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HANDLING GAINS AND LOSSES ON COOPERATIVE STOCK

— by Neil E. Harl*

The reporting of gains and losses on the stock of cooperatives has been a pressing issue in many farm communities as value-added cooperatives and other cooperatives have failed or merged with cancellation of patronage equities.¹ In many instances, the question is the proper characterization of the equity interest relinquished by the patron and whether losses are ordinary losses or capital losses.²

Rev. Rul. 70-64

A 1970 revenue ruling, *Rev. Rul. 70-64*,³ has provided helpful guidance for situations similar factually to the facts in the ruling. In that ruling, a taxpayer operating a chicken farm became a member of an agricultural cooperative for purposes of acquiring supplies and marketing eggs and chickens.⁴ The cooperative followed the practice of retaining patronage dividends to augment capital with qualified written notices of allocation.⁵ The cooperative normally redeemed the qualified notices of allocation, usually within one to two years.⁶ In the year in question, the cooperative redeemed the qualified written notices of allocation but at less than their stated amount on issuance.⁷ Thus, the taxpayer incurred a loss when the allocation was redeemed. The question was the nature of the loss—whether an ordinary loss or a capital loss.

The ruling states that

“...the taxpayer joined the cooperative to facilitate his business and to make it more profitable. The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer’s trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified written notice of allocation is an ordinary loss deductible...under the provisions of section 165 of the Code.”⁸

The loss was measured by the difference between the stated amount included in income in the earlier year and the amount received upon redemption.⁹

It is noted that the loss did not involve an equity investment by the patron in the cooperative; rather, the loss involved the failure to receive the benefit of amounts reported into income in the earlier year.

Investment in cooperatives

The more difficult question is the proper treatment of gains and losses for equity interests in a cooperative which were purchased or otherwise acquired in a

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transaction that did not involve allocated patronage earnings.¹⁰

It is important to note that all assets are considered to be capital assets other than for specified exceptions.¹¹ The exceptions are for—(1) inventory property,¹² (2) property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business,¹³ (3) depreciable property used in the trade or business,¹⁴ (4) real property used in the trade or business,¹⁵ (5) copyrights and compositions,¹⁶ and (7) U.S. Government publications.¹⁷

Stock in a cooperative does not seem to fall within any of the exceptions.¹⁸ Therefore, it would appear that an investment in stock of a cooperative, including a value-added cooperative, would be a capital asset with a loss properly characterized as a capital loss.¹⁹

Cooperative part of “trade or business”?

A further question is whether an equity interest in a cooperative could be classified as a “Section 1231 asset” which would permit net losses to be treated as ordinary losses.²⁰ Some have argued that, since membership in some cooperatives requires members to be producing a particular product (e.g., corn or sugar beets), membership in the cooperative could be deemed a part of the trade or business.

The problem with that argument is that the definition of “property used in the trade or business” for purposes of Section 1231 capital gain (or ordinary loss) treatment is relatively narrow—

“The term ‘property used in the trade or business’ means property used in the trade or business, of a character which is subject to the allowance of depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year....”²¹

Obviously, cooperative stock or other equity instruments in a cooperative are neither depreciable property nor real property used in the trade or business.²²

In conclusion

Losses attributable to allocated patronage which has been reported into income appear to be deductible as ordinary trade or business losses.²³ However, losses from investments in

cooperative equities would seem to be properly characterized as capital losses.²⁴

FOOTNOTES

- ¹ See generally 14 Harl, *Agricultural Law* § 135.01[5] (2001); Harl, *Agricultural Law Manual* § 14.03[1][a] (2001). See also McEowen & Harl, *Taxation of Cooperatives*, TM-744, Bureau of Nat’l Affairs (1999).
- ² See I.R.C. §§ 165, 1231, 1221.
- ³ 1970-1 C.B. 36.
- ⁴ *Id.*
- ⁵ I.R.C. § 1388(c).
- ⁶ Rev. Rul. 70-64, 1970-1 C.B. 36.
- ⁷ *Id.*
- ⁸ *Id.*
- ⁹ *Id.*
- ¹⁰ See I.R.C. § 1388.
- ¹¹ I.R.C. § 1221.
- ¹² I.R.C. § 1221(1).
- ¹³ *Id.*
- ¹⁴ I.R.C. § 1221(2).
- ¹⁵ *Id.*
- ¹⁶ I.R.C. § 1221(4).
- ¹⁷ I.R.C. § 1221(5).
- ¹⁸ Cf. *Peake v. Comm’r*, 10 TCM 577 (1951) (taxpayer’s interest in cooperative apartment venture consisted of stock in cooperative apartment corporation rather than of proprietary lease and deduction for loss in year investment became worthless was long-term capital loss).
- ¹⁹ I.R.C. § 1221.
- ²⁰ I.R.C. § 1231(a)(2).
- ²¹ I.R.C. § 1231(b)(1).
- ²² *Id.*
- ²³ See I.R.C. § 165.
- ²⁴ I.R.C. § 1221.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor failed to file tax returns for several years and the IRS created substitute returns based upon an interview of the debtor under oath. The debtor argued that the substitute returns were sufficient to make the taxes dischargeable under Section 523(a)(1)(B). The court held that the substitute returns were not sufficient because the debtor did not sign the returns or participate in the execution of the returns. The decision is designated as not for

publication. *In re Wright*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,127 (9th Cir. 2001).

CONTRACTS

WARRANTY. The plaintiffs were cotton farmers who purchased cotton seed from the defendants. The plaintiffs alleged that the seed was old, resulting in loss of yield. The seed was purchased by the defendant from the producer who placed the seed in labeled bags. The labels contained codes which indicated the seed’s age; however, the defendant’s employees did not know the codes or the age of the seed. The