Farmers' Cooperatives: Obtaining and Maintaining the Tax Exempt Status of Section 521

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FARMERS' COOPERATIVES: OBTAINING AND MAINTAINING THE TAX EXEMPT STATUS OF SECTION 521

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I. INTRODUCTION

The present income tax exemption of farmers' cooperatives[1] provided by section 521 of the Internal Revenue Code of 1954, as amended (the Code), began quite modestly as a simple exemption from taxation of all "labor, agricultural, or horticultural organizations."[2] From such a modest beginning have emerged cooperatives of such magnitude that they are a significant economic force in the American business community.[3]

Section 521 has been substantially unchanged for the past forty

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1. I.R.C. § 521(a), which provides as follows:

> A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

2. Act of October 3, 1913, Pub. L. No. 63-16, § 2(G)(a), 38 Stat. 114, 172.

3. The following cooperatives were included among Fortune magazine's top 500 industrials for 1976:

> No. 123—Farmland Industries
> No. 137—Associated Milk Producers
> No. 162—Agway
> No. 183—Land O'Lakes
> No. 251—Gold Kist
> No. 354—C. F. Industries
> No. 460—Dairylea Cooperative

FORTUNE, May 1977, at 370, 372, 376, 380, 384.

The success of farm cooperatives has not escaped the notice of the critics of tax exempt status. It has been suggested that tax exempt status is not equitable because cooperatives have become engaged in all segments of the economy, due in part to advantages gained because of tax exemption. Caplin, *Taxing the Net Margins of Cooperatives*, 58 GEO. L.J. 6, 7 (1969). The following hypothetical situation has been given as an example of the results of tax-exempt status:

> 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, LEGAL TAX AVOIDANCE THREATENS PRIVATE ENTERPRISE 9 (1945), *quoted in* Clark and Warlich, *Taxation of Cooperatives: A Problem Solved?*, 47 MINN. L. REV. 997, at 999 n.8 (1963).

years.[4] Congress apparently is willing to let the courts and the Internal Revenue Service (IRS) determine the qualifications for tax exempt status on a case-by-case basis.[5] This article will discuss the permissible range of activities under section 521 in which farmers', fruit growers', or like associations organized or operated on a cooperative basis may engage, without jeopardizing either their initial qualification as tax exempt organizations or their retention of that status.[6]

Initially, it should be noted that the tax exempt status of farm cooperatives already having such status may be retroactively revoked. If a cooperative engages in impermissible activities, "[t]he revocation or modification may be retroactive if the organization misstated a material fact, operated in a manner materially different from that originally represented, or engaged in a prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes. . . ."[7]

On the other side of the argument, it has been contended the tax exempt status for cooperatives is proper because cooperatives have no income in the sense that a private business does, or that if there is any income, it is virtually impossible to measure. Note, *Taxation of Cooperatives: A Tentative Explanation of a Problem in Semantics*, 1966 WIS. L. REV. 930, 932-35. *See generally*, Zivan, *Need for Reform in Taxation of Agricultural Cooperatives?*, 5 GA. L. REV. 529 (1971).

The critics of tax exempt status achieved a partial victory in 1962, when Congress passed the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960. Section 522(b)(2) of the Internal Revenue Code of 1954 had allowed exempt cooperatives, in computing their taxable income (it must be remembered that section 521 cooperatives are not totally tax exempt; *see* I.R.C. § 521(a)), to deduct for patronage dividends paid whether "paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him." Int. Rev. Code of 1954, Pub. L. No. 83-591, ch. 736, § 522(b)(2), 68A Stat. 178 (repealed by the Revenue Act of 1962, Pub. L. No. 87-834, § 17(b)(2), 76 Stat. 960, 1051). Cooperatives had used section 522 to pay dividends to patrons in forms, such as letters of advice, that were not currently taxable to the patrons. Thus, there was no tax paid on this form of income by either the cooperative or the patron. To eliminate this abuse, Congress repealed section 522(b)(2) and put in its place section 1382(b)(2), which provides that patronage dividends deducted by the cooperative must be paid "in money or other property." I.R.C. § 1382(b). The net result is that the patronage dividends are currently taxable to the patron. This was just one aspect of the taxing of cooperatives treated by Congress in the Revenue Act of 1962. The whole of subchapter T, I.R.C. §§ 1381 through 1388, deals with the tax treatment of cooperatives and their patrons. For a discussion of the effects of the Revenue Act of 1962 on cooperatives, *see generally* Joplin, *Taxation of Cooperatives Under the 1962 Revenue Act*, 41 TEX. L. REV. 908 (1963). The Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1789, had no effect on the taxing of cooperatives.

4. For a history of section 521, *see* Clark and Warlich, *Taxation of Cooperatives: A Problem Solved?* 47 MINN. L. REV. 997 (1963).

5. A cooperative seeking tax exempt status is required to file an application, form 1028, for such status with the district director of the internal revenue district in which the cooperative's main place of business is located. The procedures for obtaining tax exempt status are to be found in Treas. Reg. § 1.521-1(e) (1965) and Rev. Proc. 72-4, 1972-1 C.B. 706.

6. For a good general discussion of the tax exempt status of farmers' cooperatives, *see* Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 TEX. L. REV. 250 (1965).

7. Rev. Proc. 72-4, 1972-1 C.B. 706, 708. Revocation of tax exempt status by the commissioner is usually retroactive. For example, in Land O'Lakes, Inc. v. United States, 362 F. Supp. 1253 (1973), *rev'd*, 514 F.2d 134, *cert. denied*, 423 U.S. 926 (1975), the commissioner did not revoke the tax exempt status of Land O'Lakes for the year 1963 until 1970. It apparently takes the commissioner several years to discover and investigate the impermissible activities of cooperatives.

II. MEETING THE REQUIREMENTS OF SECTION 521

Basically, section 521 allows income tax exemption for farmers', fruit growers', or like associations organized and operated on a cooperative basis as marketing or purchasing cooperatives.[8] To have tax exempt status, a marketing cooperative must market the products of its members and turn back to them their proportionate shares of the proceeds, less necessary marketing expenses.[9] A purchasing cooperative, to have tax exempt status, must purchase supplies and equipment for the use of its members or other persons, and must turn over to them such supplies and equipment at actual cost, plus necessary expenses.[10]

Three questions arise when dealing with the permissible activities of tax exempt cooperatives: (1) what are "farmers', fruit growers', or like associations"?; (2) in what activities may a cooperative engage to help its members, while still maintaining its exempt status?; and (3) what purchases may be made by the cooperative while still maintaining its exempt status?

A. FARMERS', FRUIT GROWERS', OR LIKE ASSOCIATIONS

The threshold requirement that must be met by an association seeking tax exempt status under section 521 is that it be a "farmers', fruit growers', or like association."[11] This requirement is viewed by the courts and the IRS as embracing the traditional concept of farmer. The regulations promulgated under section 521 include within the associations exempted from income tax "[c]ooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc."[12] The question of what constitutes a "farmers', fruit growers', or like association" has been addressed by the courts and by IRS rulings. There is little controversy over what is a "farmer" or "fruit grower." Most of the problems arise from the phrase, "or like association." Associations seeking tax exempt status have contended that the phrase, "or like association," is not limited by the words "farmers' or fruit growers'."[13]

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8. I.R.C. § 521(b)(1) states as follows:
   The farmers' cooperatives exempt from taxation to the extent provided in in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.
9. I.R.C. § 521(b)(1)(A).
10. I.R.C. § 521(b)(1)(B).
11. I.R.C. § 521(b)(1).
12. Treas. Reg. § 1.521-1(a)(1) (1965).
13. *See, e.g.*, Nat'l Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d

Courts that have ruled on the question have applied the rule of *ejusdem generis*[14] and have held that the words "or like association" are limited by the words "farmers' or fruit growers'," and that members of associations seeking tax exempt status must be engaged in some sort of agricultural activity.[15]

For example, in *Sunset Scavenger Co. v. Commissioner*[16] an incorporated association of garbage collectors sought tax exempt status under the then current version of section 521.[17] The association argued that the phrase "or like association" was meant to encompass any association formed for the purpose of mutual cooperation, and was not limited to associations whose members were engaged in agricultural activity.[18] The court denied the association tax exempt status by applying the principle of *ejusdem generis*.[19] The court determined that the phrase "or like association" was limited by "farmers' or fruit growers'," and that the statute exempted "only such associations as market agricultural products, or purchase supplies and equipment for those who are engaged in producing agricultural products."[20] This same reasoning has been applied in cases denying tax exempt status to a housing corporation,[21] an association of advertising agents,[22] and an association of harbor pilots,[23] among others.[24]

There has been greater difficulty in determining tax exempt status in cases involving associations whose members are engaged in arguably agricultural activities. For example, in 1955 a cooperative association of fishermen sought tax exempt status under section 521.[25] It was contended that the association should be considered a "like association." It would seem on first view that the fishermen's association would have a stronger argument for tax exemption than would an association of garbagemen or advertising agents. Fishermen, although not engaged in an activity normally thought of as "agricul-

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Cir. 1937); Sunset Scavenger Co. v. Comm'r, 84 F.2d 453 (9th Cir. 1936); Garden Homes Co. v. Comm'r, 64 F.2d 593 (7th Cir. 1933); Mobile Bar Pilots Ass'n v. Comm'r, 35 B.T.A. 12 (1936), *rev'd on other grounds*, 97 F.2d 695 (5th Cir. 1938).

14. The rule of *ejusdem generis*, as used in statutory interpretation, is defined in Rev. Rul. 73-308, 1973-2 C.B. 193, as follows: "It is a well recognized rule of statutory construction that where general words follow the enumeration of particular classes of persons or things, the general words will be construed as applicable only to persons or things of the same general nature or class of those specifically enumerated." *Id.* at 194.

15. Sunset Scavenger Co. v. Comm'r, 84 F.2d 453, 455 (9th Cir. 1936).

16. 84 F.2d 453 (9th Cir. 1936).

17. Revenue Act of 1926, Pub. L. No. 69-20, ch. 27, § 231(2)(12), 44 Stat. 9, 40 (now I.R.C. § 521(b)(1)).

18. Sunset Scavenger Co. v. Comm'r, 84 F.2d 453, 455 (9th Cir. 1936).

19. *Id.*

20. *Id.*

21. Garden Homes Co. v. Comm'r, 64 F.2d 593 (7th Cir. 1933).

22. Nat'l Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937).

23. Mobile Bar Pilots Ass'n v. Comm'r, 35 B.T.A. 12 (1936), *rev'd on other grounds*, 97 F.2d 695 (5th Cir. 1938).

24. *See, e.g.*, Northwestern Drug Co. v. Comm'r, 14 B.T.A. 222 (1928) (an organization of retail druggists); REV. RUL. 73-570, 1973-2 C.B. 195 (independent lumber producers' association).

25. Rev. Rul. 55-611, 1955-2 C.B. 270.

tural," are engaged in the production of food. To hold that an association of fishermen is a "like association" would not seem unreasonable. Furthermore, the laws of the state in which the association was formed included in the term "agricultural products" fish and salt water sea food, and recognized the fishermen's association as an agricultural association.[26] The commissioner ruled that "[a]n association which is not composed of farmers, fruit growers, or persons engaged in similar pursuits is not exempt under section 521 of the Code unless it could be considered a 'like association' within the intendment of that section."[27] The fact that the fishermen's association was considered an agricultural association under state law was not controlling, because the provisions of state laws do not control in determining status for federal income tax purposes.[28] Applying the principle of *ejusdem generis*, the commissioner held that the association was not a "like association" and thus was not entitled to tax exempt status.[29]

The 1955 revenue ruling denying tax exempt status to a fishermen's association was explained and distinguished in a 1964 ruling in which a cooperative association organized for the purpose of marketing "farm-raised fish" was granted tax exempt status.[30] The determinative factors were that the membership of the association was restricted to persons engaged in the production of agricultural commodities, "including fish of commercial value produced in *privately owned* waters,"[31] and that "the members of the association [were] engaged in producing fish *on a farm*."[32] The 1955 ruling denying tax exempt status to a fishermen's association was distinguished on the ground that the fish in that situation had not been raised on a farm.[33]

If tax exempt status for a cooperative association is dependent upon the production of agricultural commodities by members upon a *farm*, it becomes necessary to define the term "farm." The treasury regulations promulgated under section 521 are of little help in this regard; they merely state that "[c]ooperative organizations engaged in occupations *dissimilar from* those of farmers, fruit growers, and the like, are not exempt."[34] Treasury regulations promulgated under other sections of the Code are more helpful. For example, the regulations under section 61, dealing with the definition of gross income, give the following definition: "[T]he term 'farm' embraces the farm in the ordinarily accepted sense, and includes stock, dairy,

26. *Id.* at 271.
27. *Id.*
28. Lyeth v. Hoey, 305 U.S. 188 (1938).
29. Rev. Rul. 55-611, 1955-2 C.B. 270, 271.
30. Rev. Rul. 64-246, 1964-2 C.B. 154.
31. *Id.*
32. *Id.* at 155 (emphasis added).
33. *Id.* (emphasis added).
34. Treas. Reg. § 1.521-1(d) (1965).

poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations."[35] The regulations under section 175, dealing with soil and water conservation, state that the term "farm" includes "stock, dairy, poultry, fish, fruit, and truck farms."[36]

The definitions of "farm" in the Code and treasury regulations usually include the phrase, "the farm in the ordinarily accepted sense," or a phrase with the same meaning, and then go on to list several types of operations specifically included within the definition, such as beef or dairy farming.[37] Presumably the list is not all-inclusive, and types of farming operations not specifically mentioned will qualify. This approach was taken by the commissioner in a revenue ruling issued in 1975 in which a cooperative formed to produce and market range grasses was granted tax exemption under section 521.[38] Although the raising of range grass is not specifically defined anywhere in the Code as "farming," the commissioner called the grass a "farm product."[39] It would seem that any cooperative whose members engage in an activity that could reasonably be called "farming" would qualify for tax exempt status.[40]

B. MARKETING AND PURCHASING COOPERATIVES

When the initial requirement that the association be a "farmers', fruit growers', or like association" is met, it must then be determined that the association is organized and operating as a cooperative before tax exempt status can be granted.[41]

In essence, a cooperative is an association that performs services for its members, and returns to its members all profits made.[42] Those profits are returned in proportion to the amount of business done by a member with the cooperative, and not in proportion to stock ownership in the cooperative. An association which retains profits for itself, or which pays out dividends to members on a stock ownership basis without regard to business done with the association, is not a cooperative, and will not be granted tax exempt status.[43]

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35. Treas. Reg. § 1.61-4(d) (1972).
36. Treas. Reg. § 1.175-3 (1963).
37. *E.g.*, Treas. Reg. § 1.61-4(d) (1972); Treas. Reg. 1.175-3 (1963).
38. Rev. Rul. 75-5, 1975-1 C.B. 166.
39. *Id.* at 167.
40. *But see* Treas. Reg. § 1.175-3 (1963), which states as follows: "A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming." There are conceivably situations where those engaged in growing timber are "farmers." For example, a small farmer who has a timber lot would not be considered a farmer and a tax exempt farmers' cooperative could not market his timber or purchase supplies and equipment for him. This is an anomalous situation and should be corrected.
41. I.R.C. § 521(b)(1).
42. *See generally* Zivan, *Need for Reform in Taxation of Agricultural Cooperatives?* 5 GA. L. REV. 529 (1971).
43. *See, e.g.*, Rev. Rul. 73-570, 1973-2 C.B. 195, where a marketing association was denied tax exempt status because its members were entitled to share in the association's surplus or deficit on the basis of their stock interests rather than on the basis of the amount of product marketed. *Compare with* Producers Gin, Inc., 28 T.C.M. (P-H) para.

Section 521 deals with two types of cooperatives, marketing cooperatives and purchasing cooperatives. The scope of activities in which such cooperatives may engage while still maintaining tax exempt status is a subject of great importance for farm cooperatives.

1. *Marketing Activities*

Section 521(b)(1) states that "farmers', fruit growers', or like associations organized and operated on a cooperative basis . . . for the purpose of *marketing* the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses"[44] shall be tax exempt.

If a marketing cooperative does not turn back to its members the proceeds of sales, it will lose its tax exemption because it is no longer operating on a cooperative basis.[45] In *Hills Mercantile Co. v. Commissioner*,[46] a grain marketing cooperative sold its patrons' grain and returned to them the sale price, less a service charge of two cents per bushel. The cooperative, however, also bought grain from its patrons and then sold such grain on its own account. Profits from these sales were not distributed to the patrons. Accordingly, the cooperative's tax exempt status was revoked.[47]

A marketing cooperative that is no longer performing its marketing function will also lose its tax exempt status. The treasury regulations under section 521 state that "[a]n association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521."[48] In accordance with this regulation, the commissioner in 1971 ruled that an association originally formed for the purpose of buying, selling, and storing various kinds of grain products on a cooperative basis that thereafter limited its activities to leasing its grain elevator was no longer tax exempt.[49] Although the association entered into the lease to obtain better prices for its members' grain and allocated the net proceeds from the rental income on a patronage basis, the fact that the association was no longer actually marketing the grain was determinative.[50]

59,106 (1959), where a tax exempt cooperative made equal dividend distributions to all its members regardless of the amount of product delivered by each. Tax exempt status was not denied, because the facts showed that deliveries by members over the years were substantially equal. It was stated as follows:

> [I]t may well have been considered simpler to regard all deliveries of cotton as substantially equal, as over the years they in fact almost were, than to engage in a complicated accounting procedure to determine the exact proceeds of each delivery and sale. The small difference we view as de minimis.

44. I.R.C. § 521(b)(1)(A) (emphasis added).
45. *See supra* note 42.
46. 22 B.T.A. 114 (1931).
47. *Id.* at 118.
48. Treas. Reg. § 1.521-1(c) (1965).
49. Rev. Rul. 71-100, 1971-1 C.B. 159.
50. *Id.*

In addition to the general problems outlined above, there are several specific areas in which problems arise for marketing cooperatives seeking to expand the scope of their activities while maintaining tax exempt status.

a. *Necessary Marketing Expenses*

Many disputes have arisen over the meaning of the term "necessary marketing expenses" in section 521(b)(1). A tax exempt marketing cooperative must turn back to its members the proceeds of sales, *less necessary marketing expenses.*[51] If a cooperative deducts from patronage dividends expenses that are not necessary marketing expenses, it will lose its tax exempt status under section 521.[52] The test that has been used to determine whether an expense is a necessary marketing expense is whether it is connected with, or is incidental to, the marketing of the members' products.[53]

Several revenue rulings have dealt with the question of whether certain activities in which marketing cooperatives have engaged are incidental to the marketing of their members' products. In a 1955 ruling, the commissioner held that an association engaged in the grading, packaging, precooling, and marketing of vegetables for its members could not maintain its tax exempt status if it purchased life insurance policies for its members.[54] The association had only five members, and those members contributed over ninety-five per cent of the volume of business done by the association. In view of the effect that a member's death would have on the operation of its business, the association bought a life insurance policy on the life of each of its members, naming itself as beneficiary. It was held that the payment of annual premiums on these policies was not a necessary marketing expense because they were not incidental to the marketing of the members' products. Thus, the association was not turning back to its members and other producers the proceeds of the sales of their products, less necessary marketing expenses.[55]

In a 1976 revenue ruling, the commissioner dealt extensively with the question of what expenses are incidental to the marketing of members' products.[56] A tax exempt cotton farmers cooperative association was engaged in the business of marketing cotton for its members. In order to broaden the economic base of the association, it adopted a plan to acquire unrelated business enterprises. In seeking to acquire a wool processing company, the association had in-

51. I.R.C. § 521(b)(1)(A).
52. *E.g.*, Rev. Rul. 76-233, 1976-1 C.B. 173; Rev. Rul. 55-558, 1955-2 C.B. 270.
53. *Id.*
54. Rev. Rul. 55-558, 1955-2 C.B. 270.
55. *Id.*
56. Rev. Rul. 76-233, 1976-1 C.B. 173.

curred expenditures, including fees paid to a consulting firm and a law firm, which reduced the amount of patronage dividends paid to producers. In determining whether these fees were necessary marketing expenses under section 521, the commissioner stated as follows:

> Necessary marketing expenditures include expenses, necessary to prepare a product for its final sale, incurred from the time the product is turned over to the cooperative by the producer. Expenses such as grading, packing, crating, processing, canning, drying, freezing, evaporating, and wrapping, qualify as necessary marketing expenses. However, expenses not connected with the marketing of the products of the members or other producers do not qualify as necessary marketing expenses within the meaning of section 521(b)(1) of the code.[57]

Expenses connected with the acquisition of the wool processing company were held not to be necessary marketing expenses because the operation of the wool processing company was unrelated to the marketing of cotton.[58] A cooperative may conduct business through a subsidiary corporation, and yet maintain its tax exempt status. The activities of the subsidiary, however, must be activities in which the cooperative itself could engage as an integral part of its operations without affecting its exempt status. A tax exempt cooperative may not utilize subsidiaries to conduct operations on an ordinary profit-making basis, unlike corporations in general.[59] Even investments made from a reserve properly accumulated under section 52(b)(3)[60] must be incidental to the conduct of the cooperative's business.[61]

b. *Marketing the Products of Nonproducers*[62]

Section 521(b)(4) allows tax exempt cooperatives to market the products of nonmember producers, provided that the value of such products does not exceed the value of members' products mar-

57. *Id.* at 174. Thus, the term "marketing" includes not only the sale of farm products by a farmers' cooperative for its patrons, but other activities necessary to the sale of such products. *See* Rev. Rul. 67-430, 1967-2 C.B. 220; Rev. Rul. 66-108, 1966-1 C.B. 154.

58. Rev. Rul. 76-233, 1976-1 C.B. 173, 174.

59. *Id. See also* Eugene Fruit Growers Ass'n v. Comm'r, 37 B.T.A. 993 (1938).

60. I.R.C. § 521(b)(3) provides as follows: "Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by state law or a reasonable reserve for any necessary purpose."

61. I.R.C. § 1382(c) specifically provides for the distribution of income "from sources other than patronage" by an exempt farmers' cooperative. Treas. Reg. § 1.1382-3(c)(2) (1963) defines such income as incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association, such as income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets.

62. A "producer" is one who makes his livelihood by producing on a farm the agricultural commodities the cooperative was formed to market. *See generally* Rev. Rul. 67-223, 1967-2 C.B. 214. For the definitions of the term "farm," *see supra* notes 33-39, and text accompanying.

keted. If a cooperative markets the products of *nonproducers*, however, it will lose its tax exempt status. For example, in a 1975 revenue ruling it was held that a dairy farmers' cooperative marketing association that purchased dairy products from nonproducers of dairy products lost its tax exempt status by doing so.[63] The cooperative was engaged in marketing the dairy products of its members and other patron producers. Raw milk was processed at the cooperative's various plants, and the excess cream resulting from the processing was made into ice cream. The cooperative also purchased cream from nonproducers to make ice cream. The cooperative contended that it was necessary to purchase cream from nonproducers if its ice cream operations were to be economically feasible. The marketing of ice cream made from cream purchased from nonproducers destroyed the tax exempt status of the cooperative.[64]

Under certain circumstances, however, a cooperative may market a limited amount of goods furnished by nonproducers. There are three exceptions to the general rule that the marketing of nonproducer products destroys tax exempt status: the emergency purchases exception; the sideline purchases exception; and the ingredient purchases exception.

The emergency purchases exception is applied to preserve tax exempt status when purchases from nonproducers become necessary to meet existing contractual obligations.[65] An example of this exception is provided by a 1969 revenue ruling[66] in which a fruit marketing association entered into contracts for the sale of its members' products to third persons before the marketing season to assure itself of an outlet. The association had fully expected to meet its obligations when it made its contracts. An unexpected frost destroyed a large part of the members' crops, however, and the association was forced to purchase fruit from nonproducers in order to fulfill its contractual obligations. It was held that such purchases did not adversely affect the association's tax exempt status. It was emphasized in the ruling, however, that this exception will save tax exempt status only in true emergency situations. The cooperative must reasonably expect to meet its obligations from the deliveries of producers when it incurs the obligation, and purchases from nonproducers "must be made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and not for any purpose of investment or profit."[67]

A marketing cooperative may make sideline purchases from non-

63. Rev. Rul. 75-4, 1975-1 C.B. 165.
64. *Id.* at 166.
65. Atlantic Coast Distribs. v. Comm'r, 33 F.2d 733 (4th Cir., 1929); Producers' Produce Co. v. Crooks, 2 F. Supp. 969 (W.D. Mo. 1932).
66. Rev. Rul. 69-222, 1969-1 C.B. 161.
67. *Id.*

producers without endangering its tax exempt status.[68] Such purchases may be made only to facilitate the efficient retail marketing of the products of producer patrons. For example, to facilitate the marketing of producers' products, a dairy cooperative may also offer for retail sale products acquired from nonproducers, such as fruit juice and eggs. If, however, the sales of such nonproducer items become so substantial that they are no longer merely incidental to the sale of producers' products, the exception will no longer apply and the cooperative will lose its tax exempt status. Under guidelines set out by the IRS,[69] retail sales of nonproducer sideline items will be considered incidental to the marketing of producers' products where the dollar value of such sales does not exceed five percent of total retail sales. Where retail sales of nonproducer products exceed five percent of total sales the IRS will determine on the basis of all the facts and circumstances in the particular case whether the sales constitute a necessary supplement to the efficient marketing of producer items.

Only one reported case has dealt with the purchasing and marketing of nonproducer products by a tax exempt cooperative. In *Land O' Lakes, Inc. v. United States*,[70] seventeen percent of the products marketed by a dairy cooperative through its retail outlets were nonproducer products. Although the percentage of nonproducer goods was greater than that allowed by the IRS, the district court found that the purpose for which the nonproducer goods were purchased and marketed was to enhance the sales of producer goods. Thus, the marketing of nonproducer products was "incidental to the main purpose of selling producer goods more advantageously," and the cooperative's tax exempt status was upheld.[71]

A marketing cooperative may also purchase ingredients from nonproducers to be used in processing the products of producers.[72] For example, a dairy marketing cooperative may purchase sugar and flavoring from nonproducers to make ice cream from the raw products of producers. Such purchases are justified on the ground that they are necessary to put into marketable condition the agricultural products of producers and cannot be obtained from the producers. If, however, the product can be obtained from producers, the purchase of the product from nonproducers will destroy tax exempt status.[73]

c. *The Relevance of Economic Benefit*

In most of the cases denying tax exempt status that have

68. Rev. Proc. 67-37, 1967-2 C.B. 668.
69. *Id.*
70. 362 F. Supp. 1253 (1973).
71. *Id.* at 1257.
72. Rev. Rul. 75-4, 1975-1 C.B. 165.
73. *Id.* at 166.

been discussed above, the practices or activities which rendered the association non-exempt have worked to the economic benefit of the association and its members. In the case of the grain marketing cooperative that leased its grain elevator,[74] the members benefitted from the increased income from rents. In the case of the vegetable marketing cooperative that bought life insurance policies on its members' lives,[75] naming itself the beneficiary, the cooperative and its members benefitted from the stability the arrangement gave to the association. In the case of the cotton marketing association,[76] the acquisition of the wool processing company would have broadened the economic base of the association, ultimately benefitting the association and its members. In all these situations, a beneficial activity which would have made the association's business more profitable, more efficient, or more stable, was held to abrogate tax exempt status. It seems that economics and efficiency of operation are ignored by the commissioner and the courts when guidelines for marketing association activities are delineated.

There is, however, one case in which a court has held that activities not strictly incidental to marketing the products of the association's members did not abrogate the tax exempt status of the association, because the activities assisted in the efficient performance of the marketing function. In *Eugene Fruit Growers Association v. Commissioner,*[77] the association in question not only marketed the products of its members, but also sold ice and ice cream and owned a machine shop in which custom work for outsiders was performed.[78] The association had purchased the ice cream factory because it contained the equipment needed to insure the proper refrigeration of its members' products. The ice and ice cream business was continued because to do so reduced the refrigeration costs that otherwise would have been ultimately chargeable to the members. The machine shop was used to service the association's cannery. The custom work was performed to more effectively utilize the machine shop and cut down costs chargeable to the association. The Board of Tax Appeals held as follows:

> [A]ll of the activities mentioned originated and were continuously maintained as incidents of the association's principle function, cooperative marketing for agricultural producers. They were . . . designed to assist in the efficient performance of that function by facilitating the marketing of products, on the one hand, and by reducing the cost of neces-

74. Hills Mercantile Co. v. Comm'r, 22 B.T.A. 114 (1931), *supra* notes 44-46, and text accompanying.
75. Rev. Rul. 55-558, 1955-2 C.B. 270, *supra* notes 53-54, and text accompanying.
76. Rev. Rul. 76-233, 1976-1 C.B. 173, *supra* notes 55-60, and text accompanying.
77. 37 B.T.A. 993 (1938).
78. *Id.* at 996.

> sary operations, on the other. The encouragement extended to such enterprises by the favorable provisions of the revenue acts would to say the least be anomalous if the sacrifice of efficient operation were to be required in order to attain the statutory exemption. We find no justification for such a construction of the law or of the regulations.[79]

Eugene Fruit Growers Association v. Commissioner seems to stand for the proposition that activities in which marketing cooperatives engage in order to make their operation more efficient are incidental activities and will not endanger tax exempt status. *Eugene Fruit Growers Association* could be a useful precedent for cooperatives seeking to expand into areas not strictly related to their marketing activities. If the activiity lends itself to a more economical and efficient marketing operation by absorbing fixed costs or otherwise, it can be argued that the activity is incidental and does not destroy tax exempt status.

In cases and revenue rulings since *Eugene Fruit Growers Association,* however, the economic benefit argument does not seem to have been put forth, or, if made, not with great vigor.[80] Perhaps this is because the court in that case qualified its statements about incidental activities by saying that "[such] operations are not [to be] conducted on an ordinary profit-making basis,"[81] and that "[i]t may be that the proportion of business done could be so great that it would be unreal to consider such operations incidental."[82] The cases and revenue rulings that seem to ignore economic benefit may be distinguishable in that they come within the qualifying statements of *Eugene Fruit Growers Association.* In *Eugene,* the ice cream factory was used for refrigerating members' products, and the machine shop was used primarily to service the association's cannery. The facilities were also used for other activities, but the intent of the association in purchasing them was to use them primarily in marketing activities.[83] There was no question but that the association's principal function was cooperative marketing for agricultural purposes and that the questioned activities were truly incidental. It would perhaps be unreasonable to require the association to shut down the other actitivites just to maintain tax exempt status, when the facilities in question would have to be used for marketing activities in any event.

In the cases where tax exempt status was revoked, however, the

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79. *Id.* at 1000-01.
80. *See, e.g.,* Hills Mercantile Co. v. Comm'r, 22 B.T.A. 114 (1931); Rev. Rul. 76-233, 1976-1 C.B. 173; Rev. Rul. 75-4, 1975-1 C.B. 165; Rev. Rul. 55-558, 1955-2 C.B. 270.
81. Eugene Fruit Growers Ass'n v. Comm'r, 37 B.T.A. 993, 1003 (1938), *quoting,* S. REP. No. 52, 69th Cong., 1st Sess. 23-24 (1926).
82. Eugene Fruit Growers Ass'n v. Comm'r, 37 B.T.A. 993, 1001 (1938).
83. *Id.* at 1000.

incidental nature of the questioned activities was not so apparent. Life insurance is probably not incidental to the marketing of vegetables, and the operation of a wool processing plant is probably not incidental to the marketing of cotton. The proposed ventures may have been economically desirable, but they could not have been called "incidental" to marketing activities without stretching the language of section 521 to the point where it would have become unrecognizable.

The precedent of *Eugene Fruit Growers Association* does exist, however, and it does seem to enunciate a more liberal rule with regard to the economic benefit of nonmarketing activities than do the more modern rulings. Considering the vintage (1938) of *Eugene*, however, it may not be wise for a marketing cooperative to risk its tax exempt status on that case's precedential value. The most judicious course of action may be to ask for a revenue ruling before taking any action in a questionable situation.

2. *Purchasing Activities*

Section 521 (b) (1) states that "farmers', fruit growers', or like associations organized and operated on a cooperative basis . . . for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses," shall be tax exempt. According to the treasury regulations, "[t]he term 'supplies and equipment' as used in section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household."[84] This definition would include such things as farm implements, seed, fertilizer, and buildings such as silos and granaries.[85] It would also include groceries, clothing, household appliances, furniture and other necessities. A reasonable approach to the definition of supplies and equipment leads to the conclusion that things such as personal automobiles, recreational equipment, and luxury items should be excluded.

a. *Manufacturing*

The activities in which a tax exempt purchasing cooperative may engage extend beyond the purchasing of supplies and equipment at wholesale. The cooperative may actually engage in the manufacturing of supplies and equipment.[86] "Where a farmers' cooperative purchasing association manufactures products supplied to the farmer patrons, such manufacture represents a part of the purchasing activi-

84. Treas. Reg. § 1.521-1(b) (1965).
85. The definition would also include things such as range grass, Rev. Rul. 75-5, 1975-1 C.B. 166, and cattle semen for artificial insemination, Rev. Rul. 68-76, 1968-1 C.B. 285.
86. *See, e.g.*, Rev. Rul. 69-417, 1969-2 C.B. 132; Rev. Rul. 67-346, 1967-2 C.B. 216; Rev. Rul. 54-12, 1954-1 C.B. 93.

ty of the association."[87] Thus, a fruit growers' purchasing cooperative that supplied its members with crates to be used in shipping their fruit was allowed to expand its activities beyond the mere wholesale purchasing of crates.[88] The cooperative instead purchased large tracts of timberlands and a number of crate mills, and hired labor to manufacture the crates it supplied to its members. These activities were viewed as incidental to the purchasing activities of the cooperative, and were held not to affect its tax exempt status.[89] The same reasoning has been applied to purchasing cooperatives that supply petroleum products to their members; such a cooperative may engage in the refining of petroleum products.[90]

b. *Transactions With Nonmembers*

Purchasing cooperatives, particularly those engaged in manufacturing, often sell their supplies and equipment to nonmember nonproducers. For example, a cooperative that refines its own petroleum products and retails those products will undoubtedly sell some of those products to nonmember nonproducers, such as a truck driver or the urban automobile driver who stops at the cooperative's gas station. Section 521 (b) (4) deals with this situation as follows:

> Exemption shall not be denied any such association . . . which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers *does not exceed* 15 *percent of the value of all its purchases*.[91]

Thus, a purchasing cooperative is allowed to make purchases for persons who are neither members nor producers, provided that the value of such purchases does not exceed the value of purchases made for members or fifteen percent of all purchases. Because supplies and equipment manufactured by the cooperative are treated in the same manner as are supplies and equipment purchased at wholesale,[92] the limitation on dealings with nonmembers also applies to the value of manufactured supplies and equipment.

Problems dealing with the interpretation of section 521 (b) (4) arise in several situations. A common source of disputes is the manufacture by cooperatives of supplies and equipment. For instance, a

87. Rev. Rul. 69-417, 1969-2 C.B. 132, 133.
88. S.M. 2288, III-2 C.B. 233 (1924).
89. *Id.* at 234-35.
90. *See generally* Rev. Rul. 69-417, 1969-2 C.B. 132; Rev. Rul. 67-346, 1967-2 C.B. 216; Rev. Rul. 54-12, 1954-1 C.B. 93.
91. I.R.C. § 521(b)(4).
92. *See* Rev. Rul. 69-417, 1969-2 C.B. 132.

cooperative that refines its own petroleum products often will sell the byproducts of the refining process, useless to its member patrons, to nonmember nonproducers. Such products will be treated as having been purchased for the nonmember nonproducers and their value will be used in determining whether the fifteen percent rule has been violated.[93] On the other hand, if a cooperative engaged in manufacturing merely exchanges products usable by its patrons for *like products* manufactured by nonmember nonproducer concerns closer to the cooperative's retailing outlets, in order to effect a saving in transportation costs, the value of the products exchanged shall be disregarded for purposes of the fifteen percent rule.[94] If, however, the cooperative is proposing to exchange its surplus products with a nonmember nonproducr for *unlike products* which it would not otherwise have available for distribution to its patrons, the product exchanged will be considered to have been purchased for persons neither members nor producers in determining whether the fifteen percent rule has been violated.[95]

Disputes involving the fifteen percent rule arise in many situations. A good example of such a dispute is illustrated by *Land O' Lakes, Inc. v. United States*.[96] Land O'Lakes, a large dairy farmers' marketing and purchasing cooperative, distributed supplies and equipment through independent retailers. It was agreed that the supplies and equipment furnished these nonmember nonproducer retailers constituted more than fifteen percent of all purchases made by the cooperative. It was contended, however, that the supplies and equipment furnished to the retailers eventually reached the cooperative's member patrons, and that the retailers were merely agents of the cooperative. The court disregarded the alleged agency relationship as a legal fiction and determined that because there was no way to know the identities of those buying from the retailers, the sales to the retailers must be taken into account in determining whether the fifteen percent rule had been violated.[97] Thus, Land O'Lakes was denied tax exempt status.

The fifteen percent rule is a real problem for large cooperatives. Sales of supplies and equipment by such cooperatives to nonmember nonproducers are almost inevitable. The best way for cooperatives to keep the value of their purchases of supplies and equipment that will ultimately be sold to nonmember nonproducers below fifteen percent of the value of all purchases is to maintain their own retail outlets and to curtail their sales to nonmember nonproducers.

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93. *Id.*, *modifying*, Rev. Rul. 54-12, 1954-1 C.B. 93.
94. Rev. Rul. 69-417, 1969-2 C.B. 132; Rev. Rul. 54-12, 1954-1 C.B. 93.
95. Rev. Rul. 67-346, 1967-2 C.B. 216.
96. 514 F.2d 134 (8th Cir. 1975).
97. *Id.* at 139.

C STATUS OF COOPERATIVES ENGAGING IN FARMING ACTIVITIES

It appears that a "farmers', fruit growers', or like association" may not engage in actual farming activities and yet maintain tax exempt status. In a 1966 revenue ruling, it was held that a cooperative that was established *solely* to care for and maintain its patrons orchards and to harvest their crops was not tax exempt.[98] The cooperative engaged in no marketing or purchasing activities at all. It was stated in the ruling as follows: "Grove caretaking and harvesting are farming activities, but they do not . . . constitute 'marketing' as that term is used in section 521 of the Code. Moreover, grove caretaking and harvesting do not constitute the purchase of supplies and equipment."[99]

If a cooperative engaged primarily in purchasing or marketing activities also provides other services which cause it to engage in farming activities, it will lose its tax exempt status.[100] The activities of tax exempt cooperatives are limited to purchasing and marketing. Any additional activity, however minor, will destroy tax exempt status.

III. CONCLUSION

This article has attempted to outline the nature of activities in which a "farmers', fruit growers', and like association" may engage without endangering its tax exempt status. Detail has been sacrificed in order to give a broad overview of the problem. Even from such a limited treatment, however, a conclusion can be drawn.

Many of the problems involved in obtaining and maintaining tax exempt status for marketing and purchasing cooperatives deal with definitions. What, for instance, is the definition of "farm," of "necessary marketing expenses," and of "supplies and equipment," etc.? Definitions of these and other terms often cannot be found in treasury regulations or revenue procedures. The definitions that do exist are vague and often misleading. The approach taken in defining these all-important terms is the common law case-by-case or ruling-by-ruling approach. Definitions produced by this method of problem solving are often applicable only to the facts of a particular situation. They provide little guidance to cooperatives seeking to obtain or maintain tax exempt status. Cooperatives should not have to gamble with their tax exempt status every time a change in method of operation is contemplated. Neither should they be required to request a revenue ruling in advance of the implementation of every new planned activity.

98. Rev. Rule 66-108, 1966-1 C.B. 154.
99. *Id.* at 154-55.
100. Dr. P. Phillips Coop. v. Comm'r, 17 T.C. 1002 (1951).

Rather, comprehensive regulations and procedures that set out guidelines for cooperatives to follow should be promulgated.

Farm cooperatives are a major source of investment. Uncertainty is the enemy of investment. Clear, precise, and understandable regulations delineating the permissible extent of marketing and purchasing activities are necessary to enable cooperatives to know before they act that proposed operations will or will not endanger tax exempt status. By making the investment atmosphere more certain, investment will be encouraged. And investment is the only way our chronically sluggish and inflation-ridden economy will ever be able to utilize fully the resources, natural and human, available to it.