Farm Service Cooperative v. Commissioner, 70 T. C. 145 (1978)

A cooperative can incur net operating losses from patronage activities and offset these losses against income from other activities, including nonpatronage income, and carry back these losses to prior years.

Summary

Farm Service Cooperative, an agricultural cooperative, operated four business activities: a broiler pool, a turkey pool, a regular pool, and a taxable activity. The broiler pool incurred significant losses in the fiscal years ending June 30, 1971, and 1972. The cooperative sought to offset these losses against income from the regular pool and its taxable activity, and to carry back the remaining loss to prior tax years. The Commissioner challenged this, arguing that the cooperative could not claim net operating losses from patronage activities. The Tax Court held that the cooperative could indeed incur such losses, offset them against other income, and carry them back to prior years, as these activities were conducted with a profit motive. The court rejected the application of section 277 of the Internal Revenue Code, which the Commissioner argued should prevent the deduction of these losses, due to lack of supporting evidence.

Facts

Farm Service Cooperative, an agricultural cooperative based in Arkansas, operated four activities: a broiler pool, a turkey pool, a regular pool, and a taxable activity. Membership in the cooperative was required for participation in the broiler and turkey pools but not for the regular pool, which served both members and non-members. The cooperative's bylaws allowed for the equitable distribution of net savings to members based on their patronage and the allocation of losses among profitable activities. For the fiscal years ending June 30, 1971, and 1972, the broiler pool incurred losses of $572,634. 37 and $72,040. 65, respectively. The cooperative offset these losses against income from the regular pool and its taxable activity, and sought to carry back the remaining losses to prior years, reducing its taxable income to zero.

Procedural History

The Commissioner issued a notice of deficiency, disallowing the cooperative's offsetting of broiler pool losses against other income and its carryback of these losses to prior years. The cooperative petitioned the United States Tax Court for a redetermination of the deficiency. The Tax Court reviewed the case and issued its opinion on May 2, 1978.

Issue(s)

1. Whether a patronage activity of a cooperative subject to subchapter T can incur a net operating loss.

2. Whether such a loss can offset income from nonpatronage activities.
3. Whether the loss can be carried back to earlier tax years.
4. Whether section 277 of the Internal Revenue Code applies to prevent the deduction of the broiler pool losses.

Holding

1. Yes, because the broiler pool was operated with a profit motive, and thus, the cooperative is entitled to net operating loss deductions under section 172.
2. Yes, because the cooperative's bylaws authorize the equitable apportionment of losses among activities.
3. Yes, because the cooperative is entitled to carry back net operating losses as provided by law.
4. No, because the Commissioner failed to meet his burden of proof that section 277 applies to the facts of this case.

Court's Reasoning

The Tax Court relied on *Associated Milk Producers, Inc. v. Commissioner*, which established that cooperatives can incur net operating losses from patronage activities. The court found that the broiler pool was operated with a profit motive, rejecting the Commissioner's argument that cooperatives operate patronage activities without a profit motive. The court emphasized that the cooperative's bylaws allowed for the equitable allocation of losses among its activities, supporting the offsetting of broiler pool losses against income from other activities. The court also allowed for the carryback of these losses to prior years, as permitted by law. Regarding section 277, the court found that the Commissioner failed to provide sufficient evidence or legal argument to show that it applied to the cooperative's situation, especially given the legislative history indicating that section 277 was intended to address sham losses, not the genuine losses incurred by the cooperative.

Practical Implications

This decision clarifies that cooperatives can claim net operating losses from patronage activities, offset these losses against income from other activities, and carry them back to prior years. This ruling impacts how cooperatives should structure their tax strategies, particularly in managing losses from volatile business activities. Legal practitioners advising cooperatives must consider the equitable allocation provisions in bylaws when planning for loss allocation. The decision also underscores the importance of distinguishing between genuine business losses and those intentionally generated to shelter income, affecting how section 277 is applied in future cases. Subsequent cases have referenced this decision in determining the tax treatment of cooperative losses, reinforcing its significance in cooperative tax law.