its patrons and define the rights and obligations of the cooperative

---

20. "Marketing Agreements" are expressly authorized by Minn. Stat. § 22.18 (1953). In other parts of the country, they are still widely used, but generally as a supplement to by-laws. For example, see Hulbert, *op. cit. supra* note 19, at 388; 8 Am. Jur., Legal Forms 650 *et seq.*

21. Fetrow and Elsworth, Agricultural Cooperation in the U. S. 2-3 (F.C.A., U. S. Dept. Agr. Bull. 54, 1947); McKay, *Beginning With Ben Franklin*, Marketing—The Yearbook of Agriculture 1954 248 (Supt. of Documents, Wash., D. C., 1954).



and its patrons as such.<sup>22</sup> Those by-law provisions which we refer to as the "patronage contract," deal with subject matter related to patronage, and they apply to parties who are *patrons*. They are in addition to and different from the by-law provisions which we have referred to as the "membership contract." By-laws which include such patronage provisions are peculiar to cooperatives. Confusion and wrong results will be avoided if it is realized that such by-laws include two different contracts—a "patronage contract" between the cooperative and its *patrons* in addition to the more familiar "membership contract" between a corporation and its *members* or *shareholders*.<sup>23</sup>

To the extent that such "patronage contract" provisions obligate the cooperative to pay all or part of the net margins to its patrons, a patron can compel the cooperative to account to him and to pay him the amount owing to him.<sup>24</sup> Similarly, to the extent above indicated, the net margins are *excludable* from the cooperative's gross income for corporation income tax purposes.<sup>25</sup> Such net margins paid by marketing cooperatives are *includable* in the

---

22. Most cooperatives accept patronage of both member-patrons and *nonmember*-patrons; and most of them distribute net margins to both kinds of patrons on the basis of their patronage. Thus it is "patronage," not "membership," which entitles one to the net margins; and that right is an incident of the "patron" relationship, not the "member" relationship, to the cooperative. Even in cooperatives which distribute net margins only to member-patrons to the exclusion of *nonmember*-patrons, only those members who patronize the cooperative and thereby gain the added status of "patron" are entitled to the net margins. Members who do not patronize the association and, therefore, do not become "patrons," as well as "members," are not entitled to share the net margins. Thus, even in such associations, the right to share the net margins is incidental to the "patron" relationship, not the "member" relationship.

23. In *Grey Bull Corp.*, 27 B. T. A. 853, 858 (1933), the "patronage contract" was a separate document from the by-laws. The court properly recognized that "[t]he individuals were both shareholders in the petitioner as a corporation and contractors with it as an agent, bailee or agister." Where both kinds of a contract are combined in a single document, the difference between the two contracts and the difference between the individual's two relationships to the corporation should not be overlooked. "Contract" is *not* synonymous with either "document" or "instrument" or "writing." A contract is a legally enforceable "agreement"—not a piece of paper. It may be either oral, or written, or partly oral and partly written. If it is in writing, the written evidence of the agreement may consist of either a single writing or of several. Any one document may include either parts or all of either one or several contractual agreements. Thus corporate by-laws may set forth either parts or all of either one or several contracts.

24. *Rhodes v. Little Falls Dairy Company, Inc.*, 230 App. Div. 571, 245 N. Y. Supp. 432 (1930), *aff'd*, 256 N. Y. 559, 117 N. E. 140 (1931). Compare *Hulbert, op. cit. supra*, note 19, at 69.

25. *Home Builders Shipping Ass'n*, 8 B. T. A. 903 (1927); *Farmers Union Cooperative Ass'n*, 13 B. T. A. 969 (1928); *Anamosa Farmers Creamery Co.*, 13 B. T. A. 907 (1928); *Uniform Printing and Supply Co.*, 88 F. 2d 75 (7th Cir. 1937); *Peoples Gin Co., Inc.*, 2 T. C. 325 (1943). Compare *Peoples Gin Co.*, 41 B. T. A. 343 (1940), *aff'd*, 118 F. 2d 72 (5th Cir. 1941).

patron's gross income.<sup>26</sup> In spite of much misdescriptive language,<sup>27</sup> there has been relatively little difficulty in applying those principles in cases where the cooperative paid the net margins in cash and there was no reinvestment of that cash in the cooperative.

#### IV. PAYMENT OF NET MARGINS "IN" STOCK—DISCHARGE OF "PATRONAGE CONTRACT" AND INCEPTION OF "MEMBERSHIP CONTRACT"

Where, however, the "patronage contract" obligated the cooperative to pay the net margins to its patrons and each patron was obligated to invest a like amount of money in the cooperative's capital stock, the cooperative customarily set off its obligation to each patron against that patron's obligation to the cooperative and issued stock to the patron. By issuance of the stock, (1) both parties' obligations under their "patronage contract" were fully performed and thereby discharged, and (2) that "patronage contract" itself was fully executed and thereby discharged, and (3) a new executory contract, the "membership contract," was thereby entered into by the same parties. In terms of legal relationships, the farmer thereby ceased to be a "patron" under one contract and became a "shareholder" under a new and different contract.<sup>28</sup>

The fact that, under the "membership contract" provisions of the corporate articles and by-laws, it is discretionary with the cooperative's Board of Directors as to whether or when the cooperative will repurchase or retire the *shareholder's* shares of stock does *not* establish that, under the "patronage contract," it was discretionary with the cooperative's Board of Directors as to whether or when the cooperative would pay the *patron's* net margins. On the contrary, the cooperative becomes obligated, at the time of the patronage transaction, by the terms of the "patronage contract." That obligation exists before the "membership contract" is subsequently entered into by the issuance of the stock.

That practice of setting off the cooperative's obligation against the patron's obligation and issuing shares of stock has been popularly referred to, "in a shorthand manner of speaking,"<sup>29</sup> as paying

26. See discussion and cases cited in parts VII and VIII *infra*.

27. Repeated references to patrons as "members" even in cases where nonmember-patrons also are equally entitled to the net margins.

28. See note 23 *supra*.

29. "In a shorthand manner of speaking, the cooperative has paid out the net margins by issuing stock. But no one can communicate anything by speaking or writing shorthand unless the person he is addressing under-

the net margins "in" stock. The use of that oversimplified expression obscures the actual transactions and legal theory underlying that practice. It permits the misimpression that a cooperative does not pay the net margins to its *patrons* as required by the "patronage contract" unless and until it repurchases or retires the shares of the stock by payment to its *shareholders* as permitted by the "membership contract."<sup>30</sup>

It is now well settled that if a cooperative under the provisions of its "patronage contract" with its patrons is obligated to pay the net margins to its patrons, then the cooperative receives that income without any claim of right to it but only as an agent or conduit for the payment of it to the patrons and, under such circumstances, the cooperative may exclude the patrons' net margins from its gross income when computing its income tax. That is true without reference to whether such payment is in cash or pursuant to the patrons' authorization "in" stock and regardless of the market value of the stock—properly so, because the agreement of the parties and the factual substance and legal effect of their transaction is that the cooperative has paid the full amount of the net margins to the patrons in cash. That remains true even though the patron reinvested that cash in the capital stock of the cooperative. The patron having thus received a certain amount of cash, he should include that amount as gross income in his individual income tax return.

---

stands shorthand. A great number of patrons and their lawyers, revenue agents and conferees, judges and jurymen do not understand shorthand very well. Consequently, it is a prudent precaution for the by-law draftsman to use English rather than shorthand and to spell out carefully (1) the cooperative's obligation to distribute all or a specified or ascertainable amount of the net margins in cash at a certain time, and (2) the patron's obligation to pay an equal amount of cash for a specified or ascertainable amount of stock at the same time, and (3) the cooperative's authority, upon issuing its stock to the patron, to set off against its indebtedness to the patron his indebtedness to the cooperative." Nieman, *By-Law Provisions for Patronage Distributions*, Cooperative Law—1950, 625 (Am. Inst. of Coop., Wash., D. C., 1950).

30. With that misimpression as its false major premise, the Treasury added the true minor premise that it is discretionary with the cooperative whether and when it will "pay" its stock to its shareholders. The Treasury thereby produced the false conclusion that it is discretionary with the cooperative whether and when it will pay the net margins to its patrons. That unsound syllogism was the basis for the Treasury's contention in the early 1940's that if a cooperative's by-laws permitted it to pay the net margins "in" stock which the cooperative was not obligated to "pay" in cash, the cooperative was not obligated to pay the net margins to its patrons. Therefore, so the Treasury argued, the cooperative was not entitled to exclude the net margins from its gross income when computing its income tax liability. The fallacy of that argument was exposed in *United Cooperatives, Inc.*, 4 T. C. 93 (1944). See note 6 *supra*.

## V. THE "INVESTMENT CONTRACT" °

In a non-stock membership corporation which requires no initiation or membership fee as a condition to membership and which must, on dissolution, pay the net assets to someone other than the members, there is no capital stock or membership capital. In such a corporation, the by-laws<sup>31</sup> constitute a "membership contract," but no investment is involved. On the other hand, the by-laws of a stock corporation and those of a membership corporation which requires an initiation or membership fee which becomes membership capital involve an investment as a part of the "membership contract."

Relatively few corporations, however, are financed only by capital stock or membership fees. Most corporations supplement that capital by borrowing from stockholders, banks, or the public. For stockholder or bank loans, the corporation issues its notes. For a public loan, it issues bonds. In either event, the terms of those loans are not ordinarily included in the by-laws.

Early cooperatives were financed like other corporations, principally by issuing stock and by borrowing from their members and banks. However, the peculiar corporate purposes of a cooperative—to provide services at cost for, and thereby to increase the income of, its patrons—developed the need for a new and different kind of capital.<sup>32</sup> The problems incident to shares having a fixed par or stated value and to shares or memberships constituting permanent capital were met by the creation of a new kind of temporary or

---

31. See note 9 *supra*.

32. "There is a growing realization that the capital of a cooperative, so far as the permanency or impermanency of the shares or other units of the capital is concerned, is essentially different from the capital of other business corporations. Corporate capital ordinarily represents a permanent investment for the purpose of producing a recurring income to the investor. The shareholder does not expect that the capital which he contributed will be returned to him until dissolution. He understands that, prior to dissolution, he can recover the amount of his contribution, more or less, only by selling and transferring his shares to a purchaser which sometimes may be, but ordinarily is not, the corporation. A cooperative's capital, however, more often represents essentially a loan or temporary contribution by its patrons to finance certain economic services for them. The patron-member or patron-shareholder expects that the capital which he contributes will be returned to him prior to dissolution, but not until his own and other patrons' subsequent contributions to capital render his earlier contribution unnecessary to finance the cooperative's facilities and operations. He does not expect to wait until dissolution, and he knows that his shares are not readily salable. He looks to the cooperative to return his capital contributions to him if, and as soon as, it can do so." Nieman, *Revolving Capital in Stock Cooperative Corporations*, 13 *Law & Contemp. Prob.* 393-394 (1948).

See Nieman, *Capital Securities of Agricultural Cooperative Associations*, *American Cooperation—1947* 235 (Am. Inst. Coop., Wash., D. C., 1948).

interim capital which is now quite common, although peculiar to cooperatives—that is, revolving fund capital.<sup>33</sup>

Revolving capital developed over a period of time from various experiments and innovations. Some early attempts to establish revolving capital involved no express written contract—either in the by-laws or in any other document.<sup>34</sup> Again, one should not overlook the fact that such actions, nevertheless, were based on an oral or implied contract.<sup>35</sup>

In time, those unwritten understandings relative to revolving capital were written out by adding to the by-laws provisions for a revolving fund.<sup>36</sup> Thus many cooperatives introduced into their by-laws a third kind of a contract, an “investment contract,” which

---

33. The legality of the revolving plan of financing cooperatives has been judicially recognized. See, Hulbert, *op. cit. supra* note 19, at 278 and cases cited. For discussions of revolving capital generally, see Evans & Stokdyk, *The Law of Agricultural Co-operative Marketing* 173 (1937); Hulbert, *op. cit. supra* note 19, at 276 *et seq.*; Sanders, *Organizing a Farmers' Cooperative* (F.C.A., U. S. Dept. Agr., Cir. C-108, 1939); Hedges, *Organization Structure of Farmers' Elevators* 15 (F.C.A., U. S. Dept. Agr., Cir. C-115, June, 1939); Jensen, *Revolving Capital from Patronage Refunds*, *Cooperative Law—1950*, 586 (Am. Inst. Coop., Wash., D. C., 1950); Miller and Jensen, *Failure of Farmers' Cooperatives*, *Harv. Bus. Rev.* 213, 220 (Winter 1947).

34. Hundreds of Minnesota cooperatives established a “Patrons Equity Reserve” simply by transferring net margins to a new account designated, “Patrons Equity Reserve,” without either any separate written contract, by-law amendment, or even any record in the minute book. Yet none of those transactions nor any of the thousands of subsequent additions to or payments from those “Patrons Equity Reserves” has produced any litigation. The authority for the establishment and operation of those “Patrons Equity Reserves” must be found in the common understanding (implied contract) of the cooperatives and their patrons as evidenced by the widespread and uniform acceptance of such an arrangement.

35. “Those securities, by whatever name they were called, were intended to show that the co-op had received money which—like capital and unlike indebtedness—could be retained by the co-op for so long as it needed the money; but which—like indebtedness and unlike capital—must be repaid sometime prior to dissolution. Those securities later were expressly authorized by statute in some states, but the legislators wisely refrained from attempting to define or spell out exactly what they were authorizing.” Nieman, *Capital Securities of Agricultural Cooperative Associations*, *American Cooperation—1947*, 235, 242 (Am. Inst. Coop., Wash., D. C., 1948).

36. In *Reinert v. California Almond Growers Exchange*, 63 P. 2d 1114, 1119 (1936), the accumulation of certain reserves and the revolving of them prior to 1928 had grown up as an equitable practice without any authorization or requirement of any by-law or any other written contract. However, in 1928, the by-laws were amended to provide the revolving capital plan for the future. See Jensen, *Revolving Capital from Patronage Refunds*, *Cooperative Law—1950*, 586, 590 (Am. Inst. Coop., Wash., D. C., 1950). Numerous Minnesota cooperatives similarly started “Patrons Equity Reserves” or other revolving capital plans and then subsequently reduced that previously implied contract to writing by adopting a by-law. In 1953, the Minnesota Legislature approved the wide use of revolving capital by expressly authorizing cooperatives to pay out the net margins “in cash, credits, revolving fund certificates, or its own or other securities.” Laws 1953, c. 16, § 2. (Emphasis supplied.)

ordinarily is not found in the by-laws of other kinds of corporations. Thus a third kind of a relationship arises out of many cooperatives' by-laws—corporation and investor.<sup>37</sup>

To the three farmers who are, respectively, (a) only a shareholder or member, (b) only a patron, and (c) both a member and a patron, by-laws providing for a revolving fund add parties who may be (d) only an investor, (e) both an investor and a member, (f) both an investor and a patron, or (g) all three—a member and a patron and an investor. Where revolving fund credits are originally issued for cash or property invested by one who is neither a member nor a patron,<sup>38</sup> or where a revolving fund credit was issued as a result of a patron's reinvestment of his share of the net margins but subsequently assigned by him to an assignee<sup>39</sup> who is neither a member nor a patron, the holder of the credit is by hypothesis neither a member nor a patron. Not being a member, he cannot

---

37. Under some by-laws provisions, the cooperative may be so obligated (1) to discharge the revolving fund credits at some definite or ascertainable maturity date, and (2) to pay in the meantime interest on the principal amount of such credits, that they constitute "indebtedness" and the holder of such credits is properly a "creditor." Other by-law provisions are so lacking in those indicia of indebtedness that the revolving fund credits do not properly constitute indebtedness and the holders are not creditors; on the contrary, the credits are equity or ownership capital. (See I. T. 3208, 1938-2 Cum. Bull. 127), but they definitely are not stock or memberships as such. Under both kinds of by-laws, the revolving fund may be designated by any of a wide variety of terms, such as "patrons equity reserve," "capital reserve," "deferred patronage refunds," "patrons' equities," "allocated surplus," "capital credits," etc.; and the certificates issued to evidence an interest in the fund may bear any one of an even more bewildering assortment of titles, such as "revolving fund certificate," "certificate of indebtedness," "certificate of interest," "certificate of ownership," "retain certificate," etc.; and frequently, no formal certificate is issued at all. Consequently, "investment contract" is used in this article to indicate the contractual agreement which gives rise to any of those varied interests, and "investor" is used to designate the holder of such an interest.

38. The by-laws of many Minnesota cooperatives include the following, or similar, provision: "This association may accept contributions to its revolving fund from any persons approved by the Board of Directors." While most revolving fund credits result from patrons' reinvestment of their net margins, that is neither necessarily nor in practice the only source of revolving capital. All or part of the initial capital of several cooperatives has been acquired by contributions of cash or property for which revolving fund credits were issued before the cooperative commenced operating and, therefore, before it had any patrons. Other cooperatives have purchased and wholly or partially paid for facilities and equipment by issuing revolving fund credits to the seller who generally was neither a member nor a patron.

39. Although board approval of the assignee is sometimes required, revolving fund credits usually are transferable. The plaintiff in the *Reimert* case, *supra* note 36, was the assignee of the original holder of the revolving book credits on which her suit for an accounting was based. Where the initial holder dies and his credits are thereby assigned to his personal representative or heirs, the assignee acquires all of the decedent's rights in the revolving capital. But it is a relatively unusual coincidence if the assignee is either a member or a patron.

vote. Not being a patron, he has no right to the net margins. But he does have certain rights as the holder of a revolving fund credit, *vis.*, (1) to receive cash for the retirement of his credit in the course of revolving the fund, (2) to participate in the distribution of the net assets, in order of priority, on dissolution if his credit has not previously been retired, and (3) in many cases, an absolute or conditional right to interest on it so long as his credit remains outstanding. Neither a member nor a patron has any of those rights with respect to the revolving fund. Quite plainly, the relationship between the cooperative and the investors in its revolving fund is distinct and different from either its relationship with its members or its relationship with its patrons. Moreover, the cooperative-investor relationship is based upon and arises out of different transactions and contractual provisions than either the cooperative-member relationship or the cooperative-patron relationship. It is most important to realize that where the same individual is either (1) both a member and investor, or (2) both a patron and an investor, or (3) a member and a patron and an investor, his rights and obligations in each capacity arise out of a different transaction and a different contract and involve a different relationship than his rights and obligations in either of his other capacities.

VI. PAYMENT OF NET MARGINS "IN" REVOLVING FUND CREDITS  
—DISCHARGE OF "PATRONAGE CONTRACT" AND INCEPTION OF  
"INVESTMENT CONTRACT"

Just as some cooperatives pay the net margins "in" stock,<sup>40</sup> so other cooperatives sometimes pay the net margins "in" revolving fund credits.<sup>41</sup> The substance and legal effect of the transactions are the same in both cases. Where a cooperative is obligated by its "patronage contract" to pay the net margins to patrons who are obligated to invest a like amount<sup>42</sup> of money in the revolving fund,

---

40. See part IV *supra*.

41. Still other cooperatives pay the net margins "in" various kinds of non-stock investments other than revolving fund credits. See note 37 *supra*. Regardless of which kind of credit or investment interest is issued, the applicable legal principles are the same. Hence, references to "revolving fund credits" do not imply that any different principles would apply if the cooperative issued capital credits, credits in an allocated reserve or surplus, retain credits, or any other kind of an investment interest.

42. Some by-laws obligate each patron to invest an amount equal to a percentage of his share of the net margins. If a patron is obligated to invest 75%, the cooperative will issue revolving fund credits for 75% and its check for 25%. Such a transaction is popularly summarized by saying that the cooperative "paid the net margins 75% 'in' credits and 25% 'in' cash." Actually, the cooperative pays 100% of the net margin in cash and the patron reinvests 75% as much cash in the revolving fund. See note 29 *supra*.

the cooperative sets off each patron's obligation against its own obligation and issues a revolving fund credit to the patron. When that is done, (1) each party's obligation under their "patronage contract" is fully performed and thereby discharged, and (2) the "patronage contract" itself becomes fully executed and thereby discharged, and (3) an entirely new, executory "investment contract" is then entered into by the same parties.<sup>43</sup> The relationship of cooperative-patron—based upon the patronage from which the net margins were accumulated—is terminated, and the new relationship of cooperative-investor is created.

In the cooperatives' tax cases, it is now clear that a cooperative's right to exclude from its gross income the net margins which it pays to its patrons in performance of a pre-existing obligation is unaffected by the fact that the patrons reinvested their proceeds of such payment in a revolving fund instead of in capital stock.<sup>44</sup> That sound result was obscured for a few years by dictum of the Tax Court in *Fountain City Cooperative Creamery Association v. Commissioner*.<sup>45</sup> However, in the *Colony Farms* case, the Tax Court pointed out that the basis for its decision in *Fountain City* was the absence of any obligation to pay the patrons rather than any differences between preferred stock and revolving fund

---

43. When one indebted on an open account delivers and his creditor accepts the debtor's promissory note in payment of the open account indebtedness, the open account contract is discharged and a new contract is created between the same parties. If the debtor then defaults on the note, the creditor may successfully sue on the note but not on the open account. The "patronage contract" frequently is, among other things, a contract to enter into a contract, the latter contract being the "investment contract." See note 91 *infra*.

44. *Colony Farms Cooperative Dairy, Inc.*, 17 T. C. 688 (1951); *Otsego County Cooperative Association, Inc.*, P-H 1952 TC Mem. Dec. ¶ 52,246 (1952).

45. 9 T. C. 1077 (1947), *aff'd*, 172 F. 2d 666 (7th Cir. 1949). In the *Fountain City* case, the Tax Court observed that the cooperative "has never limited the amount of dividends which it may pay to its stockholders and has therefore never made any provision for any enforceable distribution to its patrons." (p. 1080) There having been no obligation (when the cooperative received the funds in question) to pay them to the patrons, those funds became income to the cooperative as and when it received them. The subsequent voluntary payments to the patrons could not have transformed those funds into non-income receipts even though the payments to the patrons had been made in actual cash. Consequently, the above quoted finding should have ended the case with the same result as finally reached by the court, *i.e.*, the funds in question were income to the cooperative. However, the *Fountain City* net margins were paid by issuing patrons equity reserve credits. That circumstance led the court into an unnecessary and impossible attempt to distinguish the *United Cooperatives* case on the basis of differences between *United's* preferred stock and *Fountain City's* patrons equity reserve credits. Actually, all of those differences were immaterial; the essential distinction being that *United* was *obligated* to pay its patrons, but *Fountain City* was not.



credits.<sup>46</sup> Colony Farms was obligated to pay those of its patrons who also were members all of the net margins which resulted from their patronage, but the member-patrons had consented to the cooperative's retention of that money in a revolving capital fund. The cooperative allocated those net margins to those patrons, invested them in that fund, and issued to those patrons its "Certificates of Interest." The Tax Court held that the cooperative was entitled to exclude those net margins from its gross income.<sup>47</sup> Thus the Tax Court, in the cooperatives' tax cases, has reached sound and consistent results by analyzing the "patronage contract" provisions to ascertain whether or not the cooperative is obligated to pay the net margins to its patrons and if so, by recognizing that the net margins are paid and that contract is performed when the cooperative issues either stock or non-stock credits.

In the patrons' tax cases, there has been no equivalent analysis of the "patronage contract," and the result has been the confusion previously noted.<sup>48</sup> The confusion in such cases can be avoided. If the cooperative is obligated to make the payment, then the substance and legal effect of the transaction is that the patron receives his share of the net margins in cash, and he should include that amount in his gross income without regard to the disposition he makes of that income. It should be immaterial whether he reinvest that income in the cooperative or in any other venture or in none at

---

46. ". . . [I]n Fountain City . . . , the amount of the dividends on its stock was not subject to limitation. Its directors might, in their discretion allocate all of the earnings from member business as dividends upon the stock, and consequently pay no patronage dividends. In view of this condition, the power thus held by the taxpayer's directors, we held that any action on their part in making a distribution of such earnings to the members was purely discretionary and voluntary and not taken under a legal obligation to so act. The cited case has no application here where . . . the directors are definitely obligated by its by-laws. . . . The absence of this condition in Fountain City Cooperative Creamery Ass'n, *supra*, was the reason for the conclusion reached by us in that case." Colony Farms Cooperative Dairy, Inc., 17 T. C. 688, 694 (1951).

47. *Id.* at 693-694: ". . . the funds represented by these certificates of interest are retained by the cooperative with the consent of its members and represent an investment by each of them in the business to the same extent as if the distribution had been made in cash and the amount in each instance had been repaid by the member to the association for its use as working capital.

"That the distributions in the form of certificates of interest affected a distribution of the earnings just as effectively as though made in the form of cash, it is thought, cannot be disputed."

48. See note 8 *supra*. Since this article was written, the Government filed its brief in *Commissioner v. B. A. Carpenter*, on appeal in the Fifth Circuit. For the first time in a patron's tax case, the Government clearly spelled out the legal basis and authorities for excluding the patron's net margins from a cooperative's gross income. Unfortunately, however, there is no explanation of the fundamental economic factors which properly require that the patronage contract be construed as making the net margins the property of the patron rather than of the cooperative.

all. That being so, the market value of the investment in which he reinvests that cash income should be immaterial. It should be equally immaterial whether the patron is on a cash or accrued basis.

If, on the other hand, the cooperative's payment is voluntary, the measure of the income which the patron realizes should depend upon whether the payment is made in (1) cash without the privilege of reinvesting it in the cooperative, or (2) cash with the privilege of reinvesting it in the cooperative, or (3) securities of the cooperative or a third person in which the cooperative invested its cash. In either of the first two kinds of payment, the patron actually receives cash and realizes income to the extent of the cash which he receives and, in the second situation, without regard to the market value of the securities in which he reinvests his cash. If, however, such voluntary payment is made only in credits or securities, then they are all that the patron receives and the fair market value of them when received is the proper measure of the income which he then realizes.

#### VII. PATRON'S TAX CASES—IN THE TREASURY

The confusion which now confounds a lawyer attempting to advise his farmer clients with respect to reporting their net margins and if so, at what valuation, is traceable to the Bureau of Internal Revenue in the first instance. In I.T. 3280, 1938-2 C.B. 127, the Treasury indicated that amounts which a cooperative credits on its books to its patrons are taxable to them without regard to whether or not any certificate is issued. In 1943, the Bureau took the position that if patronage refunds of a marketing cooperative are paid "in" capital stock or certificates of indebtedness, they constitute income to the recipient "to the extent of the cash value of the refunds [and] this is true whether or not the [stock or certificates] have a realizable fair market value. . . ."<sup>49</sup> The Treasury subsequently

49. Letter, dated November 23, 1943, from Deputy Commissioner of Internal Revenue to National Council of Farmer Cooperatives, quoted in John H. Davis, *An Economic Analysis of the Tax Status of Farmer Cooperatives* 85-87 (Am. Inst. Coop., Wash., D. C., 1950). That ruling was interpreted to mean that "patronage refunds are taxable to the recipient (in) the year paid, regardless of the form in which distributed. The reasoning of the Bureau seems to be that since patronage refunds are not taxable to the cooperative they should logically be taxable to the patron recipient in the year in which they were deemed to have been constructively paid and reinvested." *Id.* at 87. It should be noted that that view erroneously assumes that *all* patronage refunds paid by a cooperative may be excluded from its gross income. Actually, only payments made in performance of an obligation to the patrons are excludable by the cooperative. Hence, it is necessary to determine that the cooperative's payment was obligatory, and not voluntary, in order to bring it within the reason for the Treasury's ruling that patrons should include in their returns the face value of the security regardless of its market value.

reiterated that rule at various times.<sup>50</sup> In each case, the Treasury measured the income to the patron by the full par or face value of the stock or non-stock credits issued to the patron, and without regard to whether the cooperative's payment was obligatory or voluntary, whether or not the patron had agreed to accept such stock or credits in lieu of cash, or what the market value of the same may have been. The Treasury apparently was trying to establish a rule which would both be simple in its application and require the maximum amount of tax from the patrons.

After passage of § 314(a) of the *Revenue Act of 1951*<sup>51</sup> amended *Int. Rev. Code*, § 101(12)<sup>52</sup> relative to the taxation of "exempt" cooperatives, the Treasury in 1953 amended Regulations 111.<sup>53</sup> The new regulations, for the first time, included provisions relative to "Tax Treatment as to Patrons."<sup>54</sup> In 1954, the Treasury supplemented the new regulations with Rev. Rul. 54-10.<sup>55</sup> Thus, Reg. 118, § 39.33(a)-23 and Rev. Rul. 54-10 set forth the current position of the Treasury.

It is significant that the Treasury now recognizes the necessity for determining whether the cooperative's payment was obligatory or voluntary. Where the cooperative's payment "is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents" then the measure of the income to the patron is "the face amount of such documents, if the allocation was made *in fulfillment and satisfaction of a valid obligation* of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated." (Italics added.)<sup>56</sup> That meas-

50. ". . . [I]t is held to be immaterial whether refunds are distributed in the form of cash, stock, certificates of indebtedness, or credit notices. All such forms of payment are regarded as the equivalent of cash distributions in the hands of the patrons, the theory being that they are cash payments automatically reinvested under the provisions of the charter, by-laws, or other contracts previously agreed to by the patrons." Bur. Int. Rev. Press Release, No. S-520, 19, Oct. 31, 1947.

"Patronage dividends are considered paid to you when remitted in cash, merchandise, stock certificates, or when credited to your account." Bur. Int. Rev., How to Prepare Your U. S. Income Tax Return 10 (1949).

"Distributions by cooperatives in the form of capital stock, or in any form other than cash, should be included in the gross income of the patrons to the same extent that such distributions would be included if paid in cash." Bur. Int. Rev., Income Tax Information Release No. 2, April 13, 1950.

51. Revenue Act of 1951, § 314(a), 65 Stat. 491 (1951).

52. Now Int. Rev. Code of 1954, §§ 521-522.

53. T. D. 6014, approved May 29, 1953, 1953-1 Cum. Bull. 110.

54. Reg. 111, § 29.22(a)-23; now Reg. 118 § 39.22(a)-23.

55. 1954 Int. Rev. Bull. No. 2 (1954).

56. Reg. 118, § 29.22(a)-23(b)(iii)(A). Cf. Rev. Rul. 54-10, §§ 3.01, 3.02, 3.04.

ure of income in cases of obligatory payments rests on sound analysis.

Where the cooperative's payments to its patrons are in the non-cash document forms above enumerated but are voluntary rather than in performance of a valid obligation, "such documents shall be includable in the income of the patron to the extent of their fair market value at the time of their receipt" but only if the documents are "negotiable instruments."<sup>57</sup> If the documents are not negotiable, then they need not be taken into the patron's gross income when received, but the investor must report income "to the extent of the cash or merchandise received in redemption of such [non-negotiable] instruments . . . at the time of the receipt of such cash or merchandise by the patron."<sup>58</sup> Again, it is necessary to examine the "patronage contract" in order to determine whether the cooperative's payment is voluntary. If it is voluntary but if, in addition, the patron is offered a choice of cash or documents, then the substance and effect of the transaction is a cash payment by the cooperative and a reinvestment by the patron so that the measure of income to the patron properly should be the face value of the documents, the same as in cases of obligatory payments made "in" document form. Where the payment is voluntary and the patron is offered only the documents, the measure of the patron's income properly should be the "fair market value [of the documents] at the time of receipt"—but without regard to whether the documents are negotiable or non-negotiable.<sup>59</sup>

---

57. Reg. 118, § 29.22(a)-23(b) (iii) (C). Cf. Rev. Rul. 54-10, § 3.03.

58. *Ibid.*

59. The Treasury's attempt to differentiate between negotiable and non-negotiable documents voluntarily issued to the patrons appears to be an unnecessary and unjustified complication. If, under the "patronage contract," the cooperative was not obligated to pay the net margins to its patrons and therefore its issuance of a document is voluntary, then the patron receives something which he previously did not have and to which he previously was not entitled. Under such circumstances, the cooperative's voluntary issuance and tender of the document to the patrons is an offer by the cooperative to enter into a new "investment contract." If the patron accepts that offer by accepting and retaining the document, a new "investment contract" is then and thereby entered into and a new relationship of cooperative and investor is then and thereby created. If that new "investment contract" (whether it be stock, promissory note, revolving fund credit, or any other kind of a contract) has any market value at all, the contract then (at the time of receipt) is property of some value and the patron derived it from his patronage of the cooperative. It therefore constitutes "gross income derived from business," Int. Rev. Code 1954, § 61(a)(2), and should be included in the patron's return at the fair market value of his investment interest—without regard to whether the certificate is negotiable or non-negotiable.

Negotiability frequently is one *element* of value. But it certainly is not a valid exclusive test of whether or not a document possesses *any* value. The requirement that investors report as ordinary income the proceeds received on

By its recent regulations and ruling,<sup>60</sup> the Treasury has now indicated its awareness that its earlier rule<sup>61</sup> of taxing patrons on the full face value of any and all non-cash patronage refunds was too simple. That measure of income to the patron is sound where the cooperative's payment is obligatory under the "patronage contract." However, the cooperative's voluntary offer of an "investment contract" is income to the patron who accepts it, but only to the extent of the fair market value of such investment interest when the patron receives it. It is to be hoped that the Treasury will recognize that a cooperative's voluntary alternative offer of cash or securities having a like face value and the patron's acceptance of the securities is, in substance, a payment in cash and a reinvestment of the cash in the securities; in such a case, the measure of the patron's income is the amount of cash or face value of the documents without regard to their market value. Finally, it is to be hoped that the Treasury's arbitrary distinction between negotiable and non-negotiable documents and its attempted avoidance of the statute of limitations<sup>62</sup> will not prevail. Subject to those qualifications, sound principles underlie the Treasury's recognition that "face" value is the proper measure of income to the patron in some cases while "market" value is the proper measure in other cases and the implication that, in every patron's tax case, the terms of the "patronage contract" must first be examined to determine

---

the retirement of *non*-negotiable securities appears to be arbitrary. Revenue agents, farmers, the Treasury, cooperatives, judges, lawyers, and accountants alike were, for many years, more than a little uncertain concerning the circumstances under which a cooperative could exclude its net margins from its gross income or a farmer should include his share of those net margins in his gross income, and at what value when paid "in" something other than cash. During those years, many farmers undoubtedly resolved that uncertainty in the same way that other taxpayers resolve ambiguities concerning their tax liability—by adopting whatever alternative will result in less tax. Undoubtedly, many non-cash patronage refunds were omitted from the recipients' returns in those years. However, the Treasury's tardiness in discerning or enforcing the law applicable to patrons' liability for tax on non-cash patronage refunds is no justification for ignoring sound principles and initiating an arbitrary regulation to accomplish a retroactive effect.

A further "grab" for revenue at the expense of sound principle is the Treasury's recently devised "policy" that "when a patron receives [a non-cash patronage refund] and reports less than the face amount of the . . . document, his basis [upon redemption, sale or other disposition of the document] will be limited to the amount reported in income in the year of receipt thereof and *the excess of the amount reported will represent gross income to the patron in the year of such redemption, sale or other disposition.*" Rev. Rul. 54-10, 4. It may well be questioned whether the Treasury possesses the power thus to effect a repeal or exception to the Congressionally enacted statutes of limitation.

60. See notes 54 and 55 *supra*.

61. See note 50 *supra*.

62. See note 59 *supra*.

whether the cooperative's payment by issuing an "investment contract" was obligatory or voluntary.

#### VIII. PATRONS' TAX CASES—IN THE TAX COURT

A series of patrons' tax cases in the Tax Court constitutes an interesting development, the end of which is not yet in sight. In *Harbor Plywood Corporation*,<sup>63</sup> the first such case, the court held that certain "credit memoranda" issued by a manufacturers' cooperative were income to its accrual basis patron when issued rather than when redeemed. The court noted the "well settled" rule<sup>64</sup> that cooperatives may exclude from their income net margins paid pursuant to a contractual obligation. But the court gave no indication of any analysis of the "patronage contract" to determine whether the cooperative's payment was obligatory or voluntary, and apparently no question was raised concerning the market value of the credit memoranda. The real subject of consideration was the distinction for an accrual basis taxpayer between a *contingency* as to his right to receive income and an *uncertainty* as to the time of receipt. The court assumed that the cooperative could exclude its payments and that if the cooperative may exclude that income, the patron necessarily must include it.

A week later, in *George Bradshaw v. Commissioner*,<sup>65</sup> the Tax Court held that accrual basis patrons of a dealers' wholesale grocery cooperative were required to include in their income, when received and at full face value, certain subordinated, registered notes of the cooperative which were not payable until liquidation although redeemable upon call by the cooperative's board. Again, there was no real analysis of the "patronage contract" or of the theory underlying cooperatives' payments of net margins "in" non-cash investment securities. Rather, the court again decided the case on the ground that,

"There was an uncertainty as to the time when the (patron) would receive the cash, but no contingency as to its

---

63. 14 T. C. 158 (1950), *aff'd*, 187 F. 2d 734 (2d Cir. 1951).

64. "It is now well settled, however, that cooperative associations . . . are not taxable on the income which, pursuant to their articles of incorporation or by-laws or contracts, they are required to return to the stockholders each year as patronage dividends or rebates. (cases cited) This is true whether the amounts are actually paid to the members in cash during the taxable year or merely credited to them on the books of the association. (case cited) The reason for this rule is that the patronage dividends or rebates are at all times the property of the member stockholders, and nonmembers, and that the selling association is an agent, a trustee or mere conduit for the income." *Id.* at 161.

65. 14 T. C. 162 (1950).

right to receive it or as to the amount, such as would have prevented its accrual."

The court added,

"Neither is there any evidence on which we could determine a fair market value of anything less than their face value."

Thus, the first two patrons' tax cases to come before the Tax Court involved patrons who were a building materials manufacturer and retail grocery dealers on an accrual basis. Probably as a result of those circumstances, neither any proper analysis of a cooperative-patron "patronage contract," nor the mandatory obligation and reinvestment theories, nor the series of agricultural cooperative cases in which those sound theories were hammered out over a period of years was presented to the court. Under that analysis of a "patronage contract," it is immaterial whether the patron is on a cash basis or an accrual basis and the market value of the securities involved likewise is immaterial. Without having that analysis adequately reviewed, the court was led off into considering the difference between a contingent right to income and uncertainty as to the time of receipt,—a matter of importance in cases involving accrual basis taxpayers and other kinds of contracts, but of no consequence under a proper analysis of the "patronage contract" between a cooperative and its patrons.

*P. Phillips v. Commissioner*<sup>66</sup> was the first cash basis patron of an agricultural cooperative to come before the Tax Court. Having analyzed the "patronage contract" in the cooperative's case,<sup>67</sup>

---

66. 17 T. C. 1027 (1951).

67. *Dr. P. Phillips Cooperative*, 17 T. C. 1002 (1951). That cooperative (1) cared for groves and (2) marketed. It paid part of the net margins to its patrons in cash, but it retained all net margins from caretaking and part of the net margins from marketing. The sums retained were placed in reserves against which the cooperative issued revolving fund certificates to its patrons. Some of the fruit marketed by it had been purchased by its patrons from other growers. With respect to that fruit, the patrons were dealers rather than growers. Consequently, the association did not qualify as an association of farmers or fruit growers, and its claim of exemption under Int. Rev. Code, § 101(12) was denied. It thus became necessary to determine whether the cooperative, as a non-exempt association, was entitled to exclude the net margins from its gross income. The court found that the association was not obligated to pay to its patrons the proceeds of its marketing activities and properly concluded that, "[s]ince the patrons had no right to those retained amounts and have not received them, they could not be regarded as having contributed them to the petitioner." *Id.* at 1010. However, "the caretaking contracts contained a provision requiring the issuance of revolving fund certificates for any excessive receipts over expenses retained by the petitioner. . . . It issued revolving fund certificates for those amounts and they may be excluded from income." *Id.* at 1011. The significance of the case is that the court analyzed the "patronage contract" and because there was an obligation to distribute the net margins from caretaking, the cooperative was entitled to exclude them from income; but because there was no obligation to distribute the net margins from marketing, the cooperative was not entitled to exclude them from its income.

and having incorporated the findings in that case in the patron's case,<sup>68</sup> Judge Murdock properly observed that:

"The Cooperative was under no obligation either to return the amounts to the members or to issue revolving fund certificates for the amounts it retained as a reserve from marketing operations. They belonged to and were taxable income of the Cooperative. . . . Dr. P. Phillips Cooperative voluntarily issued revolving fund certificates against the amounts retained from marketing operations. Those certificates had no fair market value and did not represent income to the petitioners on that basis. . . .

"The situation with respect to the amounts retained by the Cooperative from its 1946 caretaking activities is different. It has been held in *Dr. P. Phillips Cooperative, supra*, that those amounts never belonged to the Cooperative. It was required by its contracts with its members to issue revolving fund certificates for the funds thus retained. The members agreed in advance that those funds, which continued to belong to them, could be retained by the Cooperative for the special purpose of the reserve."<sup>69</sup>

In the cooperative's case, the court had analyzed the "patronage contracts" and determined that one kind of payment was obligatory and, therefore, excludable by the cooperative but that the other kind of payment was voluntary and, therefore, not excludable. Significantly, the court in the patron's case then recognized that the "patronage contracts" apply to *both* parties. Consequently, the patron was entitled to the obligatory payment and had received and reinvested it in the revolving fund and thereby became liable for tax on the *face* amount of it notwithstanding the fact that, "[t]he certificates had no fair market value at the times they were issued."<sup>70</sup> The patron was *not* entitled to receive the voluntary payment and, therefore, was required to take into income only the market value which was nothing. The case is an example of proper application of the two different measures of income which apply to the two different kinds of payment.

Regrettably, however, different counsel for the Treasury, at almost the same time, presented another patron's case independently of the cooperative's case, in complete disregard of any analysis of the "patronage contract," and with a consequent lack of awareness that different measures of income should apply to different kinds of payments, and on a theory which precluded any measure of income other than the fair market value of the "investment con-

---

68. P. Phillips, 17 T. C. 1027, 1029 (1951).

69. *Ibid.*

70. *Id.* at 1028.



tract." In *Estate of Wallace Caswell v. Commissioner*,<sup>71</sup> the Commissioner did not rely on any theory of actual or constructive receipt and reinvestment of money, but contended, *first*, that the patrons, in payment for their peaches, had received other property (certificates) in addition to cash and, under § 111(b),<sup>72</sup> thereby realized income to the extent of the fair market value of the certificates at the time of issue and, *second*, that the fair market value of the certificates was equal to face value.

As a consequence of that presentation, the Tax Court made no analysis of the "patronage contract," made no determination of whether the cooperative's payment was obligatory or voluntary, and did not consider whether the "investment contract" evidenced by the certificate was anything different from the "patronage contract." It appeared to the Tax Court that the patron had received something—at least a certificate—that he did not previously have. The court determined that the certificate had some value and, in the absence of evidence to the contrary, concluded that the market value was equal to the face value. Thus, without any consideration of principles applicable to patronage refunds paid pursuant to a contractual obligation of the cooperative, the market value measure was applied without even any suggestion that while that measure of income might properly apply to voluntary payments, it can have no proper application to an obligatory payment which the recipient received and reinvested in some kind of an "investment contract."<sup>73</sup> Under § 111(b), fair market value was the only possible measure of income.

In *William A. Joplin v. Commissioner*,<sup>74</sup> the Commissioner re-

---

71. 17 T. C. 1190 (1952), *rev'd*, 211 F. 2d 693 (9th Cir. 1954).

72. Int. Rev. Code, § 111(b): "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

73. In the *Caswell* case, the court recognized that, "In *Dr. P. Phillips Cooperative*, 17 T. C. 1002 . . . we declined to extend the conduit theory . . . where it was not shown that the certificates issued against the reserves were issued 'pursuant to a pre-existing obligation or liability.'" However, the court failed to analyze the *Caswell* "patronage contract" and determine whether the cooperative's payment was obligatory or voluntary. Consequently, the court failed to recognize that if the payments were obligatory, then they had been received and reinvested by the patron and should have been taxed to the patron at their *face* value without regard to their *market* value. The court cited *P. Phillips* to bolster its conclusion that the market value was equal to the face value, but again without any analysis of the "patronage contract" and with no determination of whether the payments were obligatory and reinvested or voluntary. It is unfortunate that the government rested its case on Int. Rev. Code § 111(b) instead of on a proper analysis of the "patronage contract" and the obligatory or voluntary nature of the payments as was done in *P. Phillips*.

74. 17 T. C. 1526 (1952).

lied on both cooperatives' tax cases<sup>75</sup> and patrons' cases<sup>76</sup> and not at all on § 111(b). There was an opportunity for the court to get back to the correct analysis displayed in *P. Phillips*. However, after briefs had been filed, the Tax Court decided *Caswell* and too quickly asserted that "the Caswell case is controlling here." *United* and *Colony Farms* were too summarily dismissed on the ground that they "involved non-exempt cooperatives and not the patrons."<sup>77</sup> *Harbor Plywood* and *Bradshaw* went out the window because they involved accrual basis patrons of non-exempt cooperatives.<sup>78</sup> But the *Caswell* case, which had been submitted on the radically different theory of § 111(b) was considered "controlling." It is regrettable that the court decided *Joplin* on the authority of *Caswell* without even any opportunity for counsel to argue or brief the question of whether *Caswell* could properly apply to the facts and theory of *Joplin*. It is even more regrettable that the court, in *Joplin*, did not even refer to *P. Phillips* where the court held that obligatory payments reinvested by the patron were income to the patron at face value and that voluntary payments in non-cash forms were income to the patron at market value.

If the cooperatives' payments in *Caswell* and *Joplin* were voluntary, the results of those cases which measured the patron's income by the market value of the investment he received could be sound. However, even if the results in those cases were correct, the theory was wrong.

---

75. *United Cooperatives, Inc.*, 4 T. C. 93 (1944); *Colony Farms Cooperative Dairy, Inc.*, 17 T. C. 688 (1951).

76. *Harbor Plywood*, 14 T. C. 158 (1950), *aff'd*, 187 F. 2d 734 (2d Cir. 1951); *George Bradshaw*, 14 T. C. 162 (1950).

77. It is a distinction without a difference to say that *United* and *Colony Farms* involved "cooperatives and not the patrons." Like *Joplin*, those cases involved the nature of a "patronage contract" and the question of which party to it realized the income which resulted from it. In all three cases the issue involved the proper interpretation of that contract. That affects both parties to the contract.

78. The fact that the cooperatives in *United*, *Colony*, *Harbor* and *Bradshaw* were "non-exempt" while the cooperatives involved in *Joplin* and *Caswell* happened to be "exempt" is also a distinction without a difference. A non-exempt cooperative may exclude the net margins from its gross income only to the extent that it is obligated to distribute them to its patrons, and a cooperative cannot qualify for "exemption" unless it must distribute the net margins (in excess of limited dividends on stock) to its patrons on a patronage basis. *Fertile Coop. Dairy Ass'n v. Huston*, 119 F. 2d 274 (8th Cir. 1941). In either case, if the "patronage contract" obligates the association to distribute, it necessarily entitles the patron to receive. Consequently, the "patronage contract" should be examined in all patron's tax cases regardless of whether the cooperative is exempt or non-exempt.

Finally, if the "patronage contract" is properly analyzed, and if it is found that, under the "patronage contract," the cooperative is obligated to distribute the net margins and the patron is obligated to reinvest his share of the net margins in some kind of an "investment contract," then it is immaterial whether the patron is on a cash or an accrual basis.

Only correct theory can, in the long run, produce consistently correct results. That was demonstrated in *B. A. Carpenter v. Commissioner*<sup>79</sup> where the Commissioner correctly argued that the cooperative was obligated to distribute patronage refunds, that the patron had agreed to accept them either in cash or in revolving fund credits, and that when such refunds were paid "in" revolving fund credits, the patron realized cash income which he reinvested in the revolving fund and, therefore, "that the revolving fund certificates should be taxable at their face amount regardless of whether or not they had any fair market value at the time of their issuance." However, the Commissioner complicated that sound argument by adding that, "cooperatives have been permitted to exclude the full amount of such allocated profits from income under conditions such as exist in this case" and he continued, "as a corollary, that he has included in the taxable income of the member the full amount of allocated profits evidenced by certificates in the same year the exclusion is allowed," and he concluded that, "consistency and protection of the revenue support the Bureau contention that such proceeds are properly taxable at full face value."<sup>80</sup> Being unpersuaded by the Commissioner's "consistency" argument, the court too summarily brushed aside *United* and *Colony Farms*.<sup>81</sup> The Commissioner argued for consistency of results. What is needed is consistency of analysis and principles.

If the Tax Court had studied the cooperatives' tax cases instead of brushing them aside, it could have learned *why* cooperatives are *entitled* to exclude patronage refunds under *what* circumstances.<sup>82</sup> However, the court superficially reviewed *Caswell*, *Joplin* and *P. Phillips*, and then concluded that, "the patronage dividends are to be taxed or not taxed depending on whether or not they have a fair market value." Then without analyzing the "patronage contract" before it, the court stated that the patron "never had any real dominion or control over the funds represented by the certificates," and that "we do not see whether or not the cooperative was obligated to issue such certificates adds anything significant." The certificates having no market value, the court decided that the

---

79. 20 T. C. 603 (1953). This case is being appealed to the Circuit Court of Appeals for the Fifth Circuit.

80. *Id.* at 606.

81. "Little would be gained by discussing the cases involving exclusion of patronage dividends by cooperatives. Whatever may be the virtues of consistency, it cannot always be attained. The cooperative and its patrons are different entities and we do not think it necessarily follows that what is excludable from the income of the cooperative, whether the cooperative be taxable or tax exempt, automatically becomes income to the member." *Id.* at 607.

82. See discussion in parts IV and VI *supra*.

patron owed no tax on them. It is understandable that the court saw nothing significant in an obligation to issue "certificates,"<sup>83</sup> but it is to be hoped that upon review of the cooperatives' tax cases and a proper presentation of its own conduit and reinvestment theories, the court would have seen a decisive significance in an obligation to pay over the net margins to the patrons, with or without any certificates.

In *Mary Grace Howey v. Commissioner*,<sup>84</sup> the Tax Court followed *Carpenter* and held that the recipient of certain "retain certificates" was taxable only on the fair market value of the certificates. Again, the court found that the association was not obligated to issue the "certificates" and again failed to analyze the "patronage contract" to determine whether the cooperative was obligated to pay the net margins to its patrons.

However wrong it may be in a case of obligatory payments reinvested by a patron, the Tax Court is now on record that *market* value is the measure of income to the patrons. That is in conflict with the Treasury's position that *face* value is the measure where the payment is made "in" document form pursuant to an obligation to pay out the net margins. That conflict is yet to be resolved. It is hoped that when it is resolved, it will be done with more discriminating analysis than either the Tax Court or the Treasury has shown in the foregoing cases. There is still hope for the ultimate triumph of sound analysis and principles in the fact that the Tax Court has not yet held that a patron's income from patronage payments "in" non-cash form are not taxable at face value, instead of market value, where such payments are made pursuant to a contractual obligation of the cooperative and reinvested by the patron. In the reviewed cases, other than *P. Phillips*, the court did not realize or recognize any reinvestment. The difficulties in the cases decided to date are (1) the court's emphasis on the issuance of "certificates" instead of the "investment contracts" which the certificates merely evidence, (2) the court's tendency to examine the terms of the "certificate" issued instead of the "patronage contract" to determine the reciprocal rights and obligations of the cooperative and its patrons with reference to the payment of net margins, and (3) the court's failure to explain how the cooperatives in the reviewed

---

83. A certificate is only evidence of that which it certifies. Just as the issuance of a stock certificate is not essential to the issuance of a share of stock, so it should not be necessary to issue a certificate in order to issue a revolving fund credit. It is the issuance of the stock or credit which discharge both the cooperative's obligation to pay the net margins and the patron's obligation to invest in the capital stock or revolving fund.

84. P-H 1954 TC Mem. Dec. ¶ 54,125 (1954).

cases could lawfully have diverted the funds in question from its patrons as such to its stockholders or members as such. Consequently, the way is still open for the Tax Court to review its analysis of the "patronage contracts" involved in the cooperatives' tax cases and to apply that sound analysis to similar contracts in future patrons' cases.<sup>85</sup>

#### IX. PATRONS' TAX CASES—IN THE COURTS OF APPEAL

Of the seven patrons' tax cases decided by the Tax Court,<sup>86</sup> only *Estate of Wallace Caswell v. Commissioner*<sup>87</sup> and *Harbor Plywood Corporation*<sup>88</sup> have been reviewed by a court of appeals as this is being written.<sup>89</sup> The single sentence opinion of the Court of Appeals in *Harbor Plywood* demonstrates that it was led off on the same tangent as was the Tax Court. As previously noted,<sup>90</sup> *Caswell* was presented by the Treasury exclusively under Int. Rev. Code § 111(b) and independently of any analysis of the "patronage contract." The Court of Appeals did review the association's by-laws and crop contracts and, with no indication of the nature of its analysis or reasoning, simply announced its conclusion:

"The certificates . . . were mere evidences of their [the patrons'] contingent rights in and to the commercial reserve fund mentioned above—rights which existed prior to 1945 under and by virtue of the Association's by-laws and the crop contracts mentioned above. The certificates did not give [the patrons] any new right or any greater right than they had before the certificates were issued."<sup>91</sup>

One cannot dispute the court's observation that the "certificates" were "mere evidences" only of their rights as investors under their

---

85. While all of the cases to date involved tax years prior to the enactment of the Revenue Act of 1951, it is strange that neither the Treasury nor the Tax Court has taken cognizance of the Congressional intention demonstrated in the Senate debate on that bill:

"Mr. Kerr. And this then means that patronage refunds or rebates, allocated to patrons pursuant to a pre-existing contract between patrons and the cooperative, should not be deemed to be income to the cooperative or be included in computing its net or gross income as has been true for many years past?

"Mr. George. That is a correct interpretation of the language of the bill. There is no intention whatever to treat funds allocated to patrons in any new or different way but to continue to treat them as in the past.

"Mr. Kerr. Mr. President, I thank the distinguished chairman of the committee." 97 Cong. Rec. 11960 (1951).

86. See part VIII *supra*.

87. 17 T. C. 1190 (1952), *rev'd*, 211 F. 2d 693 (9th Cir. 1954).

88. 14 T. C. 158 (1950), *aff'd*, 187 F. 2d 734 (2d Cir. 1951).

89. P. Phillips, 17 T. C. 1027 (1951), and B. A. Carpenter, 20 T. C. 603 (1953), have been appealed.

90. See discussion at note 71 *supra*, *et seq.*

91. *Caswell's Estate v. CIR*, 211 F. 2d 693, 696 (9th Cir. 1954).

"investment contracts" and not of their rights as patrons under their "patronage contract." As patrons they had no "rights in the contingent reserve fund," contingent or vested. As patrons they had a right and an obligation to invest their net margins in the fund and thereby, at that time, acquire an interest in the fund as investors.<sup>92</sup> The fact that the statute, articles, by-laws and crop contract constitute more than one kind of a contract, and the further fact that the taxpayers stand in a different legal relationship to their cooperative as patrons than they do as investors holding a credit in the commercial reserve fund, and the final fact that the "patronage contract" was discharged and the "investment contract" created by the distribution of the net margins were totally overlooked. While the result of the case may or may not be correct insofar as the patron was relieved from the payment of tax,<sup>93</sup> the theory of the case is wrong. It is an excellent example of the need for a clearer understanding of the multiple contract nature of a cooperative's by-laws.

As it stands it may be anticipated that the Court of Appeals opinion in the *Caswell* case will be cited for a third view that the patron has received no income under any measure of income<sup>94</sup> in

92. In many cooperatives, the contributions to the revolving fund and the credits issued against those contributions in each year are separately identified by years, certificates to evidence those credits are issued in annual series, subsequent losses are charged to the credits of designated years, and the retirement of outstanding credits and the cancellation of outstanding certificates as the fund revolves are related to the year of issuance. In other cooperatives, the contributions, credits and certificates, subsequent charges for losses, retirements and cancellations are all identified according to seasons or some period of time other than a year, pools, commodities or departments which produced the net margins which the patrons invested in the fund. Where that is done, on either an annual or other basis, the revolving fund is actually operated as several separate funds. If so, the fund for any particular year or other period or pool would not even exist until the net margins from that year, period or pool are invested in and thereby create such fund. In such case, it would be manifestly inaccurate to construe the "patronage contract" as having given the patron, at the time of his patronage, even a "contingent right" in a fund which then was non-existent. At most, the "patronage contract," at the time of patronage, gives the patron a right to enter into an "investment contract" if and when he invests in the revolving fund the proceeds of his share of the net margins. See note 43 *supra*.

93. Depending on whether, under a proper analysis of the "patronage contract," the cooperative was obligated to pay and the patron to reinvest the net margins which went into the reserve.

94. In an unreported oral opinion on June 30, 1954, in *Moe v. Earle* (Civil No. 7074), the U. S. District Court for the District of Oregon cited *Caswell* for its holding that the plaintiff-patrons realized no income "in the years in which such amounts were deducted from the sums of money payable to the plaintiffs for their fruit, or in the year in which such (revolving fund) certificates were issued to the plaintiffs," but that the cash which the plaintiffs subsequently received upon redemption of those certificates was income to them in the year of redemption. In arriving at that conclusion, the court was "well aware of the fact that this finding does not agree with the contentions

cases where the Tax Court would take the second view that market value is the proper measure of income to the patron and where the Treasury would insist upon the first view that face value is the correct measure of the patron's income.

#### X. CONCLUSIONS

The Treasury, the Tax Court, and the Court of Appeals of the Ninth Circuit have taken three different positions in the patrons' income tax cases. Because some of the language in the "patronage contracts" involved in some of those cases is similar to some language of numerous other cooperatives' "patronage contracts," it may be anticipated that those patrons' tax cases will be cited as authority for an erroneous construction of the latter contracts in future cooperatives' tax cases. If so, the confusion and error recently generated in the patrons' cases may be transferred to the cooperatives' cases. It also may be anticipated that the conflicting views in the patrons' tax cases may create similar confusion in future litigation between cooperatives and patrons over the meaning of their "patronage contracts."

That confusion can be avoided in the cooperatives' tax cases and in the cooperative-patron cases in either of the two ways that it still can be eliminated from the patrons' tax cases. One way is for lawyers, both in and out of the Treasury, and judges to develop an awareness of the multiple contracts and the multiple relationships involved in cooperatives' by-laws and related documents, and then to differentiate the "patronage contract" between the cooperative and its patrons from both the "membership contract" between

of either the plaintiffs or the defendant in this case." The plaintiff-patrons had contended that the statute of limitations commenced to run when they received the certificates but omitted from their income tax return the net margins which they then reinvested in the revolving fund and that the statute had expired before the certificates were redeemed; the defendant-Collector of Internal Revenue had contended that when a patron reports less than the face amount of his certificate, his basis in the year of redemption will be the amount reported when he received the certificate and the excess received on redemption will be income in the year of redemption. See Rev. Rul. 54-10, 4 and note 59, *supra*. In *Moe v. Earle*, the court also relied on *Farmers-Grain Dealers Association of Iowa v. U. S.*, 116 F. Supp. 685 (S.D. Ia. 1953) in which the plaintiff-patron was held not taxable on credits in a "Contingency Reserve" established by another cooperative which plaintiff patronized. Although the opinion refers to the patron's inability to obtain cash for its credits, examination of the cooperative's articles and by-laws and its directors' resolution creating the reserves indicates that it was not obligated to pay to its patrons the money which was transferred to the reserve so that its issuance of credits must have been voluntary and there was nothing to indicate that they had any market value. Thus, the result is sound, but the court in the *Moe* case cited the *Grain Dealers* case for holding that the cooperative paid nothing on its "patronage contract" until it redeemed its "investment contract."

the cooperative and its members or stockholders and the "investment contract" between the cooperative and the investors in its revolving fund or other kinds of capital, and then to analyze properly the "patronage contract," not the "investment contract" evidenced by the certificates, and determine whether the "patronage contract" obligates the cooperative to pay the net margins to its patrons or whether such payments, regardless of form, are merely voluntary.

Where the "patronage contract" precludes the cooperative from ultimately diverting the net margins to its stockholders or members as such, it would seem that it obligates the cooperative to pay them to its patrons.<sup>95</sup> In such cases, the patron's authorization to the cooperative to invest his net margins in capital stock or some other kind of capital for him and to issue to him shares of stock or interests in the non-stock capital in performance of its obligation to pay him his net margins is, in substance and effect, a reinvestment

95. United Cooperatives, Inc., 4 T. C. 93, 108 (1944) :

"We conclude that petitioner's patrons were entitled by reason of its by-laws to that part of the so-called patronage dividends distributed to them which was in excess of eight per cent of the par value of petitioner's common stock outstanding, and to that extent these patronage dividends were properly excluded from the taxable income of petitioner. However, that part of these patronage dividends which could have been distributed in the discretion of petitioner's board of directors as dividends upon petitioner's common stock must be considered as the property of petitioner and taxable to it as its income."

California Pine Box Distributing Company, P-H 1943 TC Mem. Dec. ¶ 43,365 (1943) :

"There was no means under the petitioner's articles of incorporation or by-laws or its operating contract by which additions to reserves could ever become its earnings. Petitioner had no right to accumulated earned surplus and was not authorized to make any dividend distribution to its members."

Grey Bull Corp., 27 B. T. A. 853, 858 (1933) :

"The individuals were both shareholders in the petitioner as a corporation and contractors with it as an agent, bailee or agister. Before the corporation could find income to itself and thus indirectly to its shareholders, it was obligated to fulfill its contractual duties."

Compare, Fountain City Cooperative Creamery Ass'n, 9 T. C. 1077, 1080 (1947) :

Taxpayer "has never limited the amount of dividends which it may pay to its stockholders and therefore has never made any provision for any enforceable distribution to its patrons."

In addition to limiting dividends on stock, cooperative by-laws also frequently limit stockholders' rights on dissolution. Lawyers drafting by-laws for cooperatives would do well to use plain English. They should avoid words like "retain" which, to many people, connote a negation of an obligation to pay and use enough words to spell out plainly (1) the cooperative's obligation to pay to the patrons in cash all or an ascertainable part of the net margins, and (2) the patron's obligation to invest a like amount or some different but ascertainable amount of cash in some definite or ascertainable kind of equity or loan capital, and (3) the application of the elementary principle of set-off to the complete or partial performance of those two obligations. See note 29 *supra*.



for and by the patron. His income from such a transaction should be measured by the *face* value of his investment interest.

On the other hand, if the cooperative is free to pay the net margins to its members or stockholders, but if it nevertheless does pay them to its patrons in a non-cash "investment contract" which the patron was not previously entitled to receive or obligated to accept, then the cooperative's payment is voluntary. The measure of the patron's income should be the *market* value of his investment interest without regard to the negotiable or non-negotiable character of the piece of paper issued as convenient evidence of that interest.

In any event, it will be necessary to ascertain and analyze the "patronage contract" in each case. Sound results will not consistently flow either (1) from a too simple rule that the patron's income should be measured in all cases by the *face* value of the "investment contract" he receives, or (2) from an equally too simple rule that the patron's income must always be measured by the *market* value of the "investment contract" issued to him, or (3) from the misconception that he has an interest in a capital fund before he invests anything in it.

If the confusion in the patrons' tax cases is not eliminated by accurate analysis of contracts and application of sound principles, it will be eliminated by legislation. It won't last forever. In the meantime, lawyers will find it impossible to advise their patron-clients reliably, and taxpayers will be put to the expense of litigating or negotiating settlements of disputes which never should have arisen.