Farmers Cooperative Co. v. Commissioner, 822 F. 2d 774 (8th Cir. 1987)

The ‘substantially all’ requirement for cooperative exemption under section 521 focuses on stock ownership by producers, not on the percentage of business they conduct with the cooperative.

Summary

In Farmers Cooperative Co. v. Commissioner, the Eighth Circuit Court of Appeals clarified that the ‘substantially all’ requirement for cooperative exemption under section 521 focuses on stock ownership by producers, not on the percentage of business they conduct with the cooperative. The court reversed the Tax Court’s decision which had applied a 50% patronage test, holding that the cooperative met the 85% stock ownership test for 1977. The case was remanded for further consideration of the cooperative’s exempt status based on the clarified statutory interpretation.

Facts

Farmers Cooperative Co. sought exemption under section 521 of the Internal Revenue Code. The cooperative’s records showed that it met the 85% stock ownership requirement by producers for 1977, but did not track the total business activity of patrons outside the cooperative. The Commissioner had applied a 50% patronage test, requiring that patrons conduct at least half of their business with the cooperative to qualify as producers under the statute.

Procedural History

The Tax Court initially denied the cooperative’s exemption, applying the Commissioner’s 50% patronage test. On appeal, the Eighth Circuit affirmed in part, reversed in part, and remanded the case, holding that the relevant consideration for the ‘substantially all’ test is stock ownership by producers at the time of the annual shareholders’ meeting.

Issue(s)

1. Whether the ‘substantially all’ requirement under section 521 focuses on the percentage of business patrons conduct with the cooperative or on stock ownership by producers.
2. Whether the Commissioner’s 50% patronage test is consistent with the statutory language and congressional intent of section 521.

Holding

1. No, because the ‘substantially all’ requirement focuses on stock ownership by producers at the time of the annual shareholders’ meeting, not on the percentage of business conducted with the cooperative.

2. No, because the 50% patronage test is not supported by the statutory language or congressional intent, which aims to maintain the cooperative's nonprofit and conduit-like status.

Court's Reasoning

The Eighth Circuit interpreted the 'substantially all' requirement under section 521 to focus on stock ownership by producers, not on the percentage of their business conducted with the cooperative. The court reasoned that the statute's purpose is to ensure the cooperative operates as a nonprofit conduit for its members, not to restrict patrons' business activities. The court rejected the Commissioner's 50% patronage test, finding no statutory basis or congressional intent to support it. The court noted that the test was first introduced in a 1973 revenue procedure, long after the statute's enactment, and had not been judicially approved. The court emphasized that the cooperative's exempt status should be determined based on the stock ownership test alone, as clarified in the opinion: 'for purposes of applying the 85% test, the relevant consideration is whether the right to vote has actually accrued or been terminated by the time of the annual shareholder's meeting following the close of the tax year. '

Practical Implications

This decision clarifies that cooperatives seeking exemption under section 521 should focus on ensuring that 'substantially all' of their stock is owned by producers at the time of the annual shareholders' meeting. The ruling eliminates the need for cooperatives to track and enforce a minimum percentage of patrons' business activity with the cooperative, simplifying compliance efforts. The decision may lead to increased cooperative exemptions by removing an additional hurdle to qualification. Future cases involving cooperative exemptions should analyze stock ownership rather than patronage levels. The ruling also highlights the limited authority of revenue procedures in establishing legal requirements, potentially impacting how the IRS and courts approach similar agency pronouncements in other areas of tax law.

