17 T.C. 1002 (1951)

A fruit growers cooperative is not exempt from federal income tax if it engages in substantial activities beyond marketing products grown by its members or purchasing supplies for them, or if it markets products purchased by its members from non-member growers near harvest.

Summary

Dr. P. Phillips Cooperative sought tax exemption as a fruit growers cooperative under Section 101(12) of the Internal Revenue Code. The Tax Court denied the exemption because the cooperative engaged in significant grove caretaking activities for its members and marketed fruit that its members purchased from non-member growers shortly before harvest. The court held that these activities exceeded the scope of activities for which a cooperative could be tax-exempt. However, the court allowed the exclusion of amounts retained for reserves where revolving fund certificates were issued pursuant to pre-existing contractual obligations related to caretaking activities.

Facts

Dr. P. Phillips Cooperative was formed by P. Phillips, his family, and several corporations they controlled. The cooperative engaged in two primary activities: maintaining/caretaking citrus groves, and harvesting/marketing citrus fruits. The cooperative provided grove caretaking services to its members under contracts. It also marketed fruit for its members, but some of that fruit was purchased by the members from non-member growers shortly before harvest. The cooperative retained a portion of its proceeds in a reserve and issued revolving fund certificates to its members as evidence of their interest in the retained amounts.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the cooperative's income tax and excess profits tax. The Cooperative challenged the deficiency assessment in Tax Court, arguing it was exempt under Section 101(12) of the Internal Revenue Code, and that retained amounts were excludable patronage dividends. The Tax Court denied the exemption but allowed exclusion of some retained amounts.

Issue(s)

1. Whether the petitioner is a tax-exempt agricultural cooperative under Section 101(12) of the Internal Revenue Code.

2. If not, whether amounts retained as a reserve for capital expenditures, for which revolving fund certificates were issued, represent income taxable to the petitioner.

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Holding

1. No, because the cooperative engaged in substantial activities beyond the scope of Section 101(12), specifically grove caretaking and marketing fruit purchased from non-member growers near harvest.

2. No, but only with respect to amounts retained from caretaking proceeds where there was a pre-existing contractual obligation to issue revolving fund certificates.

Court's Reasoning

The court reasoned that Section 101(12) exempts associations organized to market products of members or purchase supplies for them. The cooperative's activities extended beyond these limits. The court emphasized that the marketing of fruit purchased from non-members shortly before harvest did not constitute marketing the products of "farmers, fruit growers, or like associations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers." Additionally, the cooperative's grove caretaking activities, while beneficial to members, did not qualify for exemption under Section 101(12). Regarding the retained amounts, the court recognized the established practice of excluding patronage dividends from a cooperative's income, especially when revolving fund certificates are issued pursuant to a pre-existing obligation. However, as the marketing contracts did not require the issuance of such certificates, the retained amounts from marketing proceeds were not excludable. The court stated, "Congress did not provide exemption in Section 101 (12) for a corporation marketing the products of mere purchasers and taking care of groves." Only the retained amounts from caretaking activities, for which the contracts required certificates, could be excluded.

Practical Implications

This case clarifies the limitations on tax exemptions for agricultural cooperatives. It emphasizes that to qualify for exemption under Section 101(12), a cooperative's activities must be primarily focused on marketing products grown by its members or purchasing supplies for them. Substantial activities outside this scope, such as providing caretaking services or marketing products purchased from non-members, can jeopardize the exemption. Furthermore, it reinforces the principle that patronage dividends, including amounts retained for reserves, can be excluded from a cooperative's income, but only if there is a pre-existing legal obligation to distribute those amounts, often evidenced by revolving fund certificates. Later cases have cited this case to define the scope of permissible activities for tax-exempt agricultural cooperatives and to determine the excludability of patronage dividends.

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