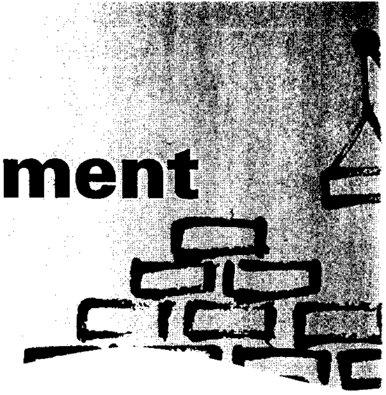
Understanding Cooperatives:

Income Tax Treatment of Cooperatives[1]



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developed by
Donald A. Frederick
Program leader,
Law and Policy

Benjamin Franklin, who among his other accomplishments helped establish a successful insurance cooperative, wrote shortly before his own demise, "Our Constitution is in actual operation; everything appears to promise that it will last; but in this world nothing is certain but death and taxes."

Fortunately, the Constitution has endured, but so have taxes. Taxes are a factor in the planning of every individual and business. Like other businesses, cooperatives pay taxes. This report is to help persons associated with cooperatives (1) understand cooperative income tax treatment, (2) avoid fundamental mistakes that cost money and may lead to an expensive and disruptive audit or assessment by the Internal Revenue Service, and (3) use tax planning options that may increase the benefits members receive from their cooperative.

Cooperatives Are Not Exempt from Taxation

Cooperatives usually pay all the special taxes levied on businesses. These include real and personal property taxes, sales taxes, employment taxes (to fund social security, unemployment compensation, and workers' compensation benefits), gasoline and diesel fuel taxes, license fees, motor vehicle registration fees, and excise taxes on telephone, power, and other utility services.

Also, no cooperative is exempt from Federal income taxation and filing Federal income tax forms. Most states with a corporate income tax generally follow the Federal rules.

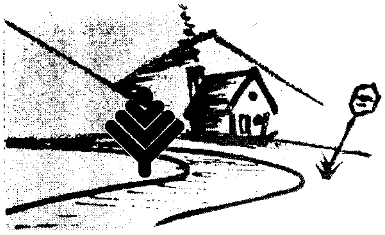
The relationship of cooperative income tax treatment to that of other business forms is set out in table 1. Of the five common types of business structures in this country, only investor-general corporations pay income tax at both the business and owner levels. And only 12 percent of American businesses are investor-general corporations.

Most rules governing cooperative income tax treatment are found in subchapter T of the Internal Revenue Code, sections 1381-1388. Subchapter T recognizes that the objective of business conducted on a cooperative basis is not to generate earnings for the cooperative, but to increase the income of the members. Thus, net margins on business with or for patrons are subject to Federal income tax only once, at either the coop-

TABLE I-Tax Treatment by Business Type

Business type	Times Earnings Taxed	Level
Proprietorship	1	Owner
Partnership	1	Owner
Corporations:		
Investor-General	2	Corporation/Owner
S Corporation	1	Owner
Cooperative	1	Owner

[1] This report does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. This publication is presented only to provide information to persons interested in the tax treatment of cooperatives.



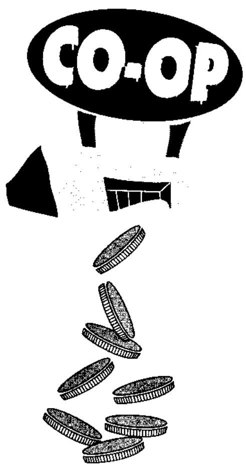
erative or the user level, but not both. Only this patronage-sourced income is eligible for single tax treatment. With certain exceptions, income from nonpatronage sources is subject to tax at the cooperative level when earned and at the recipient level when paid out to members or others.

This single tax treatment is not limited to farmer cooperatives. With certain exceptions, any business that chooses to "operate on a cooperative basis" is eligible for tax treatment under Subchapter T.

Patronage Refunds

Single tax treatment is accomplished by permitting a cooperative to deduct patronage refunds distributed according to rules in Subchapter T. A patronage refund is:

- ◆ an amount paid by a cooperative to a patron,
- ◆ based on the quantity or value of business done with or for the patron, and
- ◆ derived from the cooperative's earnings from business done with or for all patrons, usually referred to as the cooperative's margins.



PATRON

For example, if 10 percent of a cooperative's business is with or for Ms. Jones, and the cooperative has a total net margin for the year of $1,000, then Ms. Jones receives a patronage refund of $100 ($1,000 x 10%).

Payment Options, Tax Treatment

A cooperative has three options when distributing patronage refunds--cash, qualified written notices of allocation, and nonqualified written notices of allocation. Tax treatment is one of the factors to consider in deciding which option(s) to use.

Cash

A cooperative may pay out some or all of its margins to patrons in cash. The cash portion of a patronage refund is deductible by the cooperative in the year the margin being returned was earned. It is taxable income to the patron in the year received. In the example, if Ms. Jones received her entire patronage refund in cash, the cooperative would deduct the $100 from taxable income for the tax year in which the business occurred that generated the $100 in margins. Ms. Jones would include the $100 in the taxable income of the year in which she received the $100 refund.

Written Notices of Allocation

Members usually authorize their cooperative to retain at least a portion of their patronage refunds each year as additions to equity capital.

To protect single tax status for retained margins, the cooperative must, within 8 1/2 months after the close of its tax year send each patron a written statement reporting the amount of that patron's patronage refund for the year. This statement is called a written notice of allocation.

Qualified Notices

Two optional tax treatments are available for patronage refunds distributed as written notices of allocation. The type of written notice of allocation used determines which tax treatment applies.

If a cooperative meets the subchapter T requirements to "qualify" its written notices of allocation, the notice is treated just like a cash patronage refund for tax purposes. The cooperative deducts the amount allocated from its taxable income in the year earned, and the patron includes the entire amount in income in the year the notice is received.

The requirements to "qualify" a written notice of allocation are:

◆ The written notice must be part of a patronage refund package of which 20 percent or more is paid in cash, and

◆ The patrons must have consented to include the face value of the not ice in their taxable income.

The patron "consent" requirement is satisfied in one of three ways:

● By being a member of a cooperative with a bylaw that clearly states membership in the cooperative constitutes such consent. The member must receive a copy of the bylaw and a written statement of its purpose.

◆ By signing a written consent form before the end of the taxable year in which the patronage occurs.

◆ By endorsing and cashing a "qualified check." A qualified check is a specially prepared bank check which, if endorsed and cashed, establishes patron consent to include the entire refund in taxable income.

Most cooperatives have a bylaw making consent automatic with membership. Because bylaws only bind members, a separate written consent must be obtained from nonmember patrons for their consent to be effective. Qualified checks are rarely used because of the uncertainty over when and whether patrons will cash them.

Using the earlier example, if Ms. Jones received a qualified written notice of allocation reporting her patronage refund, the cooperative could deduct both the amount of cash refunded to Ms. Jones (must be at least 20 percent of the refund) and the noncash portion of her patronage refund in the year the underlying margin was earned. Ms. Jones must report the entire refund ($100) as income in the year received, even though the cooperative might retain up to 80 percent of the funds.

Nonqualified Notices

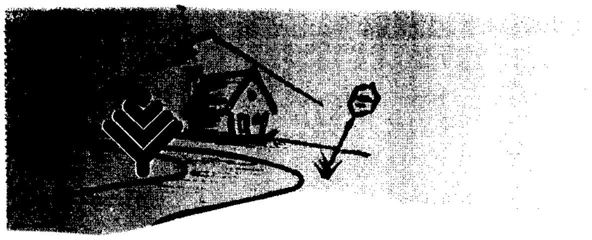
A cooperative may elect not to meet all the requirements to qualify a written notice of allocation. For example, it might pay less than 20 percent of the patronage refund in money or it might not have its patrons consent to include the face value of the notice in taxable income.

A written notice that for any reason does not meet the requisites for qualified status is called a "nonqualified written notice of allocation."

A cooperative that issues nonqualified written notices of allocation must include the face amount of such notices in its taxable income for the year the covered funds are earned and pay tax on these funds at regular corporate income tax rates. When the cooperative pays out the money represented by the nonqualified notices to the patrons (i.e., redeems them), the cooperative can recover the tax paid in the year issued, according to formulas established in Subchapter T.

The patron receiving a nonqualified notice pays no immediate tax on the funds it represents. When the cooperative redeems a nonqualified notice, the money received by the patron is taxable income to the patron in the year received.

Again referring to the example, if the cooperative issued a nonqualified written notice of allocation as a patronage refund to Ms. Jones, the cooperative would report the $100 face value of the nonqualified notice as income in the year it was earned. Ms. Jones has no immediate tax liability for the refund. When the cooperative pays Ms. Jones $100 in money to redeem the nonqualified notice of allocation, the cooperative recovers the tax it paid at the time the notice was issued. Ms. Jones reports the $100 as income for the tax year in which she received the funds.



The extent to which a cooperative pays its patronage refunds in cash, or in qualified or nonqualified written notices of allocation, is a matter within the discretion of the board of directors. Tax and financial advisers are often consulted before the decision is made.

Per-Unit Retains

Members of marketing cooperatives have an alternative method of providing patronage-based financing. They may authorize the cooperative to deduct a portion of the proceeds of sale, based on dollar value or physical volume of products marketed through the cooperative. This method of financing is called "per-unit retains."

Tax treatment of per-unit retains generally parallels that of patronage refunds. To qualify for single tax treatment the cooperative must, within 8 1/2 months of the end of its tax year, either refund the per-unit retain in cash or provide the patron with a written notice that discloses to the recipient the dollar amount retained. That notice is called a per-unit retain certificate.

If patrons consent to include the face value of the certificates in current income, the retained funds are deductible by the cooperative in the year the funds were acquired and must be included in taxable income by the patrons in the year they received the required written notice, now referred to as a "qualified" per-unit retain certificate.

If a per-unit retain does not meet the requirements for qualified status, the written notice is called a "nonqualified" per-unit retain certificate. The cooperative includes the face value of the certificate in current taxable income and recovers the tax paid at the time of redemption. The patron does not report the retained amount as income until the nonqualified certificate is redeemed by the cooperative.

Section 52 1 Cooperatives

Farmer cooperatives meeting certain tests set out in section 521 of the Internal Revenue Code may, in addition to patronage refunds and per-unit retains, deduct dividends on stock and income from business with the United States and other nonpatronage income distributed to patrons on a patronage basis.

Filing and Forms

As mentioned earlier, all cooperatives must file annual Federal income tax returns, even if they have no taxable income.

- ◆ Farmer cooperatives file form 990-C.
- ◆ Other cooperatives file form 1120.
- ◆ Other forms to be filed may include the various form 1099's to report distributions paid as interest, stock dividends, patronage refunds and per-unit retains (both cash and noncash). ■