Farmers Cooperative Co. v. Commissioner, 85 T. C. 601 (1985)

The 85% threshold is a reasonable interpretation of 'substantially all' for cooperative stock ownership under IRC Section 521(b)(2), but a facts-and-circumstances approach should also be considered.

Summary

Farmers Cooperative Co. and Farmers Cooperative Society, both tax-exempt cooperatives, were audited for the tax years 1977-1980. The IRS revoked their exemptions, arguing they did not meet the 'substantially all' requirement of IRC Section 521(b)(2), which mandates that substantially all capital stock be owned by active producers. The court upheld the IRS's 85% threshold as a reasonable interpretation of 'substantially all' but acknowledged that a rigid application might not always align with congressional intent, suggesting a facts-and-circumstances approach could be warranted in certain situations.

Facts

Farmers Cooperative Co. , a Nebraska-based cooperative, and Farmers Cooperative Society, an Iowa-based cooperative, were both tax-exempt under IRC Section 521. During audits for the tax years 1977-1980, the IRS determined that neither cooperative met the requirement that 'substantially all' of their capital stock be owned by producers who actively marketed or purchased through the cooperatives. Specifically, the IRS applied an 85% threshold to define 'substantially all. ' Farmers Cooperative Co. had 84. 78% and 82. 52% of its stock owned by active producers in 1977 and 1978, respectively, while Farmers Cooperative Society had 79. 58% and 76. 70% in 1979 and 1980.

Procedural History

The IRS revoked the tax-exempt status of both cooperatives for the years in question. The cooperatives petitioned the U. S. Tax Court for a review of the IRS's determination. The Tax Court consolidated the cases and considered the applicability of the 85% threshold established by the IRS in Revenue Ruling 73-248, which had been upheld by the Eighth Circuit in West Central Cooperative v. United States (1985).

Issue(s)

1. Whether the 85% threshold established by the IRS in Revenue Ruling 73-248 is a reasonable interpretation of 'substantially all' under IRC Section 521(b)(2)?
2. Whether the facts-and-circumstances approach should be considered in addition to the 85% threshold when determining compliance with the 'substantially all' requirement?

Holding

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1. Yes, because the Eighth Circuit's approval of the 85% threshold in West Central Cooperative v. United States (1985) was binding, and the Tax Court found it a reasonable interpretation of the statute.
2. Yes, because although the 85% threshold is generally applicable, the court recognized that a rigid application might not always fulfill congressional intent, and thus a facts-and-circumstances approach could be warranted in certain situations.

Court's Reasoning

The court applied the 85% threshold as a reasonable interpretation of 'substantially all' due to the Eighth Circuit's precedent in West Central Cooperative. The court noted that prior decisions had established that percentages below 78% did not meet the requirement, while 91% did. The court also considered the policy behind the tax exemption for cooperatives, emphasizing that the benefit should go to member-producers, not the cooperative itself. However, the court recognized that a strict application of the 85% threshold might not always align with congressional intent, suggesting a facts-and-circumstances approach could be necessary in certain cases. The court emphasized that the cooperatives failed to restrict stock ownership to active producers as far as possible, as evidenced by delays in purging nonparticipating shareholders. The dissent argued against adopting a bright-line test, favoring the long-standing regulations' facts-and-circumstances approach.

Practical Implications

This decision provides clarity on the IRS's 85% threshold for determining 'substantially all' under IRC Section 521(b)(2), which cooperatives should use as a benchmark for compliance. However, practitioners should also be aware of the court's suggestion that a facts-and-circumstances approach could be warranted in certain situations, potentially allowing for flexibility in unique cases. This ruling impacts how cooperatives manage their stock ownership, emphasizing the need for timely action in purging nonparticipating shareholders to maintain exempt status. Subsequent cases, such as Land O'Lakes, Inc. v. United States (1985), have further explored the application of the 85% threshold and the facts-and-circumstances approach. Practitioners should advise cooperatives to closely monitor their stock ownership and consider the broader context when assessing compliance with tax-exempt status requirements.

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