Producers Crop Sharing Corp. v. Commissioner, 22 T.C. 749 (1954)

A cooperative is entitled to exclude from its gross income earnings from business done with its members when it has a pre-existing legal obligation to distribute those earnings to its members as patronage dividends, even if the distribution is in the form of certificates of interest rather than cash.

Summary

Producers Crop Sharing Corp., a cooperative, sought to exclude from its gross income earnings from business done with its members, arguing these were patronage dividends it was legally obligated to distribute. The Tax Court held that the cooperative could exclude these earnings because its charter, bylaws, and contracts with members created a pre-existing legal obligation to distribute the earnings as patronage dividends, even though the distribution was in the form of certificates of interest redeemable at the discretion of the board based on the cooperative's financial condition. The court distinguished this case from situations where the distribution was entirely discretionary.

Facts

Producers Crop Sharing Corp. was organized as a nonstock corporation under the Virginia Cooperative Marketing Act of 1922. Its charter stipulated that members' property rights and interests were proportional to their business with the cooperative, evidenced by certificates of interest. The bylaws mandated that profits from member business be computed annually and set aside in a revolving fund. Members received certificates of interest reflecting their equity in this fund. These certificates were to be liquidated in cash when the directors deemed the revolving fund sufficient for operations. Contracts with members mirrored these obligations.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Producers Crop Sharing Corp.'s income tax. The cooperative petitioned the Tax Court for a redetermination, arguing it was entitled to exclude patronage dividends from its gross income. The Tax Court reversed the Commissioner's determination.

Issue(s)

Whether a cooperative can exclude from its gross income earnings from business done with its members when it is legally obligated to distribute those earnings as patronage dividends, even if distributed in the form of certificates of interest redeemable at the discretion of the board?

Holding

Yes, because the cooperative's charter, bylaws, and contracts with its members established a pre-existing legal obligation to distribute earnings from member business as patronage dividends, even though the distribution was in the form of certificates of interest redeemable at the board's discretion based on the cooperative's financial condition.

Court's Reasoning

The court emphasized that the key factor is whether the cooperative has a pre-existing legal obligation to distribute the earnings to its members. The court found that Producers Crop Sharing Corp.'s charter, bylaws, and contracts with members created such an obligation. The court noted that the Virginia statute under which the petitioner was incorporated was permissive, but that the liabilities of the corporation are determined by the obligations to its members specifically assumed by it under its charter, bylaws and contracts with each member. The court highlighted that the certificates of interest represented an investment by the members in the cooperative, akin to a cash distribution followed by a reinvestment. The court distinguished this case from *Foutain City Cooperative Creamery Association, 9 T. C. 1077, affd. 172 F. 2d 666*, where the distribution of earnings was discretionary. In contrast, Producers Crop Sharing Corp. had a definite obligation to segregate earnings and issue certificates of interest. Quoting *Peoples Gin Co. v. Commissioner, 118 F. 2d 72*, the court emphasized that "In those cases where the deduction was allowed the obligation to make rebates or refunds was in existence before the profits were earned."