

**ABA Tax Section Meeting  
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*Introduction to Cooperatives – Formation and Taxation*

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**1. Forming a Cooperative**

a) Is Filing Necessary? - To qualify as cooperative for tax purposes under Section 521 (as an “exempt” cooperative), the business need not be incorporated or take any particular form. Nonexempt cooperatives, however, must be incorporated (or otherwise taxed as a corporation for tax purposes) to be treated as cooperatives under Subchapter T.

b) Filing Advisable? – Even if not required to qualify as a cooperative for tax purposes, forming entity through which to operate a cooperative venture is advisable as with any business venture (liability protection, etc.). Additionally, filing paperwork to form the venture as a cooperative under state law may provide certain advantages under state law.

c) Which Formation Statute?

Each state has statutory laws governing cooperatives. Some states specifically provide for general or particular types of cooperatives to be formed under state law. A venture, however, can be formed as a “regular” business corporation even in these states and still qualify as a cooperative.

State cooperative law is in its infancy and varied. Several states have recently drafted laws permitting the formation of certain types of cooperatives to cater to cooperatives. Advisors to cooperatives should consider the different state formation statutes available and whether a venture should be formed in a certain jurisdiction/under a certain state law.

Examples:

WY, MN, IA, TN and WI permit the formation of cooperatives which have some LLC traits – sometimes called LLC-Cooperatives. A common feature of the LLC-Cooperatives is the ability of investors to be non-patron members of the cooperative.

Statutory law in many states does not significantly distinguish between types of cooperatives but some do (e.g., DE provides for the formation of worker cooperatives specifically as does Maine for consumer cooperatives). Whether the

specificity provided under certain formation statutes is beneficial is dependent on the facts of the particular venture.

d) Other Formation Matters/Documents - The cooperative principals are often outlined by the cooperative entity's governance documents such as its bylaws. For example, the entity's bylaws provide for how the cooperative members govern the entity and how patronage is divided among the members. Thus, the governance documents for cooperatives are often materially different than typical corporate governance documents. To qualify as an exempt cooperative under Section 521, the association must apply for exempt classification with the IRS using Form 1028.

## **2. Taxation of Cooperatives**

a) Two Types of Cooperatives – Exempt and nonexempt. Both are taxed under Subchapter T (IRC sections 1381-1383, 1385 and 1388). Section 521 also applies to exempt cooperatives. Certain types of cooperatives such as banks, insurance companies and rural electric/phone companies are not taxed under Subchapter T but taxed under different IRC sections.

### **b) Exempt vs. Nonexempt Cooperative**

1) Taxation Difference in General - As discussed below, exempt cooperatives are taxed more favorably than nonexempts because they are permitted to deduct essentially all distributions made to their patrons (if certain criteria are met) making it possible for them to achieve a single-level of taxation. Nonexempt cooperatives are only permitted to deduct certain patronage dividends and per unit retains paid/allocated to patrons.

2) Qualifying as an Exempt Cooperative – Exempt cooperatives must satisfy additional criteria under Section 521(b)(1) the most significant of these being the cooperative must be a farmers', fruit growers', or similar organization engaged in the business of marketing agricultural products or purchasing equipment/supplies. Thus, only agricultural ventures may qualify as exempt cooperatives. There are additional requirements as well such as being operated on a nonprofit basis (very limited retained earnings), limiting patrons to producers of agricultural products and limiting transactions with non-members.

c) Taxation at Cooperative Level - Cooperatives are not flow-through entities like an S corporation or a partnership – they are subject to the corporate income tax and entitled to deductions like any other corporation such as deductions for interest expense, wages, bad debts and most net operating losses. Sections 1381(b) and 1382(a). Cooperatives are also, however, entitled to additional deductions under Subchapter T which can result in a single level of tax (solely at the "owner" level) being paid by the cooperative and its members by allowing the cooperative to deduct certain distributions made to its members. Sections 1382(b) and 1382(c).

d) Types of Cooperative Income

1) Income Derived from Patronage – Depending on the type of cooperative, a cooperative may have income from both patron and non-patron sources. Example – “Patronage” with worker cooperatives is hours worked by cooperative members for the cooperatives. If the worker cooperative has both member and non-member workers, its income is attributable to both patronage (member hours worked) and non-patronage (non-member hours worked). Income attributable to patronage may be deducted by a cooperative if distributed to its members as a patronage dividend and certain requirements are met.

2) Income Derived from Non-Patronage – A nonexempt cooperative cannot deduct distribution made if such distributions are attributable to non-patronage income. Exempt cooperatives, however, generally may deduct distributions of non-patronage income if made on a patronage basis. Section 1382(c)(2). Exempt cooperative can also deduct dividends on capital stock. Section 1382(c)(1).

e) Types of Cooperative Distributions and Taxation to Members

1) Patronage Dividends (Section 1388(a)) – Distributions to patrons which are attributable to patron derived income of the cooperative. Deductible to cooperative and, generally, taxable to the patron (not as a “qualified” dividend eligible for 15% tax rate). Section 1385(a)(1). Patronage dividends are sometimes referred to as patronage refunds because the cooperative can be said to be refunding a portion of the patron’s business done with the cooperative.

a) Patronage Dividends are distributed to the cooperative members generally per their respective patronage with the cooperative based on an existing obligation and predetermined formula (as opposed to dividends on capital stock which are paid pursuant to the amount of stock held). Section 1388(a).

b) Example – Purchasing Cooperative for supplies – all purchases are made for resale to the cooperative members and patrons. Cooperative charges an administrative fee for its services. Such fee is sourced to patronage since it is related to the purchasing function provided to its members and may be paid out to the members as a patronage dividend. PLR 9827043.

c) Patronage dividends may be paid in the form of cash or in the form of a notice or certificate which will be redeemed by the cooperative at a later date for cash (thus, leaving cash in the cooperative as capital). The notice is “qualified” if the patron consented to be taxed upon receipt of the notice (for the face amount of the notice). Sections 1388(b) and 1388(c). Distributions of qualified notices are deductible to the cooperative and taxable to the patron. At least 20% of qualified notice patronage dividends must be paid in the form of cash to provide needed liquidity for members to pay taxes. Section 1388(c)(1). There are no tax consequences when qualified notices are later redeemed.

d) Question – Are patronage dividends made by corporate cooperatives subject to self-employment tax like distributions made to sole-proprietors and employee-owners of a partnership? Or are they exempt from self-employment like distributions made to owner-employees of S corporation? The very few cases on this issue lean toward concluding patronage dividends are subject to self-employment tax. See Bot v. Commissioner, 118 T.C. 138 (2002). The IRS seems to also take this view in its publications. See IRS Publication 225. Regs. section 1.1402(a)-5, however, clearly states that “[a]ll dividends on shares of stock are excluded” from self employment income. Members of corporate cooperatives purchase and hold stock in the corporation which causes them to be a member in the cooperative and entitled to receive the patronage dividend.

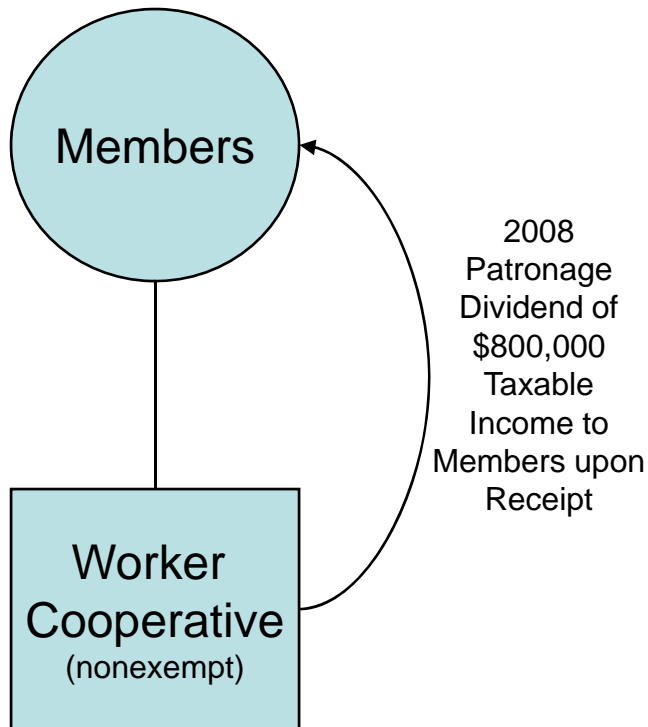
2) Per Unit Retain Allocation – Cooperatives which sell/market their patrons’ products may enter into an agreement to retain a portion of the sales proceeds. This is another method for members to provide capital to their cooperative. The tax-treatment of a qualified per unit retain is generally the same as a patronage dividend. Sections 1382(b)(3), 1385(a)(3) and 1388(h). If certain requirements are met, the amount “retained” is treated as if distributed by the cooperative to the patron and is deductible to the cooperative and taxable to the patron.

3) Distributions Attributable to Non-Patronage Income – Non-Patronage derived income is taxable at the cooperative level like any other income of the cooperative. The cooperative, however, cannot obtain a deduction for distributing such income to its members/patrons unless the cooperative qualifies as exempt under Section 521. Distributions attributable to non-patronage income are taxable to the recipient member/patron regardless of the distributing cooperative is exempt or nonexempt. This results in two levels of taxation when income sourced to non-patronage is distributed by a nonexempt cooperative to its members.

4) Dividends on Capital Stock – Taxable to shareholder recipients. The dividends paid are deductible to exempt cooperatives and non-deductible to nonexempt cooperatives.

Dividend Allocation Rule – Since 2004 if proper language is included in nonexempt cooperative’s government documents, a cooperative can treat any dividend on capital stock paid as made entirely out of non-patronage income. Section 1388(a). This is helpful for nonexempt cooperatives if the cooperative made capital stock dividends it can maximize the amount of patronage derived income distributed solely by way of deductible patronage dividends.

# Cooperative Example



## **2008 Total Hours:**

Member Worker = 8,000

Non-Member Worker = 2,000

## **Results In:**

80% Patronage Derived

20% Non-Patronage Derived

## **2008 Coop Net Income:**

Before §1382(b) Deduction =	\$1,000,000
<u>Less §1382(b) Deduction =</u>	<u>\$ 800,000</u>
Taxable Coop Income =	\$ 200,000
Income Tax on Income =	\$ 61,250