



COOPERATIVE TAXATION A NEW PROVISION

by Bob Sanders* and Ken D. Duft

During our many combined years of working with, for, or on behalf of agricultural cooperatives, we have continuously struggled with the misunderstanding by the general public about cooperative taxation. This persistent confusion is not unjustified. Continued claims that cooperative organizations enjoy a “privileged” tax advantage over their investor-owned corporate competitors are wrong - and right. In reality, the validity of such claims rests less on fact, and more on perspective and individually perceived conceptions. Within the limits of this newsletter alone we could not adequately explore the complexities of this long-standing debate. However, during 1986 a new tax provision was approved and does warrant the attention of cooperative managers. The objective of this letter is to review the origin, composition, and potential impacts of this new provision.

Origin of Cooperative Taxation

Perhaps one reason cooperative tax treatment remains so confusing is that the current body of tax law pertaining to cooperatives has such a long and diverse background. In fact, it has evolved slowly over nearly 75 years of federal legislation and a multitude of court decisions. Throughout much of this period, Congress chose to treat “nonprofit” agricultural concerns as special cases under the tax law. Qualifying organizations were

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allowed certain exemptions not afforded investor-owned “for profit” business.

Although cooperatives, as a unique form of business organization, were not specifically mentioned in the Revenue Act of 1913, it did exempt certain types of nonprofit concerns, including “agricultural and horticultural organizations.” Still not all cooperatives were exempted, because the Treasury Department subsequently ruled that cooperative dairies, telephone companies, farmers insurance groups, and others of this nature did not qualify for this special treatment. The 1916 Revenue Act, however, expanded the exemption to include those marketing cooperatives, which dealt only with members. By 1921, purchasing cooperatives, which acted as agents for their farmer members were also allowed this exempt status. Under the 1921 Revenue Act, cooperatives were, for the first time, allowed to accumulate “reasonable reserves” without losing their exempt position.

By 1922, the Capper-Volstead Act officially recognized cooperatives as a unique form of business and established specific operational criteria under which some protection from anti-trust regulations was afforded. While this Act did not reference the cooperatives’ tax status, the criteria would later reappear in the tax code and, thereby, did permit exempt cooperatives to have limited dealings with nonmember producers.

Through 1950, cooperatives qualifying as exempt were excused from paying any federal income tax. With the Revenue Act of 1951, this blanket exemption ended, and the restructuring of provisions then, and again in 1954, resulted in the creation of Sections 521 and 522. Section 521 specified the conditions under which a

cooperative could classify as exempt (similar to those established in 1926), while Section 522 outlined the manner in which exempt cooperatives would be taxed, i.e., cooperatives would be allowed to deduct both dividends paid on capital stock and amounts paid or allocated to patrons which were not the direct result of patronage. Failure to meet Section 521 provisions resulted in the payment of full corporate tax on all income earned from and not allocated to patrons.

Finally, in 1961 President Kennedy proposed the collection of a current single tax from either the cooperative or their patrons. His proposal led to the creation, in 1962, of Subchapter T of the Internal Revenue Code, which outlined in some detail the tax treatment of cooperatives (and their patrons) and specifically addressed the handling of allocated patronage refunds. As amended in 1966, Subchapter T included provisions for per unit retains. Section 521 and Subchapter T, as amended, now provide the basis for contemporary cooperative tax treatment.

Cooperative Netting

As a sub-component of the tax legislation noted above, “netting” refers to the multi-function or multi-division cooperative practice of netting gains against losses, in one or more functions/divisions, for purposes of computing taxable income. The practice of netting by a cooperative is not limited strictly to separate functions within an organization. Netting may occur between divisions under the same function, e.g., a marketing cooperative may seek to net between its handling of wheat and peas, or between patronage and non-patronage sourced income. A netting situation may also arise when firm losses in one year are carried forward or back to net positive margins in other years. Each situation has posed problems relating to Internal Revenue Code compliance and each raises philosophical and practical questions regarding the equitable treatment of cooperative patrons.

In the past, the IRS has argued that in situations where the separate functions of the cooperative serve “defineably” separate groups of patrons, this procedure of netting results in an unfair allocation of margins among those patrons. And until

recently, the tax code did not specifically address the problem. Not surprisingly, the question of equitable and permissible allocation of margins and losses often ended up in tax courts. In general, the courts have sided with cooperatives in such cases and ruled, that “fairness decisions should be made by farmer members acting through their boards of directors, not by IRS.”

Despite several adverse court decisions, the IRS released its own ruling in January 1985, which disallowed patronage dividend deductions in years in which a cooperative netted. The IRS held first that under Section 521, exempt cooperatives are required to file as if each separate function were a completely separate entity. Second, it held that cooperatives hadn’t shown convincing proof that their netting allocation methods were fair and equitable to patrons. Finally, it held that the netting cooperative would be in violation of a requirement of Subchapter T, which stated the cooperative must be under a pre-existing legal obligation to allocate earnings back to patrons. The IRS argued that by allowing netting, the cooperative directors were given too much discretion over how to allocate losses and margins.

This adverse IRS ruling prompted cooperatives and the Secretary of Agriculture to ask Congress to clarify the code, including the additions of provisions for clearly allowing netting by cooperatives. The U.S. Congress listened and responded by adding appropriate amendments to Subchapter T of the Internal Revenue code. The changes were included as Section 13210 of the Revenue Act of 1985 (PL 99-272), and were signed into law by President Reagan in April 1986.

New Provisions for Netting

The first subsection of the code revision is titled, “Optional Netting of Patronage Gains and Losses Permitted,” and specifically allows netting between allocation units of a cooperative, “whether such units are functional, divisional, departmental, geographic, or otherwise”(PL. 99-272). The wording of this section provides insight into both the intent of the lawmakers and possible interpretation by the IRS. The use of the term

“patronage” throughout the section implies that the treatment of non-patronage sourced income remains unaffected by the new law. This point is clear throughout the text of the amendments and leaves little room for argument between cooperatives and the IRS. Section (a)4, in particular, defines the terms “patronage earnings” and “patronage losses” as earnings or losses which are derived from business done for or with patrons of the cooperatives. Section (c)5 also directly addresses this question by stating that these amendments do not imply any change in the law regarding netting of non-patronage losses with patronage earnings.

An area, which does leave some room for opposing views, is the phrase “at its option,” and refers to a cooperative’s decision of whether or not to net. A very broad interpretation of this statement would be that a cooperative’s board of directors has complete discretion over whether or not to net and also over which allocation units will be netted on a year to year basis. This view will probably be popular among cooperative managers and directors. The IRS, on the other hand, will probably rule against this interpretation by citing Section 1388 of Subchapter T.

That section outlines the requirements, which must be met before a patronage dividend becomes tax deductible. One of those requirements is that the cooperative must prepare and distribute a notification to members of a prior legal obligation to pay such dividends. It can be argued that allowing the directors to have full discretion over the option of netting circumvents this prior obligation.

The new amendments also set down rules under which a cooperative may net losses between itself and a newly acquired organization. In general, a cooperative, which acquires the assets of another cooperative may offset margins earned after the acquisition with losses of the acquired cooperative. This addition to the existing law is an attempt to aid the restructuring and consolidation of cooperatives by allowing the parent the full tax benefit of absorbing the losses of financially stressed cooperatives. This law is open to exploitation, however, by large, profitable cooperatives, which may seek out and purchase

weaker organizations as an avenue of inexpensive growth.

Although the new law is retroactive back to 1962, there will be a new requirement placed on cooperatives which net after April 7, 1986. This requirement is that the cooperative must provide written notice to its patrons stating:

- * the organization has offset earnings and losses from one or more of its allocation units and that such offset may have affected the amount which is being distributed to its patrons,
- * generally, the identity of the offsetting allocation units, and
- * what rights, if any, its patrons may have to additional financial information of such organization under terms of its charter, or bylaws, or under any provision of the law “(PL. 99-272, Sec. 13210 and new sub section J of Subchapter T, IRC).”

The new amendments do not directly address the possibility of appeals to the netting procedure. However, under Subchapter T, a patron who objects to the manner in which his/her refund is allocated may have the right to appeal for a reallocation.

The information contained in these written notices need not be detailed. The new law allows the organization to withhold information which could result in an advantage to a competitor. The written notices must be provided to the patrons within eight and one-half months of the end of the taxable year.

Section (a)3 also addresses the consequences of failing to provide this notice. A careful review of this section shows that, in reality, there are no real consequences. If the Secretary of Agriculture determines that the cooperative has not met these requirements, the cooperative will be notified. The cooperative is then expected to provide a notice to its patrons which meets the requirement. The law outlines no further penalties for noncompliance, and even these loose rules are negated by the

sentence which follows them. This statement reads:

Any such failure (to provide the required written notices) shall not affect the treatment of the organization under any provision of this subchapter or Section 521.

A simple interpretation of this statement is that although written notices are required, there is nothing to be lost by not providing them. This paradox will doubtlessly become a point of future disagreement between cooperatives and the IRS.

The other important section of the new amendments relates to Section 521 exempt cooperatives. It is Section (b), "Tax-Exempt Status Not Affected By Netting," which amends Section 521 (b) of the IRC by adding a paragraph stating that exemption may not be denied a cooperative because it nets under the rules described previously. This stipulation allows Section 521 cooperatives the freedom to net without the fear of losing their tax exempt status.

Netting Options

As noted earlier, the new tax law adds nothing new to the taxation of nonpatronage sourced income. Therefore, we must fall back on the guidelines of Subchapter T and Section 521 of the code. Cooperatives which qualify for Section 521 tax exemption are limited as to nonpatron income. They are, however, able to allocate this income to their patrons as they would normal patronage income. For these reasons, the problem of netting patronage with nonpatronage income does not affect these cooperatives. Nonsection 521 cooperatives, however, do face a problem in this area. For these cooperatives, nonpatronage income (except that from business done with or for the U.S. government) is fully taxable to both the cooperative and to its patrons if it is allocated to them.

Because of this law, netting patronage losses with nonpatronage positive margins before computing the tax would lower the total tax bill. Understandably, the IRS opposes this situation and their stand has been supported by the tax courts. In an important decision, the court ruled in

Farm Service Coop. vs. Commissioner (8th Cir. 1980) that for a nonsection 521 cooperative to net nonpatronage margins with patronage losses would obliterate the distinction between them and Section 521 cooperatives. Therefore, nonsection 521 cooperatives may not engage in this practice. The reverse situation, that of patronage net margins and nonpatronage losses is not affected by this ruling. The netting of nonpatronage losses with patronage margins reduces the deduction of patronage refunds by the amount of the loss, so no net change in taxes takes place.

Netting Within a Function

The next area in which netting can occur is within a single function of a cooperative. An example of this type of netting is where a marketing cooperative nets between two different commodities which may or may not be grown by the same group of patrons. The major considerations here are the fair and equitable treatment of patrons and the ability to accurately separate the profits and losses between the allocation units. Prior to the new law, this type of netting was challenged in cases where the patrons of each commodity department were not the same nor were the departments financially or operationally integrated. The IRS ruled that this situation caused an inequitable treatment of patrons where one group was, in effect, subsidizing the other. Under the new tax laws, this type of netting is expressly permitted regardless of the financial operation or membership breakdown of the cooperative.

Netting Between Functions

A multi-function cooperative (e.g., marketing and farm supply) which sustains a loss in one function and a net margin in another may consider netting the two. This type of netting has drawn much criticism from the IRS for the same reasons as netting within a function. The IRS argues that patrons are being treated unfairly by this practice, particularly in situations where one function shows consistent losses. Another argument which has often been used is that netting of this type, when undertaken at the discretion of the board of directors, violates the requirement, under Section

1388 (a) of Subchapter T, of a pre-existing legal obligation to allocate patronage refunds.

As previously noted, the courts have ruled that decisions of equitable treatment of patrons are best left to the patrons themselves, and that their acceptance of the netting practice constitutes consent and agreement to the obligations of the cooperative. These arguments have been muted due to the passage of the new amendments to Subchapter T which now clearly allows this type of netting. Inter- or intra-function netting is not limited to offsetting net margins with losses. Another scenario in which netting may occur is when one function or department has a high net margin and another a low one. In this case also, the board of directors may choose to balance out the two allocation units when paying patronage refunds.

Netting Losses Over Time

In the case of a single function cooperative which sustains a loss from patronage alone, or both patronage and nonpatronage sources, another opportunity for netting exists. This is referred to as netting over time. Under the scenario of a one year overall loss, cooperative directors have three general options. They may:

- * reduce the current patrons' equity by the amount of the loss in proportion to patronage in the loss year,
- * ask for a proportional cash payment from their patrons to cover the loss, or
- * carry the loss forward or backward as prescribed by Section 172 of the Code.

Each of these alternatives has disadvantages to the cooperative. The first option may be ineffective as a means for allocating the loss. For example, an individual patron, particularly a new one, may not have enough equity capital built up in the cooperative to pay his/her proportionate share of the loss. Also, this practice may quickly reduce the cooperative's equity base to the point where a weakened financial structure results.

The second option carries similar problems. In the year of a cooperative loss, its patrons may have also incurred a personal loss, or at least a lower income. Asking them for cash to cover the losses of the cooperative would likely be infeasible, if not unpleasant. Also, this practice may expose the patrons to losses greater than their equity in the cooperative, thereby contradicting the principle of limited liability of corporate ownership.

Despite potential problems, the IRS argues that the basic principle of a cooperative is that it operates "at cost." Pursuant to this cost principle, the Service contends that in any year in which expenses exceed gross income, this loss must be recouped from the members who were patrons for that period. At first glance, these statements seem credible. After some thought, however, they begin to break down. A major flaw in his reasoning is based on the cooperative's right (established in 1921) to build up reserves and carry them over time. Why then is it not reasonable for them also to carry a loss?

The IRS position also ignores the possibility that a loss in one year may have actually been caused by the actions of patrons and management of previous years. The IRS presented its arguments to the Tax Court in "Associated Milk Producers vs. Commissioner" (1977). In this case, the court not only ruled against the IRS, but went on to say, "We consider the Service's position herein not only contradictory to the express provisions of Section 172, but conceptually strained and lacking in any fundamental support."

The court ruled that a cooperative may, like any other corporation, exploit the privileges of Section 172 of the Internal Revenue Code and carry losses back (a maximum of three years) or forward (a maximum of fifteen years). As previously stated, this is a form of netting where losses incurred in one year are used to offset margins of previous or future years. Netting of this type carries two potential problems.

One is the unfair treatment of new or previous patrons who did not patronize the cooperative during the loss year and had nothing to do with the loss. This problem seems unavoidable, but can be reduced if the cooperative is able to allocate

the loss over only a few years both past and future. Possibly a more formidable problem is the potential for a patron or a group of patrons to foresee the future reduction in their patronage refunds and simply terminate their patronage in anticipation of this end-result. This would push a disproportionate share of the loss onto the remaining patrons.

The new cooperative tax law does not address the netting of losses over time. Although each of these options has its disadvantages, each is currently legal and it is up to cooperative directors to choose the method, or combination of methods, which will best fulfill their needs.

Netting By Section 521 Exempt Cooperatives

As previously discussed, qualifying for Section 521 tax status provides cooperatives with certain deductions not available to nonsection 521 cooperatives. These deductions include patronage allocations of margins derived from limited nonpatronage sources. Under the new law, netting between patronage and nonpatronage sources is permissible for these cooperatives. Netting of losses and margins of the same function between different years is also permitted for Section 521 cooperatives under the Tax Court rulings earlier discussed. A long-time disadvantage of Section 521 cooperatives, however, was their inability to net between functions or departments.

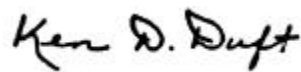
The IRS interprets Section 521 to require separate qualification by each function of a cooperative. This meant that the individual functions had to meet the operation at cost principle separately, which required a separate accounting for each. Although the IRS was unable to enforce the rule of separate accounting, the Service was able to require a bylaw provision for Section 521 cooperatives which stated that "losses will be assigned to those patrons whose business produced such losses." This provision succeeded in denying Section 521 cooperatives the opportunity to net between functions, or even to net within a function.

As previously noted, exemption can not be denied any association because it nets losses as

prescribed under the new netting amendments to Subchapter T.

Summary

It would be incorrect to suggest that those new tax provisions which permit cooperatives to net gains and losses have simplified procedures or added much to the public's general understanding of cooperative taxation. The new provisions do, however, allow some cooperatives to net the performance of divisions or functions in much the same manner as other forms of corporations. Cooperative managers and directors are encouraged to review closely these new provisions with their accountants or financial advisors. The impact of the new provisions on agricultural cooperatives is difficult to assess at this early stage. However, Washington State University is currently conducting an assessment of such potential impacts and the results will soon be made available to those seeking additional information.



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