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ACTION ON DECISION

Subject: Farmland Industries, Inc. v. Commissioner,
T. C. Memo. 1999-388, Dkt. No. 11881-93

Issue:

Whether the gains and losses that a nonexempt cooperative realized from the disposition of certain property were patronage sourced for purposes of subchapter T of the Internal Revenue Code.

Discussion:

The petitioner was a nonexempt cooperative subject to subchapter T of the Internal Revenue Code. As such, it was required to keep its accounts for its business with or for its patrons separate from its accounts for its other business. Only the income from its patronage business was eligible for deduction as a patronage dividend under section 1382 of the Internal Revenue Code..

The petitioner purchased a variety of products used by farmers, then resold those products to its members. Petroleum and fertilizer comprised its largest product lines.

The gains and losses in issue were from the disposition of the stock of three corporations and from the disposition of certain property used in a trade or business, as defined in section 1231(b) of the Code. The three corporations were all engaged in some aspect of the petroleum business – oil and gas exploration, the purchase of oil in volume from Mexico, and operation of a pipeline and terminals to move oil to refineries. The petitioner owned all the outstanding stock of the oil and gas exploration company, but minority interests in the other two corporations. The business property disposed of consisted of a gas processing plant, a soybean processing facility, and over 500 miscellaneous business assets, including vehicles, livestock, and office equipment.

The gas processing plant was used to produce propane and gas blending stock, both of which the petitioner used in its cooperative operations. By producing these fuels itself, rather than purchasing them on the open market, the petitioner sought to assure itself of an adequate supply of these fuels. The soybean facility was used to process soybeans purchased from the petitioner's patrons into soy oil and soy meal. The petitioner processed the soy meal into livestock feed and sold that feed to its members. It sold the soy oil to unrelated parties.

Patronage income is income derived from “business done with or for patrons” of a cooperative. I.R.C. § 1388(a). Treas. Reg. § 1.1382-3(c)(2) defines nonpatronage income as “incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, the income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes [nonpatronage income].”

The government argued in this and other cases that § 1.1382-3(c)(2) of the regulations means that rents, interest, and capital gains are per se nonpatronage income. However, cases have held that all three types of income can be patronage income when produced by an activity sufficiently related to the essential cooperative purpose. St. Louis Bank for Cooperatives v. United States, 624 F. 2d 1041 (Ct. Cl. 1980); Cotter and Company v. United States, 765 F. 2d 1102 (Fed. Cir. 1985); Illinois Grain Corp. v. Commissioner, 87 T.C. 435 (1986).

In light of these cases, the Service will view the examples of nonpatronage income in the regulations as instructive, but not controlling. It will look at the facts and circumstances to determine if each item of income or loss is patronage or nonpatronage sourced. The patronage or nonpatronage character of every item of income or loss will be determined by the relationship of the activity producing the income or loss to the cooperative’s business of serving its patrons. Only where the activity generating the income or loss is directly related to the cooperative business, in the sense that it is an integral part of that business, will the income or loss be considered patronage sourced.

Interest earned on an investment will be considered nonpatronage income, but interest earned on funds retained for a true cooperative business purpose will be considered patronage income. Income produced by property held for rental purposes will be considered nonpatronage income, but income produced by rental property will be considered patronage income in those unusual situations where the property was held to facilitate business conducted for the benefit of patrons. Gains or losses from the sale or exchange of a capital asset will be considered nonpatronage sourced where the asset was not used for a cooperative business purpose, but will be considered patronage sourced where the asset actually facilitated the cooperative business.

In the instant case, the Tax Court found that each corporation was formed, operated, and sold to facilitate the petitioner’s petroleum business. Because a sufficient nexus to the patronage business existed, the court found the stock not to be an investment and held its sale generated patronage income or loss. Likewise, the section 1231 assets were found to be used in the petitioner’s cooperative business and sold in the course of that business, so that their sale produced patronage gain or loss.

The Service agrees with the test used by the court and accepts the conclusions of the court. However, the Service does not agree with the court's rationale to the extent of any inference that the underlying purpose for the sale may serve as the sole basis for characterizing the gain or loss from the sale as patronage sourced.

Recommendation:

Acquiescence.

Reviewers:

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