

AGRICULTURAL GUIDE

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Cooperatives

How agricultural cooperatives are taxed

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Many Missouri farmers are members of locally owned or regional agricultural cooperatives. Cooperatives are unique in that the owners are also the patrons of the business. The cooperative's purpose is to provide marketing or supply services to its farmer-owners. Farmers act collectively in this manner to get better terms of trade for their products and to provide themselves services and supplies at cost. Cooperatives often implement the cooperative principle of "service at cost" by refunding earnings to patrons.

It is important that agricultural producers know how cooperatives are taxed, because taxation affects the amount and type of refund distributed. The cooperative's goal is to enhance the financial well-being of its owners as *producers*, not as investors. Thus, a cooperative is appropriately viewed as an extension of a producer-owner's farming operation. This concept is crucial to understanding how the Internal Revenue Code applies to farmer cooperatives.

The development of cooperative tax law represents attempts over the past few decades to bring together a set of tax rules that reflects the reality of the cooperative business world. The principle sources of cooperative tax law are located in the Internal Revenue Code, which we will call the "Code" in this guide. The sections covering cooperative taxation are Section 521 and Sections 1381-1833 in Subchapter T of the Internal Revenue Code. Corresponding Treasury Regulations are 1.521 and 1.1381-1.1388.

This guide presents an overview of how agricultural cooperatives are taxed. Always seek competent tax and legal counsel for specific advice.

tain deductions from otherwise taxable cooperative income. The co-op can take deductions if it meets certain Code requirements. The way in which the co-op distributes net margins also determines allowable deductions. Cooperative net margins may be distributed as cash patronage refunds, noncash patronage refunds, dividends on capital stock, and unallocated equity. This guide discusses each of these distribution methods and the requirements necessary for allowable deductions. It also analyzes their tax effect on a cooperative and its patrons.

Cash patronage refunds

Cash patronage refund distribution is the most direct way cooperatives implement the principle of service at cost. The amount of the cash patronage refund distributed is generally based on how much business



Deductions allowed

Cooperatives are taxed just as any other business corporation is taxed, except that the IRS allows cer-

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the member conducted with the cooperative during the fiscal year. If the cooperative meets Code requirements, it may deduct the cash patronage refund from its net income in the year in which the income was earned. The patron must include the patronage refund in his or her taxable income in the year he or she receives it.

The co-op must determine cash patronage refund on the basis of the quantity or value of business done with or for the patron. The refund must be made under the co-op's obligation to pay the amount according to provisions within a contract with the patron, the cooperative's bylaws, or state law.



Noncash patronage refunds

Cooperatives also implement the principle of service at cost by distributing a portion of net income to patrons through noncash patronage refunds. The cooperative retains the actual dollar amount by distributing net margins to its equity account. It allocates this net income to patrons based on the proportionate amount (dollar or physical quantity) of business the patron conducts with the cooperative. This equity in the cooperative is called "allocated savings" or "allocated equity." In a subsequent year, the cooperative will redeem these allocations to patrons in cash. In this manner, the cooperative maintains necessary equity financing but still allocates net savings to patrons.

Noncash patronage refunds usually take one or both of two forms: qualified notices of allocation and nonqualified notices of allocation. The Code treats each differently.

Qualified notices of allocation

If a cooperative meets certain requirements in the Code, it may issue noncash patronage refunds in the form of "qualified" notices of allocation. The cooperative may deduct the dollar amount represented by this notice from net income for the year in which it earned the income. This is called a "current deduction." The patron who receives a qualified notice of allocation must include the dollar amount in his or her taxable income for the year in which he or she received the notice.

Co-ops must meet several requirements before written notices of allocation are "qualified" and, hence, tax deductible in the year the income was earned. First, the co-op must pay at least 20 percent of the amount of the allocation in money or by

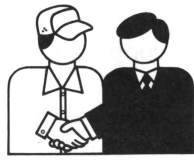
qualified check. The Congressional intent surrounding the 20 percent figure was twofold: (1) It emphasizes that the full amount of the refund, both cash and noncash, was taxable to the patrons, and (2) It provides the patrons with cash so they can meet the additional tax liability associated with recognizing the full amount of the patronage allocation as income.

Second, the co-op must meet one of two additional conditions. Either the patron must have an opportunity to cash the refund in total within 90 days after the allocation is made, or the patron must consent to have the allocation treated as having been distributed to and received by him and then reinvested back into the cooperative.

By consenting to this treatment, the patron, in effect, agrees to include in the current year of allocation the total face amount of his or her patronage refunds in his or her gross income as ordinary income. The patron may consent in any of three ways. (1) The patron may agree in writing. (2) If the co-op bylaws so state, membership in the cooperative in and of itself establishes consent. The member must receive a written notification of allocation and a copy of the bylaw. (3) If the patron endorses and cashes a qualified check he gives consent. By consenting, the patron is viewed as having received the total amount of the refund (cash and noncash) and has reinvested the noncash portion on a voluntary basis. The patron must include the total amount of the refund, cash and noncash, in his or her taxable income for the year he or she receives it.

Nonqualified notices of allocation

When the cooperative fails to meet the requirements for issuing qualified notices of allocation, it issues noncash patronage refunds in the form of "nonqualified" notices of allocation. The cooperative must include the face amount of the nonqualified allocation in its taxable income in the year of allocation. However, in a subsequent year when the allocated savings represented by the nonqualified notice are revolved out or redeemed in cash to the patron, the cooperative may treat this equity redemption in either of two ways for income tax purposes. The cooperative may calculate its tax in the year of equity redemption as the lesser of: (1) the tax for the redemption year calculated with the face amount of the equity redeemed as a deduction from taxable income, or (2) the tax for the redemption year calculated without the deduction in instance 1, less the reduction in tax for any previous year(s) if the nonqualified notices of allocation had, in those prior years, instead been qualified notices of allocation. In the year in which the allocated equity represented by nonqualified notices of allocation is redeemed, the patron must include the face amount in his or her taxable income.



Section 521

If a cooperative meets certain requirements in Section 521 of the Code, it is allowed further deductions from otherwise taxable income. The criteria for such treatment are as follows:

1. The organization must be a farmer, fruit grower, or like association organized and operated on a cooperative basis. It must *market* the products of members and other producers, and return the proceeds to them after deducting marketing expenses. Or it must *purchase* supplies and equipment for members' or others' use, and transfer the supplies and equipment to them at actual cost, after adding any expenses.

2. If the cooperative is organized as a capital stock cooperative, producers who market their produce or purchase their supplies and equipment through the cooperative must own most of the co-op's stock. This restriction does not apply to nonvoting preferred stock.

3. The dividend rate of the co-op's capital stock must not exceed the legal rate of interest in the state in which it is incorporated or 8 percent per annum, whichever is greater. In Missouri, the allowed dividend rate is 10 percent.

4. Financial reserves cannot exceed those required by state law or those maintained for a necessary purpose.

5. Business with nonmembers cannot exceed that with members and purchasing for nonmembers and nonproducers cannot exceed 15 percent of the value of all of the cooperative's purchases.

6. The cooperative must maintain permanent records of the patronage and equity interests of all members and nonmembers.

7. The cooperative must treat nonmembers the same as members regarding pricing, pooling, or payment of sales proceeds; pricing supplies and equipment; charging service fees; or *allocating patronage refunds to the accounts of all patrons.*

8. Although the Code does not specifically address them, federated cooperatives must apply a "look through" principle. The structure and activities of each member cooperative are viewed in determining whether the federated cooperative qualifies for Section 521 status.

Once a cooperative meets these requirements, it is called a 521 cooperative and is allowed certain additional deductions from its otherwise taxable income. These deductions are:

1. amounts paid during the taxable year as dividends on its capital stock; and,

2. amounts paid during the payment period for taxable year on a patronage basis to patrons from earnings derived from nonpatronage business, such as rent, interest, etc., or amounts paid in redemption of nonqualified written notice of allocation on a patronage basis to patrons from earnings derived from nonpatronage business.



Unallocated equity

Net margins not distributed to patrons are distributed to a co-op equity account called "unallocated savings" or "unallocated equity." This is equity that will not be redeemed in cash to patrons in the future. These net margins are fully taxable at corporate tax rates.

A non-521 cooperative may pay patronage refunds to all patrons or only to member-patrons. If earnings from nonmember business are not returned to nonmember patrons on a patronage basis, the cooperative pays corporate income tax on these earnings. Typically, nonmember earnings not distributed as patronage refunds are distributed to unallocated equity.

Often, cooperatives will distribute net margins as nonqualified notices of allocation and to unallocated equity to purposely create a potential tax liability that can be substantially charged off through investment tax credits.

Examples

Because of the complexity of Code treatment of cooperative income, it is helpful to illustrate agricultural cooperative taxation with numerical examples. Below are three examples.

1.

Situation: Non-521 Cooperative. Only Qualified Notices of Allocation for noncash patronage refunds.

Net Margins Before Refunds and Tax:	\$150,000
Net Margins Earned from Business with Patrons:	\$125,000
Cash Patronage Refunds:	\$ 30,000
Noncash Patronage via Qualified Notices:	\$ 70,000
Cooperative Taxable Income Calculated as Follows:	

\$150,000	Total Net Margins before Distribution and Taxes
-\$ 30,000	Cash Patronage Refunds
-\$ 70,000	Noncash Patronage via Qualified Notices
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\$ 50,000	Taxable Cooperative Income

In this example, the cooperative has net margins of \$150,000 before patronage and taxes. Of this income, \$125,000 was earned from patronage. The cooperative makes a \$30,000 distribution as cash patronage refunds and a \$70,000 distribution as qualified notices of allocation. Note that the 20 percent minimum cash requirement is met ($\$30,000 / [\$30,000 + \$70,000] = 30\%$) for qualifying the notices of allocation. The cooperative may deduct both the \$30,000 and \$70,000 from its \$150,000 net income, giving taxable income to the cooperative of \$50,000. The after-tax remainder of this \$50,000 is distributed to unallocated equity.

Patrons receiving the cash patronage refunds and the qualified notices must include such face amounts in their taxable income in the year they receive the distribution.

2.

Situation: Non-521 Cooperative, Cash Patronage Refunds, Qualified Notices of Allocation Issued, Nonqualified Notices of Allocation Issued and Redeemed, and Capital Stock Dividends.

Net Margins Before Taxes and Distribution	\$150,000
Cash Refunds Paid	\$ 20,000
Qualified Notices of Allocation Issued	\$ 60,000
Nonqualified Notices of Allocation Issued	\$ 40,000
Nonqualified Notices of Allocation Redeemed	\$ 20,000
Capital Stock Dividend Paid	\$ 10,000
Cooperative Taxable Income or Tax Calculated as Follows:	

(1)

\$150,000	Net Margins before Taxes and Distribution
-\$ 20,000	Cash Refunds Paid
-\$ 60,000	Qualified Notices of Allocation Issued
-\$ 20,000	Nonqualified Notices of Allocation Redeemed
<hr/>	
\$ 50,000	Cooperative Taxable Income

Alternatively, cooperative tax liability may be calculated in this manner:

(2)

\$150,000	Net Margins before Taxes and Distribution
-\$ 20,000	Cash Refunds Paid
-\$ 60,000	Qualified Notices of Allocation Issued
<hr/>	
\$ 70,000	

× tax rate

= Initial tax liability

- Decrease in tax in year nonqualified notices were issued if instead they had been qualified notices of allocation

= Cooperative tax liability for current year

In this example, because nonqualified notices of allocation are redeemed, the tax liability of the cooperative may be calculated in two different manners.

(1) The face amount of the cash patronage refunds and the qualified notices of allocation issued (\$20,000 and \$60,000) may be deducted from Net Margins Before Taxes and Distribution. The face amount of nonqualified notices of allocation (\$20,000) redeemed for cash to patrons may be deducted, also giving taxable income of \$50,000 to the co-op. Because this is a non-521 co-op, the capital stock dividends can't be deducted from the co-op's taxable income.

(2) As in (1), the cash patronage refund and face amount of the qualified notices of allocation may be

deducted so that \$70,000 remains. Tax on this amount is now calculated. This tax liability may then be decreased by the amount of tax the cooperative would not have paid in the year in which the redeemed nonqualified notices were distributed had they instead been qualified notices of allocation.

Cooperative patrons shall include in their taxable income the amount of nonqualified notices of allocation redeemed to them in cash in the year of receipt in addition to the cash patronage refunds and qualified notices of allocation received by them.

3.

Situation: 521 Cooperative, Cash Patronage Refunds, Qualified Notices of Allocation Issued, Nonqualified Notices of Allocation Issued, Nonqualified Notices of Allocation Redeemed, Capital Stock Dividends Issued.

Net Margins before Distribution and Tax	\$150,000
Cash Patronage Refunds	\$ 20,000
Qualified Notices of Allocation Issued	\$ 60,000
Nonqualified Notices of Allocation Issued	\$ 40,000
Nonqualified Notices of Allocation Redeemed	\$ 40,000
Capital Stock Dividends Issued	\$ 10,000

Cooperative taxable income or tax may be calculated in either of the following two manners:

(1)

\$150,000	Net Margins before Taxes and Distribution
-\$ 20,000	Cash Patronage Refunds
-\$ 60,000	Qualified Notices of Allocation Issued
-\$ 40,000	Nonqualified Notices of Allocation Redeemed
-\$ 10,000	Capital Stock Dividends Issued
<u>\$ 20,000</u>	Taxable Income

(2)

\$150,000	Net Margins before Taxes and Distribution
-\$ 20,000	Cash Patronage Refunds
-\$ 60,000	Qualified Notices of Allocation Issued
-\$ 10,000	Capital Stock Dividends Issued
<u>\$ 60,000</u>	
× tax rate	
=	Initial Tax Liability
-	Decrease in tax in year nonqualified notices were issued if instead they had been qualified notices of allocation
<u>=</u>	Tax liability in current year

The taxable income and income tax is calculated in this example as in Example 2 with the exception that the capital stock dividends are deductible because this is a Section 521 cooperative.



Summary and conclusions

The agricultural cooperative is appropriately viewed as an extension of the producer-members' own farming operations. A cooperative operates at cost by funneling earnings to its patrons. That way, the cooperative has no real income to be taxed. As such, patrons should realize these cooperative earnings are taxable income. However, because cooperatives retain earnings for equity financing, and because the Code imposes requirements to ensure co-ops follow cooperative principles, the question, "What cooperative income is taxable?" can become quite complex.

Generally, cash patronage refunds and the face amount of qualified notices of allocation are deductible from the cooperative's net margins in the year they are earned. They are taxable to the patron in the year the refunds are received. Patronage refunds distributed through nonqualified notices of allocation

can be included as cooperative taxable income in the year distributed. They are deductible, however, from a cooperative's taxable income in a subsequent year when the refund is redeemed to the patron. The patron treats the patronage refund evidenced by the nonqualified notice of allocation as taxable income in the year in which the refund is redeemed.

Whether a cooperative can or desires to meet the requirements for "qualifying" its written notices of allocation is a decision that should be made in light of what best meets the needs of the cooperative as a business and of the members as producers. Each has different tax consequences. It is allowable to qualify a portion of an allocation and not the remainder. The decision to "qualify" or "nonqualify" will depend on the cash needs and tax rates facing the cooperative and its members at the time of distribution.

A more exhaustive discussion of cooperative taxation is contained in "Legal Phases of Farmer Cooperatives, Part II - Federal Income Taxes," FCS Information 100, pp. 354 et seq. For a copy of this publication write to:

Agricultural Cooperative Service
U.S. Department of Agriculture
Washington, DC 20250