



## CONCLUSION

As a taxable cooperative, Taxpayer is required to separately compute DPAD for patronage and nonpatronage sourced income under Subchapter T.

## FACTS

Taxpayer is a large Subchapter T cooperative that markets . Taxpayer files a Form 1120C, U.S. Income Tax Return for Cooperative Associations. On Taxpayer's Form 1120C, Taxpayer had \$ in assets and \$ in sales. On Taxpayer's Schedule G of Form 1120C, Taxpayer stated \$ in patronage gross receipts and \$ in nonpatronage gross receipts. Additionally, Taxpayer claimed a DPAD of \$ for patronage income and no DPAD for nonpatronage income. Although Taxpayer computed a number for both patronage and nonpatronage income for DPAD, Taxpayer did not perform two DPAD computations, one for patronage sourced activities and another for nonpatronage sourced activities. Instead, Taxpayer computed its DPAD by aggregating the patronage and nonpatronage sourced activities.

Taxpayer stated in an email to the revenue agent that it was aware that "some [taxpayers] have taken the position that cooperatives should separately calculate DPAD for patronage and nonpatronage income." Despite this knowledge, Taxpayer took the position that because Taxpayer found no basis in section 199 or the Treasury Regulations for section 199 that requires cooperative to perform two separate calculations, Taxpayer's position is "correct, reasonable and proper based on the law and regulations."

## LAW AND ANALYSIS

### *Subchapter T*

Tax exempt farmers cooperatives ("exempt cooperatives") (section 521) and corporations operating on a cooperative basis ("taxable cooperatives") (section 1381) are subject to Subchapter T. A taxable cooperative is a hybrid business entity that conducts business both with patrons and nonpatrons. Only the portion of a taxable cooperative's business that is conducted on a cooperative basis, with or for the benefit of its members/patrons, is subject to Subchapter T. I.R.C. § 1381; Treas. Reg. § 1.1381(a). Accordingly, a taxable cooperative is taxed like an ordinary corporation in regards to nonpatronage sourced income, but like a partnership with respect to patronage sourced income. Conway County Farmers Ass'n v. U.S., 588 F.2d 592, 596 (8th Cir. 1978). When a taxable cooperative does any business with non-cooperative members or participating patrons that are themselves a taxable cooperative, the taxable

cooperative is taxed like a C-corporation. The taxable cooperative's taxable income is the total of both patronage and nonpatronage sourced income.

A "patron" is any person with whom or for whom the cooperative does business on a cooperative basis, whether a member or a nonmember of the cooperative. Treas. Reg. § 1.1388-1(e). Patronage sourced income is not defined in the Internal Revenue Code, but nonpatronage sourced income is defined as "income derived from sources other than patronage." Treas. Reg. § 1.1382-3(c)(2). The determination of whether income is either patronage or nonpatroange sourced is based on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. Rev. Rul. 69-576, 1969-2 C.B. 166. Patronage sourced income is commonly considered to be income derived from transactions that facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities, as opposed to transactions which generate income while being only incidental to those activities. *Id.*

A cooperative is allowed to reduce its patronage sourced income, but not its nonpatronage sourced income, by the amounts paid to its patrons during the payment period. I.R.C. § 1382(b). These items include patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during the taxable year (with certain exceptions); as well as per-units retain allocations to the extent paid in money, qualified per-unit retain certifications, or other property, with respect to marketing occurring during the taxable year (with certain exceptions). I.R.C. §§ 1382(b)(1) and (b)(3).

Patronage and nonpatronage sourced income are treated separately because of the different taxation of each. Since patronage sourced income is treated as partnership income, the income passes through and is taxed only in the hands of the patrons who receive it through patronage dividends, per-units retains, etc. Nonpatronage sourced income is treated like C-corporation income, and is taxed both at the cooperative level and again when distributed as dividends, etc.

### *Domestic Production Activities Deduction*

In 2004, as part of the American Jobs Creation Act, Congress phased in a new tax deduction related to qualified domestic production. Congress wanted to enact a tax law that helped the ability of particular domestic businesses, domestic producers in particular, to compete in the global marketplace. The new tax deduction, domestic production activities deduction ("DPAD"), is available for a broad range of domestic manufacturing and production businesses, as well as companies engaged in activities not traditionally seen as manufacturing, e.g. agriculture. I.R.C. § 199. For the tax years at issue, DPAD is the lesser of 6% of taxable income or 6% of qualified production activities income ("QPAI"), limited to 50% of the W-2 wages. *Id.*

The Conference Report provided additional clarification on the intent of Congress in determining QPAI for agricultural and horticultural cooperatives. The report stated that income derived from manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product by a cooperative, or from the marketing of agricultural or horticultural products by a cooperative, may be included in the cooperative's QPAI. H.R. Conf. Rept. No. 755, 108th Cong., 2d Sess. at 274.

### *Farm Service Cooperative*

The taxpayer in *Farm Service Cooperative v. Comm'r*, 619 F.2d 718 (8th Cir. 1980), was an agricultural cooperative whose business consisted of four kinds or "pools" of activities. Only the broiler (chicken) pool activity was at issue. *Id.* During the 1971 and 1972 fiscal years, the broiler pool sustained significant losses. *Id.* at 721. In 1972, the taxpayer's broiler pool's expenditures exceeded broiler receipts, and the taxpayer offset the entire amount of the broiler pool (patronage) deficit against its taxable (nonpatronage) income for the 1972 fiscal year. *Id.* The Service disagreed with the taxpayer's method of accounting, and argued that the taxpayer was required to pay tax on all income not allocated to patrons, i.e., as a taxable cooperative, taxpayer was not allowed to use patron sourced losses to offset its taxable nonpatronage income. *Id.*

The Court began its analysis with the fact that taxable cooperatives may allocate to their patrons and deduct from its taxable income only income arising from patronage activities, subject to additional conditions specified in section 1388. *Id.* at 722. Since a restriction on the scope of allowable deductions exists, taxable cooperatives must separate patronage and nonpatronage sourced income. *Id.* at 723.

The Service raised the position that it called the "cooperative tax accounting principle" – expenses allocable solely to patronage activities could not be used to offset nonpatronage income. *Id.* The taxpayer countered that its treatment of operating losses did in fact conform with the Internal Revenue Code, because Subchapter T makes no explicit rules about the appropriate treatment of net operating losses, and therefore the general rules of corporate taxation apply. *Id.* The taxpayer argued that since C-corporations are allowed to aggregate gains and losses from their different business units, the taxpayer should be allowed to do the same, aggregate gains and losses from its patronage and nonpatronage activities.

The Tax Court agreed with the taxpayer and held that the taxpayer could allocate the broiler pool losses as they saw fit. The Tax Court relied upon its decision in *Associated Milk Producers, Inc. v. Comm'r*, 68 T.C. 729 (1977). In *Associated Milk Producers*, the Court held that a taxable cooperative could employ the net loss carryover to reduce current patronage earnings by past operating losses. 68 T.C. at 738-39. The Court said the cooperative could carryover losses as it saw fit and determine whether its past, present, or future patrons should bear the loss. *Id.*

The 8th Circuit, however, distinguished the taxpayer of *Farm Service* from the *Associated Milk Producers* case. The 8th Circuit explained that *Associated Milk Producers* dealt with a “vertical” allocation of losses, which shifted the losses in time, but kept them within solely patronage business. 619 F.2d at 724. In contrast, *Farm Service*, contained a “horizontal” allocation problem, where the income and losses shifted between the patronage and nonpatronage portions of the business. *Id.* The 8th Circuit reinforced the supremacy of Subchapter T in separating patronage from nonpatronage business, holding that a taxable cooperative must segregate accounts when calculating gross income, “at least in those cases where grower payments or per-unit retain allocations contribute to net operating losses in patronage activities,” and stating that “[t]axpayer’s accounting procedures cannot supersede this statutory principle.” *Id.* at 726.

### *Analysis*

In the present case, Taxpayer aggregated its patronage and nonpatronage business activities for the purpose of calculating its DPAD. Taxpayer’s nonpatronage activities had a negative QPAI, which, if calculated separately from patronage activities, would have resulted in a DPAD of zero. By aggregating its patronage and nonpatronage activities, Taxpayer was able to turn half of its nonpatronage wages into additional DPAD.

This method of calculation creates a distortion of DPAD. While requiring a taxpayer to separate its DPAD calculations for patronage and nonpatronage activities leads to a far smaller total DPAD, aggregating the two would give a taxable cooperative a large advantage over a corporation. Taxable cooperatives are able to calculate their gross patronage sourced income for DPAD without deducting certain types of payments, e.g., per units retained paid in money (“PURPIM”), making their patronage sourced income higher than it would otherwise be. If, as Taxpayer argues, Congress intended there to be no distinction between cooperatives and other corporations under section 199, then cooperatives should not be allowed to exclude these expenses as part of their cost of goods sold.

Aggregating patronage and nonpatronage income, wages, and expenses represent a horizontal allocation of cooperative business, as discussed in *Farm Service*. Similarly, here the taxpayer is using patronage QPAI, in the form of non-deducted PURPIMs, to offset a negative nonpatronage QPAI. While section 199 does not explicitly require cooperatives to perform separate DPAD calculations, it is indisputable that section 199(d)(3) is a deduction against patronage sourced earnings only. Further, it is indisputable that cooperatives cannot deduct W-2 wages from nonpatronage activities against patronage sourced income (or vice versa). Here, however, Taxpayer is doing indirectly what it cannot do directly by using nonpatronage sourced W-2 wages to artificially increase the amount of the section 199 deduction that is solely used

against patronage income. Subchapter T has precedence over cooperatives, and therefore Taxpayer must perform separate DPAD calculations.

Please call (312) 368-8792 if you have any further questions.

JAMES M. CASCINO  
Associate Area Counsel  
(Large Business & International)

By: \_\_\_\_\_  
Tess deLiefde  
Attorney ( )  
(Large Business & International)