

Taxation of Patronage Dividends from Worker Cooperatives: Are They Subject to Employment Tax?

By: Gregory R. Wilson¹

A. The Issue

Are patronage dividends paid by worker cooperatives subject to self-employment tax? The IRS took this position with about a dozen employee-members of a worker cooperative about two years ago and then backed down when challenged (without any explanation as to why they took the original position and why they backed down). The IRS has now taken the position again with about a dozen new employee-members (or the same employee-members but for more recent tax years) of the same cooperative. Those cases are currently being contested. So who is right – the IRS agent issuing a report to the employee-member stating that his or her patronage dividend is subject to self employment tax or the IRS employee later conceding that it is not? Unfortunately, there does not appear to currently be a clear answer to this question.

B. Seeking Written Guidance

Maintain the status quo – without any published guidance from the government on the issue of the application of self-employment tax to patronage dividends – is not acceptable as long as the IRS keeps asserting this position in audits of cooperative members (even if they later back down). The cost and stress caused by these audits is unacceptable. Thus, at least one cooperative involved – is attempting to obtain written published guidance from the IRS on this issue that, hopefully, will be available for all cooperatives. The guidance may not be legally applicable to cooperatives other than the one that obtains the guidance, however, the IRS will often follow their guidance issued to one taxpayer for different taxpayers with similar material facts.

If written published guidance is obtained that says patronage dividends from worker cooperatives are not subject to self-employment tax, than cooperatives with similar material facts and their members should be able to confidently pay patronage dividends and not pay self-employment tax on those dividends. If the written guidance issued by the IRS says patronage dividends paid by worker cooperative are subject to self-employment tax, the cooperative seeking the ruling will likely litigate this issue in U.S. Tax Court. If the resulting Tax Court opinion is favorable to the taxpayer, than cooperatives/members can safely not pay self-employment taxes on patronage dividends. If the Tax Court position is unfavorable to the taxpayer, than cooperative members must pay self-employment taxes on patronage dividends.

¹ Gregory R. Wilson is a tax lawyer in San Francisco who has represented about thirty cooperative worker/members in audit/tax litigation with the IRS over the issue of the application of self-employment taxation to patronage dividends. He can be reached at grw@gwilson.com and 415-981-9545.

C. *Analyzing the Issue*

1. What is a Patronage Dividend? - A patronage dividend is an amount paid by a cooperative to a patron that meets the following requirements under Internal Revenue Code (“IRC”) section 1388:

- a) The amount is paid from earnings from business done with or for patrons.
- b) The amount is paid on the basis of quantity or value of business done with or for the patron.
- c) The amount is paid under an obligation of the cooperative to pay the amount, and the obligation to pay existed before the cooperative received the amount.
- d) The amount is determined by reference to the net earnings of the cooperative from business done with or for patrons.
- e) The amount is not paid out of earnings other than from business done with or for patrons or out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

A “patron” is as person with whom a cooperative transacts business on a cooperative basis. Treas. Reg. section 1.1388-1(e). The terminology used to describe as patronage dividend as used in the IRC does not apply very neatly to worker cooperatives. For example, it seems a little odd to refer to a person who is employed and also a member of a cooperative as a “patron” who is transacting business with the cooperative. The terminology used in this area appears designed for other types of cooperatives such as marketing cooperatives where members/patrons use the cooperative to sell their goods and the cooperative pays each member their proportionate share of the sales proceeds reduced by the related marketing expenses. Nonetheless, the law clearly holds that employee-members may be patrons and worker cooperatives may have patronage dividends if certain criteria are met. *See, e.g., Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965).

This IRS issued guidance for worker cooperatives to utilize to make sure that their patronage dividends paid meet the a) through e) criteria above. Rev. Rul. 74-20. This ruling provides one formula that the IRS sanctions for worker cooperatives to use when allocating cooperative earnings between patrons and non-patrons and among the worker-members. *See also, Linnton Plywood Association v. U.S.*, 410 F. Supp. 100 (D. Or. 1976). Therefore, the IRS and case law clearly provides that worker cooperative may qualify to pay patronage dividends if the dividend is paid out using certain factors such as outlined in Rev. Rul. 74-20.

2. Taxation of Patronage Dividends – This much we know – patronage dividends are deductible by the paying cooperative and are taxable income to the recipient member. IRC sections 1382(b)(1) and 1385(a)(1). Allowing the cooperative a deduction for the patronage dividend is beneficial because it avoids the double taxation on patronage earnings. This is an

advantage over regular non-cooperative C corporations. Non-cooperative businesses that are formed as partnerships, LLCs and S corporations, however, do not pay double taxation on any of their earnings (thus, cooperatives are actually not taxed more favorably than most other small/mid-sized businesses).

Example – XYZ worker co-op – has 10 worker-members and no worker-non-members. Each worker-member is paid employment compensation of \$35,000 in 2008. The XYZ worker co-op has patronage earnings in 2008 of \$100,000 – this \$100,000 is paid out to the worker-members based on their hours worked in 2008 as a patronage dividend (assume each worker-member receives a \$10,000 patronage dividend). XYZ worker co-op may deduct the \$100,000 paid to reduce its taxable income (hopefully to or close to zero) so it pays little/no income tax. XYZ worker co-op must pay employment tax on the \$35,000 employment compensation paid to each worker-member. The employment tax will be equal to about 15% of the \$35,000 – some of which will be paid by XYZ worker co-op and some of it by the worker-members. Self-employment tax, if applicable, is generally the same rate as employment tax – about 15% - but it is all paid by the worker-member (none by the cooperative) if applicable. The \$10,000 patronage dividend received by each worker-member is subject to regular income tax. The open question, however, is whether it is also subject to self-employment tax.

Self-Employment Tax – IRC section 1401 imposes a tax on the self-employment income of individuals. Self-employment income generally refers to an individual's income from a trade or business carried on by the individual. For example, if the individual's business is growing corn and he sells the corn through a farm cooperative, the patronage dividends he receives from the farm cooperative are related to his trade or business of growing and/or selling corn and, therefore, subject to self-employment tax. If the patronage dividend is derived from the cooperative member's transaction of business with cooperative, the patronage dividend received from the cooperative is apparently subject to self-employment tax.

There are several existing cases and rulings that hold patronage dividends received by cooperative members who are doing business with/through the cooperative are subject to self-employment tax (Fultz v. Commissioner, TC Memo 2005-45 (March 10, 2005), Morse v. Commissioner, TC Memo 2003-332, TAM 9652007, Schumaker v. Commissioner, 648 F.2d 1198 (9th Cir. 1981)). But what if the cooperative's members' only trade or business is that of being an employee of a company which is a worker cooperative. Is being an employee of a worker cooperative carrying on a trade or business which he or she is transacting with the cooperative? This seems quite different than a farmer receiving money from a cooperative through which he sells his crop. In the farmer's case, the payments from the cooperative relate to his trade or business of farming no differently than if the farmer sold his crop independent of the cooperative. But an employee-member of a worker cooperative is not carrying on a trade or business either with/through the cooperative or separately. His or her only trade or business – if you can consider it one – is being an employee. Thus, the issue is whether patronage dividends paid by worker cooperatives should be treated differently (not subject to self-employment tax).

3. Are Worker Cooperative Patronage Dividends Different (from a self-employment tax perspective) than other Cooperatives?

Worker Cooperatives – The Basics – Worker cooperatives are owned and governed by their members. All members are employees. Employees of the cooperative are typically invited to join the cooperative after a probationary period by purchasing one share of stock in the entity – which is often formed as a corporation under state law. Each cooperative member has one vote which entitles them to vote on certain matters such as electing the board. A worker cooperative is an employee owned business where the members share in the profits or losses of the business. Profits retained by the company and attributable to non-member work are taxed at the corporate level. Profits distributed to the members as patronage dividends, as discussed, are generally deductible by the corporation and only taxed at the member level.

Policy/Logic - Members of cooperatives other than worker cooperatives are typically operating a trade or business – such as farming – and use the cooperative as a part of such trade or business (e.g., selling their goods or services through the cooperatives or using the cooperative to obtain supplies or materials at a better rate). Thus, it is logical for courts to have concluded that dividends or refunds paid to these cooperative members are income in their trade or business and subject to self-employment tax. The same cannot be said of worker cooperatives. The employee-members of worker cooperatives do not have a trade or business related to the cooperative other than as being an employee. The only business is the business of the cooperative itself. The income is generated only in and by the cooperative – unlike other cooperatives such as a marketing cooperative where the cooperative only helps sell the members' goods. An employee-member in a worker cooperative is more akin to an employee-shareholder of a traditional (non-cooperative) corporation which pays the employee-shareholders both employment compensation and stock dividends. If an employee-member of a worker cooperative is engaged in trade or business with the cooperative which causes the patronage dividend to be subject to self-employment tax, than a stock dividend paid to a employee-shareholder of a corporation should also be considered to be related to the employee's trade or business which he is conducting with the corporation (and, hence, subject to self-employment tax).

The IRC and case law clearly state that stock dividends paid to employee-shareholders of corporations are not subject to self-employment tax. Rev. Rul. 59-221.² The relevant question in the case of a non-cooperative corporation is reasonableness. The employee must be paid reasonable compensation and not attempt to characterize too much of the corporation's income as dividends (in order to avoid employment taxes). This should be also the relevant question in the case of worker cooperatives. As long as each employee-member is paid reasonable market compensation for his or her services as an employee, than any patronage dividend paid should not be subject to (self)employment tax. If worker cooperatives only compensate their members through patronage dividends or do not employ them and pay the market rate wages, then the patronage dividend is more like disguised employment compensation and should probably be subject to self-employment tax.

Case Law – There is a line of cases which holds that a retired farmer who remains a

² A business entity must be a corporation to be treated as a nonexempt cooperative. IRC section 1381(a)(2); Regs. section 1.1381-1(a). Cooperatives are generally organized and operated as corporations under state law. Other forms of business entities – such as LLCs - can qualify as corporations if they are treated as corporations for federal tax purposes. See, e.g., PLR 200119016.

member of a cooperative might not be subject to self employment taxes on his patronage dividends received if his activities with the cooperative are minor. *See, e.g., Hansen v. Commissioner*, T.C. Summary Op. 1998-91. In *Hansen*, a Minnesota farmer, while actively farming, had become a member of a value-added cooperative and apparently reported distributions from the cooperative as net earnings from self-employment. After retirement, the farmer no longer produced corn to meet the delivery requirement to the cooperative and fulfilled his obligation out of the cooperative's pool. The farmer took the position that the distributions were investment income not subject to self-employment tax, and the Tax Court agreed. The IRS later announced it agreed with the holding in *Hansen* (see Chief Counsel Notice N(36)000-3, April 21, 1999), *Felber v. Commissioner*, T.C. Memo. 1992-418. In *Felber*, the Tax Court held that a wheat farmer was not liable for self-employment tax on income received by him and generated from the sale of wheat by a tenant farmer under a crop-sharing agreement because it found that the taxpayer was retired and was only minimally involved in the production of wheat. In *Ray v. Commissioner*, TC Memo 1996-436, the Tax Court held that the taxpayer was still considered to be in the business of farming even though the cooperative paid him not to farm because there was a nexus or connection between the payments made and the taxpayer's trade or business – even if the taxpayer as a farmer was being paid not to farm at that point. In the case of a worker cooperative, the questions seem to be whether being an employee of the cooperative is a trade or business and, if so, whether that trade or business is relevant to the self-employment (whether it has sufficient nexus with the patronage dividends paid by the cooperative).

Additionally, the Tax Court has held that for dividends paid to cooperative members to be subject to self-employment tax, the payments must be made from income derived from the members' business with the co-op. *Bot v. Commissioner*, 118 T.C. 82 (1992). This is the case with classic agriculture co-ops where the members are in the business of farming and agree to provide certain crops to the co-op and share in the co-op's income generated from the member-patrons. The Tax Court notes that there must be a nexus between the trade or business and the income received and the payments must be derived from the taxpayers' trade or business. *Bot, supra*, at 152. If the payments were not made from patron-member activity with worker co-op – like, arguably, in the case in of the patronage dividends paid to the worker/members by a worker cooperative where the co-op income is primarily from non-members patronizing a bookstore operated as a worker cooperative - the payments are unrelated to the worker/members' trade or business which, if they have any trade or business at all, is that of being an employee of the cooperative.

Under *Bot*, *Hansen*, *Felber* and Chief Counsel Notice N(36)000-3, employee-members of worker cooperatives currently have a reasonable argument that their patronage dividends are not subject to self-employment tax. This issue is, however, quite unsettled and written published advice from the IRS or a court opinion on this issue would be helpful.

D. Conclusion

Payment	Amount	Income Tax Applicable	Employment Tax	Self-Employment Tax
Employment Wages – paid by any	\$35,000	Yes	Yes	No

type of cooperative				
Patronage Dividend – paid by worker cooperative	\$10,000	Yes	No	?
Patronage Dividend – paid by “other” type of cooperative (non-worker)	\$10,000	Yes	No	Probably

Under current law, an employee-member of a worker cooperative (formed as a corporation) certainly has reasonable basis to take the position that his or her patronage dividend is not subject to self-employment tax. This position, however is weak if the employee-member is not paid market rate employment compensation separately from any patronage dividend. In any event, the IRS is – and may continue – challenging this position. Thus, published guidance on this issue would be helpful and is being sought.

TAX ADVICE CONTAINED IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN TO BE USED, AND SHALL NOT BE RELIED UPON BY ITS RECIPIENT OR ANY OTHER PERSON, FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED UNDER ANY TAX LAW.