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Need for Reform in Taxation of Agricultural Cooperatives

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NEED FOR REFORM IN TAXATION OF AGRICULTURAL COOPERATIVES?

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THE Tax Reform Act of 1969¹ made significant changes in the income tax treatment of individuals, exempt organizations, and corporations. Section 531 of the House of Representatives version of the Tax Reform Act² would have made a significant change in the tax treatment of cooperative organizations, but the provision was deleted by the Senate Finance Committee.³ However, the tax treatment of cooperatives was singled out as an area for future legislative scrutiny. The Senate Finance Committee requested the Treasury Department, the staff of the Senate Finance Committee, and the staff of the Joint Committee on Internal Revenue Taxation to conduct a study of the activities of cooperatives and to determine whether the present tax treatment of cooperatives should be changed with respect to certain business activities referred to in the Resolution as "unrelated."⁴ The Committee expressed its concern over the extent to which cooperatives are increasingly engaging in activities unrelated to the purpose for which the special tax treatment of cooperatives was originally granted.

In addition to the concern of the Senate Finance Committee with regard to "unrelated business activities" of cooperatives, various industry organizations have expressed the concern that cooperatives were being given a competitive advantage over profit corporations engaged in the same business. The National Tax Equality Association has been especially active in expressing such opposition to the tax treatment of cooperatives.⁵

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Alston, Miller & Gaines is counsel for Gold Kist, Inc. Gold Kist, Inc. qualifies for the preferential tax treatment which is accorded agricultural cooperatives by the federal government. This favorable tax treatment is currently under study at the direction of the Senate Finance Committee and is the subject of this article.

¹ Tax Reform Act of 1969, tit. I-X, 83 Stat. 487-742 (codified in scattered sections of 26 U.S.C.).

² H.R. 13270, 91st Cong., 1st Sess. § 531 (1969). This section would have required that cooperatives pay out a larger percentage of a patronage dividend in money and that retained patronage dividends be paid in full within fifteen years.

³ S. REP. NO. 552, 91st Cong., 1st Sess. 308-09 (1969).

⁴ *Id.*

⁵ See, e.g. Caplin, *Taxing the Net Margins of Cooperatives*, 58 GEO. L.J. 6 (1969).

This article will consider the present tax treatment of agricultural cooperatives⁶ in light of certain aspects of tax policy: neutrality, equality, and the continuing need to stimulate agricultural cooperative activity. The conclusion and underlying assumption of this article is that the present favorable tax treatment of cooperatives should be continued.⁷

I. THE NATURE OF COOPERATIVES AND THEIR TAXATION

As a preliminary matter, it will be helpful to describe what a cooperative is and how it operates.⁸ Agricultural cooperatives are associations of agricultural producers organized to market their products collectively (marketing cooperatives) or to purchase their supplies collectively (purchasing cooperatives). Cooperatives may be organized under the general corporation law of a state or under a special cooperative association law such as the Georgia Cooperative Marketing Act.⁹ Cooperatives may be organized with or without capital stock, but voting control of a cooperative is usually based on a one-member-one-vote principle rather than on a one-vote-per-share principle. Further, the dividend rate on the capital stock of a cooperative is usually limited

⁶ This article deals with agricultural cooperatives although the general principles set forth herein may be equally applicable to other types of cooperatives.

⁷ The present tax treatment is not an isolated example of federal encouragement of the cooperative method of doing business. Section 6 of the Clayton Act, 15 U.S.C. § 17 (1964), and section 1 of the Capper-Volstead Act, 7 U.S.C. § 291 (1964), shelter agricultural cooperatives from the full impact of the Antitrust Laws, and the Interstate Commerce Commission Act, 49 U.S.C. § 303(b)(5) (1964), gives special treatment to transportation cooperatives composed of agricultural cooperatives as defined in the Agricultural Marketing Act of 1929. In addition, in the Agricultural Marketing Act of 1929, Congress declared its policy of encouraging the organization of producers into effective associations or corporations. 12 U.S.C. § 1141(c) (1964).

⁸ For other accounts of the nature, history, and taxation of agricultural cooperatives, see, for example, R. PATTERSON, *THE TAX EXEMPTION OF COOPERATIVES* (2d ed. 1961); Blair, *Farmers' Cooperatives and Their Patrons Face New Problems in Reporting Income*, 28 J. TAX. 180 (1968); Brannan, *Income Tax Exemption of Co-ops*, 21 MONT. L. REV. 145 (1960); Caplin, note 5 *supra*; Logan, *Federal Income Taxation of Farmers' and Other Cooperatives* (pts. 1 & 2), 44 TEXAS L. REV. 250, 1269 (1965-66) (especially at 250 n.1); Magill, *The Exemption of Cooperatives From Income Taxation*, 21 MONT. L. REV. 155 (1960); Pearson, *The Farm Cooperative and the Federal Income Tax*, 44 N.D. L. REV. 490 (1968); Wile, *Taxation of Farmers' Cooperatives and Their Patrons*, 1966 SO. CALIF. TAX INST. 449; Note, *Taxation of Co-operatives: A Tentative Explanation of a Problem in Semantics*, 1966 WIS. L. REV. 930; Note, 17 VAND. L. REV. 646 (1964). See generally I. PACKEL, *THE LAW OF COOPERATIVES* (3d ed. 1956). Caplin's is the most recent and Patterson's the most substantial of the works which take positions contrary to that advanced in this article.

⁹ GA. CODE ANN. §§ 65-201 *et seq.* (1966).

to eight percent of the consideration received for the stock, and ownership is usually restricted to agricultural producers.

Marketing cooperatives grew out of the need of farmers to find an efficient method of marketing crops.¹⁰ Cooperatives remedied an imbalance in the bargaining power between the farmer and various "middlemen" with whom he had to deal in order to get his product to market. The *purchasing* cooperative helps the farmer overcome the inherent inefficiency and higher cost of small unit purchases by allowing a group of farmers to purchase as an economic unit.

Cooperatives return to their patrons the dollar benefit of collective activity. A marketing cooperative returns to the patron the excess of the receipts from sales of a product less expenses.¹¹ Purchasing cooperatives return the savings from collective purchasing by selling to patrons at cost plus expenses. The returns are made by distributing patronage refunds based on the "net margin" of the cooperative. The "net margin" is the measure of the benefits attained by collective activity. Agricultural cooperatives are under an obligation to distribute these net margins to their patrons on the basis of the amount of business done with each patron: the theory is that the amount of business done with a patron is the best approximation of the amount of net margin created by that patron.¹² The by-laws or the articles of incorporation of a cooperative association may give the board of directors discretion over how much of the patronage refund shall be paid in money and how much shall be paid by distributing a debt instrument or a notice of patronage refund allocation.¹³

¹⁰ Paul, *The Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperatives Organizations From Federal Income Taxes*, 29 MINN. L. REV. 343, 347 (1945). See also authorities cited note 8 *supra*.

¹¹ The marketing cooperative may also make an initial payment to the agricultural producer on delivery of his product based on the amount of product delivered. This payment is called a "per-unit retain" and is treated for tax purposes in substantially the same way as a patronage dividend.

¹² Cooperatives are not required to keep records of the profit or loss realized on each transaction for a patron but only of the total business done with or for that patron on a functional or product-line basis. Tracing of the results of each patron's products would be inconsistent with the efforts of cooperatives to overcome the effects of a fluctuating market. Cooperatives allow the patron to spread the risk of market fluctuations over a longer period of time and over a larger quantity of product. Accordingly, the patronage dividend is based on the results of transactions for the entire year.

¹³ The bylaws or articles of incorporation may instead establish an amount that each member is required to pay annually or from time to time to carry on the business of the cooperative. *E.g.*, GA. CODE ANN. § 65-207(h) (1966). The result would be that all "net margins" are paid out in cash and each member-patron would be required to reinvest a certain amount of his patronage dividend.

The most significant feature of the income tax treatment of agricultural cooperatives is found in section 1382(b) of the Internal Revenue Code. In determining the taxable income of any corporation operating on a cooperative basis, and of any organization exempt from tax under section 521,¹⁴ patronage dividends paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during a taxable year are excluded. These amounts would be included in the income of non-cooperative corporations for tax purposes.

Patronage dividends are defined as amounts paid to a patron on the basis of quantity or value of business done with or for such patron by the cooperative. The organization making the payment must be under an obligation to do so, and the obligation must have existed before the organization received the amount paid. The amount of patronage dividend must be determined by reference to the net earnings (net margin) of the organization from business done with or for its patrons. Patronage dividends may not include any amount from earnings from business done with or for non-patrons, or from business done with or for patrons to whom no patronage is paid or to whom smaller amounts are paid with respect to substantially identical transactions.¹⁵ Net margins from non-patronage business are therefore in the taxable income of the agricultural cooperative.¹⁶ The present tax treatment of patronage dividends is sometimes referred to as the "single tax treatment" since the patrons pay tax on the full amount of patronage dividends whether received in money or qualified written notice of allocation.

¹⁴ Cooperatives which meet the requirement of section 521 of the Internal Revenue Code are not really exempt from income tax but are allowed certain special deductions in addition to being able to exclude patronage dividends from income. The "exemption" is restricted to farmers, fruit growers, or like associations organized and operated on a cooperative basis either to market the products of members or other producers or to purchase supplies and equipment. "Exempt" cooperatives are also restricted in the amount of business they can do with or for nonmembers and nonproducers. Furthermore, both marketing and purchasing cooperatives must treat all patrons alike, be they members or not, with respect to patronage dividends.

¹⁵ INT. REV. CODE of 1954, § 1388(a). See also Treas. Reg. § 1.1385-1(a)(2) (1963).

¹⁶ Section 1382(c) of the Internal Revenue Code of 1954 allows "exempt" cooperatives to deduct the following items from their taxable income: (a) amounts paid as dividends on capital stock; (b) amounts paid in money, qualified written notices of allocation or other property on a patronage basis from earnings derived from business done with or for the United States or from sources other than patronage; (c) amounts paid in money or other property in redemption of a nonqualified written notice of allocation on a patronage basis with respect to earnings derived from businesses or sources described in (b) above.

A written notice of allocation must disclose to the patron the stated dollar amount allocated to him on the books of the cooperative organization and the portion thereof which constitutes a patronage dividend.¹⁷ To be "qualified," a written notice of allocation must provide that at least twenty percent of its amount is paid in money and the balance by means of (a) a written notice of allocation redeemable in cash at its stated dollar amount for at least a ninety-day period beginning on the date it is paid if the distributee has received written notice of the right of redemption at that date; or (b) a written notice of allocation which the patron has consented to include in income.¹⁸ Consequently, patronage dividends paid in money or "qualified" certificates are excluded from the income of the cooperative.

II. COOPERATIVES AND TAX POLICY

The present tax treatment of cooperatives has been criticized on two grounds: as being inconsistent with an equitable income tax system and as giving cooperatives an unfair advantage over competing corporations.¹⁹ Both types of criticism fail to give adequate play to certain policy considerations which this article will now discuss.

A. *Tax Neutrality and Equality*

An income tax system might, ideally, be neutral. That is to say, taxation might be employed only to raise revenue and not to serve also as an indirect means for allocating resources or stimulating certain economic enterprises.²⁰ Of course, the present system is not "neutral" in this sense and does serve as a method of resource allocation,²¹ but potential changes in taxation may helpfully be viewed in the light of possible ideal goals.

Notions of neutrality appear to argue neither for nor against continuation of present tax treatment of cooperatives. For example, the

¹⁷ INT. REV. CODE of 1954, § 1388(b).

¹⁸ INT. REV. CODE of 1954, § 1388(c)(1). The patron may consent in writing to inclusion of the notice of allocation in income, or such consent may be made a part of the bylaws of the association by which the patron is bound if he is a member. The patron is also deemed to consent to inclusion if he cashes or endorses a qualified check paid as part of the patronage dividend. INT. REV. CODE of 1954, § 1388(c)(2)-(4). See also Treas. Reg. § 1.1388-1(c) (1963).

¹⁹ See, e.g., Caplin, *supra* note 5; R. PATTERSON, *supra* note 8.

²⁰ See the examples of resource allocation cited in note 28 *infra*.

²¹ See generally Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

present favorable tax treatment of cooperatives does not affect capital investment in farming operations. Nor is the present tax treatment an artificial stimulant which would cause investors to put their capital in cooperatives. There is the eight percent limit on capital stock dividends, and equity appreciation is allocated on a patronage basis rather than on a basis of capital stock ownership. Private investors are, consequently, offered neither current income nor growth potential.

For another example, present tax treatment of cooperatives does not provide them with a competitive price advantage.²² The goal of the marketing cooperative is to return to the farmer as much for his products as possible. There is a consequent incentive to market at the highest possible price, and this price is not dependent on exemption from corporate tax on profits. Similarly, a purchasing cooperative cannot obtain merchandise at prices below those offered ordinary retailers as a result of the fact that it pays no federal income tax.

Considerations of an ideally neutral tax system have no impact upon the present tax treatment of cooperatives. Such treatment acts neither to attract private investor capital nor to provide cooperatives with a competitive price advantage. In brief, resource allocation is not in issue.

While tax neutrality is not in issue, tax equality is. Cooperatives are not taxed like corporations. But they should not be. If there is inequality in treatment between cooperatives and corporations, such inequality is only a reflection of the difference between the two entities.²³ The most significant distinction is the nature of their profit. The goal of the corporation is to benefit the suppliers of capital who have put their funds at the risk of the corporate business, and its business is separate and distinct from the individual pursuits of its shareholders. The net margins of cooperatives, on the other hand, are not

²² See Paul, *supra* note 10, at 355; Rumble, *Cooperatives and Income Taxes*, 13 LAW AND CONTEMP. PROB. 534 (1948). *Contra*, Caplin, *supra* note 5; R. PATTERSON, *supra* note 8.

²³ It is interesting to note that those who favor a single "comprehensive tax base"—as opposed to a complex, diverse, or ad hoc base—would do away with taxation of corporate entities. "[M]uch would be gained if the taxation of corporate profits could be integrated in the individual income tax . . ." Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 61 (1967). The recent debate about the preferred type of tax base has been carried on largely through the pages of the *Harvard Law Review*. See Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Musgrave, *supra*; Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967); Galvin, *More on Boris Bittker and The Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968).

independent of the profits of their patrons, nor do net margins represent the results of separate business transactions. The business carried on by the cooperative is but an extension of the business of its patrons. Although there may be a separation of activity between the farmer and the cooperative, the profits are generated from only one business transaction which may encompass everything from raising chickens to selling packaged chicken breasts. The interposition of an entity does not alter the economic unity of the transaction; nor does it require separation of an otherwise integrated transaction into separate elements in order to tax equitably the profits generated.²⁴

Another significant difference between cooperatives and corporations is the role of capital. Agricultural cooperatives, like corporations, need capital in order to conduct their activities. But the presence of capital investment in an agricultural cooperative does not mean that it is conducting business, like a private corporation, for the benefit of shareholders as suppliers of capital. Only where there is capital investment in unrelated facilities²⁵ is the cooperative earning entity profits for capital suppliers. In this event, it may be appropriate to tax the cooperative at the entity level on those earnings.

A third difference is the inaccessibility of agricultural cooperatives to private investor capital. In order to draw on private investor capital, the cooperative would have to offer a share of its net margins to the investor. Cooperative management would have to be responsible both to patrons and to private investors. This dual responsibility would be antithetical to the reason for the existence of farmer cooperatives. Cooperatives must turn for their capital to the farm sector of the economy, where capital is scarce.²⁶

²⁴ Compare Brannan, *supra* note 8, at 147, with R. PATTERSON, *supra* note 8, at 71-73, and Magill, *supra* note 8, at 166.

²⁵ The determination of what constitutes unrelated facilities must be premised on some conception of the permissible scope of cooperative activity. The primary focus of the current study should be, it might be argued, not so much tax reform as the role of the cooperative as an economic institution.

²⁶ The income situation of agricultural producers has improved markedly in recent years. Total net income per farm has increased from \$685 in 1939 to \$4,957 in 1968. U.S. DEPT OF AGRICULTURE, FARM INCOME SITUATION Table 3H, at 46 (July 1970). However, it is doubtful whether this increase indicates that agricultural producers can be expected to be self-sufficient. Total government payments for all farm programs during the period 1939 to 1968 have increased 354 percent, *id.* Table 21H, at 64 (derived), and in 1968 government payments to farms represented 23 percent of farmers' total net income per farm. *Id.* Table 3H, at 46 (derived). Non-farm sources of income represented 47 percent of per capita personal income of farm population in 1968. *Id.* Table 7H, at 50 (derived). Furthermore, while total net income per farm was increasing 77 percent between 1959

If cooperatives are not taxed like corporations, the difference in treatment arises from differences in nature. The present treatment of cooperatives does not impinge on tax neutrality, and tax equality would not appear to be served by a change unless it can be maintained that equality is served by taxing different entities as though they were the same.²⁷

B. *Business Competition and Continuing Need*

Even if the present tax treatment of cooperatives did not comport agreeably with tax neutrality, or if it resulted in unjustifiable inequality, economic policy would be sufficient support for its continuation. There are numerous examples in our tax system of preferential tax treatment which issues from policy considerations.²⁸ The present tax treatment of cooperatives was originally the consequence of the need for government encouragement of the agricultural segment of the national economy. The need continues, and the need for the same tax exemption continues with it.

The farmer's share of the consumer's food dollar is an indication of the relative strengths of farmer and middleman. In 1954 the civilian food marketing total was \$51 billion. Of this total, payment to farmers amounted to \$19 billion and payment for merchandising amounted to \$32 billion.²⁹ Fourteen years later, in 1968, preliminary data indicated that the civilian food marketing total had risen to some \$90 billion; the payment to farmers was \$29 billion and that for merchandising was \$61 billion.³⁰ Thus, as the marketing total increased by 76 per-

and 1968, the number of farms decreased by 25 percent, *id.* Table 3H, at 46 (derived), and in 1968 per capita disposable personal income from all sources of the farm population was still only 73 percent of that of the non-farm population. U.S. DEP'T OF AGRICULTURE, AGRICULTURAL STATISTICS 1969, Table 680, at 477 (1969) (derived).

The trend toward the elimination of the marginal producer as reflected in the decline of farm units may explain much of the increase in net income per farm. It would be helpful to the current study of cooperatives if the contribution of cooperatives to the efficiency of the larger units and to the preservation or stabilization of smaller units could be ascertained.

²⁷ Cf. Musgrave, *supra* note 24.

²⁸ The investment credit, changes in allowable depreciation rates, accelerated depreciation for low-income housing, accelerated write-off of pollution control equipment, and the pass-through tax treatment of mutual funds and real estate investment trusts are examples of the effect of larger social and economic policy considerations on the income tax system. Even those who seek adoption of a comprehensive tax base do not rule out use of the tax system to accomplish social or economic goals. See Musgrave, *supra* note 24, at 52; Pechman, *supra* note 24, at 66.

²⁹ U.S. DEP'T OF AGRICULTURE, AGRICULTURAL STATISTICS 1969, Table 668, at 461 (1969).

³⁰ *Id.*

cent, the merchandiser's share rose by over 90 percent, but the farmer's share increased only 53 percent. It would appear that the farmer has made little headway in terms of bargaining with middlemen for a fair share of the consumer food dollar. Cooperatives were expected to improve the relative bargaining position of farmers and to secure for them a larger share of the value of their products.³¹

Another way in which cooperatives were expected to make a contribution to the farm sector of the economy was to relieve the farmer of the burden of having to buy at retail and sell at wholesale. The effect of the purchasing cooperative on this situation has not been clearly analyzed; however, the continuation of the original problem can be statistically indicated. Using 1910-14 as a base period, the ratio of prices received by farmers to prices paid by farmers has dropped from 89 in 1954 to 74 in 1968.³² This would indicate that the prices farmers pay for commodities used in production have increased at a faster rate than the prices farmers receive for their products. Furthermore, whereas the wholesale price index for all commodities increased 9.8 percent during the period 1957 to 1968,³³ the comparative increase in prices paid by farmers for commodities used in their production was 13.6 percent.³⁴ The increase in the wholesale price of farm products during the same period was only 2.2 percent.³⁵ One conclusion that may be drawn is that farmers are forced to bear the burden of other businessmen's price increases without being able to command a similar increase in the price of their products. The extent to which the patrons of purchasing cooperatives were able to mitigate this burden through collective activity is certainly relevant to whether these cooperatives are serving their intended purpose.

Agricultural cooperatives may also be making other contributions to the economy. Does the presence of a strong cooperative movement in a community serve as a catalyst for other enterprises and a resultant broadening of the economic base of the community? Does the expan-

³¹ The scope of marketing activity of cooperatives should be evaluated in terms of the benefits that cooperatives were intended to supply. If vertical integration of marketing cooperatives has helped the farmer maintain or improve his share of the consumer food dollar, it might not be "unrelated business activity."

³² U.S. DEP'T OF AGRICULTURE, *AGRICULTURAL STATISTICS 1969*, Table 674, at 467 (1969).

³³ U.S. DEP'T OF COMMERCE, *STATISTICAL ABSTRACT OF THE UNITED STATES 1969*, Table 499, at 339 (1969) (derived).

³⁴ U.S. DEP'T OF AGRICULTURE, *AGRICULTURAL STATISTICS 1969*, Table 675, at 468 (1969) (derived).

³⁵ U.S. DEP'T OF COMMERCE, *STATISTICAL ABSTRACT OF THE UNITED STATES 1969*, Table 501, at 340 (1969) (derived).

sion of the scope of cooperative activities provide significant new job opportunities in farm communities and result in stemming the flow of out-migration? The answers to these questions may indicate the extent of these other benefits and would be helpful to a committee whose job it is to evaluate the present status of cooperatives. In deciding whether to eliminate certain incentives for cooperative activity, the benefits of that activity to the agricultural sector of the economy and to the economy as a whole should be determined and weighed.

III. CONCLUSION

Farmers still need help, the cooperative form of activity is still viable, and the original need for preferred tax treatment of agricultural cooperatives still continues. The present tax treatment of cooperatives is not inconsistent with either the ideal of neutrality or the goal of equality in income taxation. Consequently, the ultimate question before the various study committees which are examining the role and taxation of cooperatives should be whether the encouragement of cooperative activity provided by the present tax treatment is justified in light of what cooperatives do for their patrons and for the economy. The present scope of activities of cooperatives should not be condemned as "unrelated" if it is necessary to bring about the benefits cooperatives were intended to supply. The growth in size and scope of cooperatives should not be seen as an abuse of a privilege without looking at the size and degree of vertical integration of the non-cooperative businesses with which cooperatives must deal. The present study committees have the power to determine the future of the agricultural cooperative. This determination should be based on an assessment of the quantitative and qualitative benefits of cooperative activity, and both friends and foes of cooperatives should be prepared to furnish economic data to support their positions.