1963

Taxation of Cooperatives: A Problem Solved

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Courts have long struggled with problems concerning the nature of cooperatives. Confusion has resulted because a cooperatives possesses attributes not only of a corporation and a joint stock association, but also of a partnership, of a joint venture, of a charitable organization, and even of a social club. It is not surprising, therefore, that cooperatives have received special treatment in the tax code. Congress has recently enacted new provisions governing the taxation of cooperatives, and the purpose of this Article is to analyze the new legislation and to predict the consequences of it. After a brief historical introduction, the authors summarize each of the new sections, analyze the problems cooperatives will have in complying with them, and discuss their constitutionality. They conclude that the new provisions are constitutional, and that although there will be some confusion in administering the new law, the amount of actual litigation will be slight.

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The taxation of cooperatives and their patrons is not the first tax field in which the Congress has been thwarted by the courts. But as in others,[1] it has struck back. The purpose of this Article is

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1. An example is the historic controversy between the United States Supreme Court and the Congress over the meaning of the estate tax provisions including in the gross estate property of which the decedent made a transfer intended to take effect in possession or enjoyment at or after his death. In May v. Heiner, 281 U.S. 238 (1930), the Court held that the statute did not embrace a transfer in trust in which the transferor retained a life estate. There was substantial outcry, and the Court was given a chance to reconsider in three new cases, in two of which the circuit courts of appeals had come to an opposite conclusion. On March 21, 1931, four days after hearing argument, the Court announced its decision per curiam on the authority of *May v. Heiner*. Burnet v. Northern Trust Co., 283 U.S. 782 (1931); Morsman v. Burnet, 283 U.S. 783 (1931); McCormick v. Burnet, 283 U.S. 784 (1931). The *next day* both houses of Congress passed

to examine the new legislation designed to cure the Congress' frustration in the field of taxation of cooperatives and to predict the tax consequences to the thousands of cooperatives throughout the nation.

I. HISTORICAL BACKGROUND

Numerous reviews are available of the body of rulings and case law that created the situation faced by the Congress in 1951.[2] They indicate that the Treasury and the courts had mapped out two basic principles. First, a cooperative (or any other corporation) that distributed its net "savings" to its patrons in proportion to their patronage and pursuant to an obligation to do so existing at the time the patronage occurred was "exempt" and, thus, entitled to exclude those net savings from its gross income and, thereby, from its net income.[3] The reasoning was that the cooperative had not realized income because the amounts involved belonged to the partons from the beginning.[4] Second, the patron had realized the income that the cooperative had harvested for him, and he was taxable upon it.[5]

These principles were not without their attackers, both in and out of Congress.[6] They contended that while the rationale sounded

the famous Joint Resolution of March 3, 1931, amending the statute to include specifically transfers in which the transferor had retained a life estate. See 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION § 7.14 (1942).

2. *E.g.*, Nieman, *Multiple Contractual Aspects of Cooperatives' By-Laws*, 39 MINN. L. REV. 135 (1955); Paul, *The Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes*, 29 MINN. L. REV. 343 (1945); Rumble, *Cooperatives and Income Taxes*, 13 LAW & CONTEMP. PROB. 534 (1948); Sowards, *Should Co-ops Pay Federal Income Taxes?*, 19 TENN. L. REV. 908 (1947). See generally PACKEL, COOPERATIVES (3d ed. 1956) and the authorities cited therein.

3. G.C.M. 17895, 1937–1 CUM. BULL. 56; I.T. 3208, 1938–2 CUM. BULL. 127.

4. Various theories or analogies were advanced. The cooperative was sometimes characterized as an agent or trustee, *e.g.*, San Joaquin Valley Poultry Producers' Ass'n v. Commissioner, 136 F.2d 382, 385 (9th Cir. 1943); a conduit, United Coops., 4 T.C. 93, 105 (1944); or a large partnership of which all patrons were members, *Hearings Before the House Committee on Ways and Means on Proposed Revisions of the Internal Revenue Code*, 80th Cong., 1st Sess., pt. 4, at 1887 (1948). The result of these theories was that the patron realized the income rather than the cooperative. Uniform Printing & Supply Co. v. Commissioner, 88 F.2d 75 (7th Cir. 1937); Midland Co-op. Wholesale v. Commissioner, 44 B.T.A. 824 (1941).

5. San Joaquin Valley Poultry Producers' Ass'n v. Commissioner, 136 F.2d 382 (9th Cir. 1943); Uniform Printing & Supply Co. v. Commissioner, 88 F.2d 75, 76 (7th Cir. 1937) (dictum); P. Phillips, 17 T.C. 1027 (1951).

6. See generally *Hearings Before the House Committee on Ways and*

plausible, the facts stated were fictitious, for the earnings belonged to the cooperatives for all practical purposes.[7] They urged that cooperatives were being given an unfair advantage by the decisions, enabling them to finance expansion more easily than their competitors.[8] The issue was clouded by related "favoritisms" such as deductibility of dividends paid by exempt cooperatives on their capital stock.[9]

Congress dealt with the controversy in 1951, adopting what became sections 521 and 522 of the Internal Revenue Code of 1954.[10] Unfortunately, the new law assumed, and all concerned

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Means on Proposed Revisions of the Internal Revenue Code, 80th Cong., 1st Sess., pt. 4 *passim* (1948); Magill & Merrill, *The Taxable Income of Cooperatives*, 49 MICH. L. REV. 167 (1950).

7.

> The so-called net margins of cooperative corporations constitute in reality the net income of such corporations; and the members of the corporation have, for tax purposes, the same status as the stockholders of a business corporation. The net margin is quite as much the net profit of the cooperative as the exactly similar net margin or operating income of the stock corporation buying or selling goods next door.

Magill & Merrill, *supra* note 6, at 182.

> Patronage refunds of a cooperative, however, are not on this individualized basis. Instead they represent the net result of the pooling of both profits and losses on many individual transactions, and are profits made possible only by the pooled business operations.
>
> A cooperative may have lost money on individual business done with John Jones but, nevertheless, John Jones participates as a business owner in the overall profits earned in the business operations of the cooperative. The business as a whole, through its facilities for pooling many individual transactions in a way that resulted in earnings, was responsible for earning the profit.

National Tax Equality Ass'n, Legal Tax Avoidance Threatens Private Enterprise 18 (1945).

The position of the National Tax Equality Association is basically the same today as shown by the following statement of its president in May, 1961: "The excess of [a cooperative corporation's] receipts over its costs constitutes its income just like that of any ordinary corporation." *Hearings Before the House Committee on Ways and Means on the President's 1961 Tax Recommendations*, 87th Cong., 1st Sess., pt. 3, at 3103–04 (1961).

8. The National Tax Equality Association made the following charge:

> N.T.E.A.'s Research Department has projected the hypothetical case of two companies, each capitalized at one million dollars, each doing business at a profit, one as a tax-paying corporation and the other as a tax-exempt cooperative. Figures show that the cooperative is able to grow at a rate just ten times faster than that possible to the tax-paying corporation.

National Tax Equality Ass'n, *op. cit. supra* note 7, at 9.

9. See generally the exclusions contained in Int. Rev. Code of 1939, ch. 1, § 101(12), 53 Stat. 33.

10. See S. REP. NO. 781, 82d Cong., 1st Sess. 21 (1951). Unfortunately, the new legislation was put into the Code entirely in the framework of the provisions dealing with the exempt cooperatives. Section 521 contained a slight elaboration of the old rules for exemption as they had ex-

thought at the time, that what the cooperative distributed to the patron and then excluded from the cooperative's income was ipso facto taxable income to the patron.[11] This proved not to be so. Patrons began to contest the taxability of the "income" to them, and the courts began to agree with them;[12] the deluge came when the Treasury finally agreed to follow the court decisions.[13] The

isted in § 101(12) of the Internal Revenue Code of 1939. Section 522 codified as to exempt cooperatives the existing rules permitting the deduction of dividends paid and amounts allocated to patrons from income not derived from patronage. It went on to provide that "patronage dividends . . . shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt . . . ." To the initiated, this meant that the exempt cooperative could exclude patronage refunds in the same way that the non-exempt one could, but one had to be conversant with the existing practice of the Internal Revenue Service and its rulings to understand that. See Farmers Co-op. v. Commissioner, 288 F.2d 315, 319, 321–324 (8th Cir. 1961).

11. See Rev. Rul. 54–10, 1954–1 CUM. BULL. 24; see Farmers Co-op. v. Commissioner, 288 F.2d 315, 323 (8th Cir. 1961).

12. Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726 (4th Cir. 1957); Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955); Moe v. Earle, 226 F.2d 583 (9th Cir. 1955); Caswell's Estate v. Commissioner, 211 F.2d 693 (9th Cir. 1954). In the *Long Poultry Farms* case, after noting that a credit granted to a taxpayer was not salable and had no market value nor value as collateral for a loan, the court stated: "On these facts, as to which there is no dispute, we think it clear that taxpayer did not receive income as the result of the credit allotted, nor did it become entitled to receive anything which could be properly accrued as income." 249 F.2d at 728. In *Carpenter,* the Commissioner insisted that certificates that had no market value should be taxed at face value to the patron at the time of issuance upon the theory that the cooperative was under obligation to distribute patronage dividends either in cash or in certificates, and that respondent assented to the arrangement by becoming a patron and therefore should be treated as if he had actually received cash in the amount evidenced by the certificate and reinvested the cash in the cooperative at the time of the issuance. The court stated:

> It is abundantly clear that the taxpayer's receipt of revolving fund certificates was not the equivalent of the actual receipt of cash, because the certificates had no fair market value. Furthermore, it is obvious that the funds withheld by the cooperative were not subject to the demand of the respondent. The respondent could control neither the amount of the funds that he would ultimately receive nor the time at which he might receive them . . . . Therefore, the respondent never actually or constructively received or had any right to receive anything but the certificates.

219 F.2d at 636.

13. T.D. 6428, 1959–2 CUM. BULL. 26; T.D. 6429, *id.* at 452. To implement this, the Treasury in its annual *Farmers Tax Guide* began advising the farmer that if he received patronage dividends

> in document form, such as certificates of indebtedness, revolving fund certificates or stock certificates, which have no fair market value over which you have no control as to the amount or time of their redemption in cash or other property, they are not included in your income until they become subject to payment on your demand—regardless of your accounting period.

result was that *someone* was receiving income, but *no one* was paying tax on it. For four sessions of Congress, not only the critics of cooperatives but also some of the cooperatives themselves advocated a tax. They differed, however, on who should be taxed; the critics urged that cooperatives be taxed just like ordinary business corporations without regard to patronage refunds, while the cooperatives urged that they be permitted to exclude their patronage distribution as before, but that the patrons be taxed on them as had been intended in 1951. In the Revenue Act of 1962, Congress adopted the cooperatives' point of view with some elaborate congressional frills.[14]

II. THE NEW PROVISIONS

The basic objective of Congress could have been achieved by a simple enactment that net income of a cooperative distributed to its patrons in any of various forms constituted taxable income to the patrons. But pressures on Congress and the ideas of the members of the congressional committees were many and varied, resulting in a different approach.

There were two guiding principles. One was that distributions by cooperatives could be either "qualified" or "non-qualified." If they were qualified, they were taxable income to the patron and deductible from the gross income of the cooperative; if they were non-qualified, the patron received no income and the cooperative had no deduction. For a patronage dividend to be qualified, a portion of the entire distribution had to be paid to the patron in cash. In the mind of the Senate Finance Committee, the cash portion would give the patron funds with which to pay his income tax on the entire distribution.[15] The concept evolved because of an earlier proposal to require withholding on all corporate dividends, whether they were dividends paid by conventional corporations to their stockholders or patronage dividends distributed by cooperatives to their patrons.[16] When the withholding proposal was abandoned in the face of strong opposition,[17] the requirement of infor-

The average farmer promptly took the position that patronage refunds he receives had no market value and did not report any income from patronage dividends. In some cases where the farmer included patronage dividends in his income the Revenue Service advised him that he had made a mistake and adjusted his tax downward.

14. Revenue Act of 1962, 26 U.S.C.A. §§ 1381–88 (Supp. 1962).

15. S. REP. NO. 1881, 87th Cong., 2d Sess. 112 (1962).

16. *Id.* at 118.

17. See, *e.g.*, statement of Senator Byrd, Chairman of the Senate Finance Committee, on the floor of the Senate on May 21, 1962, reproduced in Part 10 of the Report of Hearings of the Senate Finance Committee on H. R. 10650, at 4400.

mation returns by the paying corporations was substituted.[18] At that time, the Committee insisted that the distributing cooperative pay 20 percent or more of the distribution to the patron in cash.[19] Presumably, this was related to the lowest personal income tax bracket of 20 percent although everyone concerned recognized that a given patron of the cooperative may pay no income tax or may be in the upper income brackets.

The other principle was that there must be a voluntary consent by the patron to include the patronage distribution in his income. The provisions surrounding this principle became most elaborate. If the patron agreed that the distribution was taxable income to him, then obviously he could not complain that Congress was taxing him on a mere paper distribution. Then, and only then, the cooperative was permitted a deduction. This complication was further elaborated by the provision for three permissible kinds of consents: a written consent by the patron that the patronage distribution he was about to receive or had received would be taxable income to him;[20] an appropriate endorsement of the patron's check for the portion of the patronage refund that he received in cash; and "by-law consent" by which the cooperative gained the consent of the patron by a specific provision in the by-laws to that effect. The by-law consent was carefully hedged about with provisions aimed at protecting the patron from being taxed on income represented by distributions of patronage dividends without advance notice. It required that the cooperative adopt a by-law consent provision *after* the date of the enactment of the Revenue Act of 1962; that the patron receive a copy of such by-law and "a written notification" explaining its significance; and that after those events had transpired, either an existing patron must *retain* his membership or a new patron *obtain* his membership. The Senate Finance Committee obligingly included in its report language of a by-law provision that it considered proper for a "by-law consent."[21] The

18. S. REP. NO. 1881, 87th Cong., 2d Sess. 120, 324 (1962).

19. *Id.* at 114, 317.

20. As the bill first appeared, the cooperative would have been required to obtain a new written consent from each patron *each year.* See STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 87TH CONG. 1ST. SESS. COMMITTEE DISCUSSION DRAFT OF REVENUE BILL OF 1961, at 73 (Comm. Print 1961) (for the House Committee on Ways and Means). This bill was soon modified, however, to permit the written consent to stand until revoked by the patron.

21.

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this by-law who continues as a member after such date shall, by such act alone, consent that the amount of any dis-

Committee also pointed out that the purpose of notification was not merely to quote the language of the by-law consent, but to "inform the patron . . . of its significance,"[22] and that notification must be given to each patron separately and not merely by publication in a newspaper or by posting at the cooperative's headquarters.

The provisions in the Internal Revenue Code designed to carry out these basic principles added to the brief existing provisions dealing with cooperatives some necessarily intricate language.[23] Untangled and summarized, they are basically as follows.

Section 1381. The new provisions apply both to exempt cooperatives and to non-exempt cooperatives, but a separate provision gives special consideration to the exempt cooperative. The new provisions do not apply to mutual savings banks, insurance companies, or rural electric and telephone cooperatives.

Section 1382(a)–(b). In general, taxable income of a cooperative shall be reduced[24] by the amount of patronage distributions that are paid in cash or property or that meet the test for qualified written allocations. In addition, taxable income shall be reduced by the amount paid in money or property to redeem previously issued written allocations that at the time did *not* qualify.[25]

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tributions with respect to his patronage occurring after ————, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

S. Rep. No. 1881, 87th Cong., 2d Sess. 318 (1962).

22. *Id.* at 382.

23. Section 17 of the Revenue Act of 1962, which adds Subchapter T, §§ 1381–88, to the Code, is approximately 3,000 words long. There are another 3,000 words devoted to the reporting requirements and clerical amendments, §§ 6042–44.

24. The drafters partially side-stepped the problem of whether to refer to the reduction of gross income as an "exclusion" from gross income, as has often been considered most theoretically correct, see Farmers Co-op. v. Birmingham, 86 F. Supp. 201, 217 (N.D. Iowa 1949), or as a "deduction." Section 1382(b) says that in determining taxable income "there shall not be taken into account" the patronage distributions. But its closing sentence spoils that evasion of the issue by adding: "For purposes of this title, any amount *not taken into account* under the preceding sentence shall be treated in the same manner as an item of gross income and as a *deduction* therefrom." (Emphasis added.)

25. This means written distributions that at the time of issuance did not qualify, but were issued with respect to earnings of years beginning January 1, 1963, or later. Treas. Reg. § 1.1382–3(d) (1963). This interpretation is based on the provision of § 17(c) of the Revenue Act of 1962, which provides that in case of money paid after January 1, 1963, or after the first day of a taxable year beginning in 1963, "with respect to patronage occurring before such first day, the tax treatment . . . shall

Section 1382(c). In addition to the deduction for patronage distributions, an "exempt" cooperative shall also be entitled to deduct amounts paid as dividends on its stock and as patronage refunds on earnings resulting from other business than that done with its regular patrons. This subsection carries forward, with improvement in language, the provisions formerly contained in section 522. Section 521, which defines "exempt" cooperatives, was left intact except for clerical amendment.

Section 1383. This section sets up special rules for computing the tax when previously issued non-qualifying allocations are redeemed.

Section 1385. Any patronage distribution that "qualifies" for deduction by the cooperative *is taxable income to the patron* unless it is an adjustment to basis of property (as would be the case with capital items) or is attributable to "personal, living, or family items." The same rule applies to cash or property received in redemption (or on sale or other disposition) of a previously issued non-qualified allocation.

Section 1388. This section contains definitions, including that of "qualified" distributions and, therefore, the sticky provisions relating to the "consent" of the patron. A "qualified" allocation is one that is paid 20 percent or more in money[26] and the balance either by a written notice that may be redeemed in cash at its face amount within 90 days or by a written notice that the patron has *consented* to take into account at its face value. The patron may consent in any one of the following ways: (1) by consenting

be made under the Internal Revenue Code of 1954 without regard to Subchapter T . . . ." See the note following 26 U.S.C.A. § 1381 (Supp. 1962). The Senate Finance Committee Report also made it clear that this was the intended result. S. REP. NO. 1881, 87th Cong., 2d Sess. 117 (1962).

26. The statute actually says 20% or more must be paid in money "or by qualified check." This is an interesting quirk, implying that the qualified check is not money. Undoubtedly it was inserted out of caution to avoid any assertion by the Treasury that a qualified check for 20%, endorsed and cashed, did not render the patronage distribution a "qualified" distribution. But it has caused a question to be raised as to whether, if a patron is already bound by a by-law consent, the "qualified" check sent him is a sufficient payment of the 20%. Many cooperatives apparently plan to send the "qualified" check to all patrons in spite of some of them being bound by by-law consent since it is difficult to pick out the nonmember patrons. The check is probably no longer a "qualified" check if it is received by a member who is covered by a by-law consent, the "statement imprinted thereon" being disregarded; it is then "money" for the purpose of this statute although it is true that a check does not under all circumstances constitute "money." Updike v. People, 92 Colo. 125, 18 P.2d 472 (1933); State v. Griswold, 73 Conn. 95, 46 Atl. 829 (1900); Bates v. Farmers & Merchants Sav. Bank, 219 Iowa 78, 257 N.W. 578 (1934). Compare Deones v. Zeches, 212 Minn. 260, 263, 3 N.W.2d 433 (1942).

in writing; (2) by obtaining or retaining membership in the cooperative after it has adopted a consent by-law, which must have been adopted after the passage of the 1962 Revenue Act, and after receiving written notification and a copy of the by-law; or (3) by endorsing and cashing a "qualified check" within a prescribed period. The qualified check is defined as a check or other instrument redeemable in money paid as part of a patronage distribution "on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to include" in his income the amount of the entire patronage distribution of which the check is a part. The prescribed period for cashing the check is 90 days from the close of the "payment period" of the cooperative, and the "payment period" is the period within which the cooperative must make the patronage distribution.[27] The cooperative may, however, limit the period within which the check will be honored to less than 90 days.[28]

The preceding summary omits a number of special and detailed provisions and outlines only the basic items of a complex new subchapter of the Internal Revenue Code. Congress, in attempting to tax income previously untaxed, has created a maze that requires careful parsing of language and much cross-reference. In addition, once the provisions are understood, the individual cooperative must step cautiously to avoid pitfalls. The regulation writers have worked carefully, but their product is necessarily wordy and sometimes difficult to follow. Such situations have been criticized before.[29] Both the congressional committees and the technicians do seem to be creating unduly elaborate structures to please all who have had a hand in the work. There were only two concepts to be enunciated—that part of the patronage distribution must be in cash, and that the patron must consent to include it in his income. The law became tangled in trying to specify in precise terms and with precise limitations several different ways of giving consent. One may wonder whether complexity was avoidable and whether the elaborate provisions will work.

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27. The payment period is defined in § 1382(d) as running from the first day of the taxable year to eight and one-half months after the close of such year.

28. Treas. Reg. § 1–1388.1(c)(3)(iii)(a) (1963).

29. See, *e.g.*, Robertson, *Speaking Out: Change Those Unfair Tax Laws*, Saturday Evening Post, March 17, 1962, p. 10; Wormser, *Is It Time To Write a Whole New Income Tax Law?*, U.S. News, March 18, 1963, p. 60.

III. PROBLEMS OF COMPLIANCE

Cooperatives all over the country have feverishly begun to comply with the new requirements. Hardest pressed were those operating on a calendar-year basis that desired to use the "by-law consent" method; they had to amend their by-laws and notify their members before the end of 1962 if the consent was to be effective as to patronage for the entire year 1963.[30] Regulations had not been adopted, and in fact were not even proposed, until too late in 1962 to be of any assistance[31] since the cooperatives generally had to amend their by-laws by formal action of the membership.

Some of the questions that obviously will not be settled until a substantial period has elapsed can be anticipated now. Difficulties can arise if members have not been notified of a consent by-law until after the beginning of the cooperative's fiscal year. Some cooperatives may be able to show that the period prior to the giving of notice was actually a period of loss operations. They may, therefore, argue that since all of the amount distributed was earned after the giving of notice, it is entitled to full deduction. The Treasury would probably point out that patronage refunds are based upon total patronage; if a member dealt with the cooperative only during the period before giving of notice, even if it was a "loss" period, he would still be given a patronage refund (which is true under most cooperatives' by-laws and practices). Therefore, the Treasury may take the position that regardless of losses, if notice was not given until one month of the year had gone by, one-twelfth of the amount distributed will be treated as "non-qualified" and disallowed as a deduction.

The cooperatives are unhappy about a provision of the regulations that prohibits them from treating a reduction of the debt of a patron to his cooperative as part of the required 20 percent cash payment.[32] It is understandably galling to a cooperative to have to send a check for hard cash to a patron who has been a consistent collection problem to the cooperative and who owes

30. Treas. Reg. § 1.1388-1(c)(3)(ii) states "a consent made in the manner described in this subdivision shall be effective only with respect to patronage occurring *after* the patron has received a copy of the bylaw and the prerequisite notice and while he is a member of the organization." (Emphasis added.) *Cf.* Simons v. United States, 208 F. Supp. 744 (1962) (election to be taxed as a small business corporation under Int. Rev. Code of 1954, §§ 1371-77 filed one day late was held ineffective).

31. The regulations were proposed on December 29, 1962. Treas. Reg. § 1.1381-1 (1963).

32. Treas. Reg. § 1.1388-1(c)(1)(ii): "A 'payment in money' as that term is used . . . does not include a credit against amounts owed by the patron to the cooperative organization . . . ."

a sizable balance at the moment. The organization should not have to lure every delinquent patron into its establishment for the purpose of having him endorse back to it, as payment on his account, the "20 percent" check. The Treasury's position evidently is that its regulation is in keeping with the statutory phrase "paid in money" and with the expressed purpose of the 20 percent provision, which is to furnish the patron the cash with which to pay his tax.[33] Whether any cooperative will challenge the regulation in court remains to be seen.

Another cause of uneasiness among the cooperatives is the provision binding the new member by a "consent by-law." The regulation provides that "a prospective member must receive the notification and copy of the bylaw before he becomes a member of the organization in order to have his membership in the organization constitute consent."[34] While the statute seems clearly to prescribe this requirement, it poses a severe mechanical problem for the cooperative. Many cooperatives have operated under a system whereby patronage automatically created membership. Often it is not possible to give the patron notice of the new by-law before accepting his products or selling him supplies—as where he sends products by an independent hauler who may not be his agent to receive such a notice. Some cooperatives have changed their by-laws to provide that a new patron becomes a member only after both patronizing the organization and receiving a notice of the consent by-law. This should be effective although it conceivably may be attacked by the Treasury if the facts indicate the patron received the notice *simultaneously* with becoming a member instead of *before* becoming a member. Some hair-splitting may take place before acceptable procedures are determined. In any event, the requirement of notification before membership seems certain to trap some unwary cooperatives. If someone has already become a new member and was not given notification before joining, he cannot be bound by the consent by-law. If the cooperative discovers the fact in time, it can try either to obtain a specific written consent or to give qualified checks to the new member or class of new members involved. But if it believes it has properly complied with the new law and actually has not, it may be surprised to discover two or more years later that it has made patronage distributions that did not qualify. The result would be a surprise tax possibly of substantial size.

A consequence of the new legislation only partially foreseen by

33. S. REP. NO. 1881, 87th Cong., 2d Sess. 112 (1962).
34. Treas. Reg. § 1.1388-1(c)(3)(ii) (1963).

the Congress is its impact on the exempt cooperative. The exempt cooperative is handicapped by the statutory requirements for exemption and the regulations under them that deal with the treatment of a patron who refuses to consent to take the patronage distribution into his income.[35] The non-exempt cooperative can, if its by-laws permit, discriminate between the "consenter" and the "non-consenter"; that is, the non-exempt cooperative can take the position that because it must pay tax on the portion of its net earnings that it is unable to distribute on a patronage basis in the form of qualified allocations due to the refusal of the "non-consenter" to give his consent, it will deduct the amount of the tax that it must pay from the amount that it will distribute to the "non-consenters." For example, if the total amount of net earnings otherwise allocable to the "non-consenters" doing business with a particular "non-exempt" cooperative is 10,000 dollars, the cooperative can expect to pay approximately 3,000 dollars in federal income tax on that amount. It can subtract the amount of tax paid and distribute only 7,000 dollars to the "non-consenters," and each "non-consenter" will receive a non-qualified written allocation for only 70 percent of what he otherwise would have received. If an exempt cooperative wishes to retain its exemption, this treatment is not possible. It *must* distribute by written allocation the entire 10,000 dollars, for the principle that an exempt cooperative must treat all patrons alike has been specifically incorporated in the revised regulations.[36] Since the distribution will not be a qualified distribution, the exempt cooperative is not compelled to pay 20 percent of the amount in cash, but it is required by the regulation to distribute by the written allocations the full 100 percent or lose its exemptions. Thus, we have the anomalous situation where an exempt cooperative with a total income of 100,000 dollars, 10,000 dollars of which was attributable to patronage of "non-consenters," will have to pay a tax of 3,000 dollars and still be required to distribute in qualified and non-qualified written notices of allocation the entire 100,000 dollars. The result is that it has paid in taxes and distributed in written notices a total of 103,000 dollars although its earnings were only 100,000 dollars.[37] This side-effect may result in some coopera-

35. See INT. REV. CODE OF 1954, § 521(b); Treas. Reg. § 1.1388-1 (c)(3) (1963).

36. Treas. Reg. § 1.521-1(f) (1963).

37. The Treasury points out that the situation is not as bad as it seems since the exempt cooperative will presumably receive a tax deduction later for redeeming the $10,000 of non-qualified allocations that it issues. This, of course, does not allow for the possible impairment of the exempt cooperative's surplus during the interim, nor the possibility that it may never

tives that are now exempt giving up their exempt status. Each must weigh this disadvantage against the advantages of retaining an exemption.[38]

IV. CONSTITUTIONALITY OF THE NEW PROVISIONS

While there is no case involving an identical situation,[39] cases in which similar statutory provisions have been upheld indicate that the new provisions are probably constitutional. There are many cases where stockholders of corporations are taxed on dividends or on other quasi-income items that they did not in fact receive.[40]

The first group of these involves personal holding company earnings. If a personal holding company fails to distribute its income to its shareholders, it is taxed by the federal government at a punitive rate on that income.[41] Some states, however, have adopted the alternative route of taxing the shareholders of the personal holding company on that company's income as though it had been distributed. *McCreery v. McColgan*[42] held that the California law so providing was constitutional under both state and federal constitutions. The opinion reviewed both federal and state cases and held that the statute was not a violation of either

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be able to redeem the non-qualified notice of allocation and thereby take advantage of the later deduction, nor the possibility that the law might be changed before it is able to do so. The regulation does attempt to permit the exempt cooperative to try to compensate itself for the loss of use of the money by paying a lower rate of interest on non-qualified notices of allocation than on qualified notices.

38. The advantages of "exempt" status are: (1) deductibility of dividends paid, § 1382(c); (2) deductibility of patronage refunds distributed that represent earnings on business transacted with the United States or other governmental units or from sources other than patronage (for example, rental or interest income), § 1382(c); (3) exemption from federal documentary stamp taxes, § 4382(a)(3); (4) exemption from the registration requirements of the Securities Act of 1933, 48 Stat. 76, 15 U.S.C. § 77c (a)(5) (1958).

39. In Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726, 731 (4th Cir. 1957), the court said in dictum that requiring the cooperative patrons "to pay tax upon income which they have not received, over which they have been given no control, and which they may never receive" would raise a question of constitutionality "which would be a serious one."

40. *Cf.* the numerous cases upholding the constitutionality of taxing income of a trust to persons other than the person receiving the income. *E.g.*, Burnet v. Wells, 289 U.S. 670 (1933); Reinecke v. Smith, 289 U.S. 172 (1933); Corliss v. Bowers, 281 U.S. 376 (1930); see Heffelfinger v. Commissioner, 87 F.2d 991 (8th Cir. 1937); Carlisle v. Commissioner, 165 F.2d 645 (6th Cir. 1948). Compare Hoeper v. Tax Comm'n, 284 U.S. 206 (1931).

41. INT. REV. CODE OF 1954, § 541.

42. 17 Cal. 2d 555, 110 P.2d 1051 (1941).

the due process or the equal protection clauses. The court distinguished *Eisner v. Macomber*,[43] which held that the taxation of stock dividends was unconstitutional as a levy on capital without apportionment, by pointing out that *Macomber* has not been followed in cases where the stock dividend was issued in stock of a different class than that held by the stockholders receiving the dividend. Also, the California court felt that the tone of decisions in the United States Supreme Court since *Macomber* indicates that it would approve as constitutional a statute, such as the California law, that taxes the income of the personal holding company to the stockholders whether the income had been distributed to them as dividends or not.[44]

Another group of cases involving the taxation of undistributed corporate earnings to the stockholders is that involving unreasonable accumulations. A corporation may be taxed if it is accumulating earnings and profits beyond the reasonable needs of the business.[45] Corresponding provisions in previous revenue codes and revenue acts have been upheld. In the leading case of *Helvering v. National Grocery Co.*,[46] the Supreme Court said:

> If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed . . . . Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits.

In a footnote at the end of this language, the Court implied that it was constitutional for Congress to tax the stockholder of the corporation as though he had received the corporation's income. It said in part:

> The first statute which provided for taxation where corporate profits are accumulated for the purpose of preventing the imposition of surtaxes upon stockholders was the Tariff Act of 1913 . . . . In that Act, in the Revenue Act of 1916 . . ., and in the Revenue Act of 1918, . . . the tax was laid upon the shareholder. In all later Revenue Acts, the tax is laid upon the corporation . . . . The Revenue Acts of 1918 and 1921 . . . also taxed the shareholders of "personal service corporations" like partners. Section 112(k) of the Revenue Act

43. 252 U.S. 189 (1920).

44. See Helvering v. National Grocery Co., 304 U.S. 282 (1938); Annot., 130 A.L.R. 408 (1941); *cf.* Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953), holding income of a foreign personal holding company taxable to a United States resident stockholder although the income had not been distributed to him and assuming the result was constitutional.

45. INT. REV. CODE OF 1954, § 531.

46. 304 U.S. 282, 288 (1938).

> of 1932 . . . provide[s] for the disregard of the corporate entity in certain cases where foreign corporations are used for the purpose of avoiding federal taxes. . . .[47]

Thus, the Supreme Court clearly implied that it is permissible to tax the shareholder in this manner rather than the corporation.[48]

Analogy to these cases upholding the constitutionality of similar types of provisions suggests that the by-law consent provision relating to cooperatives is constitutional.

CONCLUSION

Cooperatives cannot complain about the basic principles established in the new Subchapter T of the Internal Revenue Code. Their problems come from the complexity of the details set out in the law, some of which would have been better left out. There will be a substantial amount of bickering and confusion over the administration of the law, followed by only a modest amount of litigation. There seems to be no present disposition on the part of the cooperatives to ask for corrective or modifying legislation, nor should there be.

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47. *Id.* at 288 n.4.

48. See also Collector v. Hubbard, 79 U.S. (12 Wall.) 1 (1871), expressly so holding.

Although it has not yet been constitutionally tested the consent provisions of Subchapter S of the Internal Revenue Code of 1954 are probably valid. In general, § 1371 provides that a corporation having ten or fewer individual stockholders may elect to be taxed as a partnership. If the election is made, all stockholders are taxed individually on the corporate income as though they were partners according to the interests that they hold. Although *all* stockholders must initially assent to the election, the election when once made can be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent. INT. REV. CODE OF 1954, § 1372(e)(2). Thus, a shareholder refusing to consent to the revocation can impose his will upon other shareholders who wish to revoke the election, thereby keeping them obligated to include their share of the corporation's income as personal income. This is more onerous than the consent provision relating to cooperatives whereby a majority vote of shareholders adopting a consent by-law for the cooperative would be binding upon the minority. A patron or minority member of the cooperative can avoid the tax result by ceasing to do business with the cooperative. The minority shareholder of the small corporation, on the other hand, can avoid the tax result only by selling his stock. Because his corporation is, by definition, a closely-held one, the sale may have to be at a substantial loss. The committee reports on this provision indicate that at the time it was adopted, no questions of constitutionality were raised or discussed. 1958-3 CUM. BULL. 1008-10; 1137-47; 1223-24.