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COOPERATIVES AND TAX LAW

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INTRODUCTION

Federal income tax treatment of and Capper-Volstead protection for farmer cooperatives have stood out as targets attracting the fire of those opposed to cooperatives. These two issues, temporarily replaced by the issue of political contributions, will most likely remain important points of contention. Both antitrust and tax treatments of cooperatives are, I believe, inextricably involved with the definition of a cooperative as an extension of the farm business rather than as a separate business entity.

The operating cooperative performs the same value adding functions as other businesses and, indeed, seeks to maximize something which strongly resembles profits. The subtle but significant difference is that the excess of revenue over costs belongs to the patrons as patrons and only limited returns are available to owners (who are most likely also patrons). Thus, even in the pure case (all business done on a patronage basis), transfers of what would be profits in another organization to cooperative patrons are also payments to owners for they are the same persons. According to the critics, this renders any distinction between payments to patrons and payments to owners as a useless distinction [Caplin, 12].

One might question whether this degree of hair-splitting is relevant or even desirable. The more cynical view is that the Internal Revenue Code represents only the result of the efforts of special interest groups and political horse-trading. My efforts to place the tax treatment of various types of organizations into a single logical model certainly have not been entirely successful. I have, however, developed a very considerable respect for the Internal Revenue Code and have not yet been completely discouraged. In fact, I have found others whose approach seems more idealistic than mine. Sanden and Crawford writing in the *Financial Executive* state: "Taxes should be neutral . . . they should not be a factor in making business decisions, as, say, how a company is to be reorganized or financed." But before returning to the logical argument I'll certainly concede that a little political pull and an underdog stance is probably worth several books of logical argument.

I proceed on the basis that a valid distinction may be made between distributions to patrons and distributions to owners. In fact, the tax law and regulations do recognize the distinction and that distinction forms the basis for tax treatment of cooperatives which has evolved. I will argue that the tax status of cooperatives under current law is fundamentally sound and fair and that it is important to cooperatives. I am personally convinced that without the special status conferred by present law, cooperative operation would be made more difficult without significantly increased tax yield to the public. The issue would certainly be defused if it appears that significant progress is being made toward a "single tax" approach to corporate dividend taxation.

In the remainder of this paper I will present a brief overview of present tax treatment of cooperatives, provide some perspective on taxation of other types of businesses, provide some assessment of the distribution of benefits among cooperative patrons and provide some comments and ideas regarding the fairness and impact on the public interest of cooperative tax treatment.

PRESENT TAX TREATMENT

The basic federal income tax on corporations is remarkably simple. During the period from December 31, 1974 through January 1, 1978 the corporation income tax is at the rate of 20% of profits up to $25,000, 22% over $25,000 plus a surtax of 26% on all profits over $50,000. After January 1, 1978 the tax rate reverts to 22% of all taxable income plus a surtax of 26% on income over $25,000. Other features of the corporation tax will be considered later.

It will be necessary to distinguish between cooperatives in general and certain farmers and fruit growers cooperatives which are eligible for the so-called exempt status.

COOPERATIVES IN GENERAL

The tax treatment of cooperatives and their patrons is covered in subchapter T of the Internal Revenue Code. In general the provisions of subchapter T apply to any corporation operating on a cooperative basis and allocating funds to patrons on the basis of business done with or for such patrons. Doing business on a cooperative basis apparently means doing business on a cost basis with respect to purchases or sales for patrons and at least 50% of business done with members. This includes cooperatives of any type and regardless of whether the patrons are farmers, consumers, corporations or other types of business entities. The word patron takes on a special meaning in this regard. A patron is a person or business entity doing business with a cooperative as a part of the group which the cooperative was established to benefit. That is, the patrons of a purchasing cooperative are the buyers whereas the patrons of a marketing cooperative are sellers and it is possible for a farmer cooperative performing both the purchasing and marketing functions to have patrons on both sides of the same commodity with some farmers selling corn and others buying feed containing corn.

The essential feature of tax treatment under sub-chapter T is that there is no tax at the cooperative level if savings (earnings) are distributed (or allocated) to patrons on the basis of patronage. "Qualified" patronage refunds are treated as deductions from taxable income at the cooperative level provided such refunds are a) paid on the basis of volume of business or value of business with the patron, b) under an obligation that existed before the income was received, and c) represents earnings on business with or for patrons. Patronage refunds may not originate a) from business not done on a patronage basis or, b) from business with other patrons who received smaller amounts of patronage refunds. At least 20% of qualified patronage refunds must be paid in cash and the patron receiving non-cash allocations must agree to include such amounts in his taxable income in the year received. Patronage refunds on items used for family living need not be in-

cluded in individual taxable income. If funds are not paid to or allocated to patrons but retained within the organization or if the earnings were generated on business not done on a patronage basis ordinary income tax rates apply. Marketing cooperatives may retain patron funds as "per unit capital retains" which are not related to the earnings of the organization and which are taxed at the patron level. Thus, with the exception of consumer items, federal income taxes are paid on all net margins earned by a cooperative either at the cooperative level or at the patron level.

Ordinary accounting practices are normally used to determine earnings and to make allocation decisions.

The effect of these rules is to treat a qualified allocation as a price adjustment or as the final stage of setting a transfer price between the patron and the cooperative. It makes operation at cost possible when costs are not known until the year's business is completed. And, it also provides the means by which cooperatives' members may provide for automatic reinvestment of a portion of earnings to finance the cooperative without incurring a tax liability at the cooperative level.

EXEMPT COOPERATIVES

Section 521 of the Internal Revenue Code provides a so-called exemption for farmers, fruit growers, or like associations organized and operated on a cooperative basis. a) For the purpose of marketing the products of members or other producers and turning back to them to proceeds of sales plus the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or b) For the purpose of purchasing supplies and equipment for the use of members or other persons, in turning over such supplies and equipment to them at actual costs, plus necessary expenses.

Such an organization may have capital stock provided that the dividend rate on the face value of the stock does not exceed 8% or the maximum legal rate of interest in the state of incorporation. Substantially all the stock (except non-voting preferred) must be owned by producers who market their products or purchase their supplies and equipment through the association.

Non-member business may not exceed business done with members and a purchasing cooperative may do business with non-producers but not more than 15% of the value of all of its business. A marketing cooperative may not do business with non-producers. Business with the United States or its agencies is disregarded in calculating these percentages.

If a cooperative can qualify for exempt status it may exclude dividends on capital stock from taxable income (a privilege not extended to other cooperatives) and it may include in patronage refunds earnings from business incidental to purchasing or marketing activities for farmers. The latter category has been severely limited by I.R.S. interpretation.

The Internal Revenue Service has chosen to interpret Section 521 status on a very narrow and literal basis. The result of a series of revenue rulings from 1969 until the present time has been such to severely limit the applicability of Section 521 status. The restrictions on business necessary to qualify and the uncertainty

regarding whether that qualification can be maintained has led to a steady reduction in the number of "exempt" cooperatives during this period of time. For example, the code requires that substantially all of the voting stock of the cooperative must be held by producers purchasing or marketing through the cooperative. Subsequent rulings have resulted in the determination that "substantially all" means at least 85% of the shares of voting capital stock be held by producers and that the Internal Revenue Service will consider stock owned by persons who market more than 50% of particular products they have produced and marketed through a cooperative or who purchased from the cooperative more than 50% of their supplies and equipment of the type handled by the cooperative during the cooperative's taxable year as being owned by producers. This trend, if not reversed, reduces Section 521 to "dead letter" status in most cases.

Part of the reluctance to give up 521 status has been that certain of the securities registration regulations exemptions for agricultural cooperatives have been tied to the tax exempt definition. There may also be relationships to state income tax status which may be important in some cases.

UNRESOLVED ISSUES

The concept of a single tax, at the patron level, on the entire return from cooperative activity is simple and appealing. It is achievable by a cooperative paying no dividends on capital stock and operating entirely on a patronage basis with or without section 521 status. When dealing with his cooperative, the patron does so on the basis of an implied contract for provision of the functions of the organization at cost. The concept is clean in the case of a single function organization operating strictly on a cooperative basis but is hardly clear for a complex organization involved in several lines of business which may do at least some business on a nonpatronage basis.

Current treatment requires that patronage refunds be figured separately for marketing and purchasing patrons. How much averaging across patrons and product lines is reasonable or equitable? Conceptually, the cooperative is expected to do business with patrons on a cost basis, that is, reflecting as nearly as possible true cost of doing business with individual patrons. This would imply a product-by-product accounting if not a patron-by-patron cost assessment. But, to some extent, at least, risk sharing is a legitimate function of a farmer cooperative and that implies averaging of costs and returns. In most cases patrons expect the cooperative to initiate new lines of activities and are willing to accept the risk involved in that process. Again, averaging is implied.

How shall the organization handle losses? This remains a completely unresolved issue. Allocating losses (reducing capital accounts) on a product line basis could be a member relations disaster. If the organization is operating on a cost basis no losses are possible and it is difficult to theorize an alternate outcome. The problem of handling losses in various product lines also has important public relations aspects. The cooperative offsetting losses in one line of business with earnings from another invites comparisons with corporate conglomerates and encourages those attacking antitrust treatment.

As mentioned earlier, cooperative accounting depends almost entirely on

standard accounting practices, some of which do not fit the cooperative problem. Not the least of these is the valuation of inventories.

OTHER GAMES

The situation is not quite as simple as the single tax on cooperative earnings at the patron level versus the corporate tax outlined earlier. Special treatment afforded cooperatives also has the result of excluding cooperatives from some of the games other corporations play.

A cooperative may make use of the investment credit only to the extent of the proportion of its total income for which federal income taxes were paid at the cooperative level. That is, if the cooperative paid out or allocated all of its earnings as patronage refunds and paid no income taxes it would not be eligible to take or pass through any investment credit. The current 10% investment credit is an important tax shield.

Accelerated depreciation also creates difficulties for the cooperative corporation. Income for financial reporting cannot deviate from income for tax purposes without causing severe problems. Use of accelerated depreciation would tend to reduce the patronage refunds available to current patrons and increase the patronage refunds available to patrons at a later date. The matter becomes more complicated than a simple tax minimization program which would be suitable for the ordinary corporation. It is also interesting to compare cooperative tax status with that of the small business corporation (sub-chapter S corporation) which is taxed as a partnership. There is a parallel to the extent that the entire profit or loss of a sub-chapter S corporation is allocated to the individual stockholder and taxed at the personal tax rate. The shareholder in the sub-chapter S corporation is eligible to take advantage of the investment credit, accelerated depreciation and a pass-through of capital gains. A cooperative may pass-through capital gains, however, the capital gains must be allocated to persons who were patrons during the entire period that the capital gains were accumulated. As a practical matter this is a very difficult process.

One could list hundreds of areas in which tax code provides for very special treatment for specific categories of taxpayers (corporate or other). The purpose of these few examples is merely to point out that cooperative tax status is considerably more limiting than one might anticipate on the face of it.

THE GAINERS AND THE LOSERS

A major portion of the study by Schrader and Goldberg was devoted to the determination of the impact of cooperative tax treatment relative to other ordinary corporate tax treatment evaluated at the patron level. Such an analysis must necessarily include finance considerations. Given the dedication of the cooperative to pay all net margins to patrons one can find little reason for the outside investor to place equity capital in such an organization. Therefore, the true equity capital will likely have to be provided by the patrons. The normal practice has been to generate equity capital through retaining a portion of the net savings of a cooperative on some sort of revolving fund basis. Thus, the analysis of the patrons financial position will have

to take into account the time in which the tax payment and actual receipt of funds will occur. It is also quite clear that major variables which would determine the desirability of cooperative tax status are the rate of growth (and therefore, capital needs) and the individual tax rates of member patrons.

Clearly any business operated on a cooperative basis may elect to be taxed as a corporation. I'm aware of no organization operated on a cooperative basis which has made such an election. Many cooperatives, however, have elected to treat at least a part of their net margins as ordinary corporation income. Payment of dividends on capital stock by a non-exempt cooperative or use of unallocated retained savings as part of the capital structure amount to the election of corporate tax treatment on that portion of net margins.

The following summary observations about the benefits of cooperative tax treatment are basically those of the Schrader-Goldberg [8] study cited earlier. Subsequent study of tax treatment as well as of the financing problem have not led to their rejection.

If the cooperative business represents a situation in which there is no expansion, that is, where all net savings are allocated to patron-owners, cooperative tax status provides the most favorable result regardless of the patrons personal tax rate. With all earnings paid in cash to the owner-patrons in the year earned, cooperative tax status allows for a larger after-tax cash flow to the patron-owner regardless of personal tax rate. With no growth, value of the owners equity does not change and capital gains are not a factor.

If rapid growth involving reinvestments of earnings is desired, regular corporate tax status is more beneficial than cooperative status for patrons in the higher tax brackets. The negative cash flow resulting from income taxes on allocated earnings more than offsets a higher terminal value under the cooperative "single tax" arrangement. Ordinary corporate tax treatment results in the generation of capital gains with a much lower personal tax rate. Thus, for the very high income participant the so-called double tax may be cheaper than a single tax arrangement. It becomes clear why there is no upper limit on the size of the assets or earnings of a sub-chapter S corporation. There is no incentive to maintain sub-chapter S status once the earnings become quite large.

This reasoning does lead one to wonder why public corporations are anxious to pay dividends when the combination of corporate tax plus capital gains tax on increased value will always be less than paying the corporate tax and an immediate ordinary income tax at the full personal tax rate level.

Cooperative tax status is most beneficial to the patron-owner with a low tax rate. As the tax rate increases the relative benefit of taxation at personal rates rather than corporation rates decreases.

Cooperative patrons may be corporations as well as individuals. The patronage dividend (whether cash or other allocation) is a part of the receiving corporation's income and would be taxed at the corporate rate. If the funds were paid as dividends the receiving corporation would be taxed on only 15% of the dividends received. Thus with the likelihood of investment credit or other tax shelters the tax yield would not likely differ from that under cooperative status.

The time and space will not permit a complete discussion of the relative

benefit of cooperative tax status. It is clear that no single answer will fit all cases. It is also clear that I.R.S. rules have lessened the usefulness of exempt status and that steadily increasing personal tax rates tend to diminish the benefits from cooperative tax status.

FAIRNESS AND PUBLIC INTEREST

Perhaps one need go no further than proposals by the Ford administration and reported leanings by the Carter administration to modify or eliminate double taxation of corporate dividends. The possibility exists that Carter may propose elimination of the corporate income tax in favor of attribution of company profits to individuals (*National Journal,* March 19, 1977).

As I indicated earlier, if such changes come to pass, the cooperative tax issue would no longer be a problem. But I cannot imagine cooperative interests opposing these tax reform proposals. I doubt that many would feel a single tax approach to corporate income tax as a threat to their existence.

President Ford proposed a dividend-deduction method of restructuring the corporate income tax. Under this plan, dividends paid or a percentage thereof, are deductible in computing the corporation's taxable income. It is significant that most single tax proposals have not suggested full allocation of corporate profits to shareholders but only that dividends be taxed at the shareholder level. It appears to be tacit recognition that full allocation as typically practiced by cooperatives is not a particularly desirable alternative when compared to capital gain treatment of gains from retained profits. It will be interesting to note the position of the National Tax Equality Association if full allocation of profits to shareholders is seriously proposed.

I have argued that the cooperative advantage is much smaller than indicated by critics, if indeed it is an advantage in that sense. If that argument is valid, the revenue loss because of special treatment of cooperatives is relatively small. I have also indicated that cooperatives would not likely oppose a single tax on corporate profits.

It does not follow that cooperatives need not defend present treatment under sub-chapter T. My personal view is that what remains of section 521 status is not worth defending. Interpreted in the spirit of the law it carries important advantage. But such has not been the case.

Operation without sub-chapter T would be much more difficult for cooperatives. It is very important in facilitating acquisition of equity capital. But that is the subject of another paper. Protection for allocation of all funds is also very important, particularly in the case of marketing cooperatives dealing with commodities for which no open markets exist. One can imagine I.R.S. determining what earnings should be as a basis for taxation.

Without specific treatment in the Tax Code, I do not believe that the arguments for unique treatment of cooperative margins would convince I.R.S. or the Tax Courts. Given that patrons and equity owners tend to be the same persons I suspect that an attempt to "price out" all earnings would be considered as dividends even if such a policy could be successfully implemented.

The present system is, I believe, basically fair and one which deserves vigorous defense.

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