33 T.C. 981 (1960)

A corporation organized to finance crop operations is not exempt from tax under section 101(13) if it was not organized by, and its stock was not substantially owned by, a cooperative or members of a cooperative exempt under section 101(12); further, deposits of funds to indemnify the corporation against credit and operating losses are not taxable income to the corporation in the year of receipt if they are not under the corporation's unfettered control.

Summary

The United States Tax Court addressed two key issues: 1) whether Growers Credit Corporation (petitioner), formed to finance fruit growers, qualified for tax exemption under Section 101(13) of the Internal Revenue Code of 1939; and 2) whether deposits made by grower-stockholders to a reserve fund were taxable income in the years of receipt. The court held that the petitioner did not meet the requirements for exemption under section 101(13) because it was not organized by and its stock was not substantially owned by an exempt cooperative or members thereof. Moreover, the court determined that the reserve fund deposits were not taxable income because the funds were not under the petitioner's unfettered control.

Facts

Petitioner, a corporation established in 1944, provided financing to fruit growers in the North-Central Washington area. The corporation was formed by the efforts of a Land Use Planning Committee (LUPC) made up of fruit growers, after the area was declared a distress area by the Federal Government. The petitioner made loans to grower-stockholders. Borrowers were required to contribute to a reserve fund by depositing 5 cents per packed box of fruit sold, which served to indemnify petitioner against credit and operating losses. These deposits were made by deducting that amount from the sale proceeds, which were remitted to the petitioner and the lending bank. The funds were held in a separate account, and accounted for separately, and refunds of the funds were subsequently made to the growers. The petitioner had no other income, except for the interest from and premiums on the sale of government bonds, which held as collateral for bank loans.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in petitioner's income taxes for fiscal years 1948-1951, including a negligence penalty. The petitioner filed a case in the United States Tax Court challenging these deficiencies. The Tax Court examined the case and waived the negligence addition to tax. The case was decided based on the facts and agreements between the parties after considering the two main issues, whether the petitioner was exempt from tax under section 101(13) and the reserve fund as taxable income.

Issue(s)

1. Whether the petitioner qualifies for tax exemption under Section 101(13) of the Internal Revenue Code of 1939.
2. Whether the 5-cent-per-box deposits to the reserve fund are taxable income to the petitioner in the year of receipt.

Holding

1. No, because the petitioner was not organized by or its stock substantially owned by an association exempt under paragraph (12).
2. No, because the deposits to the reserve fund were not under the petitioner's control, and intended as indemnity, not compensation.

Court's Reasoning

The court first examined the requirements for exemption under Section 101(13). The court reasoned that for exemption to be granted, the corporation must be organized by an association exempt under Section 101(12), or members thereof, and the stock must be substantially owned by the association or its members. The court found that the petitioner was not organized by such an exempt association and that substantially all of the petitioner's stock was not held by members of the association. The court rejected the argument that the members of the cooperatives could be viewed as the individual fruit producers through a chain of membership, emphasizing the requirement that the organization be established by the exempt cooperative. The court emphasized that the individuals who were stockholders were stockholders solely because they had borrowed money from the petitioner. The court stated that the language of section 101(13) should be applied narrowly and concluded that petitioner was not exempt under section 101(13).

The court also examined the nature of the reserve funds. The court noted that the funds were intended as indemnity and were not compensation for the use of capital or for services rendered. The court emphasized that the petitioner did not have unfettered control over these funds and that the funds were to be returned to the depositors upon certain conditions. Because the funds were not under petitioner's control, they were not considered taxable income upon receipt. The court cited Supreme Court precedent on the definition of income (*Eisner v. Macomber*) and the importance of the intent of the parties.

Practical Implications

This case is significant in providing an important clarification of the requirements for tax exemption under Section 101(13). Specifically, it indicates that the language is to be interpreted narrowly, and the entity must be organized by and owned by the exempt cooperative organization. This case also provides a guideline on the treatment of reserve funds, establishing that such funds are not considered taxable income if they are intended for indemnity purposes, are held separately, and are not under the unfettered control of the entity receiving them. In order to avoid taxation, the entity receiving the funds must not claim ownership of the funds or have an unfettered right to use them for any purpose.

