

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 305

April 23, 1965

COOPERATIVE: DEDUCTION OF NOVEMBER INCOME

Syllabus:

Taxpayer was organized in 1907 under the general corporation law in order to engage in the cooperative purchasing of supplies for its members who were all required to be members of Orange, Inc., a cooperative growers association.

Each member of taxpayer is entitled to one vote for each share to taxpayer's stock it owns. Stock is held on a revolving fund basis. Each shareholder deposits two cents with Orange for each box of fruit sold. Three times a year these funds are used to purchase at their par value of \$10 a share, the oldest outstanding shares of taxpayer.

Taxpayer was required to distribute income from member business on the basis of patronage as soon after the close of the income year as practicable. The income from nonmember business, however, was distributable to members at taxpayer's election. Distributions when made were to be on the basis of patronage for the three calendar years preceding the year of distribution.

In 1959, taxpayer settled a Federal income tax controversy. As a result, taxpayer added to earned surplus a large refund of taxes for 1950 and 1951, and a contingency reserve previously established in the event of an unfavorable court decision. Because of the excess cash on hand taxpayer purchased at par its oldest outstanding shares which had been issued between October 1, 1952 and February 1, 1955. Taxpayer also reduced stated capital to agree with the total par value of the remaining outstanding shares and created a reduction surplus equal to the amount by which stated capital was reduced.

(1) Was taxpayer organized as a cooperative within the meaning of Section 24404?

(2) Is the retirement of capital stock out of earned surplus a distribution of income pursuant to Section 24404?

(3) Does nonmember income earned prior to income year 1959 but distributed during that year or subsequently qualify for the deduction provided in Section 24404?

(1) Section 24404 is based upon Federal provisions which exempted certain farmers' cooperatives from taxation. The Federal law applies to corporations

organized under the general corporation law of a state so long as the corporation is established for a proper cooperative purpose and limits its activities to the purposes for which it was organized and any other activities which are a natural outgrowth of its relations with its members. Eugene Fruit Growers Association, 37 BTA 993.

Since taxpayer was organized for a cooperative purpose and operates in part as a cooperative it qualifies for the deduction in Section 24404.

The fact that the members have unequal voting power does not affect this conclusion. Section 12702 of the Corporations Code, which provides that each member of a cooperative is entitled to one vote, does not apply to farmers' cooperatives, which at the present time are organized pursuant to Sections 1190, et seq. of the Agricultural Code, where unequal voting rights are allowed.

(2) Section 24404 provides for the deduction of nonmember income allocated to the members of a cooperative. In the present case the facts show that taxpayer clearly intended to retire shares of stock with cash received from a Federal income tax refund, rather than to distribute income. The decision to redeem the shares was made on August 5, 1959, about five months prior to the time that they would definitely know the results of their 1959 operations. In addition the members were never notified of any allocation of income as required by Section 24404. Rather the notices sent merely described the procedure by which certain shares of stock would be purchased by taxpayer. Further evidence of taxpayer's intent is its failure to make a distribution on the basis of patronage during 1956, 1957 and 1958 as required in the revolving fund agreement. The stock redeemed had been issued during the years 1952 to 1955, and members who did not wish to sell their shares received nothing.

Thus taxpayer was merely returning to its stockholders the amounts they had previously paid for their shares. The retirement of taxpayer's oldest shares substantially altered the voting power of its shareholders. If taxpayer maintained an expected level of business its shares would then revolve in five years instead of a longer period as previously, thus causing its voting power to more nearly resemble current patronage.

For tax purposes the stock retirement was a redemption pursuant to Section 24455 and the distribution is properly chargeable to capital pursuant to Section 24488. Taxpayer appears to have made the purchase from earned surplus only because of the legal restrictions placed upon reduction surplus by the Corporations Code.

(3) Senate Bill 886 as originally introduced in the Legislature in 1959 provided for the deduction of "amounts allocated during the taxable year to patrons with respect to income not derived from patronage (*Whether or not such income was derived during such taxable year*)" (italics added). As finally passed, however, the language was amended to provide for a deduction of

"all amounts, whether or not derived from patronage, allocated during the income year."

In our opinion, the elimination of the specific language allowing the deduction of prior year's income compels the conclusion that income earned prior to 1959 cannot be deducted. This interpretation seems to be the more logical since it would prevent a deduction in years subsequent to 1959 of amounts that were taxable under the law when originally received by the association. Any other interpretation could conceivably provide for a deduction of the income considered taxable in the year 1942 in the Appeal of California Pine Box Distributors, decided September 15, 1949.