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Farmer Cooperatives

By

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IN THE IMMEDIATE PAST there has been a running skirmish on the exemption from corporate income taxes provided under Section 101 (12) of the Revenue Code for certain types of farmer cooperatives, which adhere rigidly to prescribed regulations concerning their manner of operation and ownership. The United States House of Representatives Committee on Small Business held hearings on this subject during April and May of 1945. The recommendations of this committee (House Report No. 1888, 79th Congress) made it apparent that this matter will be the subject of congressional consideration at the next hearings on a new revenue act. The tremendous volume of business conducted by these farmer cooperatives, as well as their economic role, which has no counterpart in urban life, makes them of unique interest.

During the marketing year 1944, farmer cooperatives did over five billion dollars of gross business. This sum dwarfs many prominent industries of important daily concern in urban life, and should emphasize the importance of this rural segment of our economy. The interest of the farmer member is readily appreciated. Although interest of the urban population is practically nonexistent, it should be very real since housewives use some foods initially marketed through farmer cooperatives in

virtually every meal prepared. Thus, since the non-farm population is the ultimate buyer of most of the products marketed by farmer cooperatives, the non-farm population has an equal stake in this vast marketing operation.

The brunt of the campaign for Code change appears to be carried by a relatively small but extremely vocal group of self-styled businessmen located principally in farm areas or small cities serving them. Although their opposition to cooperatives seems to be based on general principles, much of their effort has centered upon subjecting all farmer cooperatives to corporate income tax.

Types

There are two basic types of farmer cooperatives, namely, marketing and purchasing. The purpose of the marketing cooperatives, which are much the larger, is to sell farm produce and return the proceeds, less expenses, to the producing farmers. The purchasing cooperatives acquire or process materials or machinery necessary on the farm and sell these to farmer members at cost, plus expenses. For the marketing year 1944, the approximate distribution of business volume was as follows:

This article embodies some of the remarks made in an address before the annual meeting of the Michigan Association of Farmer Cooperatives by the author, a Washington tax counsel, who is an attorney, and certified public accountant (Illinois, Maryland and New York), and head of Paul J. Foley & Co., Washington, Chicago and New York

All Purchasing Cooperatives.....	14%
Marketing Cooperatives	
Grains	23%
Fruits, Nuts and Vegetables..	16%
Dairy Products	23%
Livestock	15%
Cotton	3%
Miscellaneous	6%
	86%

The geographic location of these cooperative associations for the marketing year 1944 was distributed throughout the sections of the United States as follows:

West North Central.....	30%
East North Central.....	23%
Mountain and Pacific.....	20%
New England and Atlantic...	19%
South Central	8%

Exemption

Section 101 (12) had its origin in Section 231 of the Revenue Act of 1926, which clarified previous general provisions. Except for a 1934 addition providing for exclusion of government business in the qualifying calculation, the 1926 enactment stands unchanged in the Code today. The Code and Regulations prescribe a very limited framework within which a cooperative must operate in order to obtain or maintain an exemption from corporate income tax. In fact, these requirements have

been so demanding that, according to the most recent data available,¹ for the year 1944 only 5,595 out of 10,300, or about fifty-four per cent, doing about three billion dollars of business (plus volume in excess of commission reported by some commission cooperatives) filed Form 990, thus availing themselves of the exemption. It may be concluded that the remaining forty-six per cent did not consider the exemption worth the resultant restrictions.

Patronage Refund

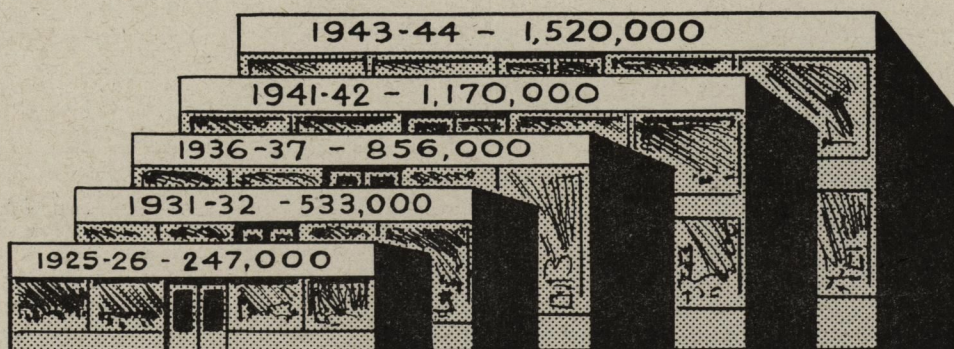
Under the general provisions of the Code² any cooperative business venture, regardless of the nature of the commodity or service in which it deals, may exclude from gross income such patronage dividends due members as the bylaws permit and as were declared by the board of directors (thus creating legal liability to pay). Such dividends are excludable when the liability has been created, even on the cash basis, and even though the cash was not paid to the patrons in the taxable year. Thus, the non-exempt status, which removes the forced inhibitions of the exempt coopera-

¹ Congressional Joint Committee on Internal Revenue Taxation, Technical Staff Preliminary Report on Tax-Exempt Organizations, December 15, 1945.

² See 471 CCH ¶ 146.539 et seq.

FARMERS' PURCHASING ASSOCIATIONS

Estimated Membership for Specified Years



1936-1937 estimates are based on data collected by the Farm Credit Administration in cooperation with the banks for cooperatives and thirty-three state agricultural colleges

CHART A

RELATIVE ADVANTAGES OF FARMER COOPERATIVES EXEMPT AND NON-EXEMPT FROM FEDERAL CORPORATE INCOME TAX

Non-exempt

1. Must file regular corporate income tax Form (1120).
2. Must pay tax on such taxable income as:
 - (a) Non-operating or extraneous income or capital gains.
 - (b) Reserved operating earnings.
 - (c) All operating earnings not distributed in prescribed manner.
 - (d) All earnings distributed as dividends or interest on capital stock.
 - (e) All earnings done for U. S. A. or its agencies, if not refunded to them.
3. Must purchase and affix excise stamps to certain documents.
4. No Social Security preference.
5. Must maintain each year its legal and corporate basis for excluding refunds from gross income.
6. May pay any rate of dividend or interest on capital shares (but is taxed on amounts so paid or accrued).
7. May have unlimited capital reserves (after income tax thereon is paid).
8. Must maintain patronage records.
9. Owned and controlled by anyone.
10. May operate in part commercially and in part cooperatively.
11. May engage in any type of business.
12. May do business with anyone.
13. Regular two-year carry-over and carry-back provisions on losses.

Exempt

1. Must obtain letter of exemption from Commissioner and then file Form 990 annually.
2. Does not pay such taxes.
 - (a) No tax.
 - (b) No tax, but subject to limitations.
 - (c) Must allocate operating savings to all patrons on a patronage basis.
 - (d) No tax, but subject to limitations.
 - (e) May distribute to all other patrons, or patronage basis.
3. Not required.
4. Have very limited exemption on this tax.
5. Must adhere to requisites for exemption at all times during subject year.
6. Rate is limited to state rate or 8%.
7. Must limit such reserves and allocate them to patrons on patronage basis.
8. Must maintain patronage and allocation records.
9. Must be substantially controlled by producer-patrons.
10. Must operate 100% cooperatively.
11. Must adhere to requisites for exemption.
12. Must adhere to requisites for exemption.
13. More flexible treatment for losses of any year.

tive, is frequently more desirable. However, since it is basic in business finance that reserves and operating capital must be maintained or increased with growth, it becomes necessary to run through the income tax wringer all sums thus retained as required to conduct the business of a non-exempt cooperative. As to the relative advantages and disadvantages of each, see Chart A, above.

Requisites for Exemption

Section 101 (12) sets forth the requisites of organizations which may be given exemption. These may be set forth categorically as follows:

A. The organization must be a farmers', fruit growers', dairymen's or like association organized and operated on a cooperative basis for the purpose of

(1) Marketing the products of members or other producers,

(2) Purchasing supplies and equipment for the use of members or other persons, or

(3) A combination of (1) and (2).

B. The value of products marketed for non-members must not exceed the value of products marketed for members, and the value of purchases of supplies and equipment by persons who are neither members nor producers must not exceed fifteen per cent of the value of purchases by all patrons.

C. In the distribution of patronage dividends member and non-member patrons must be treated alike.

D. Permanent records must be maintained showing the patronage and equity interests of members and non-members.

E. Financial reserves are restricted to those required by state laws or to those which are reasonable and necessary.

F. If the association is organized on a capital share basis, substantially all of the voting stock must be held by members who are currently producing members.

G. Dividend rate on capital shares is limited to the legal rate of interest in the state of incorporation, or eight per cent per year based on the value of the consideration for which the capital share was issued.

H. The association must be organized and operated on a cooperative basis, and its charter must contain no provisions inconsistent with these requisites.

These eight requisites have been extended through interpretation in Section 29.101 (12) and by judicial decision and administrative rulings. The following are important because of the frequent occurrence of the question involved or their implications in the determination of tax status.

Requisite A

FIELDS OF OPERATION

The term "like association" has been construed to include roadside markets or farmers' markets operated by farmers' organizations for the benefit of their members.

"Marketing" operations may include harvesting, hauling, manufacturing, packaging and processing; but these operations are limited in scope to performance by or for such associations as market agricultural products or purchase supplies and equipment for those engaged in producing agricultural products. (*Sunset Scavenger Company*

FARMERS' MARKETING AND PURCHASING ASSOCIATIONS

Number Listed¹ for Specified Years

Period	Marketing	Purchasing
1943-44	7,522	2,778
1941-42	7,824	2,726
1936-37 ²	8,142	2,601
1931-32	10,255	1,645
1925-26	9,586	1,217

¹ Includes independent local associations, federations, large-scale centralized associations and sales agencies.

² Data are from a survey made by the Farm Credit Administration in cooperation with the district banks for cooperatives and thirty-three state agricultural colleges.

v. Commissioner, 84 F. (2d) 453 (CCA-9, 1936) [36-2 USTC ¶9367].)

Supplies and equipment include grain and feed used by farmers in the maintenance and operation of a farm (*Farmers Union Cooperative Association*, 44 BTA 34 [CCH Dec. 11,741]) and also "groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household." Regulation 29.101 (12)-1 (b).)

An exempt association may appoint an individual or other representative to purchase farm products or to sell farm supplies to producers on an agency basis. Here, it is essential that (1) a written contract be executed, (2) prices be determined by the association and (3) patronage refunds be made to the patrons served by the agent. Where an organization is not acting as a mere sales agent for its members, it has been held not to be exempt from income taxes. (*Producers' Creamery Company v. U. S.*, 55 F. (2d) 104 (CCA-5, 1933) [3 USTC ¶867]; see also *Hills Mercantile Company*, 22 BTA 114 [CCH Dec. 6692].)

Requisite B

LIMITATIONS ON VOLUME OF BUSINESS WITH NON-MEMBERS

Marketing activities for non-members are limited to the value marketed for members, while purchases by non-member producers are limited to fifteen per cent of all purchases. Where an association is engaged in both activities, it must determine separately the business in each department, and each department must meet the requirement for exemption.

Division of business between members and non-members must be based on the dollar amount of transactions rather than on unit volume (this differs from basis of patronage refunds; see requisite C). However, any of the following appropriate measures may be used:

1. Purchase value of products purchased from patrons.

2. Net proceeds value of products marketed for patrons.

3. Value of marketing fees or commissions, packaging or other services.

4. Value of supplies and equipment purchased for and turned over to patrons, at purchase cost to association or at price billed to patrons. (*Farm Credit Administration Bulletin No. 53*, November, 1942.)

Requisite C

MEMBERS AND OTHER PATRONS MUST BE TREATED ALIKE

Allocation of savings of exempt marketing and purchasing cooperatives must be made among all patrons according to the proportionate volume of business done by this association with each patron. This allocation may be based on product units or dollar value. All net savings, after provision for limited dividends or capital shares, must be allocated on a patronage basis to all patrons.

Amounts credited to accounts of patrons where no further corporate action was necessary to make these amounts available to patrons, are actual rebates and should not be included in the taxable income of a cooperative association. (*Midland Cooperative Wholesale*, 44 BTA 824 (1941) [CCH Dec. 11,869].)

An exempt association may withhold and retain a non-member patron's prorated share of savings until the retained amounts are equal to the value of a capital or membership share, if the non-member is eligible for membership. (CB XII-1, 122; CB XIII-177.)

Requisite D

PERMANENT RECORDS

Records to meet the permanent requirement should be kept during the life of the association. The Code does not require, however, that the association keep ledger accounts for each producer selling through the association. Any permanent records which show the association was operating

throughout the taxable year on a cooperative basis in the distribution of patronage dividends will suffice. The ledger account, if one is kept, need not show each transaction with its date and detail but may be used merely to record the summarized totals. The actual amounts of savings allocated to each patron each year should be recorded.

Requisite E

FINANCIAL RESERVES

In something less than an affirmative statement on "necessary reserves" the Bureau states in its Regulations:

"Or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption."

Other types of reserves are deemed to come within the "necessary" class: for example, a reserve for uncollectible receivables, a reserve for possible loss from a pending lawsuit or other specifically known contingency, a reserve for educational expenditures, a reserve for cash bond, and also a reasonable reserve for possible future loss years or a reserve for working capital.

Reserves required by state law are expressly permitted and, although not restricted in amounts, must be allocated annually to all patrons.

A reasonable reserve differs in each individual case. It must be kept in mind that, where questioned, the burden of proof of "reasonable and necessary" is on the association. (*Fertile Cooperative Dairy Association v. Huston*, 119 F. (2d) 274 [41-1 USTC ¶9433].)

Requisite F

CAPITAL STRUCTURE

Substantially all capital stock, except non-voting, non-participating (even on dissolution) preferred, must be in the hands of producers who currently market their products or purchase their supplies through the association.

When stock or voting rights are sold originally to non-producers, the Bureau practice permits only a very low tolerance (usually under five per cent). More leeway is given where the non-producer holds by

virtue of a transfer from a producer by inheritance, etc., and the association cannot readily retire or reacquire the stock or rights.

It should be noted that the Regulations emphasize that *active patrons* must hold substantially all of the voting rights or stock (except preferred as above).

Requisite G

DIVIDENDS MUST BE LIMITED

Dividends on capital stock cannot exceed the legal rate of interest in the state of incorporation, or eight per cent based on the actual value of the consideration. For example, when shares are issued at less than par or at "no par," the dividend limitation is calculated on the actual amount paid for the share.

For associations organized without capital stock, the rate limitation applies to the dividend or interest paid or accrued on whatever type of certificate of equity or indebtedness exists.

FARMERS' MARKETING ASSOCIATIONS

Estimated Business in Thousands of Dollars for Specified Years

MARKETING	
1943-44	4,430,000
1939-40	1,729,000
1935-36	1,586,000
1931-32	1,744,000
1925-26	2,265,000

Requisite H

ASSOCIATION MUST BE COOPERATIVE

Exemption is determined by articles of incorporation, constitutions and bylaws, rather than by declarations of officers or the method by which a corporation conducts its business. If activities are confined to cooperative selling for its patrons, but it is granted additional power by its charter, it is not exempt. (I. C. B. 194.)

The legal papers concerned with the formation of the association must show clearly that the association is cooperative or mutual in character. Most states have in effect cooperative acts which, if followed, establish the legal relationship between association and patron required by the federal tax statute.

Strict attention, however, should be given to the federal requisites.

A farmer cooperative company was not exempt solely because it was organized under the Nebraska Cooperative Statute (Revenue Statutes of Nebraska, 1913, Section 733-735) since the requirement that the organization must be organized for stated purposes and operated therefor must be fulfilled. (*Farmers Union Cooperative Company of Guide Rock, Nebraska, v. Commissioner*, 90 F. (2d) 488 (CCA-8, 1937) [37-2 USTC ¶ 9360].)

Administrative Procedure

If a farmer cooperative is to operate under an exemption, it must comply with a special procedure. It must apply on Form 1028, stating in affidavit form the nature and scope of its activities as supported or evidenced by charter and other pertinent documents attached. Form 1028 is to be filed with the appropriate collector's office for transmittal directly to Washington, where, in the Taxpayers' Rulings Section of the Commissioner's Office, this application is processed and reviewed, and approved or rejected. This ruling is usually reserved until one year's financial and operating experience data is available for review. If application is rejected, a special hearing in Washington usually may be arranged. Frequently additional data or clarifications will be demanded by the Commissioner, and these may well be the exact basis for subsequent ruling. If the application is not rejected or tabled for each of a year's experience data, the Commissioner may approve the exemption. He will thereupon issue a Letter of Exemption to the association and may supply the appropriate

collector with a copy thereof, in order that the collector may occasionally observe the conditions upon which the exemption is based and note that the annual information return Form 990 is being filed. This Letter of Exemption, however, gives the association to which it is issued a very tenuous status. It rules merely that on the facts submitted it is the opinion of the Commissioner that an exemption exists. Not only may slight changes in the future serve to terminate this exempt status—and the association is held accountable for reporting any such changes—but the current or past exemption may be revoked merely on the assertion that all relevant factors were not disclosed. Moreover, until recent years no annual return was required although now Form 990 is required annually. Thus, the Statute of Limitations has been held not to be set in motion at all prior to the time Form 990 was required. Although there has been no litigation on the point yet, some are of the opinion that the filing of Form 990 does not start the Statute of Limitations running either. This seems to be unreasonable, but may well be held to be the law. An exempt cooperative may start the Statute of Limitations by filing Form 1120;³ and unless the Treasury soon indicates its stand on this matter, such filing may be the only sure way to remove some of the uncertainties and the precarious status for back taxes which is inherent in the present policy, through future hostility of administration or future hostility in the Taxpayers' Rulings Section itself.

Revised Form 990

Form 990, revised January, 1947, has recently been released. Many of the new questions on the revised form relate exclusively to farmer cooperatives. Question 14 requires a quantitative answer to such inquiries as (1) voting stock holdings of producers and non-producers; (2) sales to, purchases for, patronage dividends to *members*, and also similar figures relating to such *non-member* transactions; (3) of the total produce marketed for *members*, the amount which such *members* did not actually produce, and similar data as to *non-members*; (4) purchases by *members*, non-member producers, and non-member non-producers; (5) amount of business done for federal agencies.

Also a stipulation is required as to whether *non-members* were charged the same as *members* for marketing and merchandise.

³ *Southern Maryland Agricultural Fair Association*, 40 BTA 549 [CCH Dec. 10,816].

Farmer Cooperatives

In view of the foregoing changes it would appear grossly unreasonable to hold that the filing of Revised Form 990 does not start the running of the Statute of Limitations, since all data necessary to determine whether the association's activities qualified it for exemption under 101(12) are now embodied in the return.

Form 990, revised January, 1947, is reproduced at 474 CCH ¶ 6092.

Economic Justification

Cooperatives have enabled the farmer to utilize the efficient marketing in purchasing methods while maintaining his independence as an individual operator. The American agricultural system is built around the individual family type farm. There are over four million members of ten thousand farmers' cooperatives. More than half of the farmers in the United States belong to one or more cooperative associations. These associations provide for the individual farmer a sales and purchasing organization in as such are a considerable part of the farm. The machinery of the cooperative facilities, the economic distribution of products of our farms, dairies and orchards, reduce market blots and shortages; minimize

FARMERS' PURCHASING ASSOCIATIONS

Estimated Business in Thousands of Dollars for Specified Years

PURCHASING	
1943-44	730,000
1939-40	358,000
1935-36	254,000
1931-32	181,000
1925-26	135,000

waste and cost from spoilage; assist in developing grading programs, transportation, and storage services; work toward fair competition and encourage educational progress. These efficient marketing methods benefit the consumer. In the final analysis, they mean better prices, standard quantity and constant supply. This two-way benefit of cooperative marketing works directly toward increasing the standard of living of the whole country and lowering marketing and purchasing cost. For the farmer, it means he has increased buying power for purchase of the manufactured products of the urban centers. This gives increased employment, in addition to the price advantage to the consumer through the lower marketing cost of farm produce. The attempt to tax cooperatives is designed not so much to raise revenue as to eliminate cooperatives as an economic factor.

Much of the attack upon the tax status of farmer cooperatives resolves itself to the charge that businesses burdened with income tax cannot compete. This argument is certainly illogical since income taxes are applicable only to the net income after all business expenses including interest and officer's salaries. *Thus, income taxes have no direct effect on the competitive position but are merely a levy upon the prizes of such activities.* In exempt farmer cooperatives there can be no such profit prize. Furthermore, since most of the competing units would not be corporations, but proprietorships or partnerships, we must hasten to point out that such proprietors or partners are taxed only in the same manner, to the same extent and at the same rates as are the participating members of an exempt farmer

cooperative. Where the members are on an accrued basis, the status is identical; and cost basis members merely allocate the rebates, or patronage dividends, as income possibly to a different year.

Conclusion

Farming is more than an occupation or business; it is a mode of living. Attempts to apply mass production methods under big business operation have, with rare exception, been dismal failures, principally because the initiative and enterprise inherent in individual farm operation are so well suited to farm production, and because the operators value the amenities of their mode of living, as well as the financial return. Yet, with the increased integration and specialization in our economy and the growth in size of single companies in the marketing and distribution field, the farmer must be part of a large marketing mechanism lest his business suffer markedly from buying retail and selling wholesale. The success of farmer cooperatives adequately demonstrates their suitability for this unique function in our economy. To meet the exemption requirements a cooperative must, in truth, be incapable of making a profit. All net proceeds are distributed to patrons, even reserves currently withheld to provide operating funds and necessary equipment. Congress and the Bureau have done an excellent job in frustrating any abuses for tax purposes. It appears, therefore, that no adjustments are required or will be invoked as to Code or Regulation changes.

[The End]