

# **COOPERATIVE TAXATION BRIEF**

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**February 2017**

## **Implications of Cooperative's Conversion to Partnership: Are QWNAs Considered Equity or Debt?**

Cooperative tax professionals occasionally consider whether patronage dividends, such as QWNAs, are considered equity or debt. The issue was central to a recent decision by the Service's Chief Counsel Advisory. These promulgations are important because they are issued by the Office of Chief Counsel at the Service's National Office.

- Background

Cooperative was an exempt agricultural marketing cooperative that bought, processed, and then marketed the product produced by its patrons. As part of its operation as a cooperative, Cooperative issued qualified written notices of allocation ("QWNAs") to its patrons ("Holders").

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At some point after issuing the QWNAs, Cooperative reorganized, under applicable state law, by (i) a statutory merger into another corporation and (ii) a statutory conversion of the resulting corporation into a limited liability company. For federal tax purposes, Cooperative converted from a corporation to a partnership ("Partnership") that no longer operated on a cooperative basis.



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As part of the reorganization, Partnership assumed Cooperative's obligation to pay the remaining balance of QWNAs to Holders. Upon paying off the QWNAs, Partnership recognized a capital loss. The Service questioned the losses and their deductibility.

### - The Parties' Positions

Partnership and the Service agreed that the merger resulted in a tax-free reorganization under I.R.C. § 368(a)(1)(F) (i.e., a change in form of one corporation). They also agreed that the conversion from a corporation to an LLC was subject to Treas. Reg. § 301.7701-3(g)(1)(ii) (i.e., conversion from a corporation to tax partnership). As a result, they agreed that Partnership would recognize gain or loss as if (i) Cooperative distributed all its assets and liabilities to its shareholders and then (ii) shareholders contributed all such assets and liabilities to Partnership in exchange for interests in Partnership. However, the parties differed in their interpretation of how QWNAs should be treated.

Because the Service viewed QWNAs as equity interests in Cooperative, the Service contended the QWNAs were extinguished as part of the liquidating distribution in exchange for the Holder's equity (including QWNAs). As a result, the payment to Holders, ostensibly with regard to QWNAs, was merely a nondeductible distribution.

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On the other hand, Partnership viewed QWNAs as liabilities of Cooperative. As such, they were distributed along with all other liabilities and assets to the shareholders, who immediately contributed them to Partnership. As a result,



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Partnership assumed the obligation to pay Holders with respect to the QWNAs. Upon the payment of such liabilities, subject to Reg. § 1.752-7, Partnership should be entitled to a deduction.

- Conclusion and Implication

The ruling sided with the Service's position. The CCA concludes that the QWNAs were extinguished when Cooperative distributed all assets and liabilities to shareholders in exchange for their equity (including QWNAs). In concluding that QWNAs were equity, the CCA applied the factors stated in prior rulings and case law. Accordingly, the payment to Holders (intended by the taxpayer as a redemption of QWNAs) was a nondeductible distribution by Partnership to the partners.

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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.

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