

# Income Taxation of Farmer Cooperatives

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Throughout the legislative history of federal income taxation, the unique characteristics of farmer cooperatives have been recognized by United States lawmakers. There are special regulations governing the income taxation of farmer cooperatives, just as there are special regulations that govern the income taxation of individuals, general corporations and partnerships.

It is only with respect to federal income taxes, however, that a distinction is made between cooperatives and other types of businesses. Farmer cooperatives are subject to all other taxes in the same way as other forms of business.

Above all, it must be remembered that farmer cooperatives *are* subject to corporate income taxes. This has been the case since 1951 when complete exemption from taxation was terminated.

The following pages contain a review of the income tax regulations affecting farmer cooperatives today. Footnotes, citing references on specific areas of concern, are included for those wishing to explore a certain topic in more detail.

## IMPORTANT SECTIONS OF THE CODE

Three sections of the Internal Revenue Code are most important to farmer cooperatives; Sections 501, 521 and Subchapter T (Sections 1381-1388). In addition, some cooperatives are affected by special tax legislation.

*Section 501* exempts several types of cooperatives from income taxation. Discussion of these cooperatives is included with those cooperatives affected by special legislation in a later section.

*Section 521* sets forth the requirements farmer cooperatives must meet in order to obtain and maintain exempt status. These requirements are elaborated in the section on "The Exempt Cooperative."

*Subchapter T*, which was added to the Internal Revenue Code by the Revenue Act of 1962 and amended by Public Law 89-809 in 1966, governs the income taxation of "any organization exempt from tax under section 521" and "any corporation operating on a cooperative basis" other than those subject to special legislation.<sup>1</sup> Basic knowledge about Subchapter T is essential for proper understanding of how farmer cooperatives are taxed.

## SUBCHAPTER T

All organizations qualifying under Subchapter T are permitted to deduct, for purposes of income taxation, amounts paid out as patronage dividends (refunds) and per-unit retain allocations, provided these payments meet the definition of such in the law. Further, in order to be deductible, these payments must be made in either (1) money, (2) property or (3) "qualified written notices of allocation." Amounts paid in money or property to redeem "non-qualified" allocations are also deductible in the year such redemption is made.<sup>2</sup>

## Form of Payment

A "qualified" notice of allocation or per-unit retain certificate is a document which the distributee has consented to accept as income at its stated dollar amount. In the case of a "qualified" notice of patronage dividend, at least 20 percent of the total amount must be paid in cash or with a qualified check.<sup>3</sup>

Payments made in a "nonqualified" form are not deductible from the cooperative's taxable income. "Qualified" allocations are taxable to the patron while "nonqualified" allocations are taxable to the cooperative. A deduction for "nonqualified" allocations may be taken by the cooperative when the allocations are redeemed in cash or property.

## Time of Payment

Cooperatives are permitted 8½ months, after the close of their fiscal year, to distribute allocations attributable to that year's business. If allocated after this date, the payments are not deductible from their taxable income.<sup>4</sup>

## Reporting Requirements

Every cooperative subject to Subchapter T that makes payments of \$10 or more to any person during any calendar year must file a return with the Internal Revenue Service setting forth the amount of such payments and the name and address of the person to whom payments are made. A statement of the information on this return must also be sent to each person for whom a return is filed.<sup>5</sup>

## Additional Provisions

A cooperative exempt under Section 521 of the Internal Revenue Code is allowed two additional deductions under Subchapter T. These are for amounts paid as dividends on capital stock and nonpatronage income allocated on a patronage basis. These amounts are subject to the same requirements, concerning form of payment, as are patronage dividends.<sup>6</sup>

## THE EXEMPT COOPERATIVE

Farmer cooperatives complying with Section 521 of the Internal Revenue Code of 1954 are known as "tax exempt" or exempt cooperatives. Such associations are taxed in accordance with the provisions of Subchapter T of the Internal Revenue Code.

## Three Deductions

By qualifying for exempt status, a farmer cooperative is entitled to three deductions under Subchapter T: (1) Patronage refunds and per-unit retain allocations, (2) Dividends paid on capital stock and (3) Nonpatronage income which is allocated to patrons on a patronage basis.<sup>7</sup> Thus, an exempt cooperative could conceivably have no taxable income after the three allowed deductions, provided all such amounts are paid or allocated in the proper form and within the proper time.

## Filing Period

Exempt status farmer cooperatives have 8½ months following the close of their fiscal year to file their income tax returns. They must also satisfy the reporting requirement concerning payments of \$10 or more to any person in any calendar year.

## Five Requirements for Exempt Status

Section 521 of the Code is reproduced on page 4 for reference. This section contains five requirements that must be satisfied for exempt status.<sup>22</sup>

*First*, exemption applies only to "farmers, fruit growers or like associations organized and operated on a cooperative basis." The association must be marketing and/or purchasing cooperative, ultimately turning back all net proceeds to member and non-member patrons on the basis of quantity or value of business conducted by each with the association.<sup>8</sup>

*Second*, although exempt cooperatives are allowed to be organized with capital stock, the dividend rate on such stock must not exceed the legal rate in the state where incorporated or 8 percent per annum, whichever is greater. In addition, substantially all such stock (other than nonvoting preferred) must be owned by producers who market their products or purchase their supplies through the association.<sup>9</sup>

*Third*, reserves accumulated and maintained by an exempt association must either be required by state law or for a necessary purpose.<sup>10</sup>

*Fourth*, the value of products marketed by an exempt cooperative for nonmembers must not exceed the value of products marketed for members. Likewise, the value of supplies purchased for persons who are neither members nor producers must not exceed 15 percent of the value of all the cooperative's purchases.<sup>11</sup>

*Fifth*, business done by a cooperative for the United States government or any of its agencies is disregarded in determining an association's right to exempt status.<sup>12</sup>

## Application

Exempt status is granted by the Internal Revenue Service after application and is not automatic. An association applying for exempt status must file a Form 1028 (exemption application). After being granted exempt status an organization uses a Form 990-C to file its income tax return.

Exempt cooperatives are not permitted to file a consolidated tax return. Therefore, exempt status farmer cooperatives that own subsidiary corporations must file separate returns for each business enterprise. Nonexempt cooperatives may file a consolidated return if they so elect.<sup>13</sup>

## Equal Treatment

Exempt status associations must afford equality of treatment to all patrons.<sup>14</sup> This requirement applies not only to patronage dividend distributions,<sup>15</sup> but to other activities as well.<sup>16</sup> Thus, an exempt

status association is not permitted to discriminate between member and nonmember patrons in any way.

## THE NONEXEMPT COOPERATIVE

A nonexempt status cooperative is a cooperative which does not satisfy the requirements set forth in Section 521 of the Internal Revenue Code of 1954. In general, any organization not complying with Section 521 of the Code holds nonexempt status. For purposes of federal income taxation, a nonexempt organization need not be agriculturally oriented, nor is it even required to be legally organized as a farmer cooperative.

### One Deduction

Nonexempt status farmer cooperatives are subject to regular corporate income taxes with one exception. If they qualify under Subchapter T of the Internal Revenue Code of 1954, their "patronage refunds" and "per-unit retain" allocations are deductible from taxable income. In order to be deductible, these amounts must be allocated in the proper form and within the proper time.

To qualify for Subchapter T, a nonexempt association must "be operating on a cooperative basis and allocate amounts to patrons on the basis of the business done with or for such patrons."<sup>17, 28</sup> Subchapter T clearly recognizes nonexempt associations.<sup>18</sup> Prior to enactment to Subchapter T in 1962 the only statutory reference to nonexempt organization was oblique.

### Requirements for Nonexempt Status

For purposes of federal income taxation, nonexempt organizations, unlike those maintaining exempt status, are under no limitations concerning stock ownership, dividend rates, membership or business transactions with nonmembers. The only requirements a nonexempt cooperative must satisfy are those imposed by the statutes under which it is incorporated. Since corporate statutes are under state jurisdiction, these statutes are not necessarily uniform throughout the United States.

### Unequal Treatment

Since a nonexempt cooperative is not required to treat all patrons equally, a nonexempt cooperative can make patronage refund distributions to members only. This practice is recognized by the Internal Revenue Service. Any income from business with nonmembers is taxable to the nonexempt cooperative unless properly allocated to the nonmembers.<sup>19</sup>

### Filing Period

Nonexempt cooperatives are required to file their income tax returns (Form 1120) within 3½ months following the end of their fiscal year. They are permitted 8½ months for this purpose only if they are under obligation to allocate or pay at least 50 percent of their net patronage earnings in patron-

age dividends, or if they have actually allocated or paid at least that percentage of their earnings in patronage dividends during the last year in which they had such earnings.<sup>20</sup>

## STATUS OF OTHER FARMER COOPERATIVES

### Section 501

Section 501 (c)<sup>21</sup> of the Internal Revenue Code of 1954 contains a list of organizations which are exempted from federal income taxation. Paragraphs 12, 15 and 16 of Section 501 (c) are important to farmer cooperatives.

Paragraph 12 of Section 501 exempts "benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies or like organization . . ." In order to comply with this paragraph, at least 85 percent of an organization's income must come from members for the sole purpose of meeting losses and expenses.

Rural electric cooperatives are not specifically mentioned in Section 501 (c) as they were not yet in existence when this section of the Internal Revenue Code was written. By administrative interpretation, however, rural electric cooperatives have been granted exemption under this paragraph provided they are "like" a mutual telephone company in character and meet the other requirements of this paragraph.

Refunds received by consumer patrons from rural electric cooperatives are not taxable as they represent a reduction in electric rates. Farmers and other businessmen are liable for tax on the portion of their refund applicable to their farming operation or business.

Rural electric cooperatives are not required to comply with Subchapter T of the 1954 Code.

Farmer mutual insurance companies or associations may obtain exemption by qualifying under paragraph 15 of Section 501. This paragraph provides exemption for "mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from . . . (interest, dividends, rents) . . . and premiums does not exceed \$150,000."

Paragraph 16 of Section 501 provides exemption for corporations organized for the purpose of financing crop operations and operated in conjunction with organizations which qualify under Section 521. Such a corporation must meet many of the requirements applicable to Section 521, in order to obtain exemption.

### Production Credit Association

Production credit associations were exempt from federal income taxation while the federal government owned any of their capital stock. Such exemption was granted them by the Farm Credit Act of 1933.

Because all government capital has been repaid, all the associations are now taxable as regular corporations. The associations are allowed to deduct the savings they refund to their patrons, provided they are under prior contractual obligation to do so. Whenever patronage refunds are allocated in a non-cash form, the association must comply with Subchapter T of the Internal Revenue Code in order for the refunds to be deductible from taxable income.

## Banks for Cooperatives

Banks for cooperatives were also exempt from income taxation as long as they had any government capital. Now that all government capital is retired, the banks are subject to income taxes. However, interest refunds paid to cooperative borrows are deductible from the banks' taxable incomes. Member borrowers of the banks include patronage refunds as a reduction in interest costs.

## Federal Land Bank Associations

The Federal Farm Loan Act of 1916 exempted federal land bank associations from paying federal, state, municipal and local income taxes. The language of this act indicates that federal land bank associations are considered instrumentalities of the United States even though they no longer contain any government capital. If complete exemption is ever terminated, indications are that federal land bank associations will become taxable in the same way as are production credit associations.

## REFERENCES

- <sup>1</sup> Internal Revenue Code of 1954, Sec. 1381 (a).
- <sup>2</sup> Internal Revenue Code of 1954, Sec. 1382 (b).
- <sup>3</sup> Internal Revenue Code of 1954, Sec. 1388 (c), (h).
- <sup>4</sup> Internal Revenue Code of 1954, Sec. 1382 (d).
- <sup>5</sup> Internal Revenue Code of 1954, Sec. 6044 (a), (b), (e).
- <sup>6</sup> Internal Revenue Code of 1954, Sec. 1982 (c).
- <sup>7</sup> Internal Revenue Code of 1954, Sec. 1382 (c).
- <sup>8</sup> Internal Revenue Code of 1954, Sec. 521 (b) (1).
- <sup>9</sup> Internal Revenue Code of 1954, Sec. 521 (b) (2).
- <sup>10</sup> Internal Revenue Code of 1954, Sec. 521 (b) (3).
- <sup>11</sup> Internal Revenue Code of 1954, Sec. 521 (b) (4).
- <sup>12</sup> Internal Revenue Code of 1954, Sec. 521 (b) (5).
- <sup>13</sup> William H. McCullough, "Cooperatives, Exempt or Non-exempt," (paper presented at Summer Session Program of the American Institute of Cooperation, Blacksburg, Virginia, August 5, 1968), p. 21
- <sup>14</sup> Internal Revenue Code of 1954, Sec. 521 (b) (1).
- <sup>15</sup> Treas. Reg. 1.521-1 (a) (1).
- <sup>16</sup> 119 F. 2d 274 (8th Cir. 1941), *Farmers Union Coop. Oil Co.*, 38 B.T.A. 64 (1938) and S.M. 2595, III-2 Cum. Bull. 238 (1924).
- <sup>17</sup> Treas. Reg. 1.1381-1 (2).
- <sup>18</sup> Treas. Reg. 1.1388-1 (a) (2).
- <sup>19</sup> Treas. Reg. 1.1388-1 (a) (2) (ii).

<sup>20</sup> Raymond J. Mischler, "How the Revenue Act of 1962 Affects Farmer Cooperatives." *Farmer Cooperative Service General Report 105*, (Washington, D.C.: United States Department of Agriculture, 1962), pp. 4-5. 26 CFR 1.388-1.

<sup>21</sup> 68 A Stat. 165.

<sup>22</sup> 1969 Internal Revenue Bulletin No. 46 at 13, Nov. 17, 1969, 26 CFR 1.521-1.

<sup>23</sup> 1969 Internal Revenue Bulletin No. 46 at 13, Nov. 17, 1969,

## APPENDIX

Section 521 of the Internal Revenue Code of 1954 provides as follows:

Sec. 521. Exemption of farmers' cooperatives from tax;

(A) Exemption from tax.—A farmer's cooperative described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in Section 522. Notwithstanding Section 522, such an organization shall be considered an organization exempt from income taxes.

(B) Applicable rules.

(1) Exempt farmer's cooperatives.—The Farmers' cooperatives exempt from taxation to the extent provided in subsection. (A) are farmers', fruit growers' or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) Organizations having capital stock.—Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) Organizations maintaining reserve.—Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) Transactions with nonmembers.—Exemptions shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products, marketed for members, or which purchases supplies and equipment for nonmembers, in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members or producers does not exceed 15 percent of the value of all its purchases.

(5) Business for the United States.—Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.