IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF MISSOURI
SOUTHERN DIVISION

SHO-ME POWER ELECTRIC COOPERATIVE, a Missouri Corporation,	)	
Plaintiff,	)	
v.	)	No. 01-3307-CV-S-WAK
UNITED STATES OF AMERICA,	)	
Defendant.	)	

ORDER

Sho-Me Power Electric Cooperative ("Sho-Me") seeks a refund of $233,391, plus interest, of federal income taxes which it paid after the IRS determined it had not correctly reported cash received in 1995, 1996 and 1997 from Associated Electric Cooperative, Inc., ("Associated"). The payments were identified as retirement of previously allocated patronage dividends. The parties dispute whether the allocation of cash between member and nonmember income (1) should be based on power consumption in the year the patronage capital was retired or (2) should be based on power consumption in the year the patronage capital was earned or generated.

Under 26 U.S.C. § 446, "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The case law suggests that a reasonable, simple and consistent allocation method is appropriate for the allocation of patronage capital and dividends. The reported cases do not specifically address the facts and issues of this case.

A bench trial was held on October 7, 2003.

Findings of Fact

Based on the parties' joint stipulation of fact and the credible testimony at trial, the court finds the following facts.

Sho-Me Power Electric Cooperative is an electric generation and transmission cooperative that provides electricity to rural areas in Missouri. During the relevant years, Sho-Me sold electricity on a wholesale basis to nine member rural electric cooperatives, to seventeen nonmember municipalities and to a single nonmember retail customer, Fort Leonard Wood.[1] It purchased all of its electricity from another rural electric cooperative, Associated, of which it was a member.

Both entities used and continue to use cooperative accounting principles in allocating patronage dividends or refunds to their members and/or patrons on the basis of their pro-rata patronage during a given year. Patronage dividends or refunds are generally made by allocating patronage equity to members/patrons in accordance with the cooperative's bylaws. The allocation of a dividend creates no obligation for the cooperative to ever retire amounts from the capital accounts by making cash payments to its patrons and the patrons have no enforceable rights to receive any monetary amounts.

Associated allocated patronage dividends to Sho-Me's capital account in 1979 through 1992 as shown in columns 1 & 2 of the following chart.

1. Year Capital Allocated by Associated	2. Final Adjusted Allocation Amount	3. Retirement of capital by Associated in 1995	4. Retirement of capital by Associated in 1996	5. Retirement of capital by Associated in 1997
1979	$2,244,462.28	$1,143,890.07		
1980	$1,163,399.30	$1,067,088.73	$96,310.57	
1981	$1,640,720.68		$1,640,720.68	
1982	$259,173.59		$259,173.59	
1984	$1,271,056.94		$1,271,056.94	
1991	$6,776,508.93		$1,109,493.06	$5,667,015.87
1992	$22,153,137.00			$700,966.43
Total Retirement		$2,210,978.80	$4,376,754.8	$6,367,982.30

[1]Under its bylaws, Sho-Me is obligated to declare and allocate patronage dividends to its wholesale members and patrons. In this opinion, Sho-Me's wholesale customers will be referred to as members and its sole retail customer will be referred to as a nonmember.

In accordance with its bylaws, Associated identified its patronage capital retired in 1995, 1996 and 1997 with the patronage capital allocated to its members in the years 1979, 1980, 1981, 1982, 1984, 1991 and 1992 on a first-in/first-out basis.[2] The portion that relates to Sho-Me and paid in cash is set forth above. The evidence does not show that actual dollars earned in the allocation years were used to make the cash payments in the retirement years. The cash payments were made from current assets which cannot necessarily be traced back to cash received or profits made in the allocation years. In fact, profits made in 1979, 1980, 1981, 1982 and 1984 may have been wiped out by losses in 1983, 1985, 1986, 1988, 1989 and 1990. Such losses, however, cannot be used to reduce patronage capital previously allocated.

The first year Associated retired any of its previously-allocated patronage capital to Sho-Me was 1993. One must note that 1992 was the most profitable year Associated had in the prior thirteen years, and was the likely source of excess cash. In deciding whether to retire patronage capital, Associated's board considered (1) whether the retirement of patronage capital would impair the financial viability of Associated, and (2), whether there was cash to fund the retirement. In doing so, it examined the current year financial performance and did not consider the financial operations of the past years when the patronage capital was allocated.

When making such a decision, Associated had three basic options available to it. If there were sufficient cash resources, it could reduce that reserve (1) by retiring patronage capital with cash payments, (2) by reducing its income through a reduction in the amount it charged for electricity to its current customers, or (3) by providing a rebate to its current customers. Which method to use was within the sole discretion of Associated.

Between 1979 and 1992, Sho-Me received capital account credits or patronage dividends from Associated based on its patronage during those years. Sho-Me received annual notices of the amount credited to its capital account.

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[2]Under Associated's bylaws, Associated can retire patronage capital if the Board of Directors determines that the retirement of patronage capital would not impair the financial condition of Associated. Retirements of capital are to be "made in order of priority according to the year in which the capital was furnished and credited, the capital first received by Associated being retired first."

Each year, Sho-Me included as income for financial reporting the generally accepted accounting principles (GAAP) determined amount of patronage capital allocated and credited by Associated. Thus, Sho-Me's book income was computed using the amount of patronage capital credited by Associated. It was not required to and did not report that patronage capital allocation as income for federal income tax purposes.

At the end of each reporting year, Sho-Me computed and allocated patronage capital to its own members based on the current year business or billings. It was based on book income, which was income computed under GAAP, and which took into account the patronage capital allocated from Associated for the year.

During the years at issue, Sho-Me's bylaws provided that:

> The books and records of the Cooperative shall be maintained in such a manner that the amounts of capital furnished by the members are clearly reflected and credited annually to each wholesale consumer's capital account. The Cooperative shall notify all wholesale consumers of their pro-rata portion of said capital allocations between December 1 and the following January 31 of each successive year.

Sho-Me claimed a federal income tax deduction for the patronage capital it allocated each year to its own members.[3] On its federal tax return, Sho-Me reported as income the cash it received during the year from Associated's retirement of patronage capital.

Electric cooperatives pay taxes only on income attributable to nonmembers, so they separately compute, for federal tax purposes, their income and expenses based on the power consumption of members and nonmembers. Each item of taxable income and expense is allocated between member and nonmember business. For Sho-Me, the percentage used to allocate between member and nonmember income and expense was based on the "cost of service study"[4] which is reflected in

[3]The deduction is subject to the limitations of Farm Service Cooperative v. Commissioner, 619 F2d 718 (8th Cir. 1980), on Sho-Me's offset of patronage losses against nonpatronage income.

[4]Sho-Me separated and assigned items of taxable income and expense to members and nonmember business on the basis of a formal methodology which has been in use since the late 1970's. That methodology was based upon a Cost of Service Study that was the product of a settlement with the IRS in 1979.

statement 1 of the tax returns. However, if an item specifically related to either member or nonmember business, Sho-Me allocated such item specifically to either the member or nonmember business in computing the taxable income from member and nonmember business.

In computing its federal taxable income, Sho-Me treated the cash payment from Associated as income earned in the year it was received and apportioned the appropriate amounts between members and nonmembers based on current year percentages. In other words, the percentage of the retired cash from Associated which was placed in the nonmember basket and used to calculate taxable income was based on the percentage of nonmember business in the current (or retirement) year.

Sho-Me testified that these payments, which were taxable only in the years paid, created timing issues that were different for GAAP and tax reasons. "Timing differences" frequently occur between what is reported on financial statements based on GAAP and what is permitted or required to be reported on tax returns based on tax laws. Sho-Me stated that consistently using the current year method of applying the Cost of Service Study methodology prevented the shifting of income and expenses or otherwise "playing the system," because the current-year method caused each item to be treated alike.

Timing differences frequently occur with respect to tax depreciation and GAAP depreciation, or in "safe harbor" leases where assets with a useful GAAP life of 30 years are expensed over 15 years pursuant to the tax laws. Such examples clearly show that the tax code and GAAP principles are not necessarily consistent.

Upon examination, the IRS disagreed with Sho-Me's use of the current year percentages, and found that the apportionment of income from retired patronage payments should have been based on the percentages of member/nonmember business in the years of the patronage capital allocations, which were 1979, 1980, 1981, 1982, 1984, 1991, and 1992. The allocation of the retired patronage capital to the various years was designated by Associated, based upon Associated's first-in/first-out provision in its bylaws.

Sho-Me had a higher percentage of nonmember business in 1979 through 1991 than it had in 1995 through 1997. Thus, using the IRS method, nonmember income would have been increased in the tax years at issue and member income would have been decreased. As a result, the IRS issued a statutory notice of deficiency in federal income tax in the amount of $78,710 for 1995, $126,525 for 1996, and $28,156 for 1997.

Sho-Me paid the deficiency listed on the statutory notice and filed a claim for refund.

Discussion

After considering the defendant's motion for summary judgment, this court concluded that expert testimony was required to determine whether the method of accounting and allocating cash payments for retired dividends was consistent with the requirements of the Internal Revenue Code. In response, the parties produced expert and fact witnesses at a bench trial held on October 7, 2003.

Plaintiff's expert was Atlee Harman, a certified public accountant and retired partner from KPMG, which is one of the largest public accounting firms in the United States. Harman specialized in cooperative tax and accounting issues, served for 15 years as KPMG's national director of technical tax services for cooperatives, served as president of the National Society of Accountants for Cooperatives, and was active in the National Council of Farmer Cooperatives. He described cooperative tax and accounting issues as unique and highly specialized and indicated that cooperatives are subject to special tax rules.

Harmon testified that Sho-Me used an allocation methodology based upon the current year operations which applied to all items of income and expense. In his opinion, Sho-Me's methods were proper, generally accepted and did not violate any tax or accounting principle. Specifically, he believed that the method used by Sho-Me in treating patronage capital retirement payments was a "method of accounting" as used in the tax code, 26 U.S.C. § 446, and that it was logical and reasonable because it applied the current year percentages for allocating the cash retirement payment among members and nonmembers. Further, he stated the method used by Sho-Me was a practical and consistent way of reporting the income on the tax returns, and was not susceptible to gaming or manipulation by the taxpayer. He concluded that Sho-Me's use of the current year allocation method to all income and expense clearly reflected Sho-Me's income. He indicated the method used was consistent with industry practices. He also suggested that in preparing tax returns, tax rules and not GAAP rules should control the taxpayers' actions.

Harmon also testified that the cash used to retire portions of the equity accounts could not necessarily be traced to specific years. The payments were from available cash or reserves. Alternatively, Associated could have used the same cash or reserves to issue rebates for its customers, thus reducing the annual cost of electricity for those customers during that year. A rebate from Associated would have reduced Sho Me's expense for the purchase of electricity during the year of the rebate.

Dr. K. Ramesh testified for the defendant. At the time of trial, Dr. Ramesh was a tenured professor at Michigan State University. He had previously served as vice presidents of Analysis Group and Charles River Associates. He held a Ph.D. in Business Administration (Accounting) from Michigan State University and a Master of Accounting from Washington State University. Dr. Ramesh had passed the CPA examination, but had not sought his license because it was not needed for his academic career. His extensive academic background and work experience, however, did not include issues specific to tax and accounting requirements for cooperatives in general or rural electric cooperatives specifically.

Dr. Ramesh described accrual method principles to determine when patronage capital was earned. He expressed the opinion that by using the current year method, Sho-Me was probably violating GAAP-tax equality and distorting the true source of its income. He believed the appropriate method was to allocate the cash between member and nonmember income based on power consumption in the years the patronage capital was earned or generated. Thus, he believed the cooperative had to trace the income to the year in which the amount was originally treated under GAAP and to use the percentages for that year.

The undisputed testimony, however, was that operating losses were never used to reduce the amount of patronage capital allocated in prior years. Thus, patronage capital allotments were reduced only if the directors voted to retire a portion of the equity accounts by making cash payments. If net operating losses cannot be deducted from the patronage capital account, it cannot accurately be said that the money used to pay patronage dividends came from any particular prior year. The testimony indicated that the cooperatives suffered some net operating losses that were never used to reduce the capital accounts allocated to their patrons. Thus, tracing the cash to specific years based on the capital accounts would be speculation, at best.

Associated determined when to retire patronage capital based upon its current cash situation after considering profits and losses over previous years and its expectations for the amount of cash needed for the current business year. The evidence did not indicate that the cash retirement payments were made from cash earned by Associated (or traced to earnings by Associated) in the years of the original patronage allocations. There was no magic in what Associated called the payments and they were not necessarily refunds of profits earned from the allocated years, but were merely refunds of money earned at some time in the past.[5]

Under 26 U.S.C. § 446(a), "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Permissible methods under section 446(c) include "(1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary." The code requires, however, that the method used must clearly reflect income. 26 U.S.C. § 446(b).

Subchapter T (§§ 1381 - 1388) of the tax code addresses the taxation of cooperatives, but excludes rural electric cooperatives such as Associated and Sho-Me. Thus, the parties agree that the common law prior to 1962 governs the resolution of issues relating to the taxation of the plaintiff in this case and that plaintiff is permitted to deduct from its taxable income the amount earned from members that is returned to members as dividends. Amounts earned from nonmembers are taxable to the cooperative.

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[5]Associated could have reduced its available cash in any number of ways, such as a discount or rebate, or could have changed its bylaws to permit a last-in/first-out retirement. It was not required to retire the patronage capital accounts during the lifetime of the cooperative, but had discretion to do so under certain conditions.

The government is concerned that if earnings are shifted from nonmember income to member income, the amount shifted will escape taxation. Plaintiff and defendant agree that the cash payments are taxable in the years they are received by Sho-Me. They dispute the proper allocation method for those payments between member and nonmember income.

After carefully considering the evidence presented and reviewing the very sparse case law, the court finds that the method used by Sho-Me is an accepted industry practice, has been used consistently for a considerable number of years, has not been previously challenged and was adopted as a result of the government's audit of federal income tax returns in the 1970's. The court was not persuaded by the testimony at trial that the method used by Sho-Me was impermissible under the law. Sho-Me's allocation approach is "reasonable, simple and consistent." It fairly states its income in any given year and, in this particular case, it more fairly states income and allocates it than does the government's suggested approach.

The court also notes that it does not find the method suggested by the government to be inappropriate. That is not the real issue in this case. The issue is whether the method used by Sho-Me was permissible under the tax laws, and the court finds that to be the case.

For these reasons, it is

ORDERED that judgment be entered in favor of plaintiff Sho-Me Power Electric Cooperative and that defendant refund to plaintiff Sho-Me Power Electric Cooperative the amounts of $78,710, $126,525, and $28,156 for tax years 1995, 1996, and 1997, respectively, along with the statutory interest.

Dated this 1st day of March, 2004, at Jefferson City, Missouri.

/s/________________________________

WILLIAM A. KNOX
United States Magistrate Judge