United Grocers, Inc. v. Commissioner, 308 F.2d 634 (9th Cir. 1962)

Patronage dividends, which can reduce a cooperative's gross income, must be rebates or refunds on business transacted with members pursuant to a pre-existing obligation, not merely a distribution of profits.

Summary

United Grocers, a cooperative, sought to exclude from its gross income patronage dividends paid to its wholesaler members. The IRS disallowed a portion of the claimed exclusion, arguing that it was attributable to services provided to retailers, not rebates to wholesalers, and that the cooperative had discretion over the distribution. The Ninth Circuit reversed the Tax Court, holding that the payments were for services rendered to the wholesaler members under a pre-existing, binding obligation, and thus qualified as patronage dividends excludable from gross income. The court emphasized the mandatory nature of the patronage refund policy outlined in the cooperative's regulations.

Facts

United Grocers, Inc., a cooperative, provided services to its wholesaler members and their retail customers. Wholesalers paid United Grocers a fee, partly funded by retailers, for "regular services." United Grocers then distributed a portion of its earnings back to the wholesalers as patronage dividends. The Commissioner argued that a portion of these dividends, related to services provided to retailers, did not qualify as true patronage dividends.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against United Grocers, Inc., arguing that the patronage dividends were not properly excludable from gross income. United Grocers appealed to the Tax Court, which upheld the Commissioner's determination. United Grocers then appealed the Tax Court's decision to the Ninth Circuit Court of Appeals.

Issue(s)

Whether payments made by a cooperative to its wholesaler members, characterized as patronage dividends, are excludable from the cooperative's gross income when those payments are: (1) partly attributable to services provided by the cooperative to retailers, and (2) subject to the cooperative's discretion regarding distribution.

Holding

Yes, because the payments were for services rendered to the wholesaler members pursuant to a pre-existing, binding obligation, and the cooperative's regulations mandated the distribution of patronage refunds, limiting the board's discretion.

Court's Reasoning

The Ninth Circuit reasoned that the payments made by the wholesalers to United Grocers were for services rendered directly to the wholesalers, not merely acting as a conduit for payments from retailers. The court emphasized that the wholesalers were contractually obligated to pay for these services. Critically, Article VIII of the cooperative's Code of Regulations mandated the payment or credit of patronage refunds annually, stating that "At the close of each calendar year, there shall be paid or credited to the Patrons of the Corporation, a Patronage Refund * * *" The court determined this created a pre-existing, legally binding obligation, limiting the discretion of the board of directors. Therefore, the distributed amounts qualified as true patronage dividends, excludable from gross income, as they were rebates on business transacted with members under a binding obligation. The court distinguished this case from situations where the cooperative retains discretionary control over the distribution of profits.

Practical Implications

This case clarifies the requirements for patronage dividends to be excluded from a cooperative's gross income. It emphasizes the importance of a pre-existing, legally binding obligation to distribute patronage refunds, as evidenced by the cooperative's governing documents (e.g., articles of incorporation, bylaws). The key takeaway is that discretion over the distribution of profits negates the characterization of payments as patronage dividends. Legal practitioners advising cooperatives should ensure that their clients' governing documents clearly establish a mandatory obligation to distribute patronage refunds based on business transacted with members. Subsequent cases have cited United Grocers for the proposition that true patronage dividends must stem from a pre-existing obligation and not represent a discretionary distribution of profits.

