Losses Relating to Cooperatives

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Losses Relating to Cooperatives

As is becoming increasingly evident, the economic downturn with lower commodity prices is generating losses for farmers and, in some instances, cooperatives and other firms providing inputs for production. Cooperatives are particularly vulnerable inasmuch as many are capitalized at levels that make economic stress a more serious problem. Because the rules governing losses with cooperatives are somewhat different from the rules governing other types of firms, this article focuses on the uniquenesses of handling losses from a cooperative.

General rules on deducting losses

Cooperatives are the only organizational structure where the same membership interest in a cooperative may be able to deduct a loss as an ordinary loss up to a point and deduct the rest of the loss as a capital loss. That is because, for interests in a cooperative representing retained patronage dividends by the cooperative, or redemption of qualified written notices of allocation at less than the stated amount on issuance, an ordinary loss can be claimed for that portion of the overall loss. That is because the amount of loss in question has already been subjected to income tax and so an ordinary loss is appropriate. For transactions that do not involve allocated patronage dividends, but instead merely involve the taxpayer’s investment in cooperative stock, gains and losses are capital gains and capital losses.

One cooperative, trying to take advantage of the unique handling of losses involving a § 1231 asset (where gains may be capital gains but losses are ordinary losses) concluded that a cooperative’s losses are not eligible for Section 1231 treatment. That is because Section 1231 loss treatment is limited to “...property used in a trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than one year, and real property used in the trade or business, held for more than one year. . . .” That definition does not include an equity interest in a cooperative.

Losses on investments made by members (or others) in a cooperative, which are unrelated to patronage, are capital losses. One recent bankruptcy involving a major cooperative revealed that many investors, not otherwise involved in the cooperative’s activities, were using the cooperative as a “bank.” In that instance, losses would have been capital losses except for the fact that the bankruptcy process was stretched out over a period of years and during that time assets of the cooperative increased in value and additional assets were found to exist so that the payouts to mere investors were much higher than originally projected.
Are losses from a “worthless security” or a “bad debt”? 

The question of when losses are deductible depends upon whether a loss is characterized as arising from a worthless security or a bad debt.\(^7\)

**Losses on worthless securities.** The regulations do not provide guidance on whether stock in a cooperative is subject to treatment as a worthless security but the Tax Court has allowed cooperative losses under the worthless securities rules.\(^8\) Under the worthless securities rules, the cost or other basis is deducted in the year the stock became worthless.\(^9\) Thus, no deduction is allowed for partially worthless stock.

A loss from worthless stock that is a capital asset is generally subject to the limitation on capital losses.\(^10\) If any security which is not a capital asset becomes wholly worthless during the year, the loss is an ordinary loss.\(^11\) Therefore, it would seem that stock in a cooperative which was acquired as an investment, and which does not involve patronage, is a capital asset and is subject to treatment as a worthless security.\(^12\)

Whether an interest in a cooperative representing retained patronage is subject to the worthless securities rules depends upon whether the interest is a security.\(^13\) The IRS, in Rev. Rul. 70-64,\(^14\) which allowed ordinary loss treatment on such an interest, held that an interest in a cooperative, representing or including retained patronage, is not considered a capital asset. That ruling specifically noted that the ordinary loss in that ruling was deductible under the worthless securities provision which would indicate that the interest involved was not a capital asset. Keep in mind, however, that Revenue Ruling 70-64\(^15\) was issued 18 years before the United States Supreme Court chastised taxpayers and the Internal Revenue Service for ignoring the statutory definition of “capital asset” which is that everything is considered to be a capital asset except for assets specifically excluded.\(^16\)

In light of the requirement that, to be deductible, losses on worthless securities must be “wholly worthless,” 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. Abandonment is not necessary to establish worthlessness.\(^17\)

**Bad debt deduction.** In the event an interest in a cooperative representing retained patronage is subject to the worthless securities rules, the cost or other basis is deducted in the year the stock became worthless. \(^20\) For a partially worthless business bad debt, a deduction is allowed “not in excess of the part charged off” within the taxable year.\(^21\) However, a non-business bad debt must be totally worthless to be deductible; partially worthless non-business bad debts are not deductible.\(^22\) 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.\(^23\)

For a cooperative in reorganization bankruptcy, a bad debt deduction generally may not be claimable until formal action is taken by the bankruptcy court declaring that the debt has been “charged off.” \(^24\)

**ENDNOTES**

4. I.R.C. § 1231.
5. See I.R.C. §§ 1211, 1221.
6. I.R.C. § 165(g).
7. I.R.C. § 166(a).
9. 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.” See also Wagner v. United States, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,238 (M.D. Fla. 2003) (stock not completely worthless during year); Geddis v. Comm’r, T.C. Memo. 2005-191 (capital loss carryforward disallowed; failed to substantiate and failed to show stock became totally worthless).
17. CCA 200851050, Oct. 27, 2008.
18. I.R.C. § 166(a).
19. I.R.C § 166(e).