

THE FEDERAL TAX ASPECTS OF STOCK ISSUED BY BANKS FOR COOPERATIVES

Seeking adequate means of providing commercial credit at reasonable rates to farm cooperative associations,¹ Congress in 1916 established the Federal Farm Loan Board² to provide loans through the Federal land banks³ on farm mortgage security. To further improve and expand the sources of credit available to farmers and to stimulate the growth and development of farmers' cooperatives, the Farm Credit Act of 1933⁴ established a system of twelve regional banks and one Central Bank for Cooperatives⁵ which extends credit to farmers' marketing, purchasing, and service cooperatives. The system of banks for cooperatives is a part of the overall structure of the Farm Credit Administration.⁶

The initial capital for the banks was provided by congressional appropriation of public funds,⁷ with the condition that a borrowing cooperative had to purchase \$100 of stock of the lending bank for each \$2000 borrowed. Once the borrowing cooperative had completed repayment of the loan, the stock purchased was redeemable on demand. However, to effectuate the goal of organizing the banks on a truly cooperative basis, a method had to be devised which would provide for retirement of the government-supplied capital. Pursuant to a study conducted by the Federal Farm Credit Board,⁸ Congress enacted the Farm Credit Act of 1955⁹ (hereinafter referred to as Section 1134d) to provide a comprehensive plan for such retirement of the government-owned capital. Section 1134d provided for three classes of stock, each having a par value of \$100 per share: Class A for government-

¹ 12 U.S.C. § 1141j(a) (1964) provides in part:

(a) "Cooperative association" defined.

As used in this subchapter, the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services.

² Act of July 17, 1916, ch. 245, § 3, 39 Stat. 360, as amended, 12 U.S.C. § 1141 (1964).

³ 12 U.S.C. § 641 (1964).

⁴ 12 U.S.C. § 1134 (1964).

⁵ The country is divided into twelve farm credit districts with one bank in each district. The Central Bank for Cooperatives is located in Washington, D.C.

⁶ 12 U.S.C. § 1134 (1964). The Farm Credit Administration supervises, examines, and coordinates the activities of the credit agencies in the Federal Farm Credit System. The Farm Credit Administration consists of the Federal Farm Credit Board, the Governor, and other officers and employees. 12 U.S.C. § 636c et. seq. (1964).

⁷ The original authorized appropriation was \$500 million. 12 U.S.C. § 1141d (1964). The Federal Farm Credit Board was given general supervision of the banks for cooperatives and was required to consider and recommend to the Congress a method that eventually would retire the government capital from the Farm Credit System.

⁸ S. Doc. No. 7, 84th Cong., 1st Sess. 14 (1955).

⁹ 12 U.S.C. § 1134d (1964).

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owned capital, Class B for private investors, and Class C to be issued only to farmers' cooperatives as a condition of borrowing from the cooperative bank. A difficult problem has arisen as to the nature of the Class C stock for federal income tax purposes. Recent decisions have held that the stock purchased is an "expense" and have allowed a current deduction for interest or business expense; one decision has held that the stock is in the nature of a capital asset.

The purpose of this comment is to determine the proper tax treatment of the Class C shares by examining the statutory language, the legislative policy, and the several cases which have dealt with the problems raised. Finally, a method of analysis will be proposed which attempts to resolve the inconsistencies illustrated by these problems and which, it is concluded, the courts should adopt.

I. THE FARM CREDIT ACT OF 1955 (SECTION 1134d)

In order to fully comprehend the issues as to the proper tax treatment of Class C shares, it is necessary to examine the framework that Congress has established to provide for capital funding on the cooperative principle. Prior to the enactment of section 1134d, farmers' cooperative associations borrowing from the banks were required to purchase capital stock or to subscribe to a guaranty fund¹⁰ (both here referred to as capital stock), of the banks in stated amounts related to the size and type of loans. By 1955, cooperative associations held capital stock amounting to \$19,904,400, and cooperative banks held earned surplus and reserves of \$81,720,003.¹¹ The banks obtained additional capital from the sale of debentures to the public and through loans from the federal intermediate credit banks¹² with regional banks lending directly to cooperative associations. The Federal Farm Credit Administration set lending limits for the regional banks based upon a percentage of their capital, surplus and reserves.¹³ Where a particular regional bank exceeded its borrowing limits, the Central Bank was offered the amount above the lending limit.¹⁴ Although the system provided for adequate and sound credit service to cooperative associations, it could not have survived without the capital contributed by the

¹⁰ 12 U.S.C. § 1134d(b) (1964) provides for guaranty-fund subscriptions in lieu of Class B and Class C stock purchases where state law does not permit cooperative associations to acquire stock in a bank for cooperatives. The holder of guaranty-fund equivalents of Class B or Class C stock has the same rights as the holder of Class B and Class C stock. The rights and obligations of the bank toward the holder of guaranty-fund equivalents are identical to its responsibilities to its stockholders. 12 U.S.C. § 1134d(c) treats stock and guaranty-fund credits as additional collateral for any indebtedness of the borrower to the regional bank. Upon default of a loan, the bank may retire all or any part of the borrower's stock in the bank at fair book value, not exceeding par, in total or partial liquidation of the debt.

¹¹ 1955 U.S. Code Cong. and Ad. News 2950.

¹² 12 U.S.C. § 1134c (1964).

¹³ 12 C.F.R. § 670.22; 12 U.S.C. § 1134c (1964).

¹⁴ 12 C.F.R. § 670.22; 12 U.S.C. § 1134c (1964).

federal government.¹⁶ Once a borrowing cooperative had repaid its loan, the previously required purchase of capital stock was redeemable on demand. No method of providing for both the availability of credit and the simultaneous retirement of government-owned stock was in existence.

In order to provide for the retirement of the government contribution, section 1134d established a revolving capital fund¹⁷ for each regional bank using the three classes of stock, Class A, Class B, and Class C, each share having a par value of \$100. Class A stock is held only by the Governor of the Farm Credit Administration on behalf of the United States. Class A stock is not entitled to dividends and is nonvoting. At the close of each fiscal year the banks for cooperatives determine the amount of Class A stock to be retired. The minimum amount to be retired is the equivalent in dollar value of the amount of Class C stock issued by the bank for that year.

Class B stock is available for sale to investors and is one of the new means of funding the banks for cooperatives with private capital. It may be sold or transferred to any person subject to the approval of the issuing bank, but like the Class A stock, it carries no voting rights. With the approval of the Farm Credit Administration, a bank may pay non-cumulative dividends per annum, provided that the surplus account of the bank after payment of such dividends would not be less than twenty-five percent of the bank's outstanding stock. Following retirement of all the Class A stock of a regional bank, Class B could be called for retirement at par value, the oldest outstanding stock called first.

Class C stock¹⁷ is issued at its fair book value, but not in excess of par, and not paying dividends. Ordinarily, only a farmers' cooperative association is able to hold the Class C stock of a regional bank.¹⁸ A cooperative association holding one or more shares of Class C stock possesses only limited voting rights.¹⁹ Each borrower is required to

¹⁶ In 1955, approximately 88% of the total stock was owned by the United States. 1955 U.S. Code Cong. and Ad. News 2954-955.

¹⁷ A revolving capital fund may be established as either a loan fund or a stock fund. As usually employed in financing farmers' cooperatives, the members contribute the initial capital with additional yearly contributions made by each member in proportion to his use of the cooperative's facilities or services. When the capital in the fund reaches an adequate level, any excess resulting from current contributions is returned to the patrons who made the earliest contributions. I. Packel, *The Organization and Operation of Cooperatives* 176 (4th ed. 1970).

¹⁷ Instead of issuing certificates the banks may exercise the discretion granted in their by-laws and record stock ownership on their stock ledger accounts. Consequently, a cooperative association receiving Class C stock will receive a credit on the bank's books. The single qualifying share is issued in the form of a stock certificate.

¹⁸ There are certain exceptions. Approval has been granted for transfers resulting from a liquidation, merger or accommodation between cooperatives. *Mississippi Chemical Corp. v. United States*, 431 F.2d 1320, 1334 n. 26 (5th Cir. 1970) (dissenting opinion), cert. granted, 401 U.S. 908 (1971).

¹⁹ A cooperative association holding one or more shares of Class C stock of a regional bank for cooperatives is entitled to vote to designate nominees for appoint-

own at least one share of Class C stock at the time he obtains his loan. Furthermore, each borrower is required to purchase quarterly Class C shares of the lending regional bank in an amount equal to not less than ten nor more than twenty-five percent of the amount of interest on loans. Payments for the required purchases are made quarterly or at the time the regular interest payments of the borrower are due.²⁰ At the end of the fiscal year the stock is issued to the borrower in relation to the amount of required payments made during that year.²¹ Class C stock may be retired at par provided that all outstanding Class A stock has been retired, but Class C stock issued for a fiscal year period may not be retired until all Class B stock issued during and prior to that fiscal year has been called for retirement. The oldest Class C stock outstanding is retired first. The balance of net earnings remaining after any amounts expended for restoring impairment of capital stock, maintenance of surplus account, contingency reserves, franchise tax, or dividends paid on Class B stock, is distributed as patronage refunds. These refunds are in the form of Class C stock and are paid in the proportion that the amount of interest earned by the bank on the loan of each borrower bears to the total interest earned on all loans during the fiscal year.²² The refunds are paid in accordance with the cooperative principle that those who use the facilities of the cooperative should be able to reduce their costs by receiving a portion of the cooperative's profits, allocated on a patronage basis.²³

II. THE CASE TREATMENT OF TAXATION OF CLASS C STOCK

The taxpayers have recognized that their purchase of the single qualifying share of Class C stock, a prerequisite to eligibility for borrowing from the regional bank for cooperatives,²⁴ is an investment that must be capitalized.²⁵ This recognition results from the fact that

ment to the Federal Farm Credit Board, to nominate and elect members of district farm credit boards, to nominate and elect directors of the Central Bank for Cooperatives, and to elect two of the seven directors of the regional bank located in the cooperative association's district. The association possesses only one vote, regardless of the number of shares of Class C stock it may hold. 12 U.S.C. §§ 1134, 1134d (1964).

²⁰ 12 U.S.C. § 1134d(a)(3) (1964) states in part:

[E]ach borrower as defined by the Farm Credit Administration for purposes of this sentence, shall be required to invest quarterly in Class C stock an amount equal to not less than 10 nor more than 25 per centum, as prescribed by the board of directors of the bank with the approval of the Farm Credit Administration, of the amount of interest payable by it to the bank during the calendar quarter. Payments for such stock shall be made quarterly or when the regular interest payments of the borrower are payable, but the stock shall be issued to the borrower as of the end of each fiscal year in the amount of the payments for stock made by it during the year.

²¹ *Id.*

²² Unless a dividend of at least 2% is paid to Class B stockholders, patronage refunds cannot be distributed in that year. 12 U.S.C. § 1134d(a)(2) (1964).

²³ I. Packel, *supra* note 16, at 5.

²⁴ 12 U.S.C. § 1134d(a)(3) (1964).

²⁵ Only one case indicated that the qualifying share is recorded on the taxpayer's

the purchase of the initial share was viewed as "conferring upon the purchaser the full spectrum of benefits that could flow to it from stock ownership. . . ."²⁶ Since the tax treatment of the initial share was not in issue, the courts, therefore, focused upon the treatment of all subsequent purchases of Class C shares. However, in attempting to determine for tax purposes the nature of the Class C stock purchased under section 1134d, the courts have looked at the value of the stock to the holder.²⁷ This is of particular importance because all the parties in the cases have recognized that to the extent the Class C share has a fair market value, the expenditure is of a capital nature.²⁸ The courts, however, have had difficulty in determining the value of the Class C shares because their peculiar nature²⁹ is not susceptible to an easy application of the usual stock-valuation criterion. To the extent that a fair market value has been calculated or a nominal value assigned to the shares, the stock has been capitalized and the excess of purchase price over value has been held to be currently deductible as interest. Only one court has determined that the stock has such substantial value that the full purchase price of \$100 should be capitalized.³⁰

Some courts have rejected demands that the entire purchase of Class C stock be treated as a capital asset. In *Penn Yan Agway Co-operative, Inc. v. United States*,³¹ plaintiff, a New York corporation,³² argued that it was entitled to deduct as interest under section 163(a)³³ or alternatively, as an ordinary and necessary business expense under section 162(a),³⁴ the amount by which its payment to the Springfield Regional Bank for Cooperatives for 4.07 shares of Class C stock of

books at the \$100 cost. *Mississippi Chemical Corp. v. United States*, 431 F.2d at 1321. However, it is implicit in all the arguments for tax treatment of section 1134d purchases that the initial purchase of the single qualifying share is an investment.

²⁶ *Mississippi Chemical Corp. v. United States*, 431 F.2d at 1332 (dissenting opinion). There is an analogous situation in the tax law where initial entrance fees in joining a club or association for business purposes have to be capitalized as distinguished from amounts paid as due. *Mercantile Nat'l Bank*, 30 T.C. 84, 95 (1958).

²⁷ The question of the treatment of Class C patronage refunds was not explicitly before the appellate courts because it was not raised by the government on appeal.

²⁸ The fact that the shares will be retired at full par value of \$100 at some date in the future has evidently prevented the courts from holding that the shares are worthless.

²⁹ Taxpayers could only sell or transfer the shares to another qualified farmers' cooperative. The stock neither pays dividends nor has any growth potential and the bank has a first lien on the shares. The date of retirement is indeterminate since all Class A and Class B stock must be retired first. 431 F.2d at 1322-323.

³⁰ *M.F.A. Central Cooperative v. Bookwalter*, 427 F.2d 1341, 1344 (8th Cir. 1970).

³¹ 417 F.2d 1372 (Ct. of Cl. 1960), petition for cert. filed, 39 U.S.L.W. 3231 (U.S. Nov. 24, 1970) (No. 824).

³² On incorporation of cooperatives, see I. Packel, *supra* note 16, at 52.

³³ Int. Rev. Code of 1954, § 163(a) provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

³⁴ Int. Rev. Code of 1954, § 162(a) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."

that bank exceeded the fair market value of such stock when issued. Defendant argued that the purchase of the shares was a capital investment under sections 118⁸⁵ and 1221.⁸⁶

The court held that, to the extent the payments exceeded the fair market value of the stock when issued, they were currently deductible from gross income as "interest." The court recognized the problem of assigning a value to the shares but it determined that this difficulty had to be overcome if a "fair and just decision"⁸⁷ was to result. By analogizing to the method used in evaluating the stock of a closely held corporation,⁸⁸ the court was able to accept the plaintiff's valuation of \$6.90 per share as of the date of acquisition in 1959.⁸⁹ Thus, the court implicitly held that the purchase of the class C shares, to the extent they had a determinable market value, was to be considered a purchase of a capital asset.

On the question of the proper tax treatment for the balance of the \$100 purchase price, the *Penn Yan* court stated that the statutory requirement⁴⁰ of an assessment of fifteen per cent on payable interest for purchase of Class C stock could be looked at, in whole or in part, as additional interest by way of a surcharge on the basic loan rate, or as an ordinary and necessary business expense. The court was con-

⁸⁵ Int. Rev. Code of 1954, § 118 provides: "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."

⁸⁶ Int. Rev. Code of 1954, § 1221 provides in part:

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business. . . .

⁸⁷ 417 F.2d at 1378.

⁸⁸ The court reasoned that:

[T]he market value of common stock in a closely held corporation, there being no market sales of such stock, must be determined upon consideration of all relevant factors, such as earning capacity, anticipated profits, book value, and dividend yield. Obviously, the relevant factors concerning the value of plaintiff's 4.07 shares of Class C stock are extremely limited. The only right they carry and have carried is long-delayed redemption at their base purchase price. Id.

⁸⁹ The plaintiff used the present value theory to discount the \$100 purchase price to a present value of \$6.90. Experts testified that a willing investor knowing that he would receive no return on the stock except its \$100 par value upon its retirement in 30 to 31 years and demanding a return on common stock (including dividends and appreciation) of 9 to 10 percent compounded annually would pay no more than \$6.90. This amount compounded annually at such a rate would amount to \$100 in 30 to 31 years. The analysis used by the court shows that it was explicitly guided by the usual corporate law concepts and that it did not inquire into the peculiarities of a cooperative association's organization and operation. Id. at 1377.

⁴⁰ 12 U.S.C. § 1134d (1964).

tent to call the excess of purchase price over \$6.90 a surcharge⁴¹ on the basic interest rate.⁴² The *Penn Yan* court substantiated such treatment of the excess by pointing out that the plaintiff received no services other than loans from the regional bank. Furthermore, the court decided that once the plaintiff purchased the single qualifying share of Class C stock required by law as a prerequisite to obtaining loan privileges, the purchase of the additional 4.07 shares provided the plaintiff no additional rights or benefits of any kind.⁴³

The defendant had argued that both the legislative history and the use of a revolving capital fund to provide the banks for cooperatives with capital showed that the stock was intended to be an investment within the definition of section 1221.⁴⁴ In rejecting this argument the court stated that the full purchase price could not be considered an investment since the plaintiff had "received stock which was greatly less valuable from an economic and financial standpoint than the purchase price required by law and the terms of the loan agreements."⁴⁵ The court indicated that any intangible benefits granted by Congress to farmers' cooperatives do not alter this fact and concluded that the plaintiff did what any reasonable businessman would do in treating "[t]he long delay in recovery of the purchase price of such non-dividend stock as a loss of use of funds in calculating the comparative loan costs from the Springfield Bank vis-à-vis a commercial bank."⁴⁶ The court analogized to a line of cases holding that a

⁴¹ If the 15 percent assessment is considered a surcharge, the interest rate of 4.75 percent would be increased to 5.4625 percent per annum. However, since the taxpayer argued that only 93.1 percent of the 15 percent assessment (\$100-\$6.90) is currently deductible as interest or as a business expense, this would result in increasing the basic interest rate to 5.4133 percent per annum. 417 F.2d at 1375-376.

⁴² The use of a surcharge theory could be viewed as conflicting with the congressional policy of providing more favorable interest rates as compared to commercial credit rates for cooperative associations. However, the court easily resolved this conflict by taking the position that, even with the surcharge, the total loan rate was less than the cooperative could have obtained elsewhere. *Id.* at 1376.

⁴³ *Id.* The *Penn Yan* Cooperative had in fact received 9.76 shares of Class C stock as a patronage refund and had purchased 4.07 shares.

⁴⁴ The government wanted the full par value of \$100 to be capitalized on the theory that such value is established by:

- (1) the "extremely valuable intangible benefit" of being able to borrow large sums of money over extended periods at low rates;
- (2) the alleged impossibility of assigning a "determinable market value;"
- (3) fairness for tax purposes of awaiting realization since the valuation of \$6.90 per share was speculative.

The defendant had alternatively argued that even if a \$6.90 value per share is upheld, such a bad bargain or loss is not currently deductible but must await disposition of the shares. The court indicated that the argument that the taxpayer must await realization was not applicable to the situation where the taxpayer was required by law to purchase the shares and where statutory restrictions on the shares practically precluded the existence of a market. *Id.* at 1377.

⁴⁵ *Id.*

⁴⁶ *Id.* at 1378.

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bonus or premium given to induce a loan is deductible as interest⁴⁷ and that, in applying usury law principles,⁴⁸ the requirement that the borrower must purchase stock of the lender, such stock price being greatly in excess of its fair market value, the excess in price is deemed interest.⁴⁹

In *Mississippi Chemical Corp. v. United States*,⁵⁰ the facts were similar to those in *Penn Yan*, except that the taxpayers⁵¹ had reported \$1.00 per share as the cost of acquiring a capital asset and had claimed a deduction in the amount of \$99.00 a share as an interest expense.⁵² On appeal,⁵³ the Fifth Circuit concluded that the district court had not been clearly in error⁵⁴ in determining that the Class C shares had no fair market value and no more than a nominal value.

The court in *Mississippi Chemical*, although noting the attempt in *Penn Yan* to estimate the fair market value of the shares by the

⁴⁷ *Wiggin Terminals, Inc. v. United States*, 36 F.2d 893 (1st Cir. 1929); *L-R Heat Treating Co.*, 28 T.C. 894 (1957).

⁴⁸ In considering whether a transaction is usurious, if a condition precedent to the making of a loan is that the borrower must purchase property from the lender at an excessive price or sell property at a price lower than its value, then the difference will be deemed to be additional interest. 417 F.2d at 1379.

⁴⁹ A reading of the opinion shows that the court, although clearly rejecting the defendant's position that the shares were a capital asset, was troubled in choosing between the two current deduction theories. It cited the lower court opinion in *M.F.A. Central Cooperative v. Bookwalter*, 286 F. Supp 956 (E.D. Mo. 1968), rev'd, 427 F.2d 1341 (8th Cir. 1970), petition for cert. filed, 39 U.S.L.W. 3231 (U.S. Nov. 24, 1970) (No. 824) (then on appeal), as holding that the Class C stock is currently deductible as an ordinary and necessary business expense. The *M.F.A.* district court had distinguished the interest issue by observing that, unlike the situation where the debtor parts with a bonus or premium and receives only the use of money, the *M.F.A.* Cooperative received Class C shares, and in their agreement, the parties did not consider the payments as interest. The district court determined that the expenditure was for something other than for the use of money and that the stock had no fair market value at the time of issue. The *Penn Yan* court concluded that although the *M.F.A.* decision had merit, the more "logical" basis of the decision was to view it as an interest deduction, particularly because the statute and the loan agreement used a percentage of the interest payable on outstanding loans as a measure of Class C shares to be purchased. The court also concluded that the Class C stock was of absolutely no use or benefit to the taxpayer. 417 F.2d at 1382.

⁵⁰ 431 F.2d 1320 (5th Cir. 1970), cert. granted, 401 U.S. 908 (1971).

⁵¹ The government appealed from separate judgments entered for Mississippi Chemical Corporation and Coastal Chemical Corporation. The cases were consolidated in the district court.

⁵² 431 F.2d at 1321-322. Mississippi Chemical had received patronage refunds of 287, 275, and 251 shares of Class C stock for the fiscal years ending 30 June 1961, 1962, and 1963. It reported \$1.00 per share as a reduction of interest expense but made no report of the remaining \$99.00 par value of each share.

⁵³ The taxpayer had reported \$1.00 per share of the patronage refund as a reduction of interest, making no report of the remaining \$99.00 of par value. In the lower court the government had argued that the entire \$100 of the patronage dividends should be included in income. The argument was unsuccessful and the government did not appeal from that part of the judgment. *Mississippi Chemical Corp. v. United States*, 69-1 CCH U.S. Tax Cas. ¶ 9266 (S.D. Miss. 1969).

⁵⁴ Fed. R. Civ. P. 52(a).

use of a present value theory, merely affirmed the lower court's determination that, for tax purposes, the "bulk"⁵⁵ of the payments were not actually made to acquire an asset. The court agreed with *Penn Yan* that a purchase price of Class C stock in excess of the nominal value assigned to it by the taxpayer is deductible as interest in the year of purchase.

Although conceding that the shares had no readily ascertainable market value, the defendant argued that they possessed an "intrinsic" or "intangible"⁵⁶ value in the taxpayers' hands which required that the full purchase price be capitalized. The court did not accept this argument, however, and noted that "ownership here is not synonymous with control."⁵⁷ Relying on the reasoning used in *Penn Yan*, the court rejected what it considered to be the same government argument, that is, that the shares possessed intangible value.⁵⁸

Purchasers have also attempted to obtain the benefits of an immediate deduction by arguing that the expenditures are part of the cooperative's routine business activities. In *M.F.A. Central Cooperative v. Bookwalter*,⁵⁹ the district court, under facts similar to those in *Mississippi Chemical* and *Penn Yan*,⁶⁰ held that the amounts paid for Class C shares, although not deductible as interest, were deductible as ordinary and necessary business expenses⁶¹ and that the patronage refund credits were not includible in income⁶² since the Class C stock did not have a fair market value at the time it was issued.⁶³ On ap-

⁵⁵ The court evidently felt that "bulk" equaled 99% of the purchase price. 431 F.2d at 1324. Unlike that in the *Penn Yan* case, this determination seems arbitrary. The dissent in *Mississippi Chemical* points out that an expert in cooperative financing assigned values from \$3.42 per share for 1958 Class C stock to \$38.65 per share for that of 1963. 431 F.2d at 1335 (dissenting opinion).

⁵⁶ The government stressed certain intangible rights inhering in the Class C stock which give it real worth other than fair market value, for example: (1) low cost loans and other bank services (2) following retirement of Class A stock the cooperative members will be the sole owners of the regional banks. 431 F.2d at 1323.

⁵⁷ *Id.* Prior to 1964, the Class C shareholders of each regional bank could elect only one of its seven directors. Since 1964, they have elected two of the seven.

⁵⁸ The court determined that

[W]hen plaintiff cooperative shareholder paid the \$407 for the 4.07 shares, it received stock which was greatly less valuable from an economic and financial stand-point than the purchase price required by law and the terms of the loan agreements. The "intangible benefits" bestowed by Congress on farmers' cooperatives generally do not alter this fact 431 F.2d at 1324, quoting 417 F.2d at 1377-378.

⁵⁹ 286 F. Supp. 956 (E.D. Mo. 1968).

⁶⁰ Although the taxpayer had deducted the full amount of the stock purchases as interest, he argued for either a § 162(a) or § 163(a) deduction to the extent that the payments for Class C stock exceeded the fair market value of the stock.

⁶¹ The court determined that the only reason the stock had been purchased was that such purchase was imposed as a condition of receiving the loan. Since the court held that the stock was of no use to the taxpayer, it reasoned that it was impossible to separate the stock purchase from the loan.

⁶² The government did not appeal from this part of the decision.

⁶³ This was the only court holding that the stock had neither fair market value nor nominal value.

peal, this decision was reversed by the Eighth Circuit:⁶⁴ "There is not substantial evidence to establish that the stock was worthless at any time. On the contrary, the evidence establishes that Class C stock has a substantial value."⁶⁵ The court held that the full par value of the Class C stock was a capital asset within the definition of section 1221 and that a deduction under section 162 was not proper. It also agreed with the district court's rejection of the taxpayer's argument for a section 163(a) deduction.⁶⁶

In overruling the district court on the issue of a section 162(a) deduction, the *M.F.A.* court indicated that, although it might be necessary for the taxpayer to purchase the Class C stock in order to maintain its eligibility to borrow from the regional bank, the taxpayer had not established that the expenditure was an ordinary expense. The court referred to a line of cases holding that the burden is on the taxpayer to show that the expenses are both ordinary and necessary;⁶⁷ and that deductions are a matter of legislative grace allowable only to the extent authorized by statute.⁶⁸

It is thus apparent that all the courts have approached the problem on the basis of a corporate stockholder analysis, even though different results have been reached. This analysis, it is submitted, is incorrect since it fails to consider the fundamental differences between a cooperative and a corporation. Thus, if the cooperative approach is used, it is submitted that Class C shares do possess a tangible value and that they should be treated as a capital asset.

III. AN ALTERNATE METHOD OF ANALYSIS

A. *The Function of Revolving Capital Stock in Cooperative Associations*

The courts have recognized that the Class C shares present a valuation problem which results from the peculiar nature of the stock. However, instead of approaching the problem fully cognizant of the purposes behind the creation of the Class C stock, the courts have mistakenly tried to apply the well established concepts of business

⁶⁴ 427 F.2d 1341 (8th Cir. 1970), petition for cert. filed, 39 U.S.L.W. 3231 (U.S. Nov. 24, 1970) (No. 824). The court was influenced by testimony given by the bank's assistant treasurer that the Class C stock had substantial book value, and that the statutory directive to purchase stock, as well as the agreement entered into by the parties, clearly indicated that the taxpayer agreed to invest in capital stock.

⁶⁵ Id. at 1344.

⁶⁶ Id. at 1343. The lower court had reasoned that the expenditure for Class C stock was for something other than the use of money. 286 F. Supp. at 960.

⁶⁷ *Greenspon v. Commissioner*, 229 F.2d 947, 954 (8th Cir. 1956); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

⁶⁸ *Deputy v. DuPont*, 308 U.S. 488, 493 (1939); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943). This interpretive guide has been criticized. See Note, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed As A Matter of Legislative Grace*, 56 Harv. L. Rev. 1142 (1943). In *Lykes v. United States*, 343 U.S. 118 (1951), the Supreme Court cited this note with apparent approval.

corporation law to cooperative association stock. The result has been disagreement among the circuits and distinctions which are either unclear⁶⁹ or unconvincing. If the cooperative principle were to be applied, the traditional argument as to stock value would become superfluous. It has been suggested that

once one grasps the function of this particular stock in an institution organized by the Congress as a cooperative it is seen that the stock is a capital asset . . . although it does not have the usual characteristics of stock in a commercial enterprise organized under general corporation laws.⁷⁰

The fact that the attributes of section 1134d stock are different from those of a normal corporation necessarily follows from the essential differences between a cooperative and a corporation.⁷¹ When the corporate shareholder purchases stock, the purchase ordinarily represents a permanent investment for income or, alternatively, for growth. Except for dissolution, the corporate investor understands that he can only attempt to recover his investment by selling his shares in the market place. A cooperative's capital, in contrast, may represent a loan or a temporary contribution⁷² by its members to finance services for the membership at large. The cooperative member expects that the capital will be returned to him when his own contribution and subsequent contributions made by other members render his earlier contribution unnecessary to the cooperative.⁷³ No other market is available for the sale of a cooperative's shares and, in some instances, the transferability of these shares is restricted.⁷⁴

A major distinction between a corporation and a cooperative is that the usual corporate concept of profit is absent from the cooperative principle. To the economist, profit represents, in addition to a return for use of land, labor, and capital, a return for "entrepreneur profit."⁷⁵ The cooperative lacks an entrepreneur and the organization is run for the benefit of the patrons, not the organizers. The coopera-

⁶⁹ The *Mississippi Chemical* court found the distinction used by the district court in *M.F.A.* to disallow an interest deduction unacceptable because of the "peculiar nature" of the Class C shares. 431 F.2d at 1326.

⁷⁰ *Mississippi Chemical Corp. v. United States*, 431 F.2d at 1327 (dissenting opinion).

⁷¹ See generally Nieman, *Revolving Capital in Stock Cooperative Corporations*, 13 *Law and Contemp. Prob.* 393 (1948).

⁷² The term "contribution" is used in the sense that it may actually refer to a loan rather than to a donation to capital if the contract requiring such additions to capital manifests an intention to create a debtor-creditor relationship and provides for repayment of the contribution at a fixed or determinable time. *Id.* at 396 n.11.

⁷³ *Id.* at 393.

⁷⁴ It is important that the cooperative be principally controlled and owned by its patrons. If outside investors are allowed to participate in the cooperative there is a chance that the interests of these investors in maximizing profits will conflict with the interests of the patrons in obtaining services from the cooperative. *Id.* at 396; 431 F.2d at 1334 (dissenting opinion).

⁷⁵ P. Samuelson, *Economics and Introductory Analysis* 592 (7th ed. 1967).

tive exists in order to provide a specific service at cost to its members rather than to provide an investment opportunity. In addition, the cooperative and the corporation differ markedly in method of distributing profits. A corporation pays out its profits in proportion to the ownership interest of each stockholder. A cooperative, on the other hand, is owned equally by all the members. The members assume the risk of the enterprise, as do stockholders, but they contemplate no return for entrepreneurial risk.⁷⁶ Yet, the distribution of profits is not made on the basis of ownership, but rather, is made on the basis of use of the cooperative's services, that is, on a patronage allocation.

Due to the peculiar functions of the capital required by a cooperative association, it would thus seem that business and corporate law concepts traditionally applicable to capital analysis are insufficient. It has been said that the capital used in cooperative associations

cannot be assumed to result from the creation of either an exclusively debtor-creditor relationship or an exclusively corporation-stockholder relationship. Rather, it involves a blending of certain elements of both, and frequently something new has been added as well. The resultant product is *sui generis*.⁷⁷

Pursuant to the foregoing analysis of the differences between a cooperative and a corporation, it is suggested that a more acceptable analysis would result in demonstrating that the purchase of Class C shares is, in fact, a contribution of capital to the bank for cooperatives.

B. Valuation of Class C Stock

In holding that the Class C shares possessed only nominal value, the courts in *Penn Yan* and *Mississippi Chemical* reasoned that no additional economical or financial benefit could accrue to the taxpayer by its obtaining a loan and, as an incident thereof, making the required purchases of Class C stock.⁷⁸ This conclusion stems from the fact that the purchase of the single qualifying share was viewed as bestowing upon the purchaser the full benefits that flow from stock ownership. This conclusion seems tenuous at best, since the intent of Congress was to establish a permanent system of banks, based on the cooperative principle, not the corporate principle, which would service the financial needs of farmers' cooperative associations.

The experience of private cooperatives with revolving-capital fund plans had shown Congress that this new method of capital funding was fundamental to the primary purpose of organizing the banks

⁷⁶ I. Packel, *Organization and Operation of Cooperatives* 186 (4th ed. 1970).

⁷⁷ Nieman, *supra* note 71, at 402.

⁷⁸ See text accompanying note 43 *supra*.

in a manner that would eventually result in private ownership.⁷⁹ Therefore, the purchase of the Class C shares is a necessary prerequisite to borrowing from the banks since it is only by such purchases that the true cooperative nature will be realized. Thus, every purchase of Class C shares acts as an investment in the bank and as a contribution which enables the cooperative association to provide services for the membership as a whole. It does not reflect the cost of the loan but rather the cost of membership in, and ownership of, a cooperative bank.

This non-division between the initial share and the rest of the Class C shares seems implicit in the statute, which provides that a cooperative association owning Class C stock, and otherwise able to vote,⁸⁰ will not be eligible to vote if it has not been a borrower from a regional bank or from the Central Bank within a period of two years next preceding a date fixed by the Farm Credit Administration prior to commencement of voting.⁸¹ Consequently, the benefits accruing to cooperative associations from membership in the system of banks for cooperatives are directly dependent upon the continued operation of the revolving-capital fund and the continued borrowing by each member. It is thus apparent that the single qualifying share does not give the full range of benefits of being a member of the cooperative. Instead, it is the continued use of the bank's services, requiring purchase of additional Class C shares, that gives ownership. Therefore, a differentiation between the single purchase of one share and other purchases of shares is invalid.

In addition to the continued access to low cost credit,⁸² certain intangible institutional values are available to cooperative associations. Examples are the benefit resulting from the pooling of resources to effect cost savings, greater utilization of technology, and more effective marketing techniques, depending on the type of cooperative involved. A cooperative is, in effect, an organization that enables its separate members to compete more effectively in the market place. It enjoys the benefit of the economic power resulting from ownership of existing financial institutions having ready access to substantial loan funds from the federal government,⁸³ since private ownership of

⁷⁹ 1955 U.S. Code Cong. and Ad. News 2951.

⁸⁰ The association must be a "cooperative association" as defined in 12 U.S.C. § 1141j (1964) and must "conform to one or both of the following requirements": (1) a member has only one vote without regard to the total amount of his stock ownership; (2) payment on stock or membership capital is not in excess of 8 percent per annum. In addition, the association's business dealings with or for nonmembers cannot be greater in value than the total amount of business transacted by it with or for members. 12 C.F.R. § 670.2 (1970).

⁸¹ 12 U.S.C. § 1134d(a)(3) (1964).

⁸² For the years 1958-63 the New Orleans Bank for Cooperatives charged interest between 4 and 5 percent. *Mississippi Chemical Corp. v. United States*, 431 F.2d at 1333 n.19 (dissenting opinion).

⁸³ The major source of loan funds for the regional banks is not its capital but funds borrowed from the Central Bank and the federal intermediate credit bank, and proceeds

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the banks is no longer in the distant future but a present reality. As of December 31, 1968, the banks had retired all of the government's investment in Class A stock, thereby attaining the goal established in the Farm Credit Act of 1955.⁸⁴ In addition, benefits of a more tangible nature are available to patrons since, as a result of borrowing and making the required purchases of Class C shares, the taxpayers qualify for substantial patronage refunds and allocated surplus distributions.⁸⁵ These amounts actually represent a donation or contribution of the bank's margins by the patrons who receive Class C stock in exchange. They are not a return of the borrower's contributed capital but distri-

from the sale of consolidated debentures. These sources will still be available following retirement of the government's interest. 12 U.S.C. §§ 1134c, 1134m (1964). Furthermore, even after retirement of the government's interest, short-term federal investments in Class A stock will be available to meet emergency credit needs without changing the ownership status of the bank. 12 U.S.C. § 1134e (1964).

⁸⁴ Moody's Bank and Financial Manual at 1727 (April 1970). The three principal cases had utilized various projections as to when either Class C stock would be redeemed or the government's interest would be completely retired, thus signaling the start of Class B (of nominal importance) and Class C stock retirement. In *Penn Yan* the court accepted a projection that the Class C shares, acquired in 1959, would be retired in 30 to 31 years. 417 F.2d at 1377. In *Mississippi Chemical*, the dissenting justice referred to a projected 1972-73 retirement of all Class A stock and in *M.F.A. Central Cooperative*, the St. Louis Bank, by June 30, 1967, had completely retired its Class A shares and substantially reduced its Class B investment. Consequently, all Class C shares issued during the fiscal year ending June 30, 1956, were redeemed. 431 F.2d at 1324 n.20.

Viewed from hindsight, statements that the Class C shares will be redeemed in the distant future have been proved incorrect for once the retirement of the government's interest has been accomplished, redemption of Class C stock has taken place much sooner than expected. Consequently, it would appear that the intangible value possessed by the shares has been greatly diminished and that a transformation, in the form of substantial benefits, has taken place. This would be all the more true if the current experience of the Springfield Bank is representative of the system, for that bank, in 1971, is on a seven year purchase-redemption cycle for Class C shares. Telephone interview with John G. Griffin, Counsel for Springfield Regional Cooperative Bank, April 1, 1971.

	⁸⁵ Mississippi Chemical (1958-63)	Coastal Chemical (1958-63)	M.F.A. Cooperative (1958-59)
Patronage	81,273	289,310	64,762
Refund			

Allocated Surplus	35,771	127,749	N.A.
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Allocated surplus distributions are an additional patronage refund for any fiscal year, whereas the distribution of the bank's net savings as required by statute (12 U.S.C. § 1134l (1964)) results in the allocated surplus account exceeding 25% of the sum of all outstanding capital stock. Each patron receives a credit for his portion of the allocated surplus excess which will later be converted into a Class C stock credit and retired when all of the Class C stock credits for that particular year are satisfied in cash. These benefits are granted in proportion to the borrower's use of the bank's service. The taxpayer must not only borrow, but he must also purchase Class C shares in order to qualify for these distributions. Since the distributions amount to more than the Class C purchases, and will someday be returned in the form of cash, it is difficult to accept the statements that the shares are of nominal value.

butions of earnings not to be converted into cash until retirement of Class A and Class B stock has been completed.⁸⁶

The question of whether the Class C shares were of any direct benefit to the holder was an issue in *Columbia Bank for Cooperatives v. Lee*,⁸⁷ where a bankrupt cooperative owned Class B stock with a par value of \$45,000,⁸⁸ Class C stock with a par value of \$54,100, and allocated surplus of \$13,000, totaling \$113,000. The referee in bankruptcy ruled that the bank was to allow a setoff of this \$113,000, against the cooperative's indebtedness of \$162,000.⁸⁹ Following the referee's decision, the Cotton Producers Association of Atlanta had offered to buy the stock for \$50,000, or forty-five per cent of its par value. The district court affirmed the referee's decision, reasoning that no other offers were likely and that, if offsets were not allowed, the creditors would be substantially injured.⁹⁰ On appeal, the Fourth Circuit reversed, holding that the bank was not required to offset at par value, and remanded for valuation by the referee.⁹¹ On remand,⁹² no valuation was found necessary because the parties agreed that the trustee would receive a credit of \$113,000, representing the value of the bankrupt cooperative's stock and allocated surplus. This case would seem to indicate that the parties involved treated the value of Class C shares differently for tax purposes than for ordinary business purposes. If an outside purchaser offers forty-five per cent of par, it is difficult to see how a court could find the shares to be worth one per cent⁹³ or six per cent⁹⁴ of par. Even completely ignoring the general

⁸⁶ The contribution of a cooperative association to the capital of the banks for cooperatives is returned in two ways:

- (1) When the Class C shares purchased under section 1134d are returned in some ascertainable order but at an indefinite time in the future.
- (2) Patronage refunds and allocated surplus are in actuality a contribution of the bank's earnings by the patrons who receive Class C stocks in exchange. After all Class A and B stock are retired, the contributions are returned in cash to the patrons who made the earliest contributions.

12 U.S.C. §§ 1134i(a)(b); 431 F.2d at 1333 (dissenting opinion).

⁸⁷ 368 F.2d 934 (4th Cir. 1966), cert. denied, 386 U.S. 992 (1967).

⁸⁸ All figures have been rounded off.

⁸⁹ The loan of \$162,000 was secured by mortgages and deeds of trust. The bank also had a lien on the stock pursuant to 12 U.S.C. § 1134d(c) (1964). Realizing that if the stock was sold it would bring much less than its par value, the referee ordered the bank to credit against the cooperative's indebtedness the value of the stock to the bank.

⁹⁰ In the Matter of Farmers Federation Cooperative, Inc., 243 F. Supp. 650 (W.D.N.C. 1965).

⁹¹ The counsel for the bank had conceded that the book value of the Class B and Class A shares was considered to be equal to its par value, but the court insisted that since there was no testimony regarding the value of the stock in the hands of the trustee or the general creditors of the bankrupt cooperative, the case had to be remanded to give the parties an opportunity to establish the actual value of the stock. The court did not accept the single offer of \$50,000 as being representative of the true value of the shares and noted: "However thin the general market for these shares may be, the continuing stream of borrowers from the bank provides it with a ready market. No practical damage to the bank is to be apprehended from the offset." 368 F.2d at 940.

⁹² Not officially reported. See 431 F.2d at 1335 n.28.

⁹³ 431 F.2d at 1322.

intangible benefits flowing from the shares and the problems of cooperative principles, the shares have a substantial market value.

In *M.F.A.*, on the other hand, the court found no evidence showing that the stock was worthless at any time but it did find evidence establishing that the stock had substantial value.⁹⁵ Although it failed to answer certain arguments of the taxpayer⁹⁶ as to the actual book value of the stock, the court was clearly satisfied that the book value was more than nominal. Although the result in *M.F.A.* appears to be correct, the court may be criticized for its attempt to resolve the valuation issue by relying entirely on the usual stock valuation concepts.

Finally, it would seem that even Congress has especially recognized that the Class C stock has value. In 1961, Congress amended the Farm Credit Act of 1933 by adding Section 1134l(d)⁹⁷ which provides, in part, that in the case of liquidation or dissolution of a borrower from a bank for cooperatives, the bank may retire and cancel any capital stock or other equity interest owned by such borrower at the fair book value thereof,⁹⁸ not exceeding par. The legislative

⁹⁴ 417 F.2d at 1377.

⁹⁵ "While the Class C stock has no established market value, it has a substantial book value and while it is likely not worth its par value at the time it is issued, it certainly has substantial value." 427 F.2d at 1342.

⁹⁶ The taxpayer's brief points out that although the bank's assistant treasurer testified that the book value of the Class C stock had increased from \$149 to \$151 during the two years in suit, he also admitted that this was the book value of all the classes of stock since he could not segregate the Class C stock. Furthermore, in the calculation of book value he did not include the consolidated debentures although the bank was severally liable on debentures amounting to \$199,000,000 and \$284,500,000 in 1958 and 1959. Brief for appellee at 27, *M.F.A. Central Cooperative v. Bookwalter*, 427 F.2d 1341 (8th Cir. 1970). Although the issue was not resolved by the court, it seems clear that the Class C stock does have substantial book value because each share of stock, regardless of class, represents either a prior payment to the bank of \$100 or, in the case of a patronage refund, a like amount of net savings distributed in the form of Class C stock. 12 U.S.C. §§ 1134b, 1134d, 1134l (1964). Also, it is unrealistic to apply the consolidated debentures of the thirteen banks to any single bank for stock valuation purposes, for it is unlikely that the cooperative banking system as a whole would fail or that Congress would not continue to support it.

⁹⁷ 12 U.S.C. § 1134l(d) (1964).

⁹⁸ The term "fair book value" is not defined either in the statute or in the Code of Federal Regulations and a search of the financial literature was fruitless. It is arguable that the word "fair" is used only in its dictionary sense, i.e., to describe a just and impartial calculation of book value in accordance with generally accepted accounting principles. Book value, as applied to capital stock of a corporation, is the result of the book value of the net assets based on the going values customarily reflected in balance sheets divided by the number of shares of outstanding stock. E. Kohler, *A Dictionary for Accountants* 71 (3rd ed. 1963). If the market value of the assets is either above or below their recorded cost values, then the book value per share computed in the above manner is not a fair indication of their value. Accordingly, since all three classes of shares are required to have a par value of \$100, (12 U.S.C. § 1134d(a)(1) (1964).) with such value representing the minimum which must be paid to the issuing corporation as well as the basis for recording the stock on the corporate books, it is arguable that Congress, by specifying that Class C shares are to be issued at their "fair book value not exceeding par," intended to provide a mechanism for purchase of the shares at less

history indicates that the then current law prohibited retirement of Class C stock until retirement of all Class A stock had been accomplished, so that in the event that a cooperative was liquidated or dissolved and was unable to transfer such interests to another qualified holder, the bank would be unable to cancel such interests and pay over the proceeds to the member of the cooperative.⁹⁹ Although the specific purpose of the act appears to be a reduction of the bank's administrative difficulties arising from a literal reading of the statute, it seems that Congress anticipated that the shares would have substantial value. In addition, rules and regulations prescribed by the Farm Credit Administration authorize the bank, in the case where a borrower is in default, to retire and cancel all or part of the stock of the bank owned by the defaulting borrower at the fair book value thereof, not exceeding par, in total or partial liquidation of the debt.¹⁰⁰

Once the functions of Class C stock in an institution established by Congress as a cooperative are understood, it would appear that Class C stock ownership carries with it such substantial economic benefits, both tangible and intangible, that it is in all probability worth its par value. However, for the sake of argument, the question may be raised as to how the taxpayer would value the Class C shares if the courts were to hold that the shares, although not worthless, were not worth their par. An estimate of their value could be made on the basis of what an investor, solely interested in his return, would pay for the shares, as was done in *Penn Yan*.¹⁰¹ However, this method at best is speculative, since the date that a particular Class C share will be retired is little more than an educated guess. Moreover, this type of analysis ignores its own implicit assumption that the shares increase in value each year. This means that an investor wanting to buy the stock and interested in mere return would pay more for the shares as the redemption year approached. The cooperative should, then, according to the court's analysis, report the increase in value and simultaneously transfer the amount to its capital account. Absent a statutory requirement, it is doubtful that a cooperative would be so required, but it is in effect the logical result from the court's approach. Alternatively, a nominal value could be assigned as was done in *Mississippi Chemical*¹⁰² but this method is subject to the criticism

than \$100 par value when the book value of the Class C shares falls below \$100. If the shares are sold at less than par, the issue should be recorded at par and the discount charged to a "Capital Stock Discount" account which represents a contingent liability to the purchaser on possible future claims made by the corporate creditors. L. Malchman & A. Slavin, *Foundations of Accounting* 447 (1961).

Although this may be a reasonable interpretation, the issue may be academic since it appears that the bank for cooperatives, in practice, treats "fair book value and par value" as the same thing. Telephone interview with John G. Griffin, Counsel for Springfield Bank for Cooperatives, April 1, 1971.

⁹⁹ 1961 U.S. Code Cong. and Ad. News 3080.

¹⁰⁰ 12 C.F.R. § 670.153 (1970).

¹⁰¹ 417 F.2d at 1377.

¹⁰² 431 F.2d at 1321.

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that it produces not only an arbitrary result, but also completely ignores a theoretical approach to the problem. Thus, either attempt to settle upon a valuation ignores explicitly the cooperative principle and the true nature of the Class C shares.

C. Tax Treatment of Section 1134d Class C Stock

Once the issue as to the value of the purchased section 1134d stock is resolved, there remains the question of the proper tax treatment of each purchase. The resolution of this issue must be phrased in the alternative since the relevant considerations differ when the stock is deemed to have a full \$100 value and when it is valued at less than \$100.

If the stock is considered to be worth the full \$100, the issue is whether it should be treated theoretically as a capital asset or as a loan of money to the bank cooperative.¹⁰³ This question would appear to be answered by the type of funding plan Congress utilized in section 1134. There are two basic types of revolving capital plans, the revolving fund and the revolving stock plan.¹⁰⁴ The revolving fund plan represents borrowed or contributed money repayable at some ascertainable but indefinite time in the future. Where the contract between the parties clearly describes the fund as a revolving fund plan, it is similar to a corporation's funded debt although maturity is keyed to the cooperative's future operating results. However, the contributions to the fund are also intended to have elements similar to an owner's interest.

In the case of the revolving stock fund, the contract between the parties clearly intends that the contributions represent an owner's interest, but since the stock will be repurchased at some ascertainable but indefinite future time, it also has elements of a creditor's interest. For this reason the revolving capital used in cooperative associations has been referred to as being *sui generis*.¹⁰⁵ Thus, the fact that Congress has labeled the section 1134d purchases "stock,"¹⁰⁶ (albeit repayable at some indefinite future time and therefore having elements of an interest free loan), would indicate that a literal application of the usual debt-equity analysis is not appropriate. Furthermore, the congressional intent that the Class C shares be considered as equity, and therefore as a capital asset, may be evidenced by the following considerations: (1) the primary purpose behind the use of a revolving stock capital fund was to provide a method whereby capital contributions of private patrons would eventually allow for transfer from governmental to private ownership;¹⁰⁷ (2) the statute states that each

¹⁰³ See § 385 of the Int. Rev. Code of 1954, where the Secretary is authorized to prescribe such Regulations, including certain factors set forth in the section, to determine whether an interest in a corporation is to be treated as stock or indebtedness.

¹⁰⁴ Nieman, *supra* note 71, at 396-99.

¹⁰⁵ *Id.* at 402.

¹⁰⁶ 12 U.S.C. § 1134d (1964).

¹⁰⁷ Although private ownership of the banks for cooperatives is subject to the

borrower shall be required to invest quarterly in Class C stock;¹⁰⁸ (3) the distribution of patronage dividends and allocated surplus in the form of Class C shares, as measured by a patron's use of the bank's financing facilities, may be viewed as a financial return on an investment which will ultimately be converted to cash;¹⁰⁹ (4) in the event that a regional bank experiences a net loss in any fiscal year, if charges to reserve and contingency accounts are insufficient to absorb the loss, then impairment of Class C stock value would precede the diminution in value of all other stock;¹¹⁰ (5) in the event of distribution of assets upon liquidation or dissolution of the banks, after all liabilities are paid, Class C stock would follow retirement of Class A and Class B stock;¹¹¹ (6) finally, all the taxpayers involved carried the stock on their books under a stock investment account.

Therefore, once the Eighth Circuit in *M.F.A.* had decided that the stock possessed "substantial value" and was a capital asset within the definition of section 1221, the court determined that the statute clearly contemplates that the borrowing cooperative acquire stock in the lending bank and that the lending agreement "clearly indicates that the taxpayer agreed to invest in capital stock of the bank in accordance with the statutory directive."¹¹² Although the holding may be criticized for lack of analysis on the issue of value, the result seems correct. If the function of this particular stock in an organization established by Congress as a cooperative is properly understood, then, to the extent that the shares have value, they should be considered a capital asset.

If, on the other hand, the Class C shares are valued at less than their par value of \$100, the issue viewed in its simplest form is whether the excess of purchase price over value can be currently deducted under either section 162(a) or section 163(a). Once it is realized that the Class C shares possess greater than nominal value, it becomes difficult to treat the required stock purchases under section 1134d as a surcharge on the basic interest rate or as a bonus or premium paid to induce a loan. Thus, on this basis, the *M.F.A.* court, although holding that the shares were worth their par value, correctly distinguished the line of cases relied upon by the *Penn Yan* and

criticism that such ownership involves limited control by the cooperative associations, the latter will still participate in management of a joint government-private financial institution. Moreover, the major source of loan funds is not its capital but funds borrowed from the Central Bank and the federal intermediate credit bank and funds from the sale of consolidated debentures. Limited control seems to be reasonable in light of the need for governmental administration of public moneys.

¹⁰⁸ 12 U.S.C. § 1134d (1964).

¹⁰⁹ 12 U.S.C. §§ 1134l(a)(b) (1964).

¹¹⁰ 12 U.S.C. § 1134l(a) (1964).

¹¹¹ 12 U.S.C. § 1134l(c) (1964).

¹¹² 427 F.2d 1341 (8th Cir. 1970). It is suggested that use of the agreement to determine, in part, that the stock is an investment without reference to the intent of Congress in enacting section 1134d only confuses matters.

Mississippi Chemical courts.¹¹⁸ In addition, both of these courts attempted to strengthen their conclusions by focusing on the fact that the statute and the loan agreement used a percentage of the interest payable on outstanding loans as a measure of shares to be purchased.¹¹⁴ This decision seems totally unjustified because, prior to the 1955 Act, required purchases were determined by reference to the loan amount and not to interest. Given the purpose behind the enactment of section 1134d, it seems clear that purchases are keyed to interest only because the cooperative principle requires the members to contribute to the association's operating needs on the basis of their use of the facilities, and because Class C purchases keyed to interest provide a convenient method for billing and payment.

Alternatively, it would appear that no deduction should be available under section 162(a), for the purchases of section 1134d stock are not truly related to the business of the taxpayer. The test as to whether an expenditure is ordinary and necessary has been stated as "directly connected with and proximately resulting from carrying [the business] on; those normally originating in a liability created in the course of its operation."¹¹⁵ Thus, to characterize the purchase price of section 1134d stock as an ordinary and necessary business expense is to make the basic assumption that the farm cooperative is in the business of being a member of, and borrowing money from, a bank cooperative.

A possible analogy in the treatment of the purchase of section 1134d stock as an ordinary and necessary business expense for tax purposes is the sale of mortgages to the Federal National Mortgage Association (FNMA), where the seller is required to purchase from proceeds of the sale a certain percentage of FNMA capital stock. In *Ancel Greene and Co. v. Commissioner*¹¹⁶ the taxpayer had purchased stock at the par value of \$100 per share, a price considerably higher than the fair market value, and had deducted the excess paid under section 162(a).¹¹⁷ Although the court allowed the deduction, the case can be differentiated from the ordinary and necessary connection of the purchase of section 1134d stock. The taxpayer in *Ancel Greene* was clearly in the business of selling and buying mortgages, and FNMA was set up with the distinct purpose of facilitating this very business.¹¹⁸ It was an adjunct to the taxpayer's business as the purchase of section 1134d stock is not.

The final argument proffered to support the allowance of a

¹¹⁸ See cases cited in note 47 *supra*.

¹¹⁴ 417 F.2d at 1382; 431 F.2d at 1326.

¹¹⁵ *Friedman v. Delaney*, 171 F.2d 269, 271 (1st Cir. 1948).

¹¹⁶ 38 T.C. 125 (1962).

¹¹⁷ The FNMA stock was purchased at \$100 per share. In the years 1955-58 the stock fluctuated in value from a low of \$40.50 to a high of \$63.00. *Id.* at 127.

¹¹⁸ *Id.* at 126. After the holding in this case, Congress enacted § 162(d) of the Int. Rev. Code of 1954 which allows a current deduction to the extent that the purchase price exceeds fair market value.

current deduction is that an injustice will otherwise result. It is questionable, however, whether equitable considerations should play a role in interpreting the Internal Revenue Code. Rather, deductions are a matter of "legislative grace; and only as there is clear provision therefore can any particular deduction be allowed."¹¹⁹

In both *Penn Yan* and *Mississippi Chemical*, the government had contended that no deduction was allowable in the situation where a taxpayer buys something and pays more than it is worth, and more than its resale price. The government argued that the taxpayer must await a realization of his bad bargain by selling.¹²⁰ The courts determined that it was unfair to apply such a doctrine because statutory restrictions on the shares practically excluded the existence of a market and, thus, allowed a current deduction under section 163(a).¹²¹ It would seem that the courts were misled into paying heed to equitable considerations¹²² not applicable to the tax laws. It is probable that, in allowing an interest deduction, the courts were influenced by these same considerations and did not pay strict adherence to the statutory requirements for deductions. Thus, even if the shares are held not to have a full \$100 value, there can be no deduction for the excess over the ascertained value. Since the cooperative taxpayers cannot place themselves within the ambit of the permitted statutory deductions, any equitable argument should be addressed to the Congress and not to the courts.

Thus, it would appear that, although the question of taxation has to be phrased in the alternative due to the problems of valuation, the result must be the same. The fact that the shares may be held to have less than full value should not change the result. Consequently, the entire purchase price of the Class C shares should be capitalized.

IV. TAX TREATMENT OF PATRONAGE REFUNDS

The remaining issue to be considered in the tax treatment of Class C shares is the separate question of the tax treatment of patronage refunds. These refunds represent a distribution of the bank's net earnings in the form of Class C stock to those members who have utilized the bank's services.¹²³ Although this issue was not presented to the circuit courts in the principal cases discussed in this comment,¹²⁴ the present tax treatment of patronage refunds has been considerably altered by the Internal Revenue Act of 1962¹²⁵ which added subchapter T to the Internal Revenue Code.

Prior to 1962, cooperative associations could exclude from gross

¹¹⁹ *Deputy v. DuPont*, 308 U.S. 488, 493 (1940).

¹²⁰ 417 F.2d at 1379; 431 F.2d at 1325.

¹²¹ 417 F.2d at 1379; 431 F.2d at 1326.

¹²² "But allowance of deductions do not depend on equitable considerations." 308 U.S. at 493.

¹²³ See text following note 21 *supra*.

¹²⁴ See notes 27, 53 *supra*.

¹²⁵ 26 U.S.C. § 1382 (1964).

TAXATION OF STOCK ISSUED BY BANKS FOR COOPERATIVES

income the face amount of non-cash patronage refunds distributed in the form of revolving fund certificates, capital stock, certificates of indebtedness, or similar instruments. The Commissioner had issued a regulation¹²⁶ requiring patrons receiving such patronage refunds to treat them as income at their stated face value whether or not the refunds had a determinable fair market value. However, the Fourth and Fifth Circuits ruled that a patron was taxable on such patronage refunds only to the extent of their fair market value and that, where payment was contingent upon the cooperative being financially successful, and was solely within the discretion of the cooperative's directors, the refunds had no presently determinable fair market value.¹²⁷ Although the Commissioner had argued for inclusion of the non-cash patronage refunds on the theories of constructive receipt or assignment of income, the courts determined that the taxpayer never had dominion or control over the money represented by the revolving fund certificates.¹²⁸ It is implicit in the courts' holdings that their reasoning was governed by the doctrine of realization, which requires postponement of tax until a disposition when property received in a transaction is capable of being valued or determined.¹²⁹

In 1959, the Commissioner issued an amended regulation¹³⁰ which adopted the holding of these cases. Thus, prior to 1962, a tax loophole existed whereby a cooperative association could exclude from income a non-cash patronage refund, which may have represented earnings from business activities, while the patron was not required to take anything into income. The stated purpose of the Revenue Act of 1962, as it applied to patronage refunds, was to close this loophole by insuring that the earnings of cooperative associations would be taxable, to the extent they reflected business activity, either at the level of the cooperative or at the patron level when distributed as patronage refunds.¹³¹ Thus, in this situation, the bank for cooperatives is not required to take into income amounts paid out during the taxable year as patronage refunds to the extent they are paid in money, qualified written notices of allocation, or other property.¹³² However, the patron or farm cooperative receiving these same amounts is required to take them into income.¹³³ The qualified written notices of allocation include the issuance of capital stock, revolving fund certificates, certificates of indebtedness, and other written notices which specify the amount allocated to the patron.¹³⁴ The written notice of

¹²⁶ Treas. Reg. § 1.61-5, T.D. 6272, 1957-2 Cum. Bull. 24.

¹²⁷ *Long Poultry Farms, Inc., v. Commissioner*, 249 F.2d 726 (4th Cir. 1957); *Commissioner v. B.A. Carpenter*, 219 F.2d 635 (5th Cir. 1955).

¹²⁸ 249 F.2d at 728; 219 F.2d at 639.

¹²⁹ 249 F.2d at 731; 219 F.2d at 636; *Elsner v. Macomber*, 252 U.S. 189 (1920).

¹³⁰ Treas. Reg. § 1.61-5, T.D. 6248, 1959-2 Cum. Bull. 26.

¹³¹ 1962 U.S. Code Cong. and Ad. News 3414.

¹³² Int. Rev. Code of 1954, § 1382(b).

¹³³ Int. Rev. Code of 1954, § 1385.

¹³⁴ Int. Rev. Code of 1954, § 1388(b).

allocation must allow for redemption in cash within ninety days of issuance, or the patron must have consented to take the face amount into income with such consent being expressed by: (1) a written statement of consent; (2) membership in a cooperative with knowledge that a by-law provision provides that membership constitutes consent; or (3) cashing a qualified check with knowledge that such cashing constitutes consent.¹³⁵ Finally, a written notice of allocation will not be "qualified" unless at least twenty per cent or more of the amount of such patronage refund is paid in cash.¹³⁶ The purpose of the latter requirement is to allow the patron sufficient cash to pay at least the first bracket of income tax.¹³⁷

Thus, the Revenue Act of 1962 has effectively closed the tax loophole that existed prior to its enactment, but in so doing it taxes the patron on the same theory of constructive receipt which was not approved by the prior case law.¹³⁸ Although the consent requirement, together with the theory of constructive receipt, may constitute sufficient waiver of the patron's right to a realization of income before being taxed, in the case of the ninety day redeemable allocation, it is questionable whether the theory of constructive receipt standing alone will constitute a sufficient waiver. Realistically, however, it is doubtful whether a patron would challenge the statutory waiver since it prevents double taxation, once on the cooperative level and once at the patron level.

The 1962 legislation was, of course, directed at all cooperatives, not merely at the farm banks. However, in 1964, the Congress passed legislation¹³⁹ giving the banks the power to take advantage of these provisions as each bank retires the government stock. Thus, a situation now exists wherein the farm cooperatives, which are owners of the bank, are taxed on distributions of non-cash patronage refunds, while the bank receives a deduction for an equal amount.¹⁴⁰

The 1962 legislation thus emphasizes the unique features of a cooperative as distinguished from a corporation, and clearly indicates the need to treat the cooperative as an entity distinct from the corporate form for tax purposes. Congress has clearly recognized the problems arising from the competing interests of the cooperative and the bank involved, and has balanced these interests within the specific statutory requirement for taxing patronage refunds. It is submitted that if the courts had approached the problems of section 1134d on the same theoretical basis, a more desirable approach would have resulted.

¹³⁵ Int. Rev. Code of 1954, § 1388(c).

¹³⁶ Int. Rev. Code of 1954, § 1388(c).

¹³⁷ 1962 U.S. Code Cong. and Ad. News 3415-416.

¹³⁸ 1962 U.S. Code Cong. and Ad. News 3415.

¹³⁹ 12 U.S.C. § 1134l (1964).

¹⁴⁰ Int. Rev. Code of 1954, §§ 1382(b), 1385.

CONCLUSION

The courts have had difficulty in determining the proper tax treatment for required purchases of section 1134d revolving fund stock. Instead of approaching the problem by recognizing the purposes behind the creation of the Class C shares, the courts have tried to apply the well established concepts of business corporation law to stock issued by banks for cooperatives. It is concluded that this method of analysis is improper because the form of capital funding utilized by Congress results neither from the creation of an exclusively corporation-shareholder relationship nor from an exclusively debtor-creditor relationship. Rather, the fund contains elements of both and is *sui generis*. If the proper mode of analysis is applied, and the essential differences between a corporation and an institution established by Congress as a cooperative are understood, it seems clear that ownership of the Class C stock carries with it such substantial economic benefits, both tangible and intangible in nature, that the stock is in all probability worth its par value.

Finally, the question of the proper tax treatment of Class C stock purchases must be decided by referring to the intent of Congress in enacting the Farm Credit Act of 1955. Only by respecting such intent can the peculiar nature of the Class C shares be resolved. Since the primary purpose of utilizing a revolving stock fund was to provide a method by which capital contributions of private patrons would allow for transfer of ownership from the governmental to the private sector, it is manifest that Congress considered the stock purchases to be an investment. Moreover, this result is implicit throughout the Act where various statutory provisions treat the shares as equity. If the statute is analyzed with the particular nature and purpose of the cooperative association in mind, it is apparent that the Class C stock is a capital asset.

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