Cooperatives -- Allowable Federal Tax Deductions When Income Distributed In Absence of Binding Agreement

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RECENT CASES

COOPERATIVES — ALLOWABLE FEDERAL TAX DEDUCTIONS WHEN INCOME DISTRIBUTED IN ABSENCE OF BINDING AGREEMENT.

Petitioner, an Alabama corporation, legally adopted the consumer cooperative form of organization, distributed "patronage dividends" to its members in proportion to their trading operations and claimed deductions for this disbursement on its federal excess profits and income taxes for the years 1941-1942. These deductions were disallowed by the Commissioner. Held, that since there was no enforceable obligation on the petitioner to pay any dividends to its members, those dividends, when paid pursuant to corporate action taken after petitioner had received income, did not constitute allowable deductions.1

Knowledge pertaining to the tax status of consumers' cooperatives is meagre.2 No tax exemption is accorded by statute.3 But rulings by the Treasury Department4 and decisions in the lower federal courts5 have freed the difference between the cost and selling price from taxation as income to the cooperative if that difference is distributed to cooperative members in proportion to their purchases.6 There must exist, however, a legal obligation on the part of the cooperative, before the receipt of the difference, to return to its members at least part of the funds which have accrued in excess of the cost of goods sold.7 Such an obligation must

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3 Sec. 101 (12) of the Internal Revenue Code exempts entirely from federal income tax: "Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing... and turning back... the (net) proceeds of sales... or (b) for the purpose of purchasing of supplies and equipment... at actual cost plus necessary expenses..."
5 Uniform Printing & Supply Co. v. Commissioner, 88 F. 2d 75 (C. C. A. 7th 1937).
6 But in reality consumer cooperatives have often adopted the practice of distributing earnings not in cash but in pieces of paper representing the amount of the member's patronage dividends with the option of collection accompanied by a tacit agreement that the members will not collect. Thus although the cooperative is taxed on any portion of the excess not turned back to its members but set aside instead as a reserve, it can accomplish the same objective, without subjecting itself to tax, by distributing the excess in script. See Sowards, note 2 supra.
7 Peoples Gin Co., Inc. v. Commissioner, 118 F. 2d 72 (C.C.A. 5th 1941);
arise from the cooperative's articles of association, by-laws, or other binding contract.\(^8\) Distribution cannot depend upon an informal agreement between the co-op and its members\(^9\) nor upon action taken by the co-op after its receipt of the funds later distributed.\(^{10}\)

In the instant case, the cooperative's by-laws were mandatory in requiring distribution of the difference between the cost of operation and selling price to members, but a subsequent amendment to the articles of incorporation nullified these by-laws by leaving it to the discretion of the board of directors to distribute any part of the difference. The leading case of *Uniform Printing & Supply Co. v. Commissioner*\(^{11}\) seems clearly distinguishable. In that case by-laws required the directors to distribute some part of the difference; only the amount payable was left to their discretion. But in the principal case "the very obligation itself to make such refunds" was within the discretion of the directors.\(^{12}\) It is submitted that the court in the instant case properly held that there was no binding obligation, and consequently that even though distribution was effected, no allowable deduction resulted.

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**ABOLITION OF THE RULE IN SHELLEY'S CASE IN FLORIDA — EFFECT OF STATUTE ON WILLS EXECUTED PRIOR THERETO.**

Old laws, like old soldiers, die hard. The ancient Rule in Shelley's Case, abolished in Florida by act of legislature,\(^1\) appears to have been revived by a recent case.\(^2\)

These were the facts noted in the opinion: A testator directed that


\(^{2}\) *Elsasser v. Elsasser et al, Fla.,* 32 So. 2d 579 (Fla., 1947).