

§ 1.522-2

26 CFR Ch. I (4-1-09 Edition)

3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1954 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the *retain certificate* (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example 2. Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1954. On the same day Cooperative B pays to X \$1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of \$1.00 and the expenses and other charges attributable to such products. On March 5, 1957, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1957, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1954 of \$1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example 3. Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1954, and receives in return therefor \$100. On February 1, 1955, Cooperative C, having determined the excess of its receipts over its costs and expenses, allocates to Y a cash distribution of \$1.00 and a revolving fund certificate of a face amount of \$1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1955 is \$2.00, the aggregate of the cash distribution of \$1.00, and the face amount, \$1.00, of the revolving fund certificate.

Example 4. Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1954 aggregating \$75 for service rendered him by Cooperative D during that year. On May 15, 1955, Cooperative D, having determined the excess of its re-

ceipts over its costs and expenses, allocates to Z a cash distribution of \$2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1955.

(d) *Returns of exempt cooperative associations.* For requirements of annual returns by exempt cooperative associations, see sections 6012 and 6072(d) and paragraph (f) of § 1.6012-2.

§ 1.522-2 Manner of taxation of cooperative associations subject to section 522.

(a) *In general.* Farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521-1 shall be subject to the taxes imposed by section 11 or section 1201, except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, certain special deductions provided in section 522(b)(1)(A) and paragraph (c) of this section, and section 522(b)(1)(B) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 522 and in § 1.522-3.

(b) *Cooperative association exempt from tax before January 1, 1952.* (1) For the purpose of determining the method of accounting under section 446 in the case of a cooperative association which was exempt from tax for taxable years beginning prior to January 1, 1952, the method of accounting, recognized under sections 41, 42, and 43 of the Internal Revenue Code of 1939 and the regulations prescribed thereunder and utilized in the return of such association for its last taxable year to which the Internal Revenue Code of 1939 was applicable, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. Any change from this method may be made only if permission is

obtained from the Commissioner to change to another recognized method in accordance with section 446 and the regulations thereunder.

(2) In any case where inventories are an income-producing factor, see sections 471 and 472 and the regulations thereunder. The elective method of inventorying goods provided in section 472 may be adopted by the cooperative association for any taxable year beginning after December 31, 1953, in accordance with the requirements of section 472 and the regulations thereunder. However, in order to use such method for such a taxable year the cooperative association (unless it has used such method for a taxable year beginning after 1951 and before 1954 pursuant to an election exercised as provided in 26 CFR (1939) 39.22(d)-3 (Regulations 118) must exercise the election provided in section 472 and the regulations thereunder, even if it may have utilized such method for accounting purposes for taxable years beginning before January 1, 1952.

(3) The following rules shall be applicable in computing the net operating loss deduction provided in section 172: No net operating loss carryover shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101(12) of the Internal Revenue Code of 1939 and of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. However, any taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt under section 101(12) of the Internal Revenue Code of 1939 shall be taken into account in determining the period for which a net operating loss may be carried back or carried over, as the case may be.

(4) The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(5) In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of §1.1016-9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(6) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521

during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term *premium* includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521-1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term *capital stock* includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(d) *Deduction for amounts allocated from income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521-1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term *income not derived from patronage* means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by

the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

§ 1.522-3 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 522.

(a) *General rule.* Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 522 to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 522 will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the bylaws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of *reasonable reserves* and after payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, on or before the 15th day of the ninth month

following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as *reasonable reserves* of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 521 and where the allocation is made to the patron on a patronage basis is proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) *Examples.* This section may be illustrated by the following examples:

Example 1. E, a cooperative association entitled to tax treatment under section 522, organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of Cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as *reasonable reserves* necessary to the operation of Cooperative E. At the close of the taxable year, 1954, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, \$5,000 is to be retained as *reasonable reserves* for various necessary purposes of Cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 521. Such \$5,000 is apportioned on the books of Cooperative E to patrons of 1954 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1955, pursuant to the terms of the by-laws, \$200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1954 on the basis of patronage. \$100,000 of such \$200,000 is allocated in cash. The remaining \$100,000 is allocated in *retain certificates*, bearing no interest and redeemable in the discretion of the Board of Directors of Cooperative E. There may be added to the cost of goods sold by Cooperative E for 1954, \$200,000 (\$100,000 in cash, \$100,000 in retain certificates), the total amount allocated as patronage dividends, rebates, or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1955, before the 15th day of the ninth month following the close of 1954. There may not be added to the cost of goods sold by Cooperative E for 1954, \$5,000, the amount retained as reserves apportioned on