

COOPERATIVE TAXATION BRIEF

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IRS Addresses Cooperatives' Allocation Methods

Allocation and distribution of earnings is a fundamental tenant of cooperative operation. It is not only important to comply with bylaws and other contractual agreements with patrons, it is also important for tax purposes. Whether a cooperative is taxed under Subchapter T or other systems of cooperative taxation and exemption, the allocation and distribution of patronage earnings must be carefully considered.

The Service recently considered this important tenant with respect to a Subchapter T cooperative (“Cooperative”) and provided helpful guidance for other cooperatives.

- Background

Cooperative is a wholesale distributor of grocery products to individual retail grocery operates. It purchased products for a group of its patrons (“Patron Group”) from third-party wholesalers. Cooperative filed a lawsuit against certain wholesalers arising from purchases from them over a period of time (the “Litigation Period”). Notably, the litigation was funded by all member/patrons, yet the litigation arose solely from transactions for the Patron Group. The litigation ended in a settlement in which Cooperative received millions of dollars.

To fairly allocate the settlement proceeds, Cooperative passed a bylaw amendment (the “Amendment”) that changed its historical practice of patronage allocations. Historically, Cooperative allocated and distributed patronage dividends based on a single allocation unit based on current-year patronage. The Amendment authorized allocation of certain extraordinary events (including the receipt of the settlement



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proceeds) (i) based on either value or quantity of patronage business and (ii) with respect to patronage earned during the current year or prior years.

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Cooperative planned to allocate the settlement proceeds as follows: (i) a certain portion, as determined by the board, would be allocated to the general allocation unit based on current-year patronage, and (ii) the remainder would be allocated solely to the Patron Group based on patronage occurring during the Litigation Period. Cooperative filed a request for private letter ruling to confirm the propriety of handling the settlement proceed in accordance with the Amendment.

- The Ruling

After determining that the settlement proceeds constituted patronage-sourced income, the Service turned to the Amendment. First, the Service recognized that, under I.R.C. § 1388(a)(1), allocation based on patronage means “on the basis of quantity or value of business” with patrons. Thus, the Amendment was proper in that respect.

Second, the Service concluded that in allocating patronage-sourced income among patrons, the Amendment properly considered prior-year patronage. Supporting this conclusion, the Service noted a prior Revenue Ruling expressly authorizing a cooperative to consider prior-year transactions in determining patronage of current-year patronage-sourced income.

Third, the Service ruled that the Amendment did not undermine the existence of a preexisting legal obligation, which is one of the three key elements of a patronage-



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dividend deduction under Subchapter T. The Cooperative's bylaws obligated it to allocate and distribute patronage-sourced income at the time the prior-year transactions occurred and when it received the settlement proceeds. The Amendment did not affect this obligation; it only modified the method of allocation.

Moreover, the Amendment did not undermine the legal obligation merely because it granted the board discretion over the method of allocation. Such discretion is consistent with the historical principle that the board should have authority to determine the fair and reasonable allocation of patronage earnings.

As a result, the Service concluded that the Amendment resulted in an acceptable allocation of the settlement proceeds within the board's discretion.

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- Implications

This ruling demonstrates the importance of properly allocating patronage earnings. Such allocation is not a one-size-fits-all approach. There are multiple approaches that satisfy the requirements of cooperative principles and Subchapter T. The varying approaches should be carefully considered to reach the most equitable result for the patrons.

Importantly, the ruling demonstrates the important role that a cooperative's board plays in allocation. When such discretion is properly used, it can promote fairness among patrons. (For instance, in the interest of fairness, not all items of income and



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gain recognized in the current year should be allocated using a general allocation unit or pool.) But when too much discretion is granted, it can undermine the pre-existing legal obligation necessary to qualify for the patronage-dividend deduction. For these reasons, it is important for cooperatives to grant a level of discretion within the confines of federal tax law.

About the Author: David R. Cook Jr.

David is a member of the firm's cooperative tax practice group. He started his career as a C.P.A. and auditor for electric and telephone cooperatives. After attending law school, he worked as an international tax consultant at Deloitte Tax LLP until joining the firm. As part of his cooperative law practice, David advises electric, telephone, agricultural, Subchapter T, and other cooperatives on their cooperative tax and corporate questions, power-supply and other commercial transactions, governance, and various cooperative law issues.

Contact David at cook@ahclaw.com. View his profile [here](#).



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