United States Department of Agriculture

Rural Business and Cooperative Development Service

Cooperative Information Report 23

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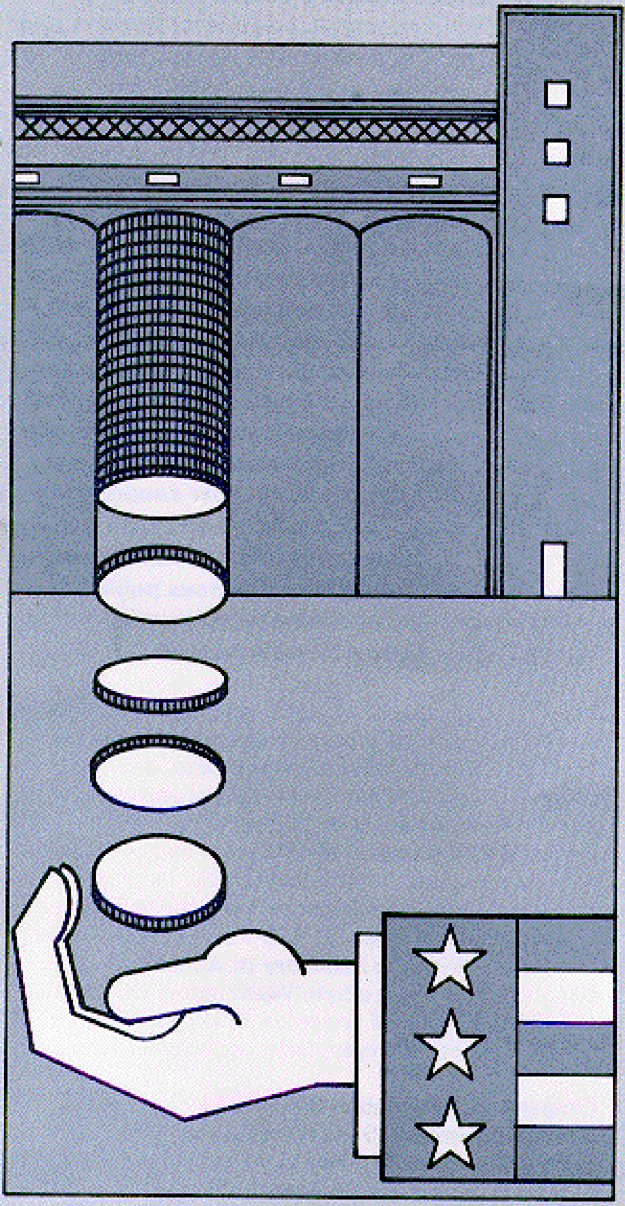

U.S. Department of Agriculture
Rural Business and Cooperative
Development Service
Ag Box 3250
Washington, D.C. 20250-3250

The Cooperative Services program of USDA's Rural Business and Cooperative Development Service provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The Cooperative Services staff (1) helps farmers and other rural residents develop cooperatives to obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs. Cooperative Services publishes research and educational materials and monthly issues Farmer Cooperatives magazine.

Cooperative Information Report 23
Issued September 1984, Revised May 1995
Supersedes "Handling Net Margins Under Federal Tax Laws," FCS Information Report 39, issued in 1979.

Tax Treatment of Cooperatives

Donald A. Frederick
Attorney

A cooperative is a business that is owned, financed, and controlled by the people who use its services. Earnings are allocated and distributed to members based on patronage, rather than to investors based on equity. The Internal Revenue Code (Code) recognizes the pass-through nature of a cooperative by providing for the single Federal income taxation of earnings generated on business conducted on a cooperative basis. This pamphlet explains how cooperatives are taxed and some tax planning options available to cooperative members.

Cooperatives Pay Taxes

Cooperatives have the same rights and responsibilities as other American businesses, including the obligation to pay taxes. Cooperatives, like other businesses, pay significant taxes.

First, cooperatives pay the special taxes assessed all businesses. These include real estate and personal property taxes, sales taxes, employment taxes (to finance social security, unemployment compensation and workers' compensation benefits), gasoline and diesel fuel taxes, license fees, motor vehicle registration fees, and excise taxes on utility services.

Second, cooperatives and their owners pay a single income tax on margins, usually at the owner level. This is the same tax treatment applied to most U.S. businesses, As table 1 shows, of the five common structures of American business, only investor-general corporations have their margins taxed at both the business entity and individual owner levels. And only 12 percent of American businesses are operated as investor-general corporations,

Most business taxes are applied uniformly to all affected taxpayers, including cooperatives. Therefore, they will not be mentioned further in this pamphlet.

Certain aspects of income taxation are unique to each form of business. While some variations exist, most States with income taxes generally follow the Federal model in taxing cooperative margins.

Table I--Income tax treatment by business type

Business Type	Times net margin subject to tax	Level
Proprietorship	1	Owner
Partnership	1	Owners
Corporations:		
Investor-General	2	Corporation Owners
Investor-Subchapter S	1	Owners
Cooperative-Subchapter T	1	Owners

Federal Income Taxes

The central feature of cooperatives' Federal income tax liability is that net margins are not taxable income to both the cooperative and the patron if they are distributed or allocated to patrons on the basis of business done with the cooperative according to certain well-defined rules. The Code recognizes cooperatives' operating principle of providing services at cost. Therefore, refunds of net margins to patrons on a patronage basis are subject to Federal income tax only once. This treatment is available to any business choosing to refund net margins in the same way. Rules cooperatives and patrons must follow to be eligible for this tax treatment are in Subchapter T of the Code.

Subchapter T contains a definition of a patronage refimd. Unfortunately, the Code uses the term "patronage dividend" instead of "patronage refund." The more common terminology "patronage refund" is used in this pamphlet, to avoid confusion with regular dividends on stock.

Subchapter T defines a patronage refund as "An amount paid to a patron by an organization..

1. On the basis of quantity or value of business done with or for such patron,

2. Under an obligation of such organization to pay such amount which obligation existed before the organization received the amount so paid, and

3. Which is determined by reference to the net earnings of the organization from business done with or for its patrons."

For example, if a cooperative has a margin of $2,000 for the year, and Ms. Jones does 10 percent of the business with the cooperative, then she receives a patronage refund of $200 ($2,000 x . 10). This allows the cooperative to return margins to members on an annual basis, consistent with standard accounting conventions and without regard to how much was earned on each transaction.

The Subchapter T definition includes several key requirements.

First, the definition refers to amounts paid to a “patron” rather than a “member.” Some cooperatives only conduct business with or for members, while others deal with both members and nonmembers. The members of a cooperative with nonmember business have the choice of whether to make patronage refunds to nonmember users.

Second, the critical characteristic that distinguishes a business operating on a cooperative basis is the requirement that distribution of net margins is based on the “quantity or value of business done with or for such patron.” Distributions to patrons not made in proportion to business done with the cooperative cannot qualify as patronage refunds. For example, dividends paid on capital stock are not patronage refunds because they are made in proportion to the amount of stock owned rather than the amount of business done with the cooperative. This standard implements the cooperative’s central objective of distributing financial benefits to patrons based on their use of the cooperative’s services rather than on the basis of their investment in its capital structure.

Third, the cooperative must have an obligation to pay net margins to patrons, and the obligation must exist before a patronage transaction takes place. Both the cooperative and its patrons know prior to any transaction that net margins from the transaction will be paid in whole or in part as a patronage refund. The preexisting legal obligation must be in enforceable written form. It can be included in a cooperative’s bylaws, articles of incorporation, marketing agreement, sales receipts, or other written contract obligating the cooperative to make the payments. If a State law makes patronage refunds mandatory, that law also is considered a valid obligation.

Fourth, patronage refunds are distributions of net margins derived from business with or for patrons. The Treasury Department regulations define net earnings (net margins) as “the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items.” Patronage refunds can come only from business done with or for patrons. Income a cooperative may receive from business unrelated to patronage cannot be included in patronage refunds under definitions of the Internal Revenue Code.’

Written Notices of Allocation

A cooperative has several options in distributing its patronage refunds and taking advantage of the tax treatment available under Subchapter T. It may simply pay out all of its earnings in cash. This is usually done by cooperatives that do not need to generate additional capital, or those whose members finance by other methods.

The most popular method of distributing patronage refunds is to pay out part of the refund in cash and part in a noncash form called a “written notice of allocation,” Funds represented by a written notice of allocation are retained by the cooperative, not as profit, but as a capital investment by the patron in the cooperative. The tax code permits the notice to be in a variety of forms so long as it is in writing and informs the patron of the total amount allocated to him or her on the books of the cooperative and the portion that is a patronage refund.

Members determine how much of the cooperative’s net margins are to be retained in the cooperative to meet its capital needs. The written notice of allocation is evidence of a patron’s share of that investment. This method of financing helps the association comply with the cooperative principle of obtaining financing from current patrons on the basis of their use of the cooperative.

A cash refund is deductible by the cooperative in the year the funds being returned were earned and is taxable income to the patron in the year received. Members and their cooperative have two alternative tax treatments available

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‘Dividends paid on capital stock and patronage-based refunds of nonpatronage income are eligible for single tax treatment if a cooperative meets the requirements of section 521 of the Internal Revenue Code. A review of 52 1 status is beyond the scope of this pamphlet. A thorough discussion of section 521 can be found in *Legal Phases of Farmer Cooperatives,* FCS Information 100, beginning at page 381.

for retained funds evidenced by written notices of allocation. Specific tax treatment will depend on whether a written notice of allocation is “qualified” or "nonqualified."

“Qualified” and “Nonqualified”

If a cooperative chooses to meet the specific requirements of the Code to “qualify” written notices of allocation, funds represented by qualified written notices are treated just like a cash patronage refund for tax purposes. The cooperative deducts the entire amount from its taxable income in the year the funds are earned and the patron includes the entire amount in his or her income in the year the written notice is received. (A cooperative is allowed 8-1/2 months from the end of its tax year to complete its tax returns and make its patronage distributions.)

An example illustrates how this works for a typical marketing cooperative. The cooperative pays the patron $600 for his crop at the time of delivery. It costs the cooperative $300 to market the crop. The cooperative sells the crop for $1,000.

The resulting margin of $100 is returned to the patron as a patronage refund. The patron receives a total payment of $700 for the crop, a $600 advance at the time of delivery and a $100 patronage refund.

Example of Tax Treatment of Cooperative and Patron
Qualified Retained Equity

Cooperative		Patron	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin	$100	Refund	$100
Taxable income	0	Taxable Income	$700

When the cooperative figures its taxable Income, it can deduct the initial payment for the crop ($600) its other expenses of marketing the crop ($300), and the patronage refund ($100). Thus, it ends up with no taxable income.

The patron includes both the initial payment ($600) and the patronage refund ($100) in taxable income, for a total of $700.

The requirements to quality a written notice of allocation are:

1. The written notice of allocation must be part of a patronage refund package of which 20 percent or more is paid in money or qualified check, and either

2a. The patron has the option of redeeming the written notice of allocation at face value for cash within 90 days of issuance, or
2b. The patron has consented to include the face value of the written notice in his or her taxable income.

The term "money" includes both cash and a regular bank check. A "qualified check" is a specially prepared bank check that can be used to establish a patron's consent to include the noncash portion of a patronage refund in his or her income for tax purposes.

A patron can "consent" to include the face value of the written notice of allocation in taxable income in any one of three ways:

1. By joining a cooperative whose bylaws clearly state that membership in the cooperative constitutes such consent, provided the patron is given a copy of the bylaw and a written statement of its purpose. This is the most common method of establishing consent.

2. By signing and furnishing a written consent to the cooperative before the end of the taxable year in which the patronage occurs. The consent must be revocable. Unless it provides otherwise, a written consent remains in effect for all subsequent years until it is revoked.

3. By endorsing and cashing a qualified check. A "qualified check" carries a clearly printed statement that endorsing and cashing the check constitutes consent by the patron to take into account, as provided in the Federal income tax laws, the stated amount of any written notices of allocation that are paid as part of the patronage refund of which the check is also a part.

A cooperative may elect not to meet all the requirements to qualify a written notice of allocation. For example, it may pay less than 20 percent of the patronage refund in money or qualified check, or it may not have its patrons consent to take the face amount of the refund into account for tax purposes. If a written notice does not meet the requisites for qualified status, it is called "nonqualified."

A cooperative that issues nonqualified written notices of allocation must include the face amount of the notice in its taxable income for the year the covered funds are earned and pay tax on these funds at regular corporate income tax rates.

The patron receiving a nonqualitied written notice of allocation does not pay an immediate tax on the funds it represents. However, when the cooperative pays out the money represented by the nonqualified notice to the patron, the money received is taxable income to the patron in the year received. The cooperative deducts the amount paid from income in the year paid according to formulas established in the Code.

If **the** cooperative in the earlier example issues its patronage refunds as nonqualified written notices of allocation, it has taxable income of $100, the amount of the margin. The patron's taxable income is $600, the payment for the crop.

Example of Tax Treatment of Cooperative and Patron Nonqualified Retained Equity

Cooperative		Patron	
Expenses		income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
income	$1000		
Margin	$100	Refund	$100
Taxable Income	$100	Taxable Income	$600

At some later time, *when the nonqualified notice is redeemed, the* cooperative will deduct the $100 (or receive a credit under certain circumstances) and the patron will report it as income in the year the cash payment is received.

Thus, the single tax treatment of cooperatives doing business with or for members is complete and consistent with that accorded other single-tax entities. Income is ultimately taxed once, at the level of the owner-user of the business.

Per-Unit Retains

Members usually have alternative methods of meeting their obligation to finance their cooperative. They may make out-of-pocket investments, such as buying a membership or shares of stock. They may leave a portion of their patronage refund in the cooperative, as previously described. Patrons of marketing cooperatives may also invest in their cooperative by authorizing it to deduct a portion of the proceeds of sale, based on the dollar value or physical volume of products marketed through that cooperative. This method of financing is called “per-unit retains.”

Tax treatment of per-unit retains generally parallels that of patronage refunds. A cooperative is required to pay tax currently on its per-unit retains unless they are evidenced by certificates “qualified” under the law. The patron must include the face value of a qualified per-unit retain in his or her income for tax purposes in the year received. The certificate is qualified only if the patron consents to include the face amount of the certificate in current income. Because per-unit retains are deducted from payments for products, there is no cash distribution rule similar to the 20-percent requirement to qualify a written notice of allocation. If a patron receives a nonqualified per-unit retain, the amount is not reported as income until the money it represents is paid to the patron.

Patronage refunds and per-unit retains are often confused. Patronage refunds are based on net margins while per-unit retains are based on the amount of business conducted without regard to margins.

Tax Planning Alternatives

The tax treatment available to businesses operated on a cooperative basis is a simple concept--a cooperative operates at cost, so it has no true income to tax. However, as the earlier sections of this pamphlet indicate, when that concept is melded into our complex Federal income tax system, it also becomes quite complex.

Careful tax planning is as important for members and their cooperatives as it is for other individuals and businesses.

This is especially true when patronage refunds are involved, because most decisions will have significant tax consequences for both the cooperative and its member-patrons. Here is a brief summary of some of the choices available:

1. How to finance the cooperative -- Members may supply equity capital through out-of-pocket investments, patronage refunds, or per-unit retains. Initial investments to start a cooperative usually come from the members. When the cooperative generates margins, retained patronage refunds generally become the principal source of capital. Marketing cooperatives may also use per-unit retains. A combination of these methods is permissible. Cooperatives are encouraged to plan what role each of these approaches should play in capital formation.

2. Who is to receive patronage refunds -- A cooperative may pay patronage refunds to all users or only member-users. If margins on nonmember business are not returned to nonmember users on a patronage basis, the cooperative must pay corporate income taxes on this money.

3. Whether to "qualify" its paper -- Most cooperatives "quality" their written notices of allocation and per-unit retain certificates because members find it to their advantage to accept immediate tax liability for their investment in their cooperative, and thereby give the cooperative the easiest possible access to needed financing. It is permissible to qualify part of an allocation and not the remainder. The extent to which nonqualified allocations are made generally depends on the cash needs and tax rates confronting both the members and the cooperative at the time of allocation.

4. How to "qualify" -- The vast majority of cooperatives use a bylaw provision to obtain the necessary consent to qualify their allocations to members. The required explanation can be provided at the time the producer applies for membership, and the pre-existing legal obligation to conduct business on a patronage basis is established. Bylaws only bind members, so bylaw consent is not available for nonmember business. A separate written consent is usually obtained from nonmembers if their business is to be conducted on a patronage basis. Qualified checks can be issued only as part of a patronage refund, and are rarely used because of the uncertainty over whether patrons will cash them.

5. How to redeem old patronage paper -- If current patrons are to meet their duty to finance the cooperative, then written notices of allocation and per-unit retain certificates that have been on the books of the cooperative for many years should be redeemed. The redemption schedule should not be so rigid that it becomes difficult to maintain adequate levels of capital. However, a formal redemption program is clearly compatible with cooperative principles.

The member-patrons must collectively decide which alternatives best fit their needs and the operation of their cooperative.