COOPERATIVE TAXATION BRIEF

May 2016

Cooperative Losses

When it comes to financial losses, many cooperatives are uncertain how to handle them. Because cooperatives attempt to operate at cost, the uncertainty likely arises from the rare occurrence of losses. Sometimes, however, losses are unavoidable, and when they arise, cooperatives must exercise care to handle them properly.

Factual Background

After incurring a substantial loss, a Subchapter T cooperative recently asked the Service for guidance. In particular, the cooperative was concerned about the interplay of Subchapter T and I.R.C. § 172 (governing net operating losses).

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Under its proposal, the cooperative first would apportion the loss based on patronage and non-patronage business. The patronage portion of the loss would be "recovered" by retaining without allocation a portion of future patronage earnings for a certain number of years (the "Plan"). Each year of the Plan, the amount to be retained would be calculated by netting the loss against certain patronage-sourced, non-operating earnings (the "Retained Amount"). After retaining the Retained Amount, the remaining patronage earnings would be available for patronage dividends. The non-patronage portion of the loss would be carried forward to offset future non-patronage income.

Next, as provided under I.R.C. § 172, the cooperative would elect to only carryforward the NOL and would not carryback any amount. On its future tax returns, the cooperative would offset the patronage-sourced portion of the NOL against any retained patronage earnings (i.e., the Retained Amount) but only after deducting any patronage dividend or per-unit retain allocations. The non-patronage-sourced portion of the NOL would offset non-patronage earnings.

For book purposes, the cooperative would reflect the Retained Amount as reductions in the deficit of its unallocated surplus account.

The Rulings

The cooperative asked the Service for guidance on several points, including these key issues: (i) whether patronage earnings remaining after deducting the Retained Amount would be eligible for patronage dividends; and (ii) whether the Plan violates any cooperative principles.

The Service first noted that case law and prior rulings generally indicate that NOL deductions do not reduce a cooperative's patronage earnings available for patronage dividends. It recognized, however, that the cooperative's bylaws or other member- and patronage-contracts may modify this rule. Thus, cooperatives may determine the impact of a NOL on the patronage dividends to be paid in years following the loss.

Applying these principles to the cooperative, the Service concluded that, after adopting the Plan, the cooperative is permitted to (i) withhold certain patronage earnings without allocation, which earnings would be taxable but offset by the NOL deduction, and (ii) use the remaining patronage earnings for patronage dividends.

The Service reasoned that the unallocated patronage earnings (i.e., the Retained Amount each year) would initially be taxable – because they were not allocated to patrons. But the NOL deduction would offset such earnings rendering them effectively non-taxable. In addition, the remaining patronage earnings, which were allocated, would be eligible for patronage dividends and thus effectively non-taxable.

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The Service also ruled that, after the cooperative applied the NOL deduction to the Recovery Amount in prior years, the cooperative need not recompute its patronage dividends in subsequent years.

Finally, the Service noticed that even though the Plan would not produce the most effective tax-minimization result, it was nonetheless within the cooperative's discretion. In addition, the Plan did not violate any cooperative principles. From a purely tax viewpoint, the cooperative could have withheld, without allocation, all patronage earnings necessary to "recoup" the patronage loss as quickly as possible. The cooperative also could have offset the patronage loss against qualified written notices of allocation, thus providing a tax benefit to its members. But the cooperative cited a number of reasons for its Plan, including restoring its balance sheet and maintaining good member relations. The cooperative's board of directors concluded that the Plan was the fairest way of restoring the loss by patrons who benefited. In conclusion, Service ruled the Plan did not violate any cooperative principles.

Implications

This private letter ruling is an example of cooperatives utilizing the discretion provided by prior case law and rulings to best serve its members and patrons. Such discretion is most effectively employed by a thorough understanding of tax rules governing losses.

The interplay of I.R.C. § 172 and Subchapter T is but one of the key issues implicated by losses. In addition, cooperatives should consider whether losses could or should be allocated to members and patrons; whether only some class or unit of members and patrons should bear the economic effect of losses; to what extent members' and patrons' interests can be diminished by such losses; whether the losses may offset patronage and non-patronage earnings or member and non-member earnings; whether the losses indicate a cooperative is not operating as a true cooperative on an at-cost basis; and the distinction between tax, accounting, and legal rules governing cooperative losses.

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