

AN ANALYSIS OF THE INCOME TAX STATUS
OF FARMER COOPERATIVES

by

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INTRODUCTION

Objectives of the Study

Although nearly half a century has passed since the first income tax law came into effect, the taxation of farmer cooperatives is still quite often misunderstood. The purpose of this report is to summarize their present status, with special emphasis being placed on an analysis of income tax.

The exempt and the non-exempt farmer cooperative will be studied separately. Each will be compared to the income tax status of corporations, individual proprietors, and partnerships.

This report has the following objectives: to gather, present, and combine information that is pertinent to farmer cooperative taxation today; to distinguish between the handling of exempt and non-exempt farmer cooperative taxation; to analyze the adequacy of present legislation; and to study the need for new legislation.

Methods Used

Three methods will be used to attain these objectives. First, the history of legislation affecting farmer cooperatives will be studied. Secondly, the decision of court cases that affect the different areas of income taxation will be reviewed. These conclusions will be taken principally from two references: "Summary of Cooperative Cases" by Farmers Cooperatives Service,

United States Department of Agriculture and "Digest of Selected Cases and Rulings" by the American Institute of Cooperation. Analyzing progressive court rulings and interpretations probably is the best method of getting a clear view of the tax status of farmer cooperatives. Thirdly, the findings from the study should enable the author to make recommendations which would help correct any existing inadequacies in the present farmer cooperative laws.

HISTORICAL DEVELOPMENT OF TAX LAWS AFFECTING FARMER COOPERATIVES

In 1913 the first income tax law was passed by the 62nd Congress. This law was very general and led to many broad and incorrect interpretations. The 16th Amendment said in part:

Article XVI. The Congress shall have power to lay and collect taxes on income from whatever source derived, without apportionment among several States, and without regard to any census or enumeration.¹

In an attempt to clarify the exemptions, the Revenue Act of 1916, Section 11 (a) eleventh allowed exemption for farmers, fruit growers, or like associations.

Farmers, fruit growers, or like associations, organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them.²

¹ United States Statutes at Large, 1911-13, 62nd Congress, Vol. 37, Part II, page 1785.

² United States Statutes at Large, 1915-17, 64th Congress, Vol. 39, Part I, page 767.

However, the 1916 act was still too general, and the interpretation as to right of exemption was disputable.

In 1921 a revenue act was passed which was more specific in outlining the right of exemption by repeating the 1916 act and adding:

. . . or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expense.³

This restricted exemption to cooperatives which marketed products of its members. This did not include non-member business.

The necessity of providing for non-member business brought about the Revenue Act of 1926, which added to the previous act.

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 per centum 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 non-voting 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; nor shall exemption 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. Such an association may market the products of non-members in an amount the value of which does not exceed the value of the products marketed for members, provided the value of the purchase made for persons who are neither members nor producers does not exceed 15 per

³ United States Statutes at Large, 1921-23, 67th Congress, Vol. 42, part I, Title II, Income Tax, part III, Sec. 231 (11) page 253.

centum of the value of all its purchases.⁴

The 1926 Act included several additional items: (1) exempted those organized and operated "on a cooperative basis," instead of exempting associations organized and operated as sales agents; (2) permitted cooperatives to do business with non-members without losing their exemption; (3) changed the term "selling expenses" to "marketing expenses" which would include all expenses necessary to prepare the product for its final sale; and (4) added quantity or the value to allow more equitable distribution, instead of using strictly quantity for allocation.

The United States Government and its agencies have been very good customers of farmer cooperatives. In 1934, Section 101 (2) quoted the Act of 1926 and added: "Business done for the United States or any of its agencies shall be disregarded in determining the right of exemption under this paragraph."⁵

Prior to the 1934 Act there were no provisions for the handling of business with governmental agencies. Thus, during the depression and drought years of the 30's, federal agencies bought supplies for consumption by persons on relief. In the 40's and 50's the government bought large quantities of supplies for the armed forces and as aid to foreign countries. The exemption status of a farmers' cooperative is not endangered

⁴ United States Statutes at Large, 1925-27, 69th Congress, Vol. 44, part II, Title II, Income tax, part III, Sec. 231 (12).

⁵ United States Statutes at Large, 1934-34, 73rd Congress, Vol. 48, part I, Title I, Income Tax--Sub-title C--, Supplemental Provision, Supplement A--, Rate of tax, page 701.

because it does not share patronage returns to non-member patrons from business done with the United States. It has been ruled that states, counties, townships, cities, towns, and villages are not considered as agencies of the United States.

The phrase in the 1934 law "business done for the United States" can be interpreted as synonymous with "Business done with the United States." It was apparently the intention of the law-maker to regard farmers' cooperatives as "agents" rather than "dealers."

The 1934 Act has been accepted as stated; therefore, the following quotation illustrated the Bureau of Internal Revenue's interpretation:

On July 18, 1950, a cooperative association telegraphed the Bureau of Internal Revenue as follows:

'We have been contacted by QM Corps of the U. S. Army to assemble, pack, and ship a possible minimum of 2,000,000 cases of rations. These cases to require 57 different items of which we shall furnish two or three out of own production--they to furnish remainder.

We are being pushed for commitment and feel it our duty to comply, but do not want to endanger our present exempt status. If we prorate revenues from this operation to member and non-member producers will we maintain exemption. Quick answer imperative, please wire collect.'

To this telegram the Bureau of Internal Revenue replied as follows:

'Reference telegram eighteenth status for Federal Income Tax purposes will not be affected by proposed transaction with Quartermaster Corps U. S. Army since under law business done for United States or any of

its agencies shall be disregarded in determining right to exemption.⁶

The first major change or addition to the 1934 Revenue Act, with regard to tax laws concerning farmer cooperatives, came in 1951. This act dealt mostly with additional requirements to the existing laws. It required all farmer cooperatives to file income tax returns by the 15th day of the third month for any taxable year commencing on or after December 31, 1951. The portion of the 1951 Revenue Act states:

(B) An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15 (corporation normal tax and surtax), or section 117 (C)(1) (the alternative capital gains tax), except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deduction allowable under section 23)--

(i) amounts paid as dividends during the taxable year upon its capital stock, and

(ii) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the fifteenth day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to

⁶ Summary of Cases Relating to Farmers' Cooperative Association, Summary No. 47: United States Department of Agriculture. Farmer Cooperative Service, page 4.

income derived before the close of such year.⁷

The much used term, "patronage dividends," was first mentioned in legislative channels in 1951. Previous to the 1951 act, farmer cooperatives had been permitted to exclude from gross income the distribution of true patronage dividends. The 1951 act made specific provisions in the law for what had been allowed in regulations, rulings, and decisions. The above was set forth in the latter portion of the 1951 act:

Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retained certificates, certificates of indebtedness, letter of advise, or in some other manner that discloses to each patron the dollar amount of such dividend, refund or rebate) shall be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt under subparagraph (A). Such dividends, refunds, and rebates made after the close of taxable year and on or before the 15th day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.⁸

The Revenue Act of 1954 was a complete revision; however, the sections dealing with farmer cooperatives were not changed substantially from the existing 1951 Revenue Act. Section 521 (exemption of farmers' cooperatives from tax) and Section 522 (tax on farmers' cooperatives) are the pertinent sections in the Revenue Code of 1954 relating to farmers' marketing and

⁷ United States Statutes at Large, 1951-53, 2nd Congress, Vol. 65, Sec. 314, page 491.

⁸ Loc. cit.

farm supply associations. They are as follows:

Sec. 521. EXEMPTION OF FARMERS' COOPERATIVES FROM TAX.

(a) Exemption From Tax. - A farmers' cooperative organization 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 for purposes of any law which refers to organizations exempt from income taxes.

(b) Applicable Rules. -

(1) Exempt Farmers' Cooperatives. - The farmers' cooperatives exempt from taxation to the extent provided in a 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 of 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 Non-members. - Exemptions shall not be denied any such association which markets the products of non-members 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 non-members in 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 nor 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.⁹

Sec. 522. TAX ON FARMERS' COOPERATIVES.

(a) Imposition of Tax. - An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) Computation of Taxable Income. -

(1) General Rule. - In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter) -

(A) amounts paid as dividends during the taxable year on its capital stock, and

(B) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letter of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 14th day of the 9th month following the close of such year shall be considered

⁹ United States Code, 1958 edition, Title 26, Sec. 521, page 4374.

as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) Patronage Dividends, etc. - Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.¹⁰

These sections compile all previous legislation into one bill.

TAX STATUS OF EXEMPT FARMER COOPERATIVES

The basis of federal income tax exemption is outlined in Section 521 of the Internal Revenue Code of 1954, subchapter F, Part III, Farmers' Cooperatives. The text of Section 521 appears on page 8 of this report.

The fundamental conditions prescribed in this section, often called "requirement for exemption," may be summarized in ten different areas.

1. Must be farmer association. Paragraph (b) (1) specifically limits this to farmers' associations, fruit growers' associations, and like associations.¹¹ Congress undoubtedly

¹⁰ Loc. cit.

¹¹ Loc. cit.

intended to limit the application of this act to associations organized and operated by farmers. Primarily, this clarification was made as an aid to farmers (not their cooperative as such) and to relieve the Treasury of the necessity of processing income tax returns for a class of organizations which would have little or no taxable income.

2. Must be organized and operated on a cooperated basis. The old English cooperative standard of one vote per member, regardless of the amount of stock, is understood to constitute "a cooperative basis."

3. Must be organized for the purpose of marketing or purchasing. The terms "marketing" and "purchasing" have caused much discussion and disagreement. The term "marketing" has been interpreted to include initial handling, grading, packaging, processing, handling, by-products, transporting, bargaining, and selling.

A marketing association may own or lease or otherwise acquire property or facilities essential for performing any necessary marketing function. It may also handle supplies essential for harvesting, packaging or otherwise facilitating the marketing process. A marketing cooperative may also own shares in another cooperative or wholly own a subsidiary cooperative if the purpose of arrangement is to facilitate its marketing function. For example, a number of local cooperatives may own and operate a central or terminal selling unit or a fruit marketing cooperative which is used to can surplus or low quality fruit not suitable for the fresh market.¹²

The term "purchasing" has been interpreted to include not only the retailing function but also wholesaling and manufacturing

¹² John H. Davis, An Economic Analysis of the Tax Status of Farmer Cooperatives, Washington, D.C., page 64.

of supplies essential for farming.

4. Must operate on actual cost basis. Section 521 states "and turning over such supplies and equipment to them at actual cost, plus necessary expense."¹³

The Bureau of Internal Revenue has interpreted this clause:

If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Internal Revenue Code and is not exempt.¹⁴

A marketing cooperative must refund to its patrons the receipts resulting from sales, less any necessary marketing expenses on the basis of either the quantity or the value of the products furnished by them.

5. Non-members must be treated on the same basis as members. Rulings from tax cases have repeatedly held that non-members must be treated on the same basis as members when determining refunds or the distribution of proceeds. There must be no discrimination between members and non-members. The Internal Revenue Service has said:

In other words, if products are marketed for non-member producers, the proceeds of the sales, less necessary operating expenses, must be returned to the patron from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. Therefore, a cooperative marketing association may not, without losing its exempt status, make a profit on the business transacted with non-member patrons and divert the proceeds of such business from the patrons entitled thereto. However,

¹³ Statutes at Large, 1958 edition, Title 26, page 4374.

¹⁴ U. S. Treasury, Bureau of Internal Revenue Regulation, Section 19.101 (12) - 1.

where a cooperative marketing association has otherwise complied with the provisions of the statute respecting exemption, but defers the payment of patronage dividends to non-members, exemption will not be denied:

1. Where the by-laws of the association provide that patronage dividends, by whatever name known, are payable to the members and non-members alike, and a general reserve is set up for the payment of patronage dividends to non-members.

2. Where the by-laws provide for the payment of patronage dividends to members but are silent as to the payment of patronage dividends to non-members, and a specific credit to the individual account of each non-member is set up on the books of the association.

3. Where the by-laws are silent as to the payment of patronage dividends to either members and/or non-members, but the evidence submitted shows that it has been the consistent practice of the association to make payment in cash or its equivalent of patronage dividends to members and non-members alike within a reasonable period after the expiration of the particular year involved.

4. Where, under the circumstances stated in 1, 2, and 3, above, patronage dividends are not payable until the non-member becomes a member of the association either through the payment of the required amount in cash or the accumulation of dividends in an amount equal to the purchase price of a share of stock or membership.¹⁵

6. Dividends on stock must be limited in amount. Dividends on capital stock may not, if continuation of exempt status is desired, be fixed at a rate exceeding 8 percent per annum, or the legal rate of interest in the state of incorporation, whichever is higher. The following is part of a court decision dealing with this area.

¹⁵ Cumulative Bulletin X-2, pages 164, 166.

Admittedly, in this case \$27,140 of the outstanding capital stock of \$45,680 was issued as stock dividends and the shareholders paid nothing therefore. This fact alone bars the petitioner from claiming exemption from income tax; for after the declaration of the stock dividends, the stockholders were receiving from 12 to 18 percent per annum on the amounts invested by them.¹⁶

7. Substantially all voting stock must be owned by active producer patrons. The definition of "substantially all" has been interpreted differently by authorities. The Internal Revenue Service has said:

It is impractical to attempt to define the term 'substantially all' as used in the statutes under discussion for the reason that what constitutes substantially all of the capital stock of the cooperative marketing association is a question of fact, which must be decided in the light of the circumstances surrounding each particular case. Any ownership of stock by other than actual producers must be explained by the association. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to actual producers who market their products through the association. However, if by statutory requirement, the officers of an association must be shareholders, the ownership of a share of stock by a non-producer to qualify him as an officer will not destroy the association's exemption; or if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional inhibition or other reason beyond the control of the association, to purchase or retire the stock of such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. On the other hand, where a substantial part of the stock was voluntarily sold to non-producers, exemption must, under the statute, be denied as long as such stock is so held.¹⁷

¹⁶ Farmers Mutual Cooperative Creamery, 33 B.T.A., pages 117, 125.

¹⁷ Cumulative Bulletin X-2, page 164.

An example of this is the decision handed to the Farmers' Cooperative Creamery by the Board of Tax Appeals.

Of the 213 shares outstanding in 1925, 194, or 91 percent, were held by persons who were producing owners either directly or on a crop-share basis. Nineteen were owned by persons who were not producers during that year, but of these 19 individuals, 7 had been producers when the stock was acquired, and 1 was the widow of a former producer. Of the 194 shares 167, or 79 percent, were held by operating farmers and 27 by persons who operated their farms by tenant farmers and received a crop share (including dairy products).¹⁸

In view of these facts, the Board held that "substantially all" of the voting stock of the cooperative was held by producers. These two rulings have established a precedent for virtually all interpretations of "substantially all" in subsequent decisions.

8. One half of the business must be with members. The importance of active membership participation and control is emphasized in Section 521 which states:

Exemption shall not be denied any such association which markets the products of non-members 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 non-members in the amount the value of which does not exceed the value of the supplies and equipment purchased for members....¹⁹

The farmer cooperative association must measure non-member business dollar value. The statute does not specify whether such value is to be determined in the case of a marketing cooperative on the basis of an advance at time of delivery, market price at time of delivery, or price at time of sale. Nor does it state

¹⁸ Farmer Cooperative Creamery, 21 B.T.A., page 265.

¹⁹ United States Code, 1958 edition, Title 26, Sec. 521 (b) (4).

whether the value of items purchased shall be based on wholesale prices, retail prices, or some other basis. The Internal Revenue Service has been permitting cooperatives considerable latitude in selecting the basis of value, provided their adopted methods are fair for the non-members as well as members.

If a farmer cooperative deals in marketing and purchasing functions, the Internal Revenue Service interprets the law as requiring that at least 50 percent of the business done in each department must be with members. Failure to comply in one department will disqualify the entire association for exemption.

9. Purchasing association must do 85 percent of business with producers. Section 521 states: "... the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."²⁰

The definition of "producer" is a very debatable issue since the term has not been defined specifically. There are several cases which have determined for a particular situation whether or not certain parties could be called producers. The following case summary will illustrate part of the problem of defining "producer." In a case

Where a feed dealer furnished poultry to a grower and the grower agreed to properly feed and care for the poultry and to turn it over to the dealer for marketing through a farmers' cooperative association, both the feed dealer and the grower are patrons of cooperative association and they qualify as producers for purposes of section 521 of the Internal Revenue code of 1954 to the extent of their respective interests in the poultry marketed. Such a course of dealing

²⁰ Ibid.

will not of itself affect the cooperative association's status as an organization exempt from federal income taxation under section 521 of the code provided that its activities otherwise conform to the requirements for exemption specified in that section.²¹

The summarization of the ruling on this states, in effect:

Under the terms of the contracts between the feed dealers and the growers it appears that the parties are tenants in common with respect to the poultry involved, so that each has an undivided interest in such poultry subject to his control. Since each grower has a property right in such poultry, each feed dealer, in marketing it, acts as agent for the grower to the extent of the grower's interest therein. Accordingly, it is clear that to the extent of the grower's interest in the poultry marketed, he is producer for purposes of section 521 of the Code and a patron of the cooperative association. It is equally clear that each feed dealer is a patron in his own right as to his interest in the poultry which he markets and that the feed dealer is a producer for purposes of the cited Code section.

Accordingly, it is concluded that the feed dealers in question qualify as producers and patrons of the instant cooperative to the extent of their interest in the poultry marketed through the cooperative. Therefore, it is held that the marketing of poultry for the feed dealers will not affect the cooperative's exempt status, provided it continues to meet the requirements for exemption prescribed by section 521 of the Internal Revenue Code of 1954.²²

10. Reserves must be for necessary purpose and reasonable in amount. Section 521 (b) (3) states that:

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.²³

²¹ Revenue Ruling 58-483; Internal Revenue Service, 1958-40, page 40.

²² Summary of Cooperative Cases, Legal Series No. 7, December 1958, page 69.

²³ United States Code, 1958 edition, Title 26, Sec. 521, page 4374.

The common practice among farmer cooperatives is for the patron to contract with the association, authorizing the retention of certain residual equities belonging to the patron, under terms which are analogous to constructive payment to the patron and reinvestment by him in the association. Such funds are usually not only allocated to the patron on the records of the association, but also evidenced by stock, certificates of equity, or other documentary certification.

Invested capital generally is not considered a part of a "reserve," the exemption statute places no limitation as to the amount of capital which patrons may invest in their cooperative, either by outright purchases or by the application of patron equities pursuant to the terms of an existing contract between the patron and the association.

Actually, then, the term "reserve" as used in Section 521 (b) (3) would seem to include those net funds retained by the association, but not allocated to the patron in such a manner as to clearly give it the status of invested capital.²⁴

An association may create any reserve permitted any non-exempt corporation such as "valuation reserves" for depreciation, depletion, and bad debt. With respect to depreciation reserves, the Internal Revenue Service has ruled:

²⁴ This does not mean that a patron has no equity in reserves. It is essential that an exempt cooperative maintain complete patronage records which would permit allocation of reserves upon dissolution.

Where such an association has investments, buildings, machinery, or other property which, due to depreciation through use in the operation of the association, eventually reach a point where their usefulness is exhausted such depreciation in a given year is properly chargeable against the patron of the association as a part of the necessary marketing expenses of that year, and a reserve for the replacement of such property set up ratably over the period of the useful life of the property will be recognized as a necessary purpose within the meaning of the statute and the Departmental regulations.²⁵

A contingency reserve for a probable loss has been considered a "reasonable reserve" for a "necessary purpose." Included in this category would be a reserve for anticipated inventory loss, loss from a pending law suit, and other specific contingencies.

The Internal Revenue Service has permitted exempt associations to withhold limited reserves for capital expansion. During the early history of exemption laws, no apparent effort was made by the Internal Revenue Service to see that patron equities in such reserves were evidenced on the record of the association. The result was that many associations treated capital reserves as being owned by the association rather than its patrons. The Internal Revenue Service published a ruling dealing with this area.

... 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 purpose will not destroy the exemption....

²⁵ Cumulative Bulletin X-2, July 9, 1931, page 168.

In order to be exempt ... an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized....²⁶

A reasonable reserve for bad debt was held allowable by the court upon appeal after disallowance by the Internal Revenue Service. The eight associations consolidated in the suit were organized under the Farm Credit Act of 1933. Their function was to make loans to farmers for agricultural purposes. The plaintiffs paid the tax deficiency assessment, then sought refunds plus interest. The court held that the 5 percent reserve for bad debts was in line with other lending agencies. The figure of 5 percent was determined from the experience of others suffering losses in depression periods following periods of higher prosperity levels.

The court said: 'The evidentiary phase, underlying the action of the plaintiffs as they made additions to reserve for bad debts, based, as the court finds, on delegated statutory authority, on weight of acts performed in obedience to recommendations or orders or mandates from a federal supervising agency and on evidence as to conditions and circumstances which necessarily enter into such a security against losses problem, impresses this court as honest, prudent, wise and determined efforts by their managers to provide against uncertainties which, because of violent ups and downs in the price structure, insects, and elements obtain in the agricultural financing fields.'²⁷

The court held that each of the plaintiffs was entitled to recover the amount which heretofore had been paid, with interest as claimed, in these cases.

²⁶ Bureau Regulation 103, pages 238-239.

²⁷ Summary of Cooperative Cases, Legal Series No. 7, page 65.

It is understood that the Government will not appeal the decision.²⁸

The area of reasonable reserve has been and probably will continue to be a much debated subject. The term "reasonable" is another word hard to define. As it stands now we have the prior decision to use as a guide.

TAX STATUS OF NON-EXEMPT FARMER COOPERATIVES

Slightly less than half of the farmers' cooperative marketing and purchasing associations are classified as non-exempt. Farmer cooperatives not exempt under Section 521 of the 1954 law are taxable in the same manner as ordinary business corporations. The income tax law gives them no special deduction, exclusions, or privileges. It has been the common accepted practice to deduct or exclude patronage refunds from gross earnings in figuring taxable income. The patronage refunds must be distributed in accordance with pre-existing obligation or agreement. If the association dealt with both member and non-member producers, and paid patronage refunds only to members, the portion of such payments to members that were attributable to the non-member patronage is not excluded from gross income, but must be treated as corporate profit.

The Pomeroy case and others concerned with this area can be cited as an illustration. The following is a summary taken after a series of cases up through 1958:

²⁸ Ibid.

The judicial authorities and administrative rulings indicate that, in order for an allocation of earnings by a cooperative association to qualify as a true patronage dividend, at least three prerequisites must be met: First, the allocation must have been made pursuant to a preexisting legal obligation; that is to say, it must have been made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative, and not pursuant to an obligation created after the allocated amount was earned. Southwest Hardware Co., 24, T.C. 75, 82. Second, the allocation must have been made out of profits or income realized from transactions with the particular patrons for whose benefit the allocations were made, and not out of profit or income realized from transactions with other persons or organizations which were not entitled to participate in such allocations. Clover Farm Stores Corporation, *supra*, 1277; And Third, the allocations must have been made equitably; so that profits realized on the one hand from selling merchandise or services to patrons, and those realized on the other hand from marketing products purchased from patrons, were allocated ratably to the particular patrons whose patronage created each particular type of profit.²⁹

The use of an example, Table 1, will help illustrate and differentiate the taxation of the different types of business. The data illustrating the non-exempt are in column two. The excess of receipts over expenses was assumed to be \$100,000 in this illustration. Seventy-five percent of this was paid to the patron as patronage returns. The \$25,000 left after patronage refunds were made was subject to the regular corporate income tax.³⁰ The board of directors declared a portion of what remained as dividends, and held the remainder in the business as

²⁹ Summary of Cooperative Cases, Legal Series No. 8, March 1959, United States Department of Agriculture, Farmer Cooperative Service, pages 4-5.

³⁰ The corporate tax rate used is the standard, on all taxable income (normal tax) 30 percent plus 22 percent taxable income over \$25,000 (surtax).

Table 1. A comparison of different forms of business regarding the computation of federal income taxes.^a

	: Exempt	: Non-exempt	: Ordinary	:
	: cooperative	: cooperative	: business	:
	: corporation	: corporation	: corporation	: Partnership
Excess of receipts over expenses	\$100,000	\$100,000	\$100,000	\$100,000
Less: Capital stock dividends (for exempt Co-op)	5,000	25,000	100,000	
Patronage refunds	75,000	75,000	46,500	
Total amount subject to corporate tax	20,000	7,500		
Corporate tax	6,000			
Amount available for dividends and retained earnings	14,000	17,500	55,500	
Dividends (other than exempt and Co-op)		3,500	10,700	
Retained earnings	14,000	14,000	42,800	
Tax paid				
Corporate	6,000	7,500	46,500	
Personal				
Dividends	1,000	700	2,140	
Patronage refunds	15,000	15,000		
Partnership share				34,800
Total tax	22,000	25,200	48,640	34,800
Tax in percent of total	22.0	25.2	48.6	34.8

^a Compiled by the author under assumptions given in footnotes in the text.

retained earnings.³¹ The federal income tax paid on the \$100,000 is shown in the lower portion of column two. The patronage returns and dividends are subject to personal income taxation.³² The amount of excess not returned as patronage refunds is taxable at the corporate rate. The dividends are subject to double taxation.

The exempt cooperative is permitted to exclude capital stock dividends and patronage refunds before determining the portion subject to corporate tax. The exempt cooperative would be required to pay corporate taxes on the portion declared available for retained earnings. The total tax burden under the exempt cooperative example, column two, is 22 percent of the excess of receipts over expenses. However, 15 percent was paid by the individual patron on patronage refunds. This is assuming that all patronage refunds were made in the cash form.

The ordinary business corporations could not deduct dividends before taxes were paid, and normally would not have pre-existing contracts with patrons to make patronage refunds. Therefore, they would be subject to corporate tax on the full amount of \$100,000. The amount remaining after taxes is available for dividends and retained earnings, column three. The full tax assessment under column three is 48.6 percent. Of this amount, the business paid 46.5 percent and the individual

³¹ The average amount of dividends returned in 1959 was 20 percent of profits, according to Dunn and Bradstreet.

³² The personal income tax rate used was 20 percent. Although in practice the tax rate is known to vary with individuals, one rate was used to maintain uniformity.

investor paid 2.1 percent.

The members of a partnership would be required to pay taxes on the personal individual basis. In the example, it was assumed there were four partners with equal interests. A partnership ordinarily would not have capital stock. The profits would be divided among the partners. Column four shows the total tax burden of 34.8 percent which is assumed to be paid equally by all partners.

It should be noted that the exempt cooperative paid 1.2 percentage points less in income taxes than the non-exempt cooperative, 26.6 percentage points less tax than an ordinary corporation, and 12.8 percentage points less tax than a partnership of four members.

A corporation or partnership business can, through prior agreement, make deductible refunds to patrons. An example of this was the promise by Ford Motor Company in 1914 to make refunds to customers if a certain sales goal was obtained. The goal was surpassed and each customer in 1915 received a refund of fifty dollars.

Detroit, July 15. The Ford Car Company this afternoon announces a refund of approximately \$15,000,000 to owners of Ford Autos who had bought their machines since August 1. On that date the company announced that if 300,000 machines were sold during the ensuing year, each buyer would receive a refund of \$40 to \$60. The 300,000 mark was reached this afternoon.

The company says that the refund is strictly in accordance with its profit distribution policy.³³

³³ New York Times, Saturday, July 17, 1915, page 11, column 8.

The money was excluded from taxable income by the Ford Motor Company.

The Railway Express Agency prorates its residual funds among the seventy railroads who own it and the three hundred other railroads which it has contracted to serve. When handling patronage refunds in this manner:

The agreement to make patronage refunds should be so clearly worded as to leave no doubt that it constitutes a binding obligation equivalent to a legal debt. Any lesser arrangement may prevent the association from excluding the refunds in computing its taxable income.³⁴

It is sometimes very difficult to work out a system in which there are actual contracts obligating the cooperative to distribute the excess of receipts over expenses to patrons. The state law, the articles, and the by-laws of the cooperative constitute a binding contract sufficient to allow patronage returns as deductible when figuring income tax. It is possible to create a binding contract with both member and non-member patrons. In both cases it is best to have some type of written formal agreement.

Many cooperatives do a substantial volume of business with non-members. Often it is difficult to establish the necessary binding contract with them. Some cooperatives conspicuously post excerpts from the articles and by-laws in their places of business; others print the applicable excerpts on order blanks, sales receipts, advertising material, and other communications

³⁴ John H. Davis, An Economic Analysis of the Tax Status of Farmer Cooperatives, page 39.

between the patrons and the association. If such posters or printed material are properly worded and conscientiously posted or distributed, it is probable that the courts would hold that the cooperative had offered to do business with the non-member patron on a cooperative patronage basis, and that the patron had accepted this offer by doing business with the cooperative.³⁵

Many cooperatives have adopted the plan of making every patron a member at the time of the first transaction between the cooperative and the patron. The patron is required to sign a membership application and agree that his first patronage dividends shall be applied on his membership fee.

INCOME TAX STATUS OF PATRONS WITH RESPECT TO PATRONAGE REFUNDS

The final settlement between a cooperative and its members has been denoted by several different terms. Among these are patronage refunds, patronage dividends, and rebates. The term "dividends" is generally associated with earnings on invested capital. The term "rebate" usually denotes a return of part of the original price. Neither of these reflect the net saving attributable to the business operation.

When the final settlement between a cooperative and its members is called a "patronage refund" it should be understood to mean "to pay back." Patronage refunds are a means of returning to a patron savings effected by cooperatively marketing their

³⁵ Legal Phases of Farmer Cooperatives, Bulletin 10, January 1958, Farmer Cooperative Service, Washington, D.C., page 213.

products or purchasing their supplies. This is fundamental to cooperatives because there would be less incentive to cooperate if the savings effected in marketing or purchasing expenses could not be returned to patrons. There is no magic or mystery about patronage refunds. They simply represent a practical means of achieving a given result, namely, the return to the members of an association savings effected by it. A true patronage refund is a distribution by a cooperative of the excess margin over expenses; which the cooperative must make to its patrons because of a prior mandatory agreement.

The income tax status of patrons with respect to patronage refunds has been a much debated issue. Some taxpayers keep their accounts on a cash basis while others use the accrual method. The system of accounting does not have a direct bearing on the tax liability of patronage refunds but may dictate the year taxes are to be paid.

It generally is understood that the accrual basis taxpayer would figure for each taxable year the amount that would accrue to him during that period. It sometimes is difficult to determine accurately the amount of patronage refunds to declare each year. Generally, the cooperative would not declare patronage refunds until the 15th day of the 9th month following the close of the taxable year.

The taxpayer who keeps accounts on the cash basis would find it easier to account for his patronage refunds. He would not consider the patronage refund in the taxable year that the business transpired but would wait and declare them during the year

that he was notified.

The portion of patronage refunds that is declared and paid is taxable as soon as taxpayers are certain of receiving them. The non-cash patronage refunds are not taxable to the patron until he is reasonably certain of obtaining possession. The non-cash controversy will be discussed in greater detail in a later section of this report.

Farmers are allowed to deduct many items used in connection with production from gross receipts when determining taxable income. Patronage returns serve to reduce the net cost of production items; therefore, this must be taken into account when calculating net taxable income. Items of production could be entered on the patron's books as either gross or net cost. Where gross is used, the offsetting entry, which reduced the cost by the amount of saving, must be recorded. For example, the farmer who received a patronage refund of \$10 on a \$100 purchase must show his cost of production as \$90.

Patronage refunds from a marketing cooperative would always need to be shown as income if they were received on a cash basis.

ECONOMIC EVALUATION OF THE INCOME TAX STATUS OF FARMER COOPERATIVES

The federal government has, through legislation, encouraged special favoritism in handling the income tax of farmers, fruit growers, or like associations organized and operated on a co-operative basis. The practice generally was accepted as justifiable and fair up through World War II. However, since the middle

40's the income tax burden of all kinds of business has increased greatly, but the income tax status of farmer cooperatives has remained essentially the same throughout this period. Consequently, a feeling of unfairness and inequality has developed in the minds of the critics who believe it is time for equal treatment.

Debatable Issues

The areas within which special favoritism can be discussed are: (1) non-cash patronage returns, (2) amounts distributed in payment of dividends upon capital stock, (3) the method of handling extraneous non-patronage income, and (4) reserves.

Patronage refunds declared by the association may be paid in cash or in some type of non-cash form, such as a certificate. Those paid in cash are taxable to the individual patron on the personal income tax basis. The portion of patronage refunds declared and paid by certificate is the area termed non-cash. Since the cooperative has issued certificates, it is not liable for taxation on this amount at the corporate rate. However, this money is held by the cooperative and often is used for financing an expansion. Herein lies the complaint of ordinary business enterprises and corporations--that unjust favoritism is afforded cooperatives by providing opportunity for capital expansion not made available to other forms of business.

Many of the critics of the cooperative form of business carry their arguments a step further to bring out the possible damaging effect this may have on other forms of business. It undoubtedly is true that many small grain elevators and small

farm supply stores have been purchased by large cooperatives. This same practice is true in almost any type of business. Many firms are becoming larger and larger. This seems to follow along with our present day "economies of scale." Presumably, every business would reach its optimum size when expanded to a certain point. It is hardly conceivable that at the present, cooperatives have reached or gone beyond the optimum.

The practice of using non-cash patronage refunds for capital expansion can justifiably be criticized if personal tax is not assessed and collected from the patron. Apparently, it was the intention of lawmakers for taxes to be collected. However, from the period 1955 through 1958, many inconsistent court rulings have been adjudged pertaining to non-cash patronage allocations. As a result, the Internal Revenue Service announced on February 14, 1958, that it would no longer attempt to assess an income tax on patrons with respect to non-cash patronage refunds having no market value.

The above Internal Revenue Service announcement was brought about by the affirmed ruling of the U. S. Court of Appeals from the B. A. Carpenter case. Text of the opinion follows:

This appeal is from a decision of the Tax Court, which held that the respondent was not liable for alleged income tax deficiencies asserted to be owing for the fiscal years ending February 1946 through 1949. The facts are not in dispute, and the only question is whether the respondent must include in his gross income the face amount of revolving fund certificates issued by a farmer cooperative association.

It is abundantly clear that the taxpayer's receipt of revolving fund certificates was not the equivalent of the actual receipt of cash, because the

certificates had no fair market value. Furthermore, it is obvious that the funds withheld by the cooperative were not subject to the demand of the respondent. The respondent could control neither the amount of the funds that he would ultimately receive nor the time at which he might receive them. These matters were left to the discretion of the cooperative's directors, and even the directors could not pay off the certificates without written consent of the mortgagee. Therefore, the respondent never actually or constructively received, or had any right to receive, anything but the certificates. It is fundamental in income taxation that, before a cash basis taxpayer may be charged with the receipt of income, he must receive cash or property having a fair market value, or such cash or property must be unqualifiedly subject to his demand. We are of the opinion that the certificates, when issued to the respondent, did not constitute income. Accordingly, the judgment appealed from should be and is AFFIRMED.³⁶

Non-cash patronage refunds are deductible from the cooperative's gross income. The certificate issued has no cash value, and it can not be sold or traded. Consequently, the patron is not required to declare their value as income until the asset is converted to cash.

This same reasoning could be carried to a further extreme. Assume that during one year the cooperative actually lost money. Losses could be absorbed or made up from previous years' non-cash patronage refunds. Taxes were not paid on the non-cash patronage refunds by the cooperative or the patron during the year they were declared. And since they were used later to absorb a loss, taxes would never be paid on them. This is a clear-cut example of net income being realized without having income taxes paid on it. An individual or a corporation would have paid taxes during

³⁶ Summary of Cooperative Cases, Summary No. 63, March 1955, pages 1-2.

the year of profit and would have had to absorb losses the best way possible. Deductions for business losses are allowed during the following taxable years. In a broad sense, non-cash patronage refunds can be used as a tax-free reserve to offset possible business losses.

When a corporation or non-exempt cooperative pays dividends on capital stock, it must come from previously taxed income. The exempt cooperative has the special privilege of deducting from gross income, amounts distributed in payment of dividends upon capital stock, if they are not in excess of 8 percent. This appears to be discrimination against not only ordinary business corporations but also non-exempt cooperatives. However, the actual amount paid usually is very small.

The structural organization required of an exempt cooperative tends to suppress the stock purchase incentive. Each member has one vote, regardless of the number of shares of stock that he owns. The providing of a means for paying capital stock dividends without double taxation should help in the sale of capital stock. Since an exempt cooperative is virtually non-profit, it needs this added incentive to induce purchase of capital stock to allow for expansion.

The handling of extraneous income by exempt cooperatives leaves room for criticism by non-exempt cooperatives and ordinary business corporations. Non-operating earnings, such as rents, interest, and dividends on capital stock, are called extraneous income. Income from the above sources must be distributed or

allocated to patrons on a patronage basis. It should be kept in mind throughout this section that business done for the United States or any of its agencies shall be disregarded in determining the right of exemption. This has also been interpreted to mean "business done with" the United States.

Additional storage facilities have been required during the last few years because of grain surpluses. The Commodity Credit Corporation has made a practice of leasing storage service from businesses which have grain storage facilities. Exempt co-operatives have done considerable business with the CCC. Income derived from the CCC is not taxable to the exempt cooperative as long as it is allocated to patrons on a patronage basis. This again provides income to the patron without double taxation.

A strong argument against the above practice can be made. Storage facilities could have been provided or financed by non-cash patronage refunds that had never been taxed. Tax-free facilities could then be used to provide income not taxed at the corporate rate, but income taxed only at the personal rate for refunds given in cash. It is conceivable that the CCC leasing income could be allocated to members as non-cash patronage refunds, and that capital expansion would be possible on untaxed funds.

Dividends referred to under extraneous income could result from owning stock in other firms which often would be stock in other cooperatives. Often stock is secured in other corporations in conjunction with obtaining supplies, equipment, and raw materials. Dividends received then can be excluded from net

income for tax purposes when distributed to patrons on a patronage basis.

Exempt cooperatives are permitted by section 521 to accumulate and maintain a reasonable reserve for a necessary purpose. Kansas cooperatives, in 1950, withheld as reserves 16 percent of the net margin.³⁷

The reserve that is to be considered necessary and reasonable has been debated in justice halls many times. Each case tends to have different extenuating circumstances. A case dealing with reserve for bad debt was cited on page 20 of this report.

Proposed Corrective Legislation

During the last presidential election campaign, both candidates mentioned the necessity for closing tax loopholes. Exempt farmer cooperatives are very much concerned with the probable outcome of any "tightening of tax loopholes," as they often referred to it.

The handling of the non-cash patronage refunds is the area of greatest concern. The Administration made the following recommendation to the legislature in the spring of 1961.

- (1) Collect a single tax currently on all cooperative earnings either from cooperatives or their patrons, assessing the patron on both cash and non-cash patronage refunds. (2) Cooperatives should not be penalized by assessing a patronage tax on them, if members elect to leave patronage refunds with

³⁷ Kansas Farmer Cooperatives, Circular 301, October 1953, page 22, Fig. 1.

their cooperative for capital purposes. (3) Exemption of REA's cooperatives (both electric and telephone) should not be disturbed. (4) Withholding on a basis comparable to that proposed for corporate dividends and interest - should be applied also to patronage refunds so that the average patron receiving a non-cash refund would, in effect, be given the cash to pay his tax on the refund.³⁸

These recommendations are actually corrective measures to make the intent of the 1951 revenue act enforceable. The legislation of 1951 was passed with the intention and assumption that earnings of cooperatives would be taxed, to the extent they reflected business activity, either to the cooperatives or the patrons.

Court decisions, notably "Long Poultry, Inc.," and "B. A. Carpenter," held that non-cash allocation of patronage refunds generally was not taxable to the patron, although it was deductible by the cooperative. The result of this holding is to give patrons, in effect, a tax deferment since they have no tax payment due until they receive the cash or their right to receive the cash is "reasonably certain," in the case of the accrual basis taxpayers.

The Administration recommended that what was thought to be the law in 1951 be stated specifically in the statute. Under this recommendation, cooperatives would be allowed to deduct amounts allocated in cash or scrip as patronage refunds, and

³⁸ Raymond J. Mischler, Attorney, U.S.D.A., Current Federal Income Tax. Developments Affecting Cooperatives Address to the New Mexico Cooperative Council at University Park, New Mexico, March 1, 1962.

patrons would be taxed on the patronage refunds allocated to them arising out of business activities.

These recommendations were finally drafted in the form of a new revenue act. Discussion on this bill started early in the 1962 Congressional session, and the bill passed the House of Representatives on March 29, 1962. At the time of this writing, the Senate has not taken a vote on the bill. The following is the portion of the "Revenue Act of 1962" that directly affects farmer cooperatives.

Section 17 - Tax treatment of cooperatives and patrons: Cooperatives are to receive a deduction for patronage dividends paid to their patrons in cash or by allocation if the patron has the option to redeem the notices of allocation in cash for a 90 day period after they are issued or if he consents to this income being treated as constructively received by him and then reinvested in the cooperative. The patron may give this consent individually in writing or the cooperative may through its bylaws require all members (after notification) to give this consent. In the case of allocations which do not qualify, the cooperative will initially be taxed on this type of patronage dividends. However, when such a patronage dividend is redeemed, the cooperative will receive a deduction (or refund of tax) at that time.

Where consent is given, or where the option to receive cash was available, the patron will be required to pay taxes on the patronage dividends which arise from business activity. The patron will also be required to take into account nonqualifying patronage dividends when they are redeemed (assuming they arise from business activity).

In addition all cooperatives (rather than merely tax-exempt cooperatives as under present law) are given until 8½ months after the end of the year in which patronage occurs to allocate amounts to the accounts of their patrons and in most cases are also given this same period of time for filing of their own income tax returns. These provisions apply to taxable years of cooperatives beginning after December 31, 1962, and with respect to amounts received

by patrons attributable to years of the cooperatives to which the new law applies. The new provision will not, however, apply to future redemption of patronage dividends declared when the old law was applicable.³⁹

The proposed 1962 Revenue Act appears to state specifically the method to be used in handling patronage refunds. If and when it is passed, it undoubtedly will be tried from several angles to test its effectiveness and legality.

Conclusions Derived

The first income tax law was passed in 1913. Following very closely were provisions for exempting farmers, fruit growers, or like associations. There was a definite need in the early part of the twentieth century for equalization of the competitive advantage for farmers as compared to other forms of business. These equalization features of tax treatment have passed our legislative groups in 1916, 1921, 1926, 1934, 1951, and 1954. Following the passage of legislation in each of these years, there have been many court cases interpreting the law. The courts have, in several instances, rendered decisions that did not follow the intentions of the lawmakers, therefore necessitating corrective legislation. There is legislation before Congress at the present time which is designed to clarify the intent of the 1951 Revenue Act.

It is a fairly easy task to read and record the wording of statutes. The difficult task is to analyze the economic aspects

³⁹ Congressional Record, 87th Congress, 2nd Session (1962), page 4995.

of that tax treatment. In the early part of the twentieth century, farmers were working under a distinct disadvantage with respect to purchasing supplies and selling products. The provision for cooperative action often was an economic necessity. At that time farmers were buying at retail and selling at wholesale.

Exemption of farmer associations from income tax was a minor thing up to the middle 40's. After World War II, income taxes greatly increased for all forms of business.

There are at present a few tax features afforded to farm cooperatives that are difficult to justify economically. The following are areas which received much attention in this study: (1) non-cash patronage returns, (2) amounts distributed in payment of dividends upon capital stock, and (3) the method of handling extraneous non-patronage income.

Non-cash patronage refunds are deductible from gross income in determining taxable income. It was the intention of the 1951 Revenue Act to make the non-cash patronage refund taxable to the patron during the accounting period it was declared. However, the court ruled in the "Carpenter" and "Long" cases that a patron would not be subject to personal income tax on patronage returns until they were "reasonably certain" of obtaining possession. Thus, a large percentage of non-cash patronage refunds still remain untaxed. Proposed legislation, if passed, will correct this deficiency.

The amount distributed in payment of dividends upon capital stock of cooperatives is excluded from gross income before taxable

income is determined; but the amount involved is so small that a justification of this practice is not warranted.

The method of handling extraneous non-patronage income has become quite a problem. Due to CCC grain storage operations, much of the extraneous income is derived from governmental sources. Business with an agency of the United States does not affect the exemption status if prorated on a patronage basis according to the law. This matter is not being considered in legislation that is pending.

While the necessary correction of earlier income tax laws actually was made by the 1951 legislature, these laws still need clarification to make them enforceable. Present indications are that this will be accomplished by Congress in 1962 or 1963 with new legislation.

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AN ANALYSIS OF THE INCOME TAX STATUS
OF FARMER COOPERATIVES

by

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B. S., Kansas State College, 1957

AN ABSTRACT OF A MASTER'S REPORT

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Although nearly half a century has passed since the first income tax law came into effect, taxation of farmer cooperatives is still quite often misunderstood. The purpose of this report is to study the effect of changing legislation and to analyze the present tax status of farmer cooperatives.

The first income tax law was passed in 1913. Following very closely were provisions for exempting farmers, fruit growers, or like associations. There was a definite need in the early part of the twentieth century for legislation which would help farmers to compete with others. As a result, laws affecting the tax treatment of farmers' cooperatives have passed legislative groups in 1916, 1921, 1926, 1934, 1951, and 1954. Following the passage of legislation in each of these years, there have been many court cases interpreting the law. The courts have, in several instances, rendered decisions that did not follow the intentions of the lawmakers, therefore necessitating corrective legislation. There is legislation before Congress at present which is designed to clarify the intent of the 1951 Revenue Act.

It is a fairly easy task to read and record the wording of statutes. The difficult task is to analyze the economic aspects of that tax treatment. In the early part of the twentieth century, farmers were working under a distinct disadvantage with respect to purchasing supplies and selling products. The provision for cooperative action often was an economic necessity. At that time, farmers were buying at retail and selling at wholesale.

Exemption of farmer associations from income tax was a minor thing up to the middle 40's. After World War II, income taxes greatly increased for all forms of business.

There are at present a few tax features afforded to farmer cooperatives that are difficult to justify economically. The following are areas which received special attention in this study: (1) non-cash patronage returns, (2) amounts distributed in payment of dividends upon capital stock, and (3) the method of handling extraneous non-patronage income.

Non-cash patronage refunds are deductible from gross income in determining taxable income. It was the intention of the 1951 Revenue Act to make the non-cash patronage refund taxable to the patron during the accounting period it was declared. However, the court ruled in the "Carpenter" and "Long" cases that a patron would not be subject to personal income tax on patronage returns until they were "reasonably certain" of obtaining possession. Thus, a large percentage of non-cash patronage refunds still remain untaxed. Proposed legislation, if passed, will correct this deficiency.

The amount distributed in payment of dividends upon capital stock of cooperatives is excluded from gross income before taxable income is determined; but the amount involved is so small that a justification of this practice is not warranted.

The method of handling extraneous non-patronage income has become quite a problem. Most of the extraneous income is derived from governmental sources. The law currently states that business

with an agency of the United States does not affect the exemption status if prorated on a patronage basis. This matter is not being considered in legislation that is pending.

While the necessary correction for earlier income tax laws actually was made by the 1951 legislature, these laws still need clarification to make them enforceable. Present indications are that this will be accomplished by Congress in 1962 or 1963 with new legislation.