**Cooperative Taxation**

**Phil Kenkel**

**Bill Fitzwater Cooperative Chair**

Sub-Chapter T

Any corporation or LLC “operating on a cooperative basis” can be taxed under Sub Chapter T of the Internal Revenue Code. Sub Chapter T does not apply to mutual savings banks, mutual insurance companies, or rural electric or telephone cooperatives. All of those organizations are taxed under separate special sections of the IRS code. Consumer and retail cooperatives are taxed under Sub Chapter T. The taxation classification of a cooperative business is separate from its incorporation status. For that reason, a LLC or corporation operating on a cooperative basis can be taxed under Sub Chapter T while an entity incorporated as a cooperative would not qualify if it did not distribute patronage based on use and follow the other principles of operating on a cooperative basis.

The basic rationale of Sub-Chapter T and cooperative taxation is that the cooperative is an extension of the patrons who own the cooperative. Sub-Chapter T allows a cooperative corporation, in addition to making deductions for expenses allowed by other businesses, to also deduct certain distributions of net income made to the members. Those distributions become taxable income to the member. Consequently the net income is only taxed once. In some cases the taxation is immediately passed on to the patron and in some cases the income is taxed at the cooperative level and then the cooperative receives a tax deduction and the member accepts the taxation for that income in a future period of time. Profits from non-member business cannot be distributed as patronage under the general provisions of Sub-Chapter. Cooperatives pay taxes on non-member profits and any undistributed member profits at the general corporate rate. Sub-Chapter T also includes Section 521 of the code which describes the requirements for a more restrictive form of cooperative termed a Section 521 cooperative. Section 521 cooperatives (which are discussed in a later section) must distribute profits to non-members but are also allowed to deduct that non-member profit distribution.

Patronage Refunds

Sub-Chapter T allows cooperative to exclude patronage refunds and per-unit retains from their taxable income. Patronage refunds are profit distribution made to the patron on the basis of business volume. That business volume can be calculated on the basis of quantity or value and can be separated by product or department or pooled. The IRS used the term “patronage dividends” but most cooperative scholars prefer the term “patronage refund” to avoid confusion with a dividend made on the basis of stock ownership. Non-member profits and earnings not based on the use of the cooperative (such as a gain from the sale of an asset) cannot be distributed as a patronage refund. Patronage refunds can be in the form of cash or equity. When patronage is distributed in the form of equity it is typically called a retained patronage distribution or a stock patronage refund.

Qualified versus Non-qualified

The term “qualified” refers to whether the patronage distribution is tax deductible to the cooperative in the current year. Cash patronage refunds are always qualified. Cash patronage is therefore tax deductible to the cooperative and taxable income to the patron in the year it is distributed. Retained patronage refunds (stock patronage refunds) can be either qualified or non-qualified. A qualified stock patronage refund is taxable to the cooperative and tax deductible to the member in the year it is distributed. A non-qualified stock patronage refund is tax deductible to the cooperative and tax deductible to the member in the year it is redeemed. When issuing non-qualified retained patronage the cooperative pays taxed on that income in the year of distribution and then gets a tax deduction in a later year when the equity is redeemed. The taxation is ultimately transfer to the patron but the timing is shifted to match the cash payment rather than the stock distribution.

In order for a cooperative to make a qualified patronage distribution (cash or stock) it must be

(1) made within 8 months from the end of tax year in which in the income occurred,

(2) the member must receive written notice of allocation,

(3) at least 20% of the total distribution must be in the form of cash and

(4) the member must consent to include the patronage on their tax return as ordinary income.

The rationale for the 20% cash rule is that the member should have enough cash to pay the taxes on the stock patronage received. Many producers have effective tax rates above 20% and would still be in a negative cash flow position if they received a 20% cash and 80% qualified stock patronage refund. For that reason, most agricultural cooperatives try to pay more than 20% cash. Not that the 20% cash requirements applies to qualified stock distributions. There is no cash requirement associated with a non-qualified stock patronage refund. The patron consent requirement is typically satisfied by having the patron sign an agreement as part of the membership application or is specified as part of endorsing and cashing a qualified check.

If the cooperative does not meet any of the requirements for a qualified distribution or chooses not to classify the distribution as qualified it becomes a non-qualified distribution. Because cash patronage is always qualified it is only the stock portion of the patronage refund that could be structured as non-qualified. Non-qualified patronage distributions cannot be deducted in the year they are issued but the cooperative can deduct the redemption of non-qualified stock. That non-qualified redemption becomes taxable income for the patron in the redemption year.

Historically, most agricultural cooperatives distributed patronage in combinations of cash and qualified stock. That stemmed from the historic situation where producers faced low tax rates while the corporate tax rate was much higher. That made it logical to shift the tax to the patron’s lower tax rate immediately rather than “park the tax payment” with the cooperative until the time of equity retirement. The Tax Cuts and Jobs Act of 2017 substantially reduced the corporate income tax from a maximum of 37% to a flat rate of 21%. That resulted in cooperatives having lower tax rates relative to most of their patrons. I have done substantial research and simulations involving represented cooperatives and have research illustrating the fact that non-qualified distribution maximize the member’s return from the cooperative. At the request of the National Council of Farmer Cooperatives, our academic group of cooperative specialists conducted national workshops and webinars on this subject. That effort led to a national award from the American Agricultural Economics Association for Outstanding Group Extension Program. Currently we are seeing more interest in non-qualified distributions and more agricultural cooperatives are shifting to non-qualified.

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| Comparison of Tax and Timing of Tax on Cooperative and Patron from Qualified and Non-qualified Stock Patronage |
|  | Cooperative | Patron |
|  | Qualified | Non-Qualified | Qualified | Non-Qualified |
| Income before patronage | $100 | $100 |  |  |
| Cash Patronage | $20 | $20 | $20 | $20 |
| Stock patronage | $80 | $80 | $80 | $80 |
| Taxable income | $0 | $80 | $100 | $20 |
| Tax | $0 | $16.8 | $21 | $4.20 |
| Redemption year |  |  |  |  |
| Redemption | $80 | $80 | $80 | $80 |
| Taxable income + or deduction - | $0 | -$80 | $0 | +$80 |
| Tax effect | $0 | -$16.8 | $0 | $16.2 |
| Final tax paid | $0 | $0 | $21 | $21 |
| For simplicity a 21% tax rate is assumed for both the cooperative and patron |

Per-Unit Retains

A per-unit retain is an deduction of an amount of equity from a unit of commodity marketed. Some marketing cooperative operate as pooling cooperatives. All of the commodity delivered by the patrons are pooled and then processed, packaged and marketed by the cooperative. The patrons often receive an intermediate payment to cover their production expense and then receive a final distribution when all of the commodity is sold and the pool is closed. While one can think of the intermediate payment as a commodity payment and the final payment as patronage there is really no dividing line because there is no defined price for the commodity. Pooling cooperative therefore do not have patronage and cannot make retained patronage distributions (stock patronage). The per-unit retain is an alternative means for the cooperative to create equity. Per-unit retains differ from retained patronage in that they are based solely on the units of commodity handled and not on profits. Per-unit retains can be qualified or non-qualified and can be revolved under the same types of systems as retained patronage. The 20% cash patronage rule does not apply to a qualified per-unit retain.

When cooperatives make payments to the members under the per-unit retain system is it termed a “per-unit retain paid in money” or ‘PURPIM. The PURPIM structure was once unique to specialty crop pooling payments. In recent years, tax deductions including the Domestic Production Activities Deduction (DPAD) and Section 199A have been available to marketing cooperatives. The tax deduction are based on the minimum of 20% of qualified income or 50% of W-2 wages. Because a cooperative that distributed all of its income to members as patronage would not have taxable income, the tax credit calculations allowed the cooperative to calculate patronage income before patronage. That structure was extended to pooling cooperatives allowing them to calculate income before PUPPIM payments. After examining that structure, many grain cooperatives began classifying their purchases of grain from producers as PURPIMs instead of as purchases. That allowed them to calculate their tax deduction income without reflecting the commodity purchase as a cost of goods sold which resulted in significantly higher tax deductions. The Section 199A tax deduction has therefore made the payment aspect of the per-unit retain structure much more prevalent. The availability of the tax deduction has also increased interest in nonqualified patronage since the cooperative can offset the cooperative level tax with the tax deduction.

Section 521 Cooperatives

Sub-Chapter T also contains provisions for a more restrictive form of cooperative designated a Section 521 cooperatives. These cooperatives are sometimes termed “exempt” cooperatives but that term is misleading because they are only exempt from some forms of taxation. In order to qualify for Section 521 a cooperative must: Be a farmer or fruit grower cooperative operated on a cooperative basis and involved in marketing farm products and/or providing farm supplies and equipment

1. 85% of the capital stock must be owned by producers who market or purchase from the cooperative in the current year (85% stock owned by active producers)
2. Dividends on capital stock are limited to 8%
3. Must conduct at least 50% of its marketing business with members and 50% of supply business with members and total marketing and supply business with non-members cannot exceed 15%
4. Must treat non-members the same as members for patronage, pricing and pool payments (pay patronage to non-members)

A Section 521 cooperative must also maintain records of patronage and equity and not maintain excessive levels of financial reserves (unallocated equity). Section 521 cooperatives are often exempt from SEC security registration laws. For that reason, many closed membership New Generation cooperatives choose to organize as Section 521 cooperatives. Under the closed cooperative model they had no non-member business and 100% of their members did business every year so they had difficulties meeting the Section 521 restrictions. It is interesting to note that many of the Section 521 requirements appear to relate back to the Rochdale principles.

The tax advantages of Section 521 cooperatives is that while they have to pay patronage on non-member business they can deduct those patronage payments along with all qualified patronage and per-unit retain payments to members. In essence, a Section 521 cooperatives operates and is taxed as if all of its business in member business. Additionally, a Section 521 cooperative can deduct dividends paid on capital stock, while those dividends are limited to 8%.

Non-Member Business and Unallocated Retained Earnings

Cooperatives are taxed at the ordinary corporate rate on their taxable income calculated after cash patronage and qualified retained patronage and qualified per-unit retain payments. All cooperatives except Section 521 cooperatives must include non-member income in their taxable income. All cooperatives including Section 521 cooperatives would also include income from rents, investment revenues, gain on sale of capital assets and income from sales to the federal government as taxable income. For that reason, even Section 521 cooperatives often have some taxable income. Cooperatives generally retain non-member and non-patronage income as unallocated retained earnings. Because of the tax effect is it actually the after-tax portion of those profits that is retained. If the cooperative was in the 21% tax bracket and received $100 of non-patronage income it would pay $21 in tax and retain the after tax portion of $79.

Cooperatives also have the option of retaining a portion of member profits as unallocated retained earnings. Because that income is not distributed as qualified retained patronage it is not deductible and the cooperative actually retains the after tax portion. The availability of the Section 199A tax deduction has allowed cooperatives to offset that tax effect and has led some cooperatives to retain more member profits as unallocated retained earnings. Cooperative scholars would argue that a better approach would be to retain those profits as non-qualified retained patronage and use the tax deduction in the same manner. By retaining the profits as non-qualified the cooperative will get a deduction in the equity retirement year. Non-qualified stock essentially allows the cooperative to bank the tax deduction for a future year.

Taxation of Federated Cooperatives

Federated cooperatives are taxed in the same fashion as the local cooperative. When a federated regional cooperative makes a cash or qualified stock patronage refund to the local cooperative that patronage becomes part of the local cooperative taxable income. The local cooperative must distribute that income within 8 ½ months to its local patrons in a tax deductible form (cash, qualified stock or a qualified per-unit retain distribution) or otherwise it must pay tax on that income. The treatment of dividends on capital stock is more complex. A Section 521 cooperative is allowed to deduct 80% of the capital stock dividends it receives from other cooperatives. A Section 521 cooperative is allowed to deduct all of the capital stock dividends it receives from other cooperatives as long as it distributes those dividends to its patrons.

A look through procedure is used to determine the Section 521 status of a regional cooperative. The regional cooperative must meet the Section 521 requirements on its producer members and if it has cooperatives as members, the IRS will look through to determine if those cooperatives meet the Section 521 provisions.

Tax Credits and Deductions

As discussed, marketing cooperatives have been able to use the Section 199A tax deduction in recent years, Congress has from time to time implemented other tax credits and deductions such as Investment Tax Credits for investment in depreciable property or accelerated depreciation tax deductions. Those tax credits and deductions are often not useful to cooperatives since they severely reduce or eliminate their taxable income by making patronage payments. Tax rules often do not allow a cooperative to carry unused tax credits backward or forward to other tax yeas as other businesses do. Cooperatives are sometimes allowed to allocate unused tax credits to their members similar to the way it allocates patronage refund. Under the current Section 199A, producers who market through a cooperative face a tax penalty. That tax penalty is the reduction is an otherwise available tax credit. The cooperative can allocate all of a portion of its Section 199A tax deduction to the patrons. Most marketing cooperatives attempt to allocate sufficient tax deduction to keep their members equivalent with producers marketing through non-cooperatives and retain the rest to offset the taxation from issuing non-qualified stock.

Other Taxes

Cooperatives are usually subject to all other taxes on the same basis of other businesses. Cooperatives pay sales tax, payroll taxes, license, property and excise tax. In some states cooperatives are exempt from corporate franchise taxes which are taxes on the net worth of corporations. States with income tax generally follow the basic provisions of federal tax laws in taxing cooperatives.

Taxation of Other Cooperatives

The tax rules discussed apply to farmer owned cooperatives. Other cooperative businesses may fall under different tax regulations. Section 501 of the IRS code deals with not-for-profit corporations. Religious, charitable and civic institutions owned and operated for the benefit of their members fall under Section 501. Some cooperatives including some credit unions, mutual insurance agencies and rural electric and telephone cooperatives are able to be taxed under Section 501. CoBank and most other branches of the Farm Credit System operate on a patronage basis and are taxed under subchapter T. Consumer cooperatives are taxed under Sub-Chapter T and since Section 521 cooperatives must be owned agricultural producers there is no such thing as a Section 521 consumer cooperative. Consumers cooperatives deduct patronage refunds in a similar fashion as do farmer-owned cooperatives. Patronage refunds related to purchases of personal living or family items are not taxable income to the patron. The logic is that unlike an agricultural cooperative where the cooperative activities are an extension of the farm business, the patrons of consumer cooperatives are purchasing with after tax income. Consumer cooperatives are the only type of cooperative that can exclude patronage refunds from taxable income.

Summary

The principal of cooperative taxation under Sub-chapter T is that cooperative net income is generally taxed at either the cooperative level or the patron level but not both. Sub-Chapter T allows cooperatives to deduct certain types of patronage refunds from their taxable income and that is the vehicle that accomplishes single taxation. Cooperatives are taxed on any remaining income, including non-member income, non-patronage income and member income not distributed as patronage, at the regular corporate rate.

A patronage refund that is deductible to the cooperative and taxable to the member is termed a “qualified” refund. Cash patronage is always qualifies although it seldom termed that way. Retained patronage refunds (stock patronage) can be either qualified or non-qualified. Cooperatives can deduct non-qualified stock patronage when they redeem it. In the case of non-qualifies stock patronage the cooperative pays tax on that income in the distribution year but eventually gets a deduction when it is redeemed. The ultimate effect is that the member pays taxes on the profits represented by the non-qualified distribution but the timing of the tax effect differs from that of qualified stock where the patron is taxed upon receiving the stock.

Section 521 cooperatives are a more restrictive form of cooperative that must meet certain requirements. The major tax advantage of Section 521 is that those cooperatives can deduct patronage paid to non-members and can deduct dividends paid on capital stock.

Federated cooperatives are taxed similar to local cooperatives. When a local cooperative receives cash or qualified stock patronage from a federated regional cooperative, they must pass it on in to their patrons in a tax deductible form with 8 ½ months or pay taxes on that income.

Cooperatives qualify for some tax deductions and credits similar to other businesses. Those tax deductions and credits may not be useful to the cooperative if they are distributing their income as qualifies patronage sense they will have very low taxable income. In some cases cooperative can allocate unused tax deductions and credits to their members in a similar manner as patronage.