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11-15-2002

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Recommended Citation
Harl, Neil E. and McEowen, Roger A. (2002) "On Failure of a Cooperative: When is a Loss Deductible?," *Agricultural Law Digest*: Vol. 13 : No. 22 , Article 1.
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Agricultural Law Press
Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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Agricultural Law Digest

Volume 13, No. 22 November 15, 2002 ISSN 1051-2780

ON FAILURE OF A COOPERATIVE: WHEN IS A LOSS DEDUCTIBLE?

— by **Neil E. Harl[*] and Roger A. McEowen[**]**

The failure, merger or bankruptcy reorganization of several farm cooperatives in recent months[1] has raised questions concerning the character of losses for income tax purposes, what Code section applies and when such losses may be claimed.[2]

Character of losses

For interests in a cooperative representing retained patronage dividends, redemption of qualified written notices of allocation at less than the stated amount on issuance produces an ordinary loss.[3] The loss is measured by the difference between the stated amount that was included in income in an earlier year and the amount received upon redemption.[4] Ordinary losses can be used to reduce ordinary income without limit.[5]

For transactions that do not involve allocated patronage dividends, but instead involve the taxpayer's investment in stock of the cooperative, the outcome is a capital gain or capital loss.[6] An equity interest in a cooperative is not eligible for treatment as a trade or business gain or loss under I.R.C. § 1231. That's because a "trade or business" is defined as "property used in the trade or business, of a character which is subject to the allowance for depreciation…held for more than 1 year, and real property used in the trade or business, held for more than 1 year…."[7] Cooperative stock is neither depreciable property nor real property.[8]

For members of a cooperative that incur a write-down of equity, if the equity was based on patronage, the nature of the loss is an ordinary loss.[9] However, for a cooperative that had triggered gains or losses from the sale of facilities, the treatment is more complex. In a 1999 Tax Court case[10] involving the sale of facilities by Farmland Industries, the court said the proper patronage classification test is whether each item of gain or loss was realized in a transaction that either directly related to the cooperative's enterprise or facilitated the cooperative's activities on behalf of its patrons. If that test is met, the write-down of equity produces an ordinary loss; if that test is not met, the write-down produces a capital loss.[11] The Tax Court rejected the IRS argument that capital gains and losses never qualify as patronage income.[12] IRS had previously allowed capital gains representing unrealized appreciation in the value of a cooperative's assets to be classified as patronage income.[13]

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Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405 (ph 541-302-1958), bimonthly except June and December. Annual subscription $110 ($90 by e-mail). Copyright 2002 by Robert P. Achenbach, Jr. and Neil E. Harl. No part of this newsletter may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording or by any information storage or retrieval system, without prior permission in writing from the publisher. http://www.agrilawpress.com Printed with soy ink on recycled paper.

Losses on investments made by members or others in the cooperative, such as uninsured and unsecured debt securities offered by the cooperative to investors, are capital losses.[14]

Applicable Code Section

The appropriate Code section for the deduction of losses depends on whether the loss is properly characterized as a loss from worthless securities[15] or a bad debt.[16] The two are mutually exclusive inasmuch as the bad debt deduction provision is specifically made inapplicable to a debt which is evidenced by a security as defined in the worthless securities provision.[17]

Worthless securities. Although the regulations do not provide guidance on whether stock in a cooperative is subject to treatment as a worthless security, the Tax Court has allowed losses on cooperative stock to be deducted under the worthless security rules.[18]

Under the worthless securities rules, the cost or other basis of stock is deducted in the year that the stock becomes totally worthless.[19] No deduction is allowed for partially worthless stock.[20] A loss from worthless stock that is a capital asset is generally subject to the limitation on capital losses.[21] Note that if any security which is not a capital asset becomes wholly worthless during the year, the loss is an ordinary loss.[22]

Therefore, it would seem that stock in a cooperative which was acquired as an investment, and which does not involve retained patronage is a capital asset and is subject to treatment as a worthless security.[23] However, whether an interest in a cooperative representing retained patronage is subject to the worthless securities rules depends upon whether the interest is a capital asset.[24] The fact that the Internal Revenue Service in *Rev. Rul. 70-64*[25] allowed ordinary loss treatment on such an interest would indicate that an interest in a cooperative representing or including retained patronage is not considered a capital asset. *Rev. Rul. 70-64*[26] specifically noted that the ordinary loss in that ruling was deductible under the worthless securities provision, *I.R.C. § 165*.[27] Keep in mind that *Rev. Rul. 70-64*[28] was issued well before the U.S. Supreme Court chastised taxpayers (and the Internal Revenue Service) for ignoring the plain meaning of the statutory definition of capital asset which is that everything is considered to be a capital asset except assets specifically excluded.[29]

Bad debt. If an interest in a cooperative is not considered subject to the worthless securities rules,[30] on the grounds that the interest in the cooperative that represents retained patronage is not a "security" within the meaning of the worthless securities provision, any loss may be allowable as a bad debt deduction.[31] In that event, a deduction is available if the debt becomes wholly worthless during the year.[32] Only a bona fide debt qualifies for a bad debt deduction.[33] A bona fide debt is a debt arising from a debtor-creditor relationship based upon a valid and enforceable obligation.[34]

For a partially worthless bad debt, a deduction is allowed "not in excess of the part charged off" within the taxable year.[35] However, nonbusiness bad debts must be totally worthless; partially worthless nonbusiness bad debts are not deductible.[36]

A business bad debt, which can be deducted directly from gross income, relates to operating a trade or business and is mainly the result of credit sales to customers or loans to suppliers, clients, employers or distributors.[37]

Nonbusiness bad debts include debts other than debts created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.[38] As noted above,[39] to be deductible nonbusiness bad debts must be totally worthless; partially worthless nonbusiness bad debts are not deductible.[40]

When are losses deductible?

For losses involving worthless securities, remember that only the basis of "wholly worthless" securities is deductible in a taxable year.[41] Losses involving a cooperative in reorganization bankruptcy (Chapter 11) would seem *not to be deductible until there is a formal determination that the securities are indeed worthless.*

It would seem that losses on interests in a cooperative, representing retained patronage, may be classified as business bad debts.[42] While partially worthless bad debts are deductible as business bad debts,[43] it is necessary to show that the deductible amount was "charged off"[44] during the year. Bankruptcy is generally good evidence that at least part of a debt is worthless.[45] As stated in the regulations [46]

"In bankruptcy cases a debt may become worthless before settlement in some instances; and, in others, only when a settlement in bankruptcy has been reached."

For a cooperative in reorganization bankruptcy, a bad debt deduction may not be claimable until formal action is taken by the bankruptcy court declaring that the debt has, indeed, been "charged off."[47]

The inability to claim a current year loss on a cooperative interest may be a particularly bitter pill to swallow for a member-cooperative of a cooperative in reorganization bankruptcy that has had several successive years of patronage allocation deductions.

FOOTNOTES

1 Ag Way, Inc., a large northeastern farm and horticulture cooperative based in New York filed for Chapter 11 bankruptcy on October 1, 2002; Farmland Industries, Kansas City, filed for bankruptcy on May 31, 2002; Tri-Valley Growers, a major Northern California vegetable processing cooperative, is in liquidation after filing for bankruptcy; Crestland Cooperative in Creston, Iowa, filed for Chapter 11 bankruptcy in September of 2001; Ty-Walk Cooperative in Illinois failed in 2001 as did a large farm cooperative in Lawrence, Kansas, in September, 2000. See Harl, "Tax Consequences of Cooperatives That Fail," 6 *Ag Lender*, Issue 11 (2002).

2 See Harl, "Handling Gains and Losses on Cooperative Stock," 13 *Agric. L. Dig.* 1 (2002). See generally 14 Harl, *Agricultural Law* § 135.01[5] (2002); Harl, *Agricultural Law Manual* § 14.03[1][a] (2002). See also McEowen and Harl, *Taxation of Cooperatives*, TM-744, Bureau of National Affairs (1999).

3 Rev. Rul. 70-64, 1970-1 C.B. 36 (chicken farmer who had acquired supplies from local cooperative).

[4] *Id.*
[5] See I.R.C. § 162(a).
[6] See I.R.C. § 1221(a).
[7] I.R.C. § 1231(b)(1).
[8] *Id.*
[9] See Rev. Rul. 70-64, 1970-1 C.B. 36.
[10] Farmland Industries v. Comm'r, T.C. Memo. 1999-388.
[11] *Id.*
[12] *Id.*
[13] Rev. Rul. 74-24, 1974-1 C.B. 244; Rev. Rul. 71-439, 1971-2 C.B. 321.
[14] See I.R.C. § 1221(a).
[15] I.R.C. § 165(g).
[16] I.R.C. § 166(a).
[17] I.R.C. § 166(e).
[18] Morton v. Comm'r, 38 B.T.A. 1270, Dec. 10,517 (non-acq.); Peake v. Comm'r, 10 TCM 577 (1951).
[19] I.R.C. § 165(g)(1). See Treas. Reg. § 1.165-5(c) (requiring that the security be "wholly worthless at any time during the taxable year").
[20] *Id.*
[21] Treas. Reg. § 1.165-5(c).
[22] Treas. Reg. § 1.165-5(b).
[23] Treas. Reg. § 1.165-5(c).
[24] I.R.C. § 1221(a).
[25] 1970-1 C.B. 36.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] See Arkansas Best Corp. v. Comm'r, 485 U.S. 212 (1988).
[30] I.R.C. § 165(g).
[31] I.R.C. § 166(a).
[32] I.R.C. § 166(a)(1).
[33] Treas. Reg. § 1.166-1(c).
[34] *Id.*
[35] I.R.C. § 166(a)(2).
[36] Treas. Reg. § 1.166-5(a). See, e.g., Scagliotta v. Comm'r, T.C. Memo. 1996-498 (taxpayer expected to receive some distribution from bankruptcy estate; not worthless in year at issue).
[37] See I.R.C. § 166(d)(2). See 5 Harl, *Agricultural Law* § 39.05[3][b] (2002).
[38] I.R.C. § 166(d)(2).
[39] Note 37 *supra* and accompanying text.
[40] Treas. Reg. § 1.166-5(a).
[41] Treas. Reg. § 1.165-5(c).
[42] See I.R.C. § 166(d)(2).
[43] Treas. Reg. § 1.166-5(a).
[44] I.R.C. § 166(a)(2).
[45] Treas. Reg. § 1.166-2(c).
[46] *Id.*
[47] I.R.C. § 166(a)(2).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

ABANDONED RIGHT-OF-WAY. The parties' lands were separated by a railroad right-of-way. The defendant's title covered land on both sides of the right-of-way, including a small strip on the plaintiff's side. The plaintiffs and their predecessors in interest had farmed all the land up to the right-of-way for over 20 years when the railroad abandoned the tracks and right-of-way. The railroad abandoned the tracks five years before the defendant purchased the defendant's land and the defendant discovered the true boundary a few years later. The defendant argued that the plaintiff could not acquire title to the disputed land because the plaintiff had no idea that the land did not belong to the plaintiff. Essentially, the defendant argued that the plaintiff needed a specific intent to claim ownership of land which the plaintiff knew belonged to someone else in order for the plaintiff's possession to be hostile and give rise to passage of title by adverse possession. The court held that no such specific intent was required in Missouri. The plaintiff was only required to treat the land as the plaintiffs' for the specified time, 10 years, in order for hostile possession to occur. In addition, because the plaintiff had adversely possessed the disputed land for more than 10 years before the right-of-way was abandoned, the plaintiff also acquired one-half of the right-of-way. **Kohler v. Bolinger, 70 S.W.2d 616 (Mo. Ct. App. 2002)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. The debtor entered into an agreement with a creditor to allow the creditor to cut timber from the debtor's land in exchange for money. After the creditor cut a substantial amount of timber, the debtor claimed that the contract limited the cutting to 119 trees and prevented the creditor from cutting any more trees. The creditor sued in state court and obtained a judgment in the creditor's favor. After the debtor filed for bankruptcy, the creditor sought to have the judgment declared nondischargeable, under Section 523(a)(2)(A), as obtained through fraud. The court held that the claim was based upon a breach of contract dispute and lacked any intent to defraud the creditor; therefore, the judgment was not nondischargeable. ***In re* Smith, 281 B.R. 613 (Bankr. W.D. 2002)**.

FEDERAL TAX-*ALM* § 13.03[7].*

ADEQUATE PROTECTION. The debtor was in the construction business and sought permission to incur debt in