This is the 1st affidavit of Andre Beaudry in this case
And was made on September 24, 2020

No. _____ Vancouver Registry

In the Supreme Court of British Columbia

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-36, AS AMENDED

AND

IN THE MATTER OF MOUNTAIN EQUIPMENT CO-OPERATIVE AND 1314625 ONTARIO LIMITED

Petitioners

AFFIDAVIT

I, Andre Beaudry, of Ottawa, Ontario, Co-operative expert, swear/affirm that:

1. I am the Executive Director of Co-operatives and Mutuals Canada ("CMC") and as such, I have personal knowledge of the facts and matters hereinafter deposed to, except where stated to be based on information and belief, in which case I verily believe the same to be true.
2. Prior to taking this role with CMC, I served as Chief Advancement Officer at Saint Paul University. I was responsible for collaborating with internal and external champions to secure funds and establish Canada's first School of Social Innovation; Canada's first School of Transformative Leadership; the Mauril Bélanger Social Innovation Workshop; a new Centre for Student Life; a new Centre for Counselling and Psychotherapy; and a $1M fund to educate Indigenous psychotherapists. Earlier in my career, I served as Director of Development with the British Columbia Institute of Technology Foundation.
3. I make this affidavit in support of the application on behalf of CMC's application for standing as a public interest intervenor in this matter.

Factual Background

4. Mountain Equipment Co-operative (MEC or Co-operative) concluded a bidding process for an asset sale on August 28, 2020 (1st Affidavit of Philippe Arrata, para. 78(d))

5. On September 14, 2020, legal counsel representing the board of directors of Mountain Equipment Co-operative filed a petition with this honourable court to enter into insolvency proceedings through the Companies' Creditor Arrangement Act ("CCAA") process.

6. The 1st Affidavit of Mr. Arrata discloses that the Co-operative's directors entered into an asset sale agreement with a U.S. Venture Capital Firm, Kingswood Capital Management under a Canadian subsidiary, 1264686 B.C. Ltd., as of September 11, 2020. (the "Intended Asset Sale")

7. An initial order has been granted, staying creditor proceedings and permitting the Co-operative to continue operating in the interim.

8. Upon information and belief, both the petition and the Intended Asset Sale were executed without notice to the MEC's approximately five (5) million member-owners. No attempts to canvas the membership regarding alternatives to the Intended Asset Sale appear to have been made. No general meeting has been called to address the issue of insolvency, or to propose insolvency proceedings and the sale of substantially all of the Co-operative's assets. No attempt has been made to canvas members regarding private proprietary information currently in MEC's possession. No opportunity has been provided for the Co-operative's members to organize an effort to restructure the Co-operative as a Co-operative.

9. At present, it appears that a viable alternative to the sale of substantially all of the Co-operative's assets is a legitimate possibility. The membership has rallied to save the Co-operative on social media through the campaign 'Save MEC'. At least one member group is now represented by Counsel, having raised over $90,000 for legal fees via crowdfunding, and collected approximately 130,000 member signatures supportive of keeping the Co-operative from being demutualized through the Intended Sale.

10. There is a growing possibility that membership, or a partnership including members, could raise sufficient capital as part of a restructuring process that would keep the MEC brand under the Co-operative's ownership, and preserve employment and operations under the Co-operative's democratic enterprise.

11. CMC was founded in 1909 as the Co-operative Union of Canada. In 2013, became Co-operatives and Mutuals Canada when it merged with the Conseil Canadien de la coopération et de la mutualité (CCCM), which had been established in 1944.

12. Co-operatives and Mutuals Canada (CMC) is a national/bilingual apex organization with a mandate to support the development of Canada's national ecosystem of 8,000 small, mid-sized and large member-owned co-operative enterprises (businesses).

13. CMC's members are Canada's largest financial and non-financial co-operatives and mutuals, provincial/territorial co-operative associations, and national sector federations. In addition to representing some of the largest employers in their respective provinces and territories, CMC also provides a voice to 99.1% of Canada's active non-financial co-operatives that are small and medium-sized enterprises (SME).

14. The co-operative sector in Canada is a major contributor to the national economy, representing $85.9 billion in business volume per year, with $503 billion in assets, 31.8 million members, and employing 182,253 individuals.

15. CMC wishes to apply our expert knowledge of the co-operative model to make submissions related to the public interest in preserving the legal authority of BC Co-operative Associations Act (the "Act"), an Act five (5) million members of the Co-operative rely on to preserve their ownership of the Co-operative. MEC's five (5) million member-owners are part of the nine (9) million Canadians who own 31.8 million co-operative memberships in co-operatives. The authority of the Act has been put in jeopardy by the Co-operative's petition for approval of the Intended Asset Sale under the CCAA.

16. The Honourable Court should be advised that a ruling in the present case may impact the ownership, financial and governance rights of nearly 32 million Canadians who are members of a co-operative.

17. Co-operatives across Canada, while corporations, are legally distinct enterprises from other types of business corporations, both in law and practice. Uniquely, the Co-operative model is animated by seven shared co-operative principles. These principles are the following as set out by the International Co-operative Alliance (ICA):

    1. Voluntary and open membership- Co-operatives are voluntary organizations open to all persons able to use their services without discrimination.
    2. Democratic member control- Co-operatives are democratic organizations controlled by members, who actively participate in setting their policies and making their decisions according to the rule 'one member = one vote'. The men and women serving as elected representatives are accountable to the membership.
    3. Member economic participation- Members contribute equitably to, and democratically control, the capital of their co-operative. Surplus is allocated according to co-operative principles to the benefit of members in proportion to their transactions with the Co-operative.
    4. Autonomy and independence- Co-operatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or corporations, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.
    5. Education, training, and information- Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of the co-operative.
    6. Co-operation among co-operatives- Co-operatives serve their members by working together to strengthen the co-operative movement.

7. Concern for community- Co-operatives work for the sustainable development of their communities through policies approved by their members.

   Attached as **Exhibit "A"** is a CMC article discussing the international co-operative principles.

18. There is limited case law interpreting the nature of co-operatives, but what does exist is supportive of co-operatives as corporate bodies that are distinct from business corporations. The federal Tax Court of Canada, in *Joncas v. the Queen* considered the distinct nature of co-operatives citing, "the co-operative is a unique form of partnership originating in the spirit of economic development and mutual aid. This mode of operation has managed to meet market needs such that it is now an important part of our economy and has evolved in various forms. Among the features that distinguish the co-operative from other entities is the fact that its customers are its owners and that it therefore acts, above all, in their best interests..." The court proceeds to cite "a co-operative is a partnership of members who have common economic and social needs and who, with a view to satisfying those needs, join forces to operate a business in accordance with certain rules of action specific to the co-operative movement..." Attached as **Exhibit "B"** is an excerpt with the above quote from *Joncas v. the Queen*.

19. The leading U.S case, *Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue* reviews the distinct history of the Co-operative movement finding 'three guiding principles' for the definition of operating on a co-operative basis, "(1) Subordination of capital, both as regards control over the co-operative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their co-operative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the co-operative endeavor." Subsequent Revenue Rulings emphasized that these principles were necessary to a determination that a business was operating on a co-operative basis. Attached as **Exhibit "C"** is a copy of *Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue.*

20. In the event this Honourable Court allows the CCAA process to circumvent the substantive and procedural provisions of the Act, it would have the effect of permitting Co-operative boards to sell member-owned enterprises without any opportunity to restructure internally. This would, in effect, vitiate the legal distinction of co-operatives from other legal persons, as well as the authority of all provincial co-operative legislation in circumstances of a cooperative's illiquidity.

21. Permitting the Intended Asset Sale without upholding member governance rights as enshrined in provincial co-operative legislation will severely undermine the Canadian co-operative sector as a whole, weakening the member rights and capital contributions to co-operatives of more than 31 million Canadians. I verily believe that this cannot be the intent of parliament in enacting the CCAA.

22. There are several examples of large co-operatives restructuring with member participation, and one could argue that it occurs anytime a co-operative calls on its

members in moments of difficulty to help restructure the business accordingly. For instance, asking members to not receive patronage refunds, issuing non-voting shares, increasing membership fees etc. For example:

a. Vancity issued investment shares as part of its financial restructuring, which sold out in 24 hours;

b. The Co-operators restructured as a multi-stakeholder co-operative in the 1980s;

c. The recent conversion of six Quebec dailies of the *Groupe Capitales Médias* (GCM) would not have been possible without raising worker and reader-community investments (as well as provincial and solidarity funds) to piece together the buy out.

23. There is a strong public interest in ensuring the Co-operative model remains sustainable and resilient in the face of legal processes that may be abused, and result in the flight of valuable social and financial capital away from Canadian citizens and Canadian communities.

24. I verily believe that the application of federal jurisdiction under the CCAA to the authority of the provincial co-operative legislation is an unsettled area of law, that potentially engages constitutional issues such as 'paramountcy' and 'interjurisdictional immunity'. I submit that it is in the public interest to include submissions from CMC as a national representative of the sector with the capacity to bring the sector's unique perspective to these proceedings.

25. I further verily believe CMC is able to bring resources to assist the court in analyzing these novel issues as a public interest intervenor and friend of the court with minimal or no prejudice to the parties.

AFFIRMED BEFORE ME at Ottawa, Ontario, on 24/Sep/2020.

A Notary Public for taking Affidavits for Ontario

Andre Beaudry

Mark K. Habib
Barrister & Solicitor + NOTARY PUBLIC
Habib & Associates Law Office
16-2450 Lancaster Road
Ottawa, ON K1B 5N3

This is **Exhibit "A"** referred to in the Affidavit No. 1 of Andre Beaudry sworn before me on 24/Sep/2020

Notary Public

Mark K. Habib
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co-operatives and mutuals canada

Values & Principles

Co-operatives are based on the values of **self-help**, **self-responsibility**, **democracy**, **equality**, **equity and solidarity**. In the tradition of their founders, co-operative members believe in the ethical values of **honesty**, **openness**, **social responsibility** and **caring for others**.

The co-operative principles are guidelines by which co-operatives put their values into practice.

1. Voluntary and Open Membership

Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2. Democratic Member Control

Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote) and co-operatives at other levels are also organised in a democratic manner.

3. Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

4. Autonomy and Independence

Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

5. Education, Training and Information

Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They

inform the general public - particularly young people and opinion leaders - about the nature and benefits of co-operation.

6. Co-operation among Co-operatives

Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures.

7. Concern for Community

Co-operatives work for the sustainable development of their communities through policies approved by their members.

This is **Exhibit "B"** referred to in the Affidavit No. 1 of Andre Beaudry sworn before me on 24/Sep/2020

Notary Public

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Joncas v. The Queen, 2002 CanLII 3 (TCC)

Date:	2002-11-28
File number:	1999-3421-IT-G
Other citations:	[2004] 2 CTC 2877 — 58 DTC 2315
Citation:	Joncas v. The Queen, 2002 CanLII 3 (TCC), <http://canlii.ca/t/1h061>, retrieved on 2020-09-23

[OFFICIAL ENGLISH TRANSLATION]

1999-3421(IT)G

BETWEEN:

PAUL-AIMÉ JONCAS,

Appellant,

and

Her Majesty The Queen,

Respondent.

Appeals heard on July 8 and 10, 2002, at Québec, Quebec, by

the Honourable Judge Louise Lamarre Proulx

Appearances

Counsel for the Appellant: René Roy

Marie-Hélène Bétournay

Counsel for the Respondent: Anne-Marie Boutin

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 1993, 1994 and 1995 taxation years are allowed, with costs, and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 28th day of November 2002.

"Louise Lamarre Proulx"

J.T.C.C.

[OFFICIAL ENGLISH TRANSLATION]

Date: 20021128

Docket: 1999-3421(IT)G

BETWEEN:

PAUL-AIMÉ JONCAS,

Appellant,

and

Her Majesty The Queen,

Respondent.

Reasons For Judgment

Lamarre Proulx, J.T.C.C.

[1] These appeals concern the 1993 to 1995 taxation years.

[2] The point for determination is whether the appellant incurred an amount of $162,325.71 for the purpose of gaining or producing income from a business or property within the meaning of subparagraph 40(2)(*g*)(ii) of the *Income Tax Act* (the "*Act*") and is thus entitled to an allowable business investment loss under paragraph 38(*c*) of the *Act* for the 1993 taxation year.

[3] At the outset of the hearing, the parties informed the Court that they had reached agreements on a few points, as follows:

[TRANSLATION]

(a) The amount of the business investment loss is $162,325.27, and the respondent admits that the loss has the characteristics required by paragraph 39(1)(*c*) of the *Act*. The remaining issue therefore is the one regarding the requirement of subparagraph 40(2)(*g*)(ii) of the *Act*, that the debt or right was acquired for the purpose of gaining or producing income from a business or property.

(b) For the 1993 and 1994 taxation years, the appellant has admitted that he must add the respective amounts of $15,488 and $6,421 as income from his medical profession in computing his income for those years. Those amounts are those referred to in subparagraph 8(e) of the amended Reply to the Notice of Appeal (the "Reply"). The respondent has agreed to delete the penalties in respect of those amounts, which penalties are referred to in subparagraphs 8(f) and (g) of the Reply.

(c) According to subparagraphs 8(h) to (k) of the Reply, the Minister of National Revenue (the "Minister") has added an amount of $8,657.16 to the appellant's income for the 1995 taxation year in respect of a benefit relating to the use of a motor vehicle put at his disposal by 162481 Canada Ltd. The appellant was the principal shareholder of that corporation. That amount must be reduced to $2,992.34, according to the respondent, because the appellant was only in Canada for the last four months of the year. However, the appellant disputes the inclusion of that benefit.

(d) The respondent consents to the write-off of $3,586.19, which was included in computing the appellant's income in respect of a benefit relating to the use of a snowmobile and described in subparagraphs 8(l) to (p) of the Reply.

(e) For the purposes of the bill of costs, the parties agree that the tariff that should apply to these appeals is Tariff B.

[4] With respect to the benefit relating to the use of a motor vehicle, the Minister relied on the following facts:

[TRANSLATION]

(h) During the 1995 taxation year, the appellant was the principal shareholder of 162481 Canada Ltd.;

(i) During the entire 1995 taxation year, 162481 Canada Ltd. put a motor vehicle at the disposal of the appellant and/or a person related to him;

(j) During the 1995 taxation year, 162481 Canada Ltd. was the lessee of the motor vehicle put at the appellant's disposal; the monthly cost of that lease was $721.43;

(k) For the appellant's 1995 taxation year, the Minister of National Revenue added the amount of $8,657.16 ($721.43 x 12 months) to the appellant's income in respect of a benefit relating to the use of a motor vehicle;

[5] The amended Notice of Appeal states the following on this subject:

[TRANSLATION]

. . .

13. In addition, the agents of the respondent have added taxable benefits from the use of a snowmobile and a motor vehicle to the appellant's income for the 1995 taxation year.

. . .

18. The appellant further appeals from the Minister's decision to tax taxable benefits for the 1995 taxation year regarding the use of a snowmobile and a motor vehicle because those assets were never used for his personal purposes during that taxation year.

[6] A tax expert from the accounting firm of Price Waterhouse Coopers sent a letter dated September 22, 1998, stating the following (Exhibit A-15):

[TRANSLATION]

. . .

TAXATION OF A BENEFIT FOR THE USE OF A MOTOR VEHICLE

During the years in issue, Dr. Joncas owned a truck that was registered in his name until December 1997.

Corporation 162481 Canada Inc. owned a car. When Dr. Joncas left Blanc-Sablon, he and the corporation exchanged vehicles without there being a change of owner. Dr. Joncas continued to pay for the registration and insurance of his truck, and the corporation did the same with respect to its car. Dr. Joncas therefore received the use of the car in exchange for the use of his truck by the corporation. Consequently, he received no benefit through that transaction.

. . .

[7] At paragraph 18, the amended Notice of Appeal reads as follows on the subject:

[TRANSLATION]

18. The appellant further appeals from the Minister's decision to tax taxable benefits for the 1995 taxation year regarding the use of a snowmobile and a motor vehicle because those assets were never used for his personal purposes during that taxation year.

[8] The appellant stated in his testimony that the car had not been leased as was stated in the Reply. The car was the property of the corporation, and the corporation had let him use it in Québec because he had allowed the corporation to use his truck in Blanc-Sablon. That is not what was stated in the amended Notice of Appeal. In a letter dated January 15, 1999, the appellant gave the following explanation to an appeals officer (Exhibit A-16):

[TRANSLATION]

. . .

(b) Taxable benefit for the use of a motor vehicle provided by 162481 Canada Inc.

I admit that that vehicle had been put at my disposal for personal and business purposes for four months of 1995 (i.e., from September to December of that year). During that period, the vehicle was used for business for the various companies related to 162481 Canada Inc. The business and personal use portions for that period were approximately 40 percent for business and 60 percent for personal use.

Under the agreement I had with 162481 Canada Inc., in exchange for my personal use of their vehicle, I lent them my vehicle, a four-wheel-drive Ford F150 truck. They used my Ford truck for strictly business purposes during all of 1995 (i.e., 12 months).

Therefore, for four months I had access to the use of a vehicle provided by 162481 Canada Inc. for personal (60 percent) and business (40 percent) purposes, and, in exchange, 162481 Canada Inc. used my personal vehicle, which was in Blanc-Sablon, for business purposes (100 percent) for 12 months.

For that exchange, in which I am at a financial loss, I have been assessed a taxable benefit of $8,567.

Whereas there was an exchange of vehicles; whereas 162481 Canada Inc. received a financial advantage from that exchange; and whereas I gained nothing financially from that exchange-it was quite the opposite-I ask that this assessment be vacated.

. . .

[9] A motor vehicle insurance policy (Exhibit A-14) was filed as evidence of ownership of the truck in 1995 and of the appellant's use of it for the corporation's business purposes. It states that the effective period of the insurance policy was from March 18, 1996, to March 18, 1997, that the vehicle was to be used for pleasure driving, excluding round trips to work, and that the appellant was the principal driver.

Business Investment Loss

[10] The facts on which the Minister relied in disallowing this loss as an allowable business investment loss are described in subparagraphs 8(q) to (aa) of the Reply:

[TRANSLATION]

(q) For his 1993 taxation year, the appellant claimed a business investment loss of $222,325.77, which he purports to have paid to the Lower North Shore Transportation Integrated Cooperative (hereinafter the "Cooperative"); the appellant thus claimed an amount of $166,744 (75 percent of $222,325.77) as an allowable business investment loss;

(r) The Cooperative was founded on March 26, 1990;

(s) The only document that was provided to the Minister of National Revenue is a financial statement of the Cooperative for the period from April 1 to November 30, 1990;

(t) At November 30, 1990, the 272 members of the Cooperative holding 8,645 shares had invested $86,450;

(u) The appellant provided no documents showing that he in fact lent the Cooperative the amount of $222,325.77;

(v) The appellant provided no documents showing the Cooperative's activities;

(w) The Cooperative did not carry on a business;

(x) The appellant provided no documents on the basis of which it could be concluded that the Cooperative had ceased its activities;

(y) The appellant provided no documents on the basis of which it could be concluded that the Cooperative had assigned its property;

(z) The appellant provided no documents showing that he had a debt of $222,325.77 that had become unrecoverable.

[11] The amended Notice of Appeal states the following on this subject at paragraphs 3 to 10:

[TRANSLATION]

3. The appellant is a doctor, a member of the Corporation professionnelle des médecins du Québec, and also carries on various commercial undertakings, some of which are involved in passenger air transportation.

4. In addition, during the 1993 taxation year, the appellant was a member of a cooperative having the corporate name "Lower North Shore Integrated Transportation Cooperative" (hereinafter the "**Cooperative**").

5. The **Cooperative** offered certain administrative services (accounting, bookkeeping, etc.) and operated a transportation business and owned a helicopter for that purpose.

6. The appellant was involved in the management of the **Cooperative**for a number of years as chairman of the board of directors.

7. The appellant left the board of directors of the **Cooperative** in view of the potential conflict of interest between his professional activities as a physician and the operation of the **Cooperative**'s business.

8. Given the financial difficulties facing the **Cooperative**, the appellant made advances to the Corporative totalling $222,325.00, **bearing interest**, to enable it, among other things, to replenish the working capital of the business and to repay the amounts owed to the financial institution that had financed the helicopter purchase.

9. The **Cooperative** ceased operating its business in 1993 and the amounts advanced by the appellant then became a bad debt for him.

10. In his return of income for the 1993 taxation year, the appellant subsequently claimed "a business investment loss" in respect of that amount of $222,325.00.

[12] One must recall the admissions that the parties made and that were referred to at the start of these reasons, that is, that the debt is in the amount of $162,325.27 and that it has the characteristics required by paragraph 39(1)(*c*) of the *Act*. The only remaining issue is whether the debt was incurred for the purposes of gaining or producing income from a property or business within the meaning of subparagraph 40(2)(g)(ii) of the *Act*.

[13] Upon hearing the evidence, I find that the amended Notice of Appeal correctly stated the facts.

[14] James Fequet was the first witness. Mr. Fequet has been a chartered accountant since 1990. He worked at the accounting firm of Samson et Bélair from 1986 to 1990. In 1990, he returned to St-Augustin, where he is originally from.

[15] The articles of incorporation of the Lower North Shore Integrated Transportation Cooperative (the "Cooperative") were filed as Exhibit A-1. The Cooperative's project began to be developed in 1989. The Cooperative was incorporated on March 26, 1990, and its purpose was:

[TRANSLATION]

- To operate a business in order to provide its members with goods and/or services in the field of maritime, land and air transportation;

- To hold and use every transportation permit necessary in order to achieve the purposes of the business;

- To acquire, lease or manage any apparatus, equipment or immovable necessary to the operation of the business; and

- To promote the economic, social and cooperative training of its members in order to promote the economic development of the Lower North Shore.

[16] The appellant's name is the first indicated on the list of the 12 founders (natural persons). The names that follow are those of four merchants, a garage operator, a garage manager, the director of the Caisse populaire, a day labourer, an information officer, a plumber and a middle manager. The list of corporate members includes a number of corporations of which the appellant was the principal shareholder.

[17] Exhibit A-1 also includes the report of the organizational meeting held on May 20, 1990. The appellant is named as chairman and James Fequet as secretary. There were 10 other directors, a number of whom were on the list of the founders.

[18] Mr. Fequet was the director general of the Cooperative until September 25, 1992. He remained secretary of the board of directors until 1995. He and two other persons were the employees of the Cooperative.

[19] Exhibit A-2 is the Master Plan of the Lower North Shore Integrated Transportation Cooperative dated October 1991. That document states that the Cooperative's head office is in St-Augustin and that there is a branch office of the Cooperative on leased premises in Blanc-Sablon. The objectives of the Cooperative were, briefly stated, to operate a business in order to provide its members with goods and/or services in the field of maritime, land and air transportation and to promote the economic interests of the region by promoting the economic interests of its members.

[20] That same document states that there were 177 members and four auxiliary members. Some 102 persons had begun to pay their membership dues of $550. At the time, the Cooperative appeared to have had six employees in addition to Mr. Fequet.

[21] The Cooperative also offered bookkeeping, financial statement preparation and business consultation services. The Cooperative offered the services of Mr. Fequet and two assistant accountants for that purpose.

[22] The same report (Exhibit A-2) states that a Bell 206 BII helicopter was bought for $500,000. The purchase was financed by the Laurentian Bank, and the helicopter was operated by Trans-Côte Inc., a corporation of which the appellant was the principal shareholder.

[23] The report also refers to a contract for the supply of services by the Cooperative to Essor Helicopters Inc. at the Chevery Airport in 1990; the purchase and renovation of a building in St-Augustin for the Cooperative's head office; the construction of a helicopter hangar at Chevery Airport; the installation of the aircraft fuel tank; the management of a scallop farm project for the consortium P.A.S. Enr.; the purchase of office equipment; the purchase and resale of a barge and the participation in various files of the departments of Transport and Health and Social Services.

[24] The report (Exhibit A-2) refers to a $1,013,000 financing agreement with various banks. That agreement reads in part as follows:

K. Start-up Financing Agreement with the Federation of Caisses Populaires.

During September 1991 an agreement was reached between the cooperative, Laurentian Bank of Canada, Federation of Caisse Populaire, Caisse Populaire de Lourdes de Blanc Sablon, Caisse Populaire de La Tabatière, Caisse Populaire de Tête à la Baleine and the Société de Développement Industriel (SDI) on a financing deal for the cooperative of $1,013,000 as follows:

Institution	**Participation**	
Laurentian Bank of Canada	$ 493,000	capital lease
Caisse Populaire de Blanc Sablon	*150,000	loan
	50,000	credit margin
Caisse Populaire de La Tabatière	*150,000	loan
Caisse Populaire de Tête à la Baleine	*85,000	loan
Cooperative members	85,000	common share issue
	$1,013,000	

The funds from this financing project were used to help finance the achievements mentioned in A to J, plus the cooperative's start-up costs and working capital.

*$190,000 of these loans are guaranteed by the SDI.

[25] The first and last financial statements prepared by an outside auditor are dated November 30, 1990, and were filed as Exhibit A-3. On page 8, in the chapter entitled "Long Term Debt", an amount of $3,000 is indicated

respecting a "Note payable from a director, without interest nor terms of repayment". Exhibits A-4 and A-5 are draft financial statements prepared by Mr. Fequet.

[26] Exhibit A-6 is a document written by hand by the appellant and addressed to the two senior directors and to Mr. Fequet. The appellant had ceased to be chairman in 1991, but he had remained an active advisor to the Cooperative. That document is a summary of a meeting held on February 19, 1992. The appellant reviewed the decisions that had been taken and gave additional instructions for the management of the Cooperative's business. The last page of the document is addressed in particular to James [Fequet]. It states very clearly that the amounts lent by the appellant bear interest at the same rate as the rate granted to the Cooperative by the Laurentian Bank.

[27] Exhibit A-7 is a list of advances the appellant made to the Cooperative. That list was apparently typed by Revenue Canada officers. Mr. Fequet said he had typed the list by hand. It states the date and amounts of the cheques written by the appellant to make the instalments payable on the helicopter. The amounts lent were spread over the period from November 19, 1990, to May 25, 1993. Exhibit A-8 is the minutes of a directors' meeting dated March 14, 1992. There were now four directors. The appellant was present but not as a director. The appellant granted the Cooperative a $20,000 loan at 10 percent interest. That amount appears in Exhibit A-7. There were two amounts of $10,000 each.

[28] Mr. Fequet admitted that the Cooperative had wanted to acquire Trans-Côte Inc., a corporation of which the appellant was the principal shareholder. Exhibit I-3, a letter from Mr. Fequet to an official of the Centre de santé de la Basse Côte-Nord, states that the Cooperative had acquired Trans-Côte Inc. but explained that, for some reason, the agreement had never been completed.

[29] The appellant testified. He is a physician and a native of Blanc-Sablon. He and his family own a number of businesses there. Before studying medicine, he had studied engineering.

[30] The appellant stated that another Quebec region had managed to establish an integrated transportation cooperative on a profitable basis and that this was the hope of the members for both their own economic purposes and those of their region. He had made loans to the Cooperative to enable it to start up and get through its growth period.

[31] As Exhibit A-10, the appellant filed a financial lease agreement entered into between the Laurentian Bank and the Cooperative concerning the acquisition of a helicopter for $450,000. That document is dated April 24, 1991. The appellant had signed it as president of the Cooperative. Exhibit A-11 is a demand note dated April 24, 1991, issued by the Cooperative to the bank. Exhibit A-12, dated April 29, 1991, also concerns the acquisition of the helicopter. Exhibit A-13 is a surety dated April 24 that was signed by the appellant for the bank concerning the helicopter acquisition.

[32] The appellant admitted that most of the loans to the Cooperative had been made to help it make the financial lease payments on the helicopter acquired by the Cooperative for the purposes of establishing integrated transportation.

[33] Harold Bouchard testified for the respondent. He had calculated the benefit as being in respect of a leased vehicle. Corporation 162481 Canada Inc. from which he had obtained the computerized statement of advances to the appellant, which he filed as Exhibit I-5, did not explain the true nature of the payments.

[34] He also filed the various requests for information sent to the appellant, requests that apparently went unanswered for a long period of time. The last of the requests is dated January 15, 1997 (Exhibit I-6). One request had been made to Mr. Fequet on October 17, 1996 (Exhibit I-7). However, on February 28, 1997, there is a letter of that date from the appellant to Mr. Fequet, which was filed as Exhibit I-8. That letter requested financial statements and other documents from the Cooperative substantiating the business investment loss and the notice of bankruptcy.

Arguments

[35] Counsel for the appellant argued that the amounts of money lent to the Cooperative were interest-bearing. Furthermore, the purpose of those loans was to enable the Cooperative to retain ownership of the helicopter, as a result of which the appellant's various businesses, which were members of the Cooperative, were able to earn business income.

[36] Counsel referred to the *Cooperatives Act*, R.S.Q., c. C-67.2, as amended on July 1, 1999, and argued that the rebates provided for by that act were a source of income.

[37] Counsel for the respondent suggested that the appellant's purpose in his investment in the Cooperative was to sell the shares he had held in a corporation called Trans-Côte Inc., not to benefit the businesses of which the appellant was a shareholder.

[38] Counsel stated that payment of interest on the loans was not enforceable. No document clearly states that the Cooperative undertook to pay interest on the loans. Furthermore, the rebates to the members of the Cooperative did not constitute income. She noted, however, that the purpose of the Cooperative was to provide services to its members at lower cost, but she argued that the relationship between loans and income must be more immediate.

[39] With respect to rebates, she referred to the *Cooperatives Act, supra*, in particular to subsection 4(5) and to the relevant portion of section 143 concerning operating surplus or surplus earnings:

4. The rules of cooperative action are as follows:

. . .

(5) the surplus earnings or operating surplus must be allocated to the reserve or to rebates to members in proportion to the business carried on between each of them and the cooperative, or to other accessory purposes determined by law;

. . .

CHAPTER XX

OPERATING SURPLUS OR SURPLUS EARNINGS

143. . . .

Rebates.

The rebates are allotted to the members and to the auxiliary members, if any, in proportion to the business done by each of them, during that fiscal year, with the cooperative.

. . .

[40] Counsel referred to an article by Professor Roger Durand, *Les traits juridiques distinctifs de la coopérative et de la compagnie au Québec*, (1987) 17 R.D.U.S. 415, at page 476:

[TRANSLATION]

. . . The allotment of rebates to members of a cooperative adheres to an exclusive rule; rebates are allotted to members in proportion to the business done by each of them with the cooperative, as stipulated by the Commission on Cooperative Principles of the International Cooperative Alliance and as codified in the Quebec legislation. That rule is based on the very nature of the operating surpluses of a cooperative, which, it should be recalled, constitute all overpayments made by members for the goods and services purchased from their cooperative and not profits. . . .

Conclusion

[41] I shall begin by including in the appellant's income a benefit in respect of the personal use of a car, which is the property of a corporation of which he is the principal shareholder. Apart from the appellant's statements that he allowed that corporation to use a truck of which he was the owner and that this constituted an exchange and not a benefit, there is no written evidence to that effect. The only document filed was the appellant's proof of insurance on a truck but that was insurance for a year subsequent to the one in question, and the use stated was pleasure driving. There is no corporate document. The Notice of Appeal does not state the exact facts. Accordingly, the evidence is insufficient to have the taxed benefit written off.

[42] Now let us turn to the allowable business investment loss. I will begin with the first point raised by the respondent-that the appellant lent money to the Cooperative so that it could acquire Trans-Côte Inc., a corporation of which the appellant was the principal shareholder. It is impossible for me to assess the weight and significance I should attach to that statement. That is a point that should have been alleged because evidence is required in order for it to be understood. In fact, no allegation was made on that point and accordingly no evidence was brought to explain or rebut it. I therefore set it aside.

[43] As to the binding force, or lack thereof, of the agreement on interest, I find that the evidence showed that, if the Cooperative had been able to repay the loans, it would have done so with interest.

[44] In my opinion, however, the evidence showed that the appellant's primary purpose in lending the amounts in question to the Cooperative was to enable the Cooperative to have the necessary operating funds and to retain ownership of the helicopter.

[45] It was as a member of the Cooperative that the appellant lent it the amounts in question. A member of a cooperative is not a shareholder. Section 51 of the *Act* provides that, to be a member of a cooperative, a person or a partnership must have an interest as a user of the cooperative's services.

[46] The meaning that should be given to subparagraph 40(2)(*g*)(ii) of the *Act* is explained in the decision of the Federal Court of Appeal in *Byram v. Canada*, [1999] F.C.J. No. 92 (Q.L.). At issue in that case was a capital loss from an interest-free loan granted to a corporation by a lender who was a shareholder. The Court found that the loan had been granted for the purpose of earning income from dividends.

[47] The passages that I find most informative in helping to determine whether a debt was incurred for the purpose of gaining or producing income from a property or business are quoted:

11 It is not disputed that the Respondent issued interest-free loans to USCO for the purpose of earning income in the form of dividends from the company. The Appellant, the Crown admits that, in a broad sense, the disputed loan was a device for financing the operations of USCO and that the expected return from the loan is through dividend income.

. . .

14 In contrast, subparagraph 40(2)(g)(ii) of the Act provides that any capital loss from the disposition of a debt is deemed to be nil, unless the debt was acquired for the purpose of gaining or producing income from a business or property. The relevant portions of this section read as follows:

40(2)(g) a taxpayer's loss, if any, from the disposition of property, to the extent that it is . . .

(ii) a loss from the disposition of a debt or other right to receive an amount, unless the debt or right, as the case may be, was acquired for the purpose of gaining or producing income from a business or property (other than exempt income) or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm's length, . . . is nil.

15 Unlike paragraph 20(1)(c) this section only requires a single stage inquiry, namely what was the purpose for acquiring the debt. . . .

16 The language of section 40 is clear. The issue is not the use of the debt, but rather the purpose for which it was acquired. While subparagraph 40(2)(g)(ii) requires a linkage between the taxpayer (i.e. the lender) and the income, there is no need for the income to flow directly to the taxpayer from the loan.

17 Such an approach is also consistent with commercial reality. Frequently, shareholders make such loans on an interest-free basis anticipating dividends to flow from the activities financed by the loan. To adopt the position of the Minister would require that this Court ignore this reality. It would also be contrary to the comments of the Supreme Court of Canada in Stubart Industries Ltd. v. The Queen. Commercial reality is to be considered by the Courts in interpreting tax provisions like subparagraph 40(2)(g)(ii) so long as it is consistent with the text and purpose of the provision.

18 The ultimate purpose of a parent company or a significant shareholder providing a loan to a corporation is, without question, to facilitate the performance of that corporation thereby increasing the potential dividends issued by the company. This purpose is clearly within the scope of both the text and the purpose of subparagraph 40(2)(g)(ii), a section which is directed towards preventing taxpayers from deducting losses that are not incurred for the purpose of earning income from a business or property.

19 There is a growing body of jurisprudence that considers current corporate reality as being sufficient to demonstrate that the expectation of dividend income justifies a capital loss deduction under subparagraph 40(2)(g)(ii). As articulated above, this approach is consistent with current corporate realities and the purpose of subparagraph 40(2)(g)(ii).

. . .

21 It is equally clear that the anticipation of dividend income cannot be too remote. It is trite law that sections 3 and 4 of the Act, in conjunction with the rules set out in subdivisions (a) through (d) of division B, establish that the income of a taxpayer is to be determined on a source by source basis. Furthermore, the availability of certain deductions under the Act, including subparagraph 40(2)(g)(ii), require that some regard be given to the source of income that is relevant to the deduction. Accordingly, a deduction cannot be so far removed from its corresponding income stream as to render its connection to the anticipated income tenuous at best. This does not preclude a deduction for a capital loss incurred by a taxpayer on an interest-free loan given to a related corporation where it had a legitimate expectation of receiving income through increased dividends resulting from the infusion of capital.

23 . . . The determination of whether there is sufficient connection between the taxpayer and the income earning potential of the debtor will be decided on a case by case basis depending on the particular circumstances involved.

[48] According to that decision, the lender taxpayer need not derive income directly from the loan because taxpayers sometimes grant interest-free loans, expecting that the activities financed by those loans will produce income. Commercial realities must be taken into account. The question as to whether there is a sufficient connection between the debt and the taxpayer's income is decided on a case-by-case basis on the facts of each case.

[49] In this instance, the nature of cooperatives must be considered. I refer on this point to the article by Jean-Pierre DesRosiers, *supra*, at page 39:5:

[TRANSLATION]

The cooperative is a unique form of partnership originating in the spirit of economic development and mutual aid. This mode of operation has managed to meet market needs such that it is now an important part of our economy and has evolved in various forms. Among the features that distinguish the cooperative from other entities is the fact that its customers are its owners and that it therefore acts, above all, in their best interests. . . .

A cooperative is a partnership of members who have common economic and social needs and who, with a view to satisfying those needs, join forces to operate a business in accordance with certain rules of action specific to the cooperative movement, including the following: . . .

[50] As to the nature of rebates, it seems established that they do not constitute a sharing of profits, but rather a remittance of the costs of services rendered by the Cooperative to its members. I refer on this point to a passage from an article in the appellant's book of authorities by Jean-Pierre DesRosiers, CA M. Fisc., entitled *La fiscalité des coopératives et de leurs membres*, APFF Congrès 1995, at page 39:14:

[TRANSLATION]

. . . A cooperative does not realize a profit or loss, but rather an operating surplus or surplus earnings, or a deficit. . . . Deficits are charged against the reserve, whereas operating surpluses or surplus earnings are allotted as rebates or paid into the reserve in accordance with the members' decision at the annual meeting.

2.5.1 - Rebate Payments

A rebate is a remittance of the overpayment made by members or an adjustment of prices of the goods and services delivered or rendered to the cooperative. Rebates may not be paid from other sources of income such as investments. It is expected that rebates may vary with the nature or quality of the goods and services transacted.

[51] In the appellant's case, the monetary reward for his investment will not be potential dividend income, as in *Byram, supra*, but a reduction in the cost of services required by his businesses in the course of their affairs. It seems to me that the relationship is just as close as in the case of a shareholder who lends to his corporation.

[52] The purposes for which the appellant made the loans were business purposes. The loans were not made for philanthropic or family purposes. His purpose in making the loans to the Cooperative was to facilitate and promote the commercial activities of his businesses and thus to increase his own income. I therefore conclude that the debt was acquired by the appellant for the purpose of earning income from his businesses within the meaning of subparagraph 40(2)(g)(ii) of the *Act*.

[53] The appeal is allowed on the following basis: (a) the appellant is entitled to deduct the amount of $162,325.27 in respect of allowable business investment losses; (b) as admitted at the start of the hearing, the appellant shall include in his income for 1993 and 1994 the respective amounts of $15,488 and $6,421 and the penalties assessed in respect of those amounts shall be deleted; (c) the benefit in respect of the personal use of an automobile in the amount of $2,992.34 shall be included in computing the appellant's income, but the benefit in respect of the use of a snowmobile is cancelled.

Signed at Ottawa, Canada, this 28th day of November 2002.

"Louise Lamarre Proulx"

J.T.C.C.

This is **Exhibit "C"** referred to in the Affidavit No. 1 of Andre Beaudry sworn before me on 24/Sep/2020

Notary Public

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Docket No. 3933-62
Tax Court of the United States.

Puget Sound Plywood, Inc. v. Comm'r of Internal Revenue

44 T.C. 305 (U.S.T.C. 1965)
Decided Jun 4, 1965

Docket No. 3933-62.

1965-06-4

PUGET SOUND PLYWOOD, INC., PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Karl D. Loos, Paul P. Ashley, and John A . Whitney, for the petitioner. Wilford H. Payne and James M. Carter, for the respondent.

PIERCE

305 *305 Karl D. Loos, Paul P. Ashley, and John A . Whitney, for the petitioner. Wilford H. Payne and James M. Carter, for the respondent.

The petitioner was and is a cooperative association of the type commonly known as a workers cooperative association, which was incorporated and operated in accordance with a statute of the State of Washington that pertains particularly to the creation and regulation of associations operating on a cooperative basis. Held, that said cooperative association is entitled to be classified and treated for Federal income tax purposes, as a 'nonexempt cooperative association'; and that as such, it is entitled to exclude from the proceeds of the association's operations, for Federal income tax purposes, the patronage dividends which were, pursuant to a preexisting legal obligation, allocated to the worker-members in proportion to the hours worked by them in producing and marketing the products of their cooperative endeavor.

PIERCE, Judge:

The respondent determined deficiencies in income tax against the petitioner for the following years and in the following amounts:

+----------+ ¦*Calendar year* ¦*Deficiency* ¦ +----------+----------¦ ¦ ¦ ¦ +----------+---------- --¦ ¦1958 ¦$390,113.51 ¦ +----------+----------¦ ¦1959 ¦520,936.08 ¦ +----------+----------¦ ¦1960 ¦207,538.17 ¦ +----------+

The sole issue for decision herein is whether the petitioner, which is a cooperative association of the type commonly known as a workers cooperative association, that was incorporated and operated in accordance with a statute of the State of Washington that pertains particularly to the formation and regulation of associations operating on a cooperative basis: (1) Is entitled to be classified and treated for Federal income tax purposes as a 'nonexempt cooperative association,' within the meaning of that term as employed in the Federal income tax statutes, the long-established rulings and practice of the Internal Revenue Service, and various judicial decisions; and (2) is entitled as such, to exclude from the proceeds of the association's operations, for Federal

306 *306 income tax purposes, the 'patronage dividends' which were, pursuant to a preexisting legal obligation, allocated to the worker-members in proportion to the hours worked by them in producing and marketing the products of their joint efforts.

The only other issue raised in the pleadings is an alternative one which has been settled by the parties through a written stipulation. Effect will be given to this stipulation to the extent that the provisions thereof are pertinent after disposition of the previously stated issue.

FINDINGS OF FACT

Some of the facts have been stipulated. This stipulation of facts and all exhibits identified therein are incorporated herein by reference; subject however to agreement of the parties that certain words employed therein, such as 'shareholder,' 'member,' or 'margins,' are not conclusive as to the true character of the organization and transactions here involved.

Petitioner was incorporated in 1941 under a statute of the State of Washington (hereinafter cited) that pertains particularly to the formation and regulation of associations operating on a cooperative basis. It filed a Federal income tax return for each of the years involved with the district director of internal revenue at Tacoma, Wash.

Facts re History and Characteristics of Cooperative Associations

A 'cooperative association' has been defined in Income Tax Regulations, sec. 1.522-1(b)(1), as follows:

The term 'cooperative association' includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons * * * [with certain exceptions not here relevant.] [Emphasis supplied.]

Another and more detailed definition is this:[1]

[1] 7 Ency.Amer. 639 (1959 ed.)

A cooperative is an organization established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor. The means of production and distribution are those owned in common and the earnings revert to the members, not on the basis of their investment in the enterprise but in proportion to their patronage or personal participation in it. Cooperatives may be divided roughly into consumer cooperatives and producer cooperatives.

Consumer (cooperative) organizations operate for the benefit of the members in their capacity as individual consumers. * * *

Producer (cooperative) organizations operate for the benefit of the members in their capacity as producers. Their function may be either the marketing or processing of goods produced individually (as in fishermen's or
307 farmers' marketing associations, or associations which make butter or cheese from farm products*307 received from farmer members), or the marketing of goods processed or produced collectively (as in the so-called workers' (cooperative) productive associations operating factories or mills).

The history and characteristics of cooperative associations may be summarized as follows.[2] One of the earliest examples of cooperative associations as they exist today was the Rochdale Cooperative, which was founded in England in 1844 by 28 textile weavers who associated themselves together for the purpose of operating a retail store. The objectives which the members of that association sought to attain were: (1) For themselves to own and manage the store, as distinguished from having it owned and managed by outside equity investors; and

then, (2) to have their association turn back to the members the excess of the receipts from the store sales over the cost of the goods sold and the expenses of operation. This general form of cooperative organization thereafter spread from England to other nations including the United States, where it has since been utilized not only by consumer cooperatives, but also by producing and marketing cooperatives. Thus is the United States for example, in years immediately preceding and following the War Between the States, various types of cooperative enterprises were organized, including those composed of farmers, dairymen, shoemakers, textile and clothing manufacturers, coopers, and ironworkers.

[2] In the instant case, the history and characteristics of cooperative associations were developed extensively in the testimony of Dr. Edwin G. Nourse. Dr. Nourse was formerly Chairman of the Council of Economic Advisers, established in the Executive Office of the President of the United States under the Employment Act of 1946; and he also was formerly a director, later vice president, and more recently a consultant at the Brookings Institution in Washington, D.C. He is one of the outstanding authorities on the subject of cooperative associations in the United States and foreign countries. Also, additional helpful testimony on this subject was presented by Kelsey Gardner, formerly associated for many years with the Bureau of Cooperative Marketing of the U.S. Department of Agriculture.

The worker type of cooperative (which included many of those above mentioned) was intended to provide an alternative to the corporation-for-profit form of organization for conducting manufacturing enterprises. Under the corporation-for-profit form of organization, the profit of the enterprise is vested in outside parties who supply the equity capital which is placed at the risk of the business; who select the management and assume the direction over the enterprise; whose separate corporate entity employs workers that derive only those wages which they are able to obtain through bargaining with the representatives of the equity owners; and which equity owners then receive directly or indirectly the benefit of such net profits as the corporation-for-profit form or organization may produce. Under the cooperative association form or organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management
308 and supply *308 their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocation of the same among themselves as coowners, in proportion to the amounts of their active participation in the cooperative undertaking.

The founders of the above-mentioned Rochdale Cooperative formulated three guiding principles, which still persist as the core of economic cooperative theory:

(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

Implementation of the first of these three principles, relating to the subordination of capital contributions in determining the right to the pecuniary benefits, is effected through the statutes under which the cooperatives are organized, and also by the charters and bylaws of the cooperatives themselves— all of which contain limitations upon the amounts that may be distributed to members in respect of the stock which represents the necessary capital that the members themselves supply. Indeed in the case of many cooperatives, distributions in respect of the worker-members' stock are forbidden entirely. Also, implementation of the subordination of

capital as regards control over the management and direction of the cooperative, is achieved through bylaw provisions which vest in the members themselves the right and power to elect the trustees and the officers of the cooperative.

Implementation of the second of the above principles, relating to democratic control, is effected by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted; and these workers there deal personally with all problems affecting the conduct of the cooperative.

And finally, the third of the above-mentioned principles of cooperatives, relating to the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the association are required to make periodic allocations of the same among the members in proportion to their active participation as workers.

Cooperatives— including worker cooperatives— are, and have been for many years, authorized by statutes of
309 many of the States. Typical *309 of these statutes is one which was enacted by the State of Washington in 1911 (Wisc. Laws 1911, ch. 368), which has since provided the pattern for similar statutes of other States, including the statute of the State of Washington here involved.

Thus, the basic and distinguishing feature of a workers cooperative association, as compared with a corporation-for-profit, is that in the case of a workers cooperative association the fruits and increases which the worker-members produce through their joint efforts are vested in and retained by the workers themselves, rather than in and by the association, as such, which functions only as an instrumentality for the benefit of the workers; and that these fruits and increases of the cooperative effort are then allocated among the active workers as patronage dividends, in proportion to their participation in producing the same. In the case of the corporation-for-profit, on the other hand, the fruits and increases of such organization belong to the corporate entity itself; and these increases (called net profits) are then either distributed or retained for the benefit of the equity owners, not in proportion to their personal efforts but rather in proportion to the amounts of capital which they supply. And also these same equity owners, acting either directly or indirectly, also select the management and control the functions and policies of their entity— not on a one-person one-vote basis without use of proxies, but rather through multiple voting in proportion to the number of shares of capital stock which they hold.

Facts re Organization of the Petitioner

In 1913, the legislature of the State of Washington enacted a statute (Wash. Laws 1913, ch. 19) entitled 'Co-operative Associations— An act providing for the formation and carrying on of co-operative associations and providing for the rights, powers, liabilities and duties of the same.' Said chapter of the session laws (as amended in respects not here material) is now codified as chapter 23.86 of the Code of Washington.[3] Those provisions of said code which are here material, are as follows:

[3] The Revised Code of Washington makes provision, in other chapters and sections thereof, for corporations of several types other than that here involved. See, for example, ch. 23.01— Private Business Corporations Act; ch. 24.04— Nonprofit, Nonstock Corporations; and ch. 23.42— Agricultural Cooperative Associations.

23.86.010 Cooperative associations— Who may organize. Any number of persons, not less than five, may associate themselves together as a cooperative association, society, company or exchange for the transaction of any lawful business on the cooperative plan. For the purposes of this chapter the words 'association,'

'company,' 'exchange,' 'society' or 'union' shall be construed the same.

23.86.020 Business authorized. An association created under this chapter, being for mutual welfare, the words
310 'lawful business' shall extend to every kind *310 of lawful effort for business, agricultural, dairy, mercantile, mining, manufacturing or mechanical business, on the cooperative plan.

23.86.080 Trustees. Every such association shall be managed by a board of not less than three trustees. * * * The officers of every such association shall be a president, one or more vice presidents, a secretary and a treasurer who shall be elected annually by the trustees. Each of said officers must be a member of the association. All elections shall be by ballot.

23.86.100 Bylaws. Any association formed under this chapter may pass bylaws to govern itself in the carrying out of the provisions of this chapter which are not inconsistent with the provisions of this chapter.

23.86.110 Stock— Issues— Vote— Limits. * * *

No stockholder at any meeting shall be entitled to more than one vote.

23.86.160 Apportionment of earnings. The trustees may apportion the net earnings by paying dividends upon the paid-up capital stock at a rate not exceeding eight percent per annum. They may set aside reasonable reserves out of such net earnings for any association purpose. The trustees may, however, distribute all or any portion of the net earnings to stockholders in proportion to the business of each with the association: * * * All dividends declared or other distributions made under this section may, in the discretion of the trustees, be in the form of capital stock or other capital or equity certificates of the association. * * *

23.86.170 Distribution of dividends. The profits or net earnings of such association shall be distributed to those entitled thereto at such time and in such manner not inconsistent with this chapter as its bylaws shall prescribe, which shall be as often as once per year. [Emphasis supplied.]

At the time when the present petitioner cooperative association was organized in 1941, five individuals executed, under oath, articles of association which provided in material part:

KNOW ALL MEN BY THESE PRESENTS, that we * * * do hereby associate ourselves together for the purpose of forming, and do hereby form a Co-operative Association, under and by virtue of the laws of the State of Washington, and to that end we do hereby make, certify and subscribe in triplicate the following:

NAME:

The corporate name of the corporation hereby formed shall be 'PUGET SOUND PLYWOOD, INC.'

OBJECTS AND PURPOSES

The objects and purposes for which this corporation is formed, are as follows:

(a) To purchase, lease, acquire, construct, erect, own, operate, and maintain in Pierce County, Washington, or in any other county of the State of Washington, a plywood mill or mills or any other manufacturing plants for manufacturing and processing of all kinds of wood products, and by-products.

(i) This corporation is formed under and by virtue of the Chapter 19, 1913 Session Laws of the State of Washington relative to co-operative associations, and shall have and enjoy all the powers and privileges granted
311 by the laws of *311 Washington to co-operative associations. The capital stock shall be $2,850,000.00 divided

into 2850 shares of $1,000.00 each. No shareholder shall own more than ten shares of stock in the association, nor be entitled to more than one vote. (Amendment 5/2/49)

TRUSTEES

The number of Trustees of this Association shall be nine (9) elected from the stockholders. * * *

Petitioner's bylaws, as amended and in force and effect throughout the taxable years involved, contained the following provisions:

Section 1

A COOPERATIVE ASSOCIATION

This association is organized to operate and shall operate on a cooperative, non-profit basis for the mutual benefit of its members as producers of wood products and marketing thereof. Any excess of receipts from the production and marketing of wood products over expenses shall be the property of the members of the association, the basis of each member's interest therein being as set forth in these by-laws.

Section 2

WHO SHALL BE A MEMBER

A member must be elected by a vote of a majority of the Board of Trustees, and shall possess the following qualifications:

(a) He must be a worker, or potential worker, in or in connection with one of the production facilities of the association. The right of a member to work shall at all times be recognized, subject to unavoidable conditions causing temporary unemployment. * * *

(b) He must be a shareholder in the association. Each worker must own the same number of shares in the association as every other worker, the number of shares to be determined by the Board of Trustees.

Section 3

TERMINATION AND TRANSFER OF MEMBERSHIP

(a) When a member permanently ceases to be a worker for any reason or sells his shares in the association, he shall cease to be a member of the association.

(b) When a membership ceases for any reason, the former member, his heirs or personal representatives, shall offer to sell his entire unit of stock to the association, and the association shall have the first option to buy. If this option to buy is not exercised by the Board of Trustees within sixty (60) days, the former member (his heirs or personal representative) is free to dispose of his stock to a potential worker, the transfer of the shares on the
312 books of the association being contingent on his election to membership by the Board of Trustees.*312

Section 4

MEETINGS OF MEMBERS

(g) Each shareholder shall be entitled to cast one vote upon any question coming before a meeting.

Section 6

MISCONDUCT

Should any member be discharged for refusing to obey orders, or for drunkenness or disorderly conduct, he shall have the right, within forty-eight (48) hours thereafter, to place the matter as he chooses before the Board of Trustees by reducing his claims to writing and leaving the same with the secretary of the association. The board shall act promptly on such matters, and if the member has been unjustly discharged he shall be reinstated without loss of time. Should such member fail, within forty-eight (48) hours, to place his contentions before the Board of Trustees, he shall forfeit his right to a hearing.

Section 8

TRUSTEES

(f) The compensation for trustees shall not exceed $5.00 per month unless authorized by the members at a regular or special meeting. There shall be no compensation for officers as such unless authorized in writing by the Board of Trustees.

Section 11

COMPENSATION OF MEMBERS

Members shall be entitled to compensation for work performed for the association. Their compensation shall be fixed from time to time by the Board of Trustees. The rate of compensation so fixed shall be uniform among the members. Rate of compensation shall comply with all state and federal laws and shall be subject to such withholding as may be required by law. Each working member shall sign a membership agreement consistent with these by-laws.

Section 12

EMPLOYMENT AND COMPENSATION OF NON-MEMBERS

In all instances where a member is qualified to perform particular work for the association, he shall have preference in working over a non-member. Where, however, the Board of Trustees is satisfied that it is in the best interest of the association to employ a non-member or non-members in any capacity, the Board may authorize such employment and fix a reasonable rate of compensation which need not be uniform with that paid
313 to members.*313

Section 13

DIVIDENDS ON CAPITAL STOCK

No dividends shall be paid on the capital stock of the association.

Section 14

DISTRIBUTION OF MARGINS

(a) The margins of the association in each fiscal year and periods thereof shall be determined in accordance with sound principles of accounting.

(b) All margins arising from the production and marketing of wood products by members shall be refunded to the members in the following manner:

(i) Such margins shall be determined four times in each fiscal year of the association, as of the 31st day of March, the 30th day of June, the 30th day of September and the 31st day of December. As soon as practicable after the last day of March, June and September in each year, three-fourths of the margins earned during the

preceding quarter shall be refunded to the members. As soon as practicable after the 31st day of December in each year all margins not theretofore refunded during the fiscal year shall be refunded to the members.

(ii) Each member shall be entitled to receive refunds of margins as above provided in proportion to the number of hours worked by him, as a member, for the association, compared to the total number of hours worked by the members of the association: (1) during the three months period ended March 31, in each fiscal year, (2) during the three months period ended June 30 in each fiscal year, (3) during the three months period ended September 30 in each fiscal year, and (4) during each entire fiscal year ended December 31.

(c) The Board of Trustees shall have the right to determine whether the refunds of margins in or during any fiscal year shall be made in cash or in certificates of indebtedness or partly in cash and partly in certificates of indebtedness. To the extent that refunds are made in certificates of indebtedness, the amounts retained and represented by such certificates shall be such as, in the opinion of the Board of Trustees, are reasonably necessary for the purpose of establishing or adding to reasonable reserves for capital needs; for the purpose of adding new facilities or equipment or adding to or replacing existing facilities or equipment; for the purpose of adding to or replacing working capital; or for the purpose of repaying money borrowed, including that represented by outstanding certificates of indebtedness. Each member authorizes the Board of Trustees to invest all or any part of the refunds or margins due him in certificates of indebtedness of the association and agrees to receive them in place of cash refunds of margins.

[Emphasis supplied.]

After the present petitioner had been so organized as a cooperative association, each of the members contributed $1,000, of which $500 was to be paid immediately and the balance was paid over a period of time. They then hired an engineer, and as worker-members they built the association's plywood plant from the
314 ground up. This plant was located in Tacoma, Wash.; and it included a plywood mill, *314 and an office which was the association's principal place of business. While building the plan, the worker-members received compensation of 90 cents an hour; and at one time a collection of $5 apiece was taken up to buy paint for use in painting the plant.

The principal activity of this cooperative association, at all times material including the years here involved, was the manufacture and sale of plywood and related wood products.

The number of members of the association during the years involved was approximately 270; and of these an average of 260 were regular full-time workers in the association's plant. Typical reasons for a member not working were: (1) Military service; (2) prolonged illness; and (3) departure from Tacoma with expectation of returning.

Each member was the owner of 10 shares— no more or less— of the association's stock. The holding of such shares entitled the member to one—and only one— vote at any meeting of the association. Ownership of such 10 shares also entitled the owner to work as a member of the association.

The Trustees investigated and passed upon all applicants for membership in the association, including transferees of the association's shares. These trustees required, among other things: (1) That any person applying for membership be less than 45 years of age; (2) that he submit to a physical examination and obtain the physician's report thereon, showing that he was in good health; and (3) that the applicant be competent to hold a job in the association's plan. After the applicant had met these tests, he presented himself to the trustees for questioning; and there he was required to agree that he would acquire his shares of the association in good faith, for membership purposes only; that he would sign the association's membership agreement and observe

its bylaws, rules, and regulations; that when called upon to work in the plan, he would accept and be capable of handling satisfactorily the work assigned to him; and that he would comply with the usual conditions of such employment.

No shares were issued or transferred until the application for membership in the association had received the approval of the trustees. After receiving such approval, the president of the association and the new member signed a membership agreement which provided in material part, as follows:

(1) The Association will afford the member employment and refund to him his proportionate share of all margins arising from the production and marketing of wood products in accordance with its Articles of Incorporation and Amended By-Laws.

(2) The member will cooperate with the other members to the end that by their joint efforts the maximum
315 production and efficiency be attained. [Emphasis supplied.]*315

Meetings of the association's worker-members were held at least semiannually in accordance with the bylaws. At these meetings various business and operating problems were discussed and dealt with by majority vote. The average attendance at these meetings during the years here involved was 223, or about 83 percent of the entire membership. The matters there dealt with included such things as election of trustees, capital expenditures, production efficiency, new methods of operation, claims, and purchases of timber.

During the years involved, almost all the workers in the association's plant were members (being about 260 in number). But there also were employed from five to seven nonmembers, who were chiefly young women in clerical positions, and the plant superintendent.

About two-thirds of the logs used by the association in the manufacture of plywood and other wood products, were acquired through purchase of standing timber from the Forestry Service of the U.S. Department of Agriculture; and the balance was acquired from timber-owners or on the open market. The products manufactured by the association were sold to commercial dealers or users of such products.

Facts re Allocation of Margins among Worker-Members

Participating payments in respect of the fruits and increases from the worker-members' cooperative efforts were made to the active worker-members on the basis of the number of hours worked by each, as follows:

(1) On or about the 20th of each calendar month, a so-called draw check in the uniform amount of $100 was issued to each worker-member. These amounts were in the nature of drawing-account payments to provide the worker-members with current living expenses.

Thereafter, as of the end of each calendar month, a so-called advance check was issued to each worker in an amount representing the hours worked by him during the month multiplied by a uniform hourly rate, and less the amount previously distributed to him as a draw check. The said hourly rate was fixed by the trustees in an amount which more or less approximated the average union rate in the area where the association's plan was located. With minor exceptions, hereinafter noted, the payments and distributions received by each worker-member were uniform in relation to the number of hours worked by him, regardless of the character of the services which he contributed to the cooperative endeavor (i.e., regardless of whether he swept the floors of the plant or was in charge of an operating department). The exceptions were: (1) That the trustees received no compensation for their services as such, except a token payment of $1 per year; (2) that the general manager (a

316 worker-member selected *316 by the trustees) received a differential of $2,500 in 1958 and of approximately $6,000 in 1959 and 1960; and (3) that the officers of the association received no compensation for their services as such, except a token payment of $1 per year.

The amounts represented by the foregoing checks were issued pursuant to section 11 of the bylaws, and they were considered to be advances against the 'patronage dividends' thereafter allocated.

(2) At the close of each quarter of a particular calendar year, a patronage dividend check was issued to each worker-member who had participated during that period. For each of the first three quarters, 75 percent of the fruits and increases of the association (called margins) for that quarter, were distributed to the worker-members on the basis of the hours worked by each in that quarter. And then at the end of the year, the total margins for the year were computed and allocated to all worker-members on a pro rata basis according to the hours worked for the full year, less the amounts of the previously mentioned draw checks, advance checks, and patronage dividends which had been distributed for the preceding three quarters of such year.

In the event that the trustees determined, in accordance with section 14(c) of the bylaws, that it was essential to retain portions of the margins for necessary association purposes, then certificates of indebtedness in lieu of cash would be issued to the worker-members for the portions so retained.

The amounts of the aggregate margins for each year that were distributed to the worker-members as patronage dividends, represented the net proceeds realized by the association from the sale of plywood and related wood products, after elimination therefrom of the portion of these proceeds which was attributable to the participation of employed nonmember workers— and less the amounts previously advanced to the worker-members through the above-mentioned draw checks and advance checks.

The petitioner association instructed the worker-members to file, for each year, individual declarations of estimated tax based on the anticipated patronage dividends to be allocated to them for such year, and to pay Federal income taxes on all such patronage dividends which they received, either in cash or in certificates of indebtedness. In accordance with the requirements of section 6044 of the 1954 Code, the amounts of all margins allocated to worker-members as patronage dividends were reported by the association to the Internal Revenue Service on Form 1099.

The nonmember workers who were employed at the plant during any taxable year did not receive any
317 patronage dividends from the margins so allocated; and also any member who did not work during *317 any particular year likewise did not receive any patronage dividend with respect to margins attributable to such year.

The petitioner association filed a Federal income tax return (Form 1120) for each of the taxable years involved; and it paid tax on the amount of taxable income reported therein. The taxable income so reported was from sources that were not related to any cooperative efforts of the worker-members; and these sources included the following: That portion of the income from mill operations which was attributable to the services of nonmember workers employed at the plant; miscellaneous interest income; small capital gains in 1958 and 1959 only; and other miscellaneous items such as income from the sale of scrap materials, taxable income in respect of fire insurance recoveries, and income from cold-drink machines in the plant. On said Federal income tax returns, the petitioner association excluded from income the amounts of the margins allocated and distributed to its worker-members as patronage dividends.

The Commissioner, in his notice of deficiency herein, disallowed the exclusion of all patronage dividends in respect of margins.

FINDINGS OF ULTIMATE FACT

The petitioner association operated in each of the taxable years involved on a cooperative basis for the mutual welfare of its worker-members.

The right to all fruits and increases from the cooperative efforts of the worker-members (represented by its so-called margins) was vested in and retained by the worker-members themselves, and not in and by the association as a separate entity— which association functioned only as an instrumentality through which the worker-members carried on their cooperative endeavors.

Said margins were allocated among the worker-members as patronage dividends, pursuant to a preexisting legal obligation created by the statutes of the State of Washington, the association's bylaws, and the agreements entered into between the association and the workers at the times when these workers became members. Such margins distributed as patronage dividends, arose out of transactions between the cooperative association and its worker-members. And the same were equitably allocated among the worker-members in proportion to the amount of service which each such worker contributed to the total cooperative effort that produced said margins.

OPINION

The problem here presented is a novel one, insofar as this Court is concerned. The petitioner, as we have hereinbefore shown, is a workers cooperative association located in the State of Washington, which was
318 formed, incorporated, and operated by the worker-members on a *318 cooperative basis, for their mutual benefit in producing and marketing plywood and related wood products; and this petitioner, acting in accordance with the cooperative plan and pursuant to a preexisting legal obligation, allocated patronage dividends to its worker-members in proportion to the hours worked by them in their joint endeavor.

The specific question to be here answered is: Whether this petitioner, as so formed and so operated, should be regarded for Federal income tax purposes, as a 'nonexempt cooperative association' within the meaning of that term as used in the Federal income tax statutes, in numerous rulings of the Internal Revenue Service, and in various judicial decisions (all hereinafter identified); and thus be entitled to exclude from the income which is taxable to itself (and leave for taxation to the individual worker-members) the patronage dividends which were so allocated during the taxable years involved.

After considering and weighing all the evidence in the light of the relevant authorities, we are convinced that this question should be answered in the affirmative, for the following reasons.

1. Since the year 1926, the Federal income tax statutes have accorded exemption from income taxes to certain cooperative associations composed of farmers, fruitgrowers, and the like— which engage in the marketing of farm products or the buying of farm equipment for both members and nonmembers, and which then turn back to such participants the net proceeds of the cooperative activities. The provision for such tax exemption is presently embodied in section 521 of the 1954 Code. The parties to the present case agree that the instant petitioner does not qualify for exemption under said section.

Notwithstanding this exemption which is accorded a limited type of cooperatives which are able to qualify therefor, the Internal Revenue Service has recognized for many years, in numerous rulings published since at least as early as 1922, that there are many other cooperative associations which, even though they do not qualify for exemption under the above statute, are nevertheless entitled (in their capacity as nonexempt cooperative associations) to exclude from their gross incomes, patronage dividends that equitably allocated to their participating members pursuant to preexisting legal obligations. Several examples of these administrative

rulings, which recognized the right of nonexempt cooperatives to exclude patronage dividends, are: I.T. 1499, I-2 C.B. 189, 191 (1922); A.R.R. 6967, III-1 C.B. 287 (1924); S.M. 2595, III-2 C.B. 238 (1924); G.C.M. 12383, XIX-2 C.B. 398 (1933); G.C.M. 17895, 1937-1 C.B. 56; I.T. 3208, 1938-2 C.B. 127; Rev. Rul. 57-59, 1957-1 C.B. 24.

This same principle that nonexempt cooperatives are entitled to exclude true patronage dividends from their
319 gross incomes has also been recognized by the courts in several reported decisions. See, for *319 example, Pomeroy Cooperative Co., 31 T.C. 674, affirmed on this point 288 F.2d 326 (C.A. 8); Smith & Wiggins Gin, Inc. v. Commissioner, 351 F.2d 341, (C.A. 5), affirming 37 T.C. 861; United States v. Mississippi Chemical Co., 326 F.2d 569 (C.A. 5); Clover Farm Stores Corporation, 17 T.C. 1265, 1277; Dr. P. Phillips Cooperative, 17 T.C. 1002, 1010; United Cooperatives, Inc., 4 T.C. 93, 106; Midland Cooperative Wholesale, 44 B.T.A. 824, 830; Fruit Growers Supply Co., 21 B.T.A. 315, 326, affd. 56 F.2d 90 (C.A. 9); and Farmers Cooperative Co. v. Birmingham, 86 F.Supp. 201 (N.D. Iowa). In the case of Dr. P. Phillips Cooperative, supra, this Court said:

> Although the Commissioner has held that the petitioner is not exempt under section 101(12) (the predecessor of section 521 of the 1954 Code), nevertheless he has allowed the petitioner as a cooperative to exclude from income for tax purposes the amounts which it has distributed in cash as patronage dividends. There is no express statutory authority for this action but for many years the practice has been followed by the Treasury Department and it has received judicial sanction. The theory is that the cooperative is merely a conduit for the patronage dividends. * * *

Also in Harbor Plywood Corporation, 14 T.C. 158, 161, this Court stated:

> The reason for this rule is that the patronage dividends or rebates are at all times the property of the member stockholders, and nonmembers, and that the selling association is an agent or trustee or mere conduit for the income.

The mere fact that the cooperative may have been organized as a corporation under local law, is not significant as regards its right to exclude patronage dividends. Indeed, most cooperatives are incorporated and regulated under the laws of some State; and all the above-cited judicial decisions in which the right to exclude patronage dividends was recognized, involved incorporated cooperatives; and at least one of them (United Cooperatives, Inc.) was incorporated under the general corporation statute of Indiana.

Also, the particular name by which a cooperative's distributions are designated (such as 'patronage dividends,' 'refunds,' or 'rebates') is not in our opinion determinative of the cooperative's right to exclude the same. Dr. Nourse (the expert witness above mentioned) pointed out during the course of his testimony that the term 'patronage' originated with the above-described Rochdale Cooperative that was founded in England in 1844 and operated a retail store— and in that cooperative endeavor, the participants were of course patrons. He further pointed out that the designation 'dividends' had its origin in the fact that most distributions out of corporations are called dividends (even though they may not constitute distributions from the corporation's profits— as for example, so-called dividends on mutual life insurance policies). Dr. Nourse suggested that the
320 more accurate *320 designation for amounts allocated by cooperative associations is 'participating distributions.'

2. In 1951 the Federal tax statutes, for the first time, gave express recognition to the principle that both exempt cooperative associations and also nonexempt cooperative associations are entitled to exclude true patronage dividends from their gross incomes. In that year, Congress, in section 314 of the Revenue Act of 1951, amended section 101(12) of the 1939 Code by inserting a provision relating to the exclusion of patronage

dividends by exempt cooperatives; and in this provision, it was stated that such patronage dividends 'shall be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt.' And thereafter, this same language was carried forward into section 522 of the 1954 Code, as it existed throughout all the taxable years here involved.

In 1962, President Kennedy brought to the attention of Congress that the above-mentioned provisions of the 1951 Act had proved inadequate in several respects; and he recommended that supplemental provisions be enacted, so that the purpose of Congress, which had been intended to be reflected in the 1951 Act, might be achieved.[4] This resulted in the enactment of subchapter T (secs. 1381-1388) of the 1954 Code; and in these new supplemental provisions, Congress again gave express recognition (in sec. 1381(a)) to the fact that the new and more comprehensive provisions would be applicable, not only to exempt cooperatives but also to 'any corporation operating on a cooperative basis other than * * * (one) which is exempt.'

[4] H. Rept. No. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 405, 482-483; S. Rept. No. 1881, 8th Cong., 2nd Sess., 1962-3 C.B. 707, 817.

3. Neither the above-cited Federal statutes nor any published judicial decision relating thereto have restricted to any particular type of cooperatives the basic principle that corporations operating on the cooperative basis are entitled to exclude from their gross incomes true patronage dividends or participating distributions allocated by them.

As heretofore shown, section 1.522-1(b)(1) of the Income Tax Regulations defines a 'cooperative association' to be 'any corporation operating on a cooperative basis.' This obviously is sufficiently broad to cover both marketing cooperatives and also producing cooperatives.

Furthermore in 1962, when the Congress had under consideration the matter of making more effective the cooperative provisions of the 1951 Act through enactment of the supplementary provisions which later became subchapter T of the 1954 Code, a question arose as to whether the phrase 'business done with or for patrons,'
321 which was contained in these new provisions, was sufficiently broad to cover *321 services done with or for patrons— so as to cover participating distributions of a cooperative association engaged in the manufacture of plywood. In this connection, the following colloquy was had in the Senate between Senator Kerr (floor manager of the bill), Senator Magnuson of Washington, and Senator McCarthy of Minnesota:

Mr. MAGNUSON. Mr. President, I wish to ask the distinguished Senator from Oklahoma (Senator Kerr) a question.

On pages 295 and 296 of the bill, in the definition of the term 'patronage dividend,' it is stated that a patronage dividend is a payment 'determined by reference to the net earnings of the organization from business done with or for its patrons.'

In a case which has been called to my attention— it involves the manufacture of plywood in the Pacific Northwest, and many of the companies are cooperative organizations— the cooperative renders services for the patron. I wanted to be sure that in the opinion of the Senator from Oklahoma the phrase 'business done with or for its patrons' includes services with or for patrons.

Mr. KERR. I think it is clear, both under the interpretation of a patronage dividend under present law and also under the words 'business done with or for its patrons,' that services rendered with or for patrons are included. Business done is not necessarily limited to products sold to or purchased for patrons. Business done also includes services performed for patrons as well.

Mr. MAGNUSON. I thank the Senator from Oklahoma.

Mr. McCARTHY. Mr. President, if the Senator will yield, let me say I think this is a reasonable and desirable interpretation of the language; and I believe that any other interpretation would create an impossible distinction. (108 Cong.Rec. 18322.)

4. The most recent development in this field is the decision of the U.S. District Court for the District of Oregon, in the case of Linnton Plywood Association v. United States, 236 F.Supp. 227 (decided Oct. 30, 1964), on appeal (C.A. 9). That court is located in the heart of the plywood industry; and said decision was written by Chief Judge Solomon of that court. Both the issue there involved and the facts found by the court were substantially the same as those in the instant case. The opinion of the court, which was in favor of the taxpayer, states in material part as follows:

The Government admits that retained patronage dividends are excludable from gross income of non-exempt cooperatives provided they are either purchasing or marketing cooperatives. It insists that the exclusion is not applicable to workers' cooperatives.

Workers' cooperatives are among the oldest forms of cooperatives and exist in many countries of the world. Many people regard a worker's cooperative as the basic type of cooperative. The Government concedes that if the members had individually created the plywood products and then brought them to the cooperative for marketing, the cooperative would be entitled to the exclusion, but claims that since the members collectively manufacture the products as well as market them, the cooperative is not entitled to the exclusion. I think that this is an illogical and absurd distinction. In my view, (nonexempt) workers' cooperatives are entitled to exclude retained patronage dividends from gross income to the same extent as purchasing or marketing
322 cooperatives.*322

To avail itself of the exclusion, a cooperative must satisfy three requirements, (1) The allocation must be made pursuant to a legal obligation existing when the patron transacted business with the cooperative. (2) The allocation must be made out of profits or income realized from transactions with its patrons. (3) The allocations must have been equitably made. United States v. Mississippi Chemical Co., 326 F.2d 569, 573-574 (5th Cir. 1964); Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326, 328 (8th 1961). Plaintiff has met all these requirements.

We agree with the views expressed by Chief Judge Solomon in the above case. We have found no published court decision to the contrary.

5. The Internal Revenue Service in 1961, which was subsequent to the taxable years here involved, issued a ruling (Rev. Rul. 61-47, 1961-1 C.B. 193) to the effect that amounts distributed by a nonexempt cooperative association to its worker-members, are not patronage dividends excludable from such cooperative's gross income. Such ruling is in direct conflict with the above-mentioned decision of the Oregon District Court in the Linnton Plywood case; is unsupported by citation of any statutory provision or judicial authority; and is out of harmony with the basic distinguishing principles of cooperative organizations generally. In our opinion, the ruling is erroneous.

In the instant case, we have found as an ultimate fact that the petitioner association was organized and operated on a cooperative basis by the worker-members, who joined together for their mutual benefit in not only marketing their products cooperatively, but also in producing them cooperatively. If, as suggested in the Linnton Plywood case, these worker-members had manufactured wooden products (such as chairs or tables) in their own individual workshops and then had marketed the same through their cooperative association, there

could be no dispute that the participating distributions in respect of the marketing function would, when allocated to the members pursuant to a preexisting legal obligation, be excludable from the gross income of the cooperative. Here however, because of the nature of the plywood product, the character of the necessary machinery, and the intricacy of the skills required, the members joined in working under a common roof, rather than in separate workshops, to both produce and market their products cooperatively. We perceive of no warrant in law, fact, or logic why these two methods of cooperative endeavor should not be accorded equal treatment for Federal income tax purposes.

We have hereinbefore found as an ultimate fact, and we here hold, that the right to the fruits and increases of the cooperative efforts of petitioner's worker-members (i.e., margins) was vested in and retained by such workers, and not in and by the cooperative association as a separate entity. And we further hold that the
323 amounts of such *323 margins, which for the taxable years here involved were equitably allocated to the worker-members as patronage dividends pursuant to a preexisting legal obligation, are excludable from the petitioner-association's gross income for Federal income tax purposes.

Review by the Court.

Decision will be entered for the petitioner.