Every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part.

Martin D. Ginsburg
FUNDAMENTALS OF COOPERATIVE TAX SYSTEM

Characterization as a Cooperative

- May be formed under a specific state cooperative statute, general for profit or not-for-profit corporation, or LLC taxed as a corporation
- Key is operation on a cooperative basis
- No Code definition
- Judicial and administrative guidance

Federal Income Tax Treatment of Cooperative

- Cooperative is a C corporation
- Operates as a pass-through entity for patronage sourced income
- Cooperative pays tax on its non-patronage sourced income
Form of Cooperative

- Rural electrification act
- Agricultural marketing act
- General for-profit corporation statute
- Not-for-profit statute

Ownership

Cooperative is owned by its members and its patrons that do business with the cooperative on a patronage basis.

Historical Perspective

- Cooperatives have been around 160 years
- Rochdale Cooperative formed by 28 textile weavers for operating a retail store
- IRS recognized cooperative through administrative rulings as early as 1922
- The Code never addressed taxation of cooperatives or even recognized the deduction of patronage dividends until 1950s
General Requirements for Cooperative Status

Code law and rulings have set forth cooperative principles. The basic principles are generally:
- Subordination of capital
- Democratic control
- Vesting and allocation of benefits

Subordination of Capital

- In a cooperative, the capital is subordinated
- Unlike a normal for-profit corporation, stock ownership determines participation of corporation’s profit and voting rights
- In cooperative, profits based on business and democratic voting

Democratic Control

- IRS generally has stated that a cooperative should operate on a one member, one vote basis
- IRS recognized variances based upon
  - floor space in a housing cooperative
  - current patronage
- IRS rejected method based on past patronage
Vesting and Allocation of Benefits

- Cooperative’s income must be allocated and vest to the cooperative’s member/patrons based upon contributions.
- Most important element of a cooperative.

Fifty Percent Test

- Historically, IRS took the position that in order to operate on a cooperative basis had to do at least 50% of business with members/patrons.
- In Rev. Rul. 93-21, IRS conceded that 50% test was not law.
- If do inadequate amount of patronage business, it is not really a cooperative, but no set standard.

Operating as a Cooperative – Mississippi Cement

- Formed under state law as a cooperative.
- Cooperative operated as an agent for all of the members to sell product.
- Coop was not operating as a cooperative, and court held so.
Taxation of Cooperatives and Patron

Taxation of Cooperative

- Cooperative is a C corporation
- Subject to all of the other provisions of Subchapter C
- Pass-through taxation through payment of patronage dividend
- Pays tax on patronage income not paid out as a patronage dividend and non-patronage sourced income

Taxation of the Member/Patron

- Recipient of patronage dividend must include amount in taxable income
- Supply cooperative – reduction of cost of item purchased
- Marketing cooperative – increase in sales proceeds
- Patronage dividend paid with respect to capital asset is a basis reduction
- No income on patronage dividend on personal use
Definition of Patronage Dividend

"an amount paid to a patron by [a cooperative] --
(1) on the basis of . . . business done with or for such patron,
(2) under an obligation to pay such amount . . .
(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons."

The Code further provides that “[s]uch term does not include any amount paid to a patron to the extent that . . . such amount is out of earnings other than business done with or for patrons.”

Prior to 1962

- **Cooperative Deducted Patronage Dividend when Paid - Both Cash and Scrip**
- **Patrons report Cash Dividend Currently**
- **Patrons report Scrip Dividend at FMV:**
Prior to 1962

Congress enacted legislation in 1951 which the Service believed would require the matching of the cooperative's deduction and the patron's income.

Subchapter T

Congress enacted Subchapter T in 1962. Subchapter T codified the Federal income tax treatment of patronage dividends for cooperatives and their patrons. Subchapter T basically required the timing of the cooperative's deduction and the patron's income to be matched.
Subchapter T

- Subchapter T does not address all of the Federal income tax issues for cooperatives and their members
- Many issues must be resolved by other Code provisions, some of which are designed for regular C corporations
- Application of general rules at times fail to make sense when applied to a cooperative

Tax Categories of Cooperatives

- Subchapter T cooperatives
  - Section 521 cooperatives
  - Non-exempt cooperatives
- Non-subchapter T cooperatives
  - Exempt cooperatives
  - Cooperatives providing electrical or phone service to persons in rural areas
  - Mutual savings banks or insurance cooperatives

Patronage Dividend

- Patronage sourced income
- Reg. § 1.1382-3(c)(2) – example of non-patronage sourced income for exempt cooperative
The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

Inasmuch as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's purchasing activities, it is held that the allocation and payment of this same amount by the nonexempt farmers' cooperative to its own patrons (farmers) qualifies as a patronage dividend.

Interest income from bonds plaintiff held for liquidity purposes is patronage sourced because the transactions involved are directly related to plaintiff's services to its patrons. They were a prerequisite to plaintiff's functions. Unless the bonds were held, plaintiff could not issue consolidated bonds, the primary source of loan funds for its patrons.
CF Industries, Inc. v. Commissioner

To allow a cooperative to deduct its cash-management income creates an arbitrary disparity in the tax treatment of the cash-management income of cooperatives and of other forms of non-tax-exempt enterprise, which are required to pay income taxes on all their interest income. (On the other hand, disparity is built into Congress's decision to have special tax rules for cooperatives.) CF's position can also be challenged as placing cooperative taxation on the crest of a steep and slippery slope.

The danger of the slippery slope is aggravated by the fact that there appears to be no limitation, other than what state statutes may or may not impose, on how much business a cooperative can do with nonmembers without forfeiting its cooperative status.

Preexisting Legal Obligation

- Legal obligation created by articles of incorporation and by-laws
- Only effective after creation of obligation
- Impact on creation of reserves
- Book v. taxable income

Interest Income

- Rev.Rul. 74-160 – interest income to key supplier is patronage sourced
- St. Louis Bank for Cooperative – short term investment of temporary excess funds
Other Types of Income

- Dividends
  - Limtten Plywood – dividend from non-coop sub
  - Land ‘O Lakes – patronage dividend from coop bank
- Rental Income
  - Cotter – temporary excess space
- Capital Gain
  - Farmland Industries – gain on subsidiary stock sale
- Section 1231 Gain
  - Rev. Rul. 74-84 – section 1245 was patronage sourced but section 1231 was not
  - Farmland – section 1231 gain was patronage sourced
- Blended Products
  - TAM 9143002 if blended product is insignificant portion, then all is patronage sourced

Patronage Treatment of Partnership Income

- Aggregate and Entity Theory of Partnership
- Private letter rulings
  - Profac/Curtiss Burns
  - 9033006 – supply coop refinery
  - 9846022 – agronomy supply coop
  - 199920034 – sugar marketing coop (processing and sales operation)
  - 200244013 – marketing coop (purchase activity and processing operation)

Form of Patronage Dividend Payment

Written Notice of Allocation

- Certificate or other form of written advice to patron reflecting dollar amount allocated by cooperative
- May be either
  - qualified written notice of allocation (deductible currently)
  - nonqualified written notice of allocation (not presently deductible)

Non-Subchapter T Cooperative

- Not subject to qualified and non-qualified written notices of allocation

Discrimination

- Must pay patronage based on volume or value
- May pay different portions in cash vs. written notices of allocation
- Base capital plans
Pools of Income

- In allocating patronage, the cooperative may separate operations in multiple pools for allocating patronage income
- Separate computations of patronage dividends for the separate pools

Netting Income

- Section 1388(j) allows a cooperative to net losses from one pool against other pools
- Cooperative must provide notice to members of netting
- If fail to, the remedy is?

Losses

- Section 277
  - Not applicable to subchapter T cooperatives
  - Might be applicable to non-subchapter T cooperative
**NOL Carryforwards**

- Farm Service – Patronage losses are not allowed to offset non-patronage income
- Counter to Farm Service – A cooperative is a single taxable entity and the Code does not separate a single taxpayer into two entities of patronage/non-patronage
- Ford-Iroquois – IRS has challenged coop’s ability to carry NOLs to offset future patronage income on the basis of changed membership. This has been rejected by the courts.

**Bylaw Netting Provisions**

- Cooperative may build flexibility to offset

**Pass-Through of Losses**

- Cancellation of patronage equity
- Qualified and Non-Qualified Written Notices of Allocation
- Ordinary loss v. Capital loss
Redemption of Patronage Capital

- Redemption of Patronage Equity at a discount
- Tax Benefit rule
- Gold Kist
  - 11th Circuit – treated as transaction separate from patronage dividend

Farmland Rulings

- 200341017 – cancellation of patronage equity is not taxable income to cooperative
- 200414019 – cooperative does not recognize income on bankruptcy liquidation

Reorganizations

- Tax-free reorganizations – predominantly an A reorganization
- Triangular reorganizations
Non-statutory Requirements

- Business purpose
- Continuity of proprietary interest
- Business continuity

Limitations of Net Operating Loss Carryforwards of Acquired Entity

- Section 269
- Section 382
  - Ownership change – more than 50%
  - Ownership change based on value
  - Limit is based upon FMV of equity times tax-exempt rate

Types of Coop

- Marketing
- Supply
- Bargaining
- Service
- Federated
- Closed
Glossary of Key Terms

Operating Terms

- Member
- Patron
- Producer
- Patronage Income
- Non-patronage income

Distribution of Earnings Terms

- Patronage dividend
- Per Unit retain
- Written notice of allocation
- Qualified written notice of allocation
- Non-qualified written notice of allocation
- Payment Period
- Apportioned reserves
Subsidiaries

- One member cooperative
- Single member LLC
- Consolidated returns

Tax-Exempt Status Under Section 501(c)(12) for Electric Cooperatives

Expansion of Cooperative Services by Rural Electric Cooperatives
Statutory Requirements for Section 521 Cooperative

- Organization Attributes
- Capital Stock
- Patron Composition
- Producers
- Distribution of Net Margins

Organization Attributes

- Farmers', Fruit Growers', or Like Association
- Organized and Operated on a Cooperative Basis
- Organization Purpose
  - to market products or purchase supplies and equipment for patrons
  - may have supply and marketing departments
  - may engage in other activities, if incidental

Capital Stock

- Common Stock Ownership
  - Substantially (85%) all voting stock held by active producers
- Preferred Stock
  - May be issued to public if nonvoting and does not participate in profits beyond fixed dividend rate
  - Dividends limited to > of maximum legal rate or 8%
- Voting
Patron Composition

• Marketing Cooperatives
  • Member/Producers - value of products marketed for member/producers must be at least 50%
  • Nonmembers - may market as long as does not overshadow
  • Nonproducers - emergency purchases, ingredients to produce marketable product or facilitate product line

Patron Composition

• Supply Cooperative
  • Member/Producers - value of supplies should be at least 50% of total sales, although not required
  • Nonmembers - may market as long as does not overshadow
  • Nonmember/Nonproducers - may sell up to 15% - potential look-through issue

• Business done for the United States government is disregarded
  • Producers - Generally an owner or tenant who bears the risk of production - sharecropper is a producer, while a landlord receives fixed rate rent is not
Distribution of Net Margins

- Marketing cooperative - must “turn back” proceeds less necessary marketing expenses
- Supply cooperatives - must sell at cost plus operating expenses
- Equal treatment for members and nonmembers
- May establish reasonable reserves

Federated Cooperatives

- Look-through theory in determining whether section 521 satisfied
- Taxable year does not have to correspond to that of members or vice versa
- Supply - may treat non-qualified as part of the 15%

Subsidiaries

- May own subsidiary
- Can’t carry on activity through subsidiary which section 521 cooperative may not do
Tax Return Considerations

Coop Taxable Income

- Regular Corporation Rules (Appendix C)
- Patronage Deductions
  - Exempt
  - Non-Exempt

Federal Form 1120-C Required to be Filed by both Exempt and Non-Exempt Farmer Cooperatives

- APPENDIX C
Schedule G, Form 1120-C

- Exhibit C
- Page 3 of Form 1120-C
- Complete Patronage and Nonpatronage columns
- Maintain appropriate schedules

Flow of Cooperative Taxable Income

- Allocation Unit
  - Department
  - Division
  - Geographic
  - Function
  - Other

Flow of Cooperative Income

- Netting/Separate
- Patronage v. Non-Patronage
- Member v. Non-Member
- Patronage Deduction
- Taxable Income
Netting Election

- Written Notice
- 8 1/2 Months
- Identity Units/Rights
- Remedial Action
- Appendix I

Cooperative Deductions

- General
- Patronage Dividend
  - Qualified Written Notices
  - Consent
  - Cash Payments of 20%
- Nonqualified Written Notice
  - Not Deductible When Issued
  - Deduct When redeemed
- Per Unit Retains

Exempt v. Non-Exempt

- Returns
  - Exempt 1120-C
  - Non-Exempt 1120-C/Consol.
- Capital Stock
  - Exempt - Producers
  - Non-Exempt - No Requirement
- Business Volume
  - Exempt - 15%
  - Non-Exempt - Any Amount
### Exempt v. Non-Exempt

- **Patronage Dividends**
  - Exempt - 100% Coop
  - Non-Exempt - Distribute to Members Only
- **Dividends on Capital Stock**
  - Exempt - 8%
  - Regular Corp
- **Non-Patronage Income**
  - Exempt - Distr./Exclude
  - Non-Exempt - Cannot Distribute

### Notices of Allocation

- **Written Notice - Glossary**
- **Qualified Notice**
  - Patron Consent
  - Payment of Cash
- **Non-Qualified Notice**
  - Nondeductible When Issued
  - Deductible When Redeemed

### Patron Consent

- **By-Law (Appendix III)**
- **Written Agreement (Appendix IV)**
- **Qualified Checks (Appendix V)**
Per Unit Retains

- Marketing Coops
- Value/Quantity Allocation

Tax Return Considerations

- Form 1120-C (Appendix C)
  - Exempt
  - Non-Exempt
- 15th Day of 9th Month
- Six-Month Extension Allowed

Exempt Cooperatives

- File Form 1028 for Exemption
- File Form 1120-C
Information Returns
- Reports to Patrons
- Forms 1096, 1099-PATR (Appendix D)
- Cash, Written Notices, Redemptions

Pooling Arrangements
- Crop Year Basis
- Difference in Fiscal Years
- Completed Pool Method - Not Available Per IRS

Filing Consolidated Returns
- Non-exempt cooperative and regular corporation subsidiaries can file consolidated return if consolidated return requirements are met
- Exempt cooperative cannot be included in consolidated return
**IRS Examinations**

- Exempt v. non-exempt coops
- IRS restructuring of exam division based on type and size of entity
- Coops file Form 1120-C and are assigned to IRS audit division based on asset size
- Coop issue – any change to patronage taxable income may mean tax on otherwise allocable patronage income

**Summary**

- Cooperative principles
- Exempt v. Non-exempt cooperatives

**Important Documents and Example**

A. Netting notification (Appendix I)
B. Examples of patronage & Nonpatronage sourced items (Appendix II)
C. Notice of adoption of consent provision (Appendix III)
D. Written notice of allocation (Appendix IV)
E. Qualified check (Appendix V)
F. Bylaw consent provision (Appendix VI)
G. Purposes and powers (Appendix VII)
Section 199 – Domestic Production Activities Deduction

- Law effective for tax years beginning after 12/31/05
- Purpose – provide tax benefit to U.S. manufacturers
- Cooperatives got special provision because of repeal of Foreign Sales Corporation and Extraterritorial Income Exclusion rules that Section 199 replaced
- Section 199 – from a cooperative perspective
  - Marketing Ag Coops & Manufacturing Supply Coops qualify
  - Marketing Coops have special “attribution” rule
    - Activities of member/farmer is attributed to cooperative for Sec 199 purpose
  - Benefit can be retained or passed through to members

Section 199 – Domestic Production Activities Deduction

- Section 199 calculation
  - Deduction = percentage of taxable income attributable to Qualified Production Activities Income (QPAI)
  - QPAI = “domestic production gross receipts” less related cost of goods sold and other expenses
- Formula is lower of QPAI or taxable income times the deduction percentage:
  - For fiscal years beginning in 2010 and after, percentage is 9%
- Deduction limited to 50% of the taxpayer’s wages paid during the year in connection with qualified production activities and cannot create or increase a net operating loss

Section 199 – Domestic Production Activities Deduction

- Taxable income and QPAI of the coop is computed without regard to any deduction allowable under § § 1382(b) and (c)
  - All cash and qualified written notices of allocation – per-unit retains (includes advances) and patronage dividends
  - All non-patronage distributions from § 621 coops
- Per-unit retain paid in money (PURPM) or certificates
  - Payments/distributions not based on profits
  - PURPMs came into the law in 1969 to solve the marketing cooperatives’ problem with prior law
  - ALL PAYMENTS TO MEMBER/PATRONS FOR THEIR PRODUCT MEETS PURPM DESIGNATION
Section 199 – Domestic Production Activities Deduction

- Most coops – pooling and non-pooling – treated PURPIMs as inventory costs for book purposes
  - Form 1120-C and old Form 990-C showed them in Cost of Goods Sold section
- Many pooling coops adjust their tax reporting to deduct these payments within 8 ½ month "payment period"
- Most non-pooling coops (e.g. grain) do not

Section 199 – Domestic Production Activities Deduction

- 2007 – IRS Technical Advisor asked IRS National Office how to compute the Sec 199 deduction for pooling and non-pooling coops
- ILM 200806011 – Chief Counsel replied that PURPIMs should be added back along with patronage dividends for pooling and non-pooling coops
- Coops began requesting rulings to confirm this position for their coop
  - Dollars are too big to risk being wrong

Section 199 – Domestic Production Activities Deduction

- Many private letter rulings have been issued for all types of cooperatives consistently holding that payments to member for their crop are PURPIMs and are therefore added back for purposes of Section 199
Section 199 – Domestic Production Activities Deduction

- Other issues
  - Can you use patronage based DPAD against nonpatronage income?
  - Can a supply coop use Section 199? Is it a "manufacturer" for this purpose? Treasury Regulations are not clear on this.
  - Form 8903 (for DPAD calculation) – new instructions raise questions on how the coop should do the patronage vs non-patronage computation.

Section 199 – Domestic Production Activities Deduction

- NSAC Annual Meeting usually has a session on Section 199 which gives current updates.
- NSAC CLN session is given on the internet during the year also.
- NSAC local chapter meetings also have updates.