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The Farmer's Cooperative Yardstick: Should Your Cooperative be "Exempt" or "Non-Exempt"

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By:

Lionel Williamson

University of Kentucky
Department of Agricultural Economics
400 Charles E. Barnhart Bldg.
Lexington, KY 40546-0276

Phone: 859-257-5762
Fax: 859-323-1913
http://www.uky.edu/Ag/AgEcon/

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Perhaps the most talked about and least understood aspect of farmer cooperatives is their tax treatment. In fact, even co-op leaders sometimes contribute to the confusion concerning cooperative taxation. The issues most often discussed are

- Do cooperatives pay taxes?
- If so, who pays them and when are they paid?
- And why do cooperatives appear to receive favorable tax treatment as compared to other corporate businesses?

A few sources of confusion arise from legal terminology, court decisions and various rulings of the Internal Revenue Service and the Federal Trade Commission.

Several terms relating to cooperative taxation are often misunderstood and thus are further causes of confusion. Such terms include the following:

Exemption:

Illustrates the lack of precision used in describing a cooperative's income tax status. **Exempt status** of some cooperatives is often interpreted as meaning that they are exempt from paying taxes. Rather, the actual situation may be that these cooperatives operate in such a way that they owe no income tax.

Profits:

If an organization operates with fundamental cooperative principles, it has a contractual obligation to allocate and return to patrons all funds remaining after paying expenses. Therefore, its net margins or savings belong to its patrons and constitute additional income for which they are subject to income taxes.

Patronage Dividends:

Refer to how cooperatives distribute their net savings. **Dividends** are returns made on capital investments. Although cooperatives may pay true dividends, the term patronage refunds is an entirely different concept.

Are Agricultural Cooperatives "Tax-Exempt?"

Like other business organizations, cooperatives are subject to a number of tax assessments at the state and local level:

1. state property taxes on buildings, office equipment and other physical property,
2. county property taxes,
3. school tax,
4. excise tax,
5. communication tax,
6. unemployment tax,
7. social security tax,
8. transportation tax,
9. franchise tax on an annual fee in lieu of such taxes, and
10. sales taxes.

The real question is whether or not cooperatives are subject to federal income tax at both the cooperative and member-patron level (dual-taxation). An understanding of a cooperative's nonprofit business objectives is vital to any discussion of cooperative taxation. Unlike profit-based corporations, the cooperative operates to provide its members with goods and services at cost. If benefits from participation in the cooperative increases member-owners' income, then they (member-owners) incur a higher tax liability.

Present federal income tax statutes assure that a tax will be paid either at the cooperative or member-patron level. If a cooperative declares a patronage refund, and the entire patronage refund is to be taxed at the patron level as a qualified patronage refund, then at least 20% of the refund must be paid in cash. The member must pay an income tax based on his/her full qualified allocation, regardless of the cash proportion of the refund. Therefore, because the cooperative realizes no profits, it pays no Federal Income taxes.

The following example illustrates how cooperatives might choose to distribute net margins:

Marketing/Supply Cooperative Statement of Operations

Total Sales	$ 250,000
Cost of Sales	202,250
Gross Margin	47,750
Operating Expense	20,000
Interest	1,250
Depreciation	1,500
NET MARGIN	$ 25,000

This abbreviated statement of a marketing/supply cooperative shows total sales minus the cost of sales equal gross margins. The net margin, which is the net savings, or profit, is the gross margin minus the operating expense, interest, and depreciation.

The net margin is the amount allocated to member-patrons in proportion to the volume of business done with the cooperative during the year. From the above statement note that no income tax liability is identified, reflecting that 100 % of the net margin is allocated to member-patrons.

If a member-patron (patron-A) did $500 of business with the cooperative, the patron is entitled to a patronage refund of 0.2% ($500 divided by $250,000) of the total net margin. In this example, the patronage refund would be $50 (0.2% of $25,000).

The cooperative has the authority to determine how the allocated net margin will be distributed. However, the IRS requires a minimum of 20 % of the patronage refund to be paid in cash. If the cooperatives' board of directors elected to distribute 30% in cash, Patron-A would receive a $15 cash refund (30% of $50).

Patron-A, however, is required to pay income tax on the total patronage refund of $50. Thus, Patron-A, in this example, receives $15 in cash, but must pay income tax on both the cash and non-cash portion of the refund. If net margins are distributed to all member-patrons, no profits exist and therefore no federal income tax liability exists.

For cooperatives to exclude patronage refunds in determining federal income tax liability, such refunds must be distributed in cash or in "qualified written notices of allocation" that the patron has the option to (1) redeem in cash during a 90-day period after issuance, or (2) consent to treat the refund as his current income. In any event, an allocation is deductible only if at least 20 % is paid in cash.

What are the Requirement Exempt-Status?

Farmer cooperatives that qualify under Section 521 of the Internal Revenue Code of 1954 generally operate so as to have little or no taxable income. They are often referred to as exempt cooperatives or associations. Cooperatives not qualifying under Section 521 are liable for income tax on net income used to pay a return on capital and on receipts not distributed to patrons as true patronage refunds in the manner prescribed by the Code.

To be exempt a cooperative must fit the following requirements:

1. It must be an association for farmers, fruit growers, or similar groups organized and operated on a cooperative basis to
   a. market the products of members or other producers, or

b. purchase supplies and equipment for the use of members or other persons.

2. Substantially all of its stock (other than preferred non-voting stock) must be owned by producers marketing products or purchasing supplies through it, if it is organized on a capital share basis.

3. The dividend rate on capital shares must not exceed the legal rate of interest in the state of incorporation, or 8% a year, whichever is the greater, based on the value of the consideration for which the capital share was issued.

4. Financial reserves are restricted to those required by state laws or those that are reasonable and necessary, and must be allocated to patrons unless the cooperative includes them in computing taxable income.

5. The business with nonmembers may not exceed 50% of the cooperative's total business, and the purchasing for persons who are neither members or producers may not exceed 15% of the cooperative's total purchasing.

6. Nonmembers are to be treated the same as members in such business transactions as pricing, pooling or payment of sales proceeds, in price of supplies and equipment, in fees charged for services, or in the allocation of patronage refunds to patrons.

7. Permanent records of the patronage and equity interests of all members and nonmembers must be maintained.

8. The legal structure of the organization must be cooperative in character and contain no provision inconsistent with these requirements, and the association must actually operate in the manner and for the purpose outlined in the requirements.

What is the Federal Income Tax Status of Non-Exempt Coops?

Cooperatives that do not qualify under Section 521 (Exempt Status) are called nonexempt associations. Such associations, covered by the definition in Subchapter T, file a regular corporate income tax return but can exclude patronage refunds and certain other payments from their gross income.

A nonexempt farmer cooperative and an ordinary corporation do not differ taxwise except that the nonexempt cooperative more often makes obligatory patronage refunds. Both are subject to double taxation on any income distributed as stock or capital dividends to stockholders; both are subject to single taxation on unallocated income retained in the business and neither must pay corporate income tax on earnings distributed to patrons where a prior contractual obligation exists to make such distributions, provided they comply with the 1962 Revenue Act.

When is "Exempt" Status Most Advantageous to Farmer Cooperatives?

Exempt status is especially advantageous to farmer cooperatives which:

- Have large capital stock and subsequent stock dividends payable; stock transfers that are numerous for documentary stamp purposes.
- Conduct a substantial amount of business with the U.S. Government.
- Issue stock which otherwise would be regulated under SEC.
- Receive substantial amounts of non-patronage income.
- Do not have a large volume of non-member business.
- Would fall in the "Over $25,000" corporate income tax bracket, and
- Have extensive ICC-Covered business.

Is Non-Exempt Status Sometimes Better?

About half of the farmer cooperatives in the U.S. are non-exempt. Several compelling reasons cause cooperatives to give up tax exemption:

* Non-exempt cooperatives are under no limitations about stock ownership, dividend rates, membership or business transactions with nonmembers.
* They have no requirement to treat all patrons equally. A nonexempt cooperative can make patronage refunds distributions to members only.
* Nonexempt cooperatives need not be a purchasing or marketing cooperative.
* Nonexempt cooperatives may do business with nonmembers for a profit if state laws permit.
* Nonexempt status provides greater business flexibility that can accommodate joint-venture arrangements more easily.
* With nonexempt status cooperatives can more easily engage in multi-product and full service type business.

Which Tax Status is Best?

Member-patrons will want to select the tax status most advantageous for their cooperative's organizational and operational characteristics. Consider several factors to determine the appropriate tax status for your cooperative:

- **Member-Nonmember Business.** The larger the proportion of nonmember business the more significant are the economic gains derived from restricting patronage refunds to members. To a cooperative with no nonmember business, nonexempt status would offer no economic advantage.

- **Type of Financial Organization.** Should the cooperative be organized with or without capital stock? Exempt cooperatives are not subject to a capital stock tax. Nonexempt cooperatives must pay a capital stock tax.

- **Non-patronage Income.** If a cooperative does not allocate non-patronage income to patrons, neither tax status holds an advantage. However, if non-patronage income is allocated to patrons, exempt status has the advantage because the full amount of non-patronage income can be passed on to patrons. Nonexempt associations can pass on only the amount left after taxes.

  EXAMPLE:
  If an exempt cooperative has $5,000 of patronage income, it could allocate the whole $5,000 to its patrons. With a corporate tax rate of 50% a nonexempt association with the same $5,000 nonpatronage income could allocate only $2,500. The association would be required to pay $2,500 of income tax.

  If both cooperatives (exempt and nonexempt) paid 20% of the allocation in cash, the exempt cooperative could retain $4,000 (0.8 x 5,000) in its revolving fund. The non-exempt cooperative would have only $2,000 (0.8 x 2,500) to retain as revolving capital.

- **Size of Net Margin and Tax Structure.** In 1968 the corporate tax rates were 22% on taxable income less than $25,000 and 48% on all income over $25,000. Exempt status is best when net margin is over $25,000. Net margins allocated to member-patrons would, in most cases, not subject other patrons to taxes at the 48% level.

- **Additional Business Activities.** Exempt cooperatives must limit their business activities to marketing farm products or to purchasing farm supplies. Such cooperatives must ensure that at least 50% of their total business is done with members and purchasing for individuals who are neither members nor producers may not exceed 15% of the cooperative's total purchasing.

  Nonexempt cooperatives are free to conduct additional business and serve as large a segment of the population as they want, since they are free from limitations placed on exempt cooperatives.

- **Effect on Other Cooperatives**. A cooperative's income tax status affects not only its own operation but the operations of other cooperatives with which it conducts business. Therefore, the taxation of dividends and patronage refunds paid to one cooperative from another is affected by the tax status of the two associations. The tax status of members of a federation affects the federations' ability to qualify for exempt status. Therefore, if a member association gave up exempt status and altered its operations accordingly, the federation might cease to qualify for exempt status.

Current Cooperative Tax Issues

The scope of the favorable tax treatment given to cooperatives under Subchapter T and Section 521 is always under close scrutiny by the for-profit competitors of cooperatives and by the Internal Revenue Service. Three long-standing cooperative tax problems currently under consideration by the IRS are netting, tracing and voting.

The netting issue is concerned with whether a cooperative with several profit centers can combine positive net margins from the profitable operations with negative net margins from other operations in determining net margins. The tracing issue is concerned with whether it is legal for cooperatives with joint venture or other subsidiary arrangements to defer patronage refund payments to their members. The voting issue is concerned with whether a cooperative that allows members to have more than one vote, based on volume, is adhering to the co-op principle of democratic control. The IRS currently claims that weighted voting permits the larger farmer-patron to misallocate the cooperative's resources at the expense of small farmer-patrons.

Other Publications about Cooperatives

The organization and operation of a successful cooperative requires detailed information, above average managers and informed, concerned decision makers. To help your cooperative succeed, the Kentucky Cooperative Extension Service publications will be available through your local Extension office.

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