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Income Tax Exemption of Co-ops*

By CHARLES F. BRANNAN†

Despite the extensive and expensive publicity critical of the so-called tax exempt status of the patronage rebates which are regularly made by farmers' cooperatives to their members, there is small area for genuine difference of opinion between practical and reasonable men as to their legality. The constitutional premises and Court decisions upon which these patronage rebates or refunds or dividends or net margins, however called, are excluded from the computation of the cooperative are well established and have not been frontally attacked in the past several decades.

As is well recognized, the right of the federal government to impose an income tax on any one—be it an individual, a corporation, partnership, cooperative, or any other type of legal entity—came into being with the adoption of the sixteenth amendment to the Constitution of the United States in 1913. This amendment reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

In due course the Supreme Court was called upon to define "income" as used in this new amendment. The Court, in *Eisner v. Macomber*,² defined "income" for taxation purposes as "the gain derived from capital, from labor, or from both combined." Thus, if there is no gain to the individual, corporation, cooperative, partnership or other entity in question, there is no income and, hence, there can be no income tax.

Clearly, the Congress cannot exempt from taxation that which it has no power to tax in the first instance. Hence, the term "exemption," as used in the title of our discussion is somewhat misleading.

It is not here maintained that cooperatives are or should be exempt from federal income tax simply because they are cooperatives. On the contrary, cooperatives are subject to income tax on their true gains or profits and many of them pay substantial income taxes annually. Only one exception is made to this statement. It concerns the limited class of farm cooperatives to which the Congress granted exemption, in the correct sense of that term, by sections 521 and 522 of the Internal Revenue Code of 1954, more commonly known as sections 101 (12) (a) and (b) of the Internal Revenue Code of 1939.

In order to take advantage of this exemption the cooperative must serve primarily farmers who own substantially all of its voting stock; purchases by persons who are not members or patrons may not exceed 15 per

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²252 U.S. 189, 207 (1920).

cent; non-members may not be discriminated against in the allocation of patronage refunds; and the annual dividend may not exceed 8 per cent, or the legal rate of interest in the state of incorporation, whichever is higher. If the cooperative meets these and several additional tests, the dividends paid to stockholders may be deducted from gross income when computing its income tax.

When viewed from its revenue-raising potentials for the federal government, this right of farmer cooperatives to deduct from real gross income the dividends which are paid to patron-stockholders of its capital stock is of minor significance.

Furthermore, the Treasury Department has been so very strict in its application of this test that the cost of maintaining records in order to prove eligibility for this exemption has also outweighed the possible benefits for many cooperatives.

In these same sections, Congress determined that the earnings of a cooperative on the business of patrons to whom there is no contractual obligation to make refunds are profits of the corporation and taxable as such. This is to be found in the language of section 522 which states that patronage rebates should 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.

The very fact that the Congress has formally established this limited income tax "exemption" for a strictly farm cooperative clearly shows that other style or type cooperatives *are* subject to income tax. Otherwise, why would it be necessary to enact special and elaborate provisions for the farm cooperatives the operation of which fall within this limited definition?

The real objective of the National Tax Equality Association and its financial backers is the patronage rebate which farmer-owned cooperatives exclude from gross income in computing their federal income tax. However, this right to exclude such patronage rebates from gross income is not a special privilege granted by the Congress to farmer cooperatives alone. It is not even a special privilege for the benefit of cooperatives in general. It is the right of any corporation or other organization which operates on a non-profit basis under a firm contractual obligation to return to its members, whose patronage creates the "net margins" in its possession, the surplus of such funds after all expenses are paid.

The fallacious assumption of those who keep this campaign alive is that the funds which are distributed to a cooperative's patrons are "income" to the cooperative or other operating entity, although they are paid or credited to the patrons pursuant to a firm contract to return such accumulations. The law is patently to the contrary. Patronage rebates, when accumulated and distributed pursuant to a binding agreement between the operating entity and its patrons, are not income to the operating entity for tax purposes be that entity a farm cooperative, any other type of cooperative, a corporation, a partnership, a syndicate, or an individual.

These same persons impliedly maintain that there is something im-

break even or non-profit basis, if by some chance this may increase competition within the free enterprise system between the cooperative and one of their financial backers. Such phrases as "plugging tax loopholes," or "income from whatever source should be taxed," or "unfair exemption from income tax," when directed at patronage rebates, ignore the true nature and well settled legal status of patronage rebates.

When the whole controversy boils down to its essentials, it is quite elementary. Suppose an attorney who is supplementing his income from the practice of law by the operation of a farm (or perhaps the more realistic view today would be that the income from his legal practice is subsidizing his farming operation) should approach nine other lawyers similarly situated with the proposal that if they would all join him in a consolidated purchase of ten new tractors, a reduction of 15% could be obtained from the list price which each would otherwise have to pay for his tractor if purchased separately. This enterprising individual would also indicate to the other nine that in the process of acquiring the ten tractors it would be desirable to create an unincorporated entity to make the purchase, which he proposes to call "Tractor Buyers Syndicate." Further, each individual would have to pay to the Syndicate in the first instance the total amount of the list price of the tractor he desired but the Syndicate would agree unconditionally to return to each of the ten participants his proper share of the excess cash on hand, less expenses if any, immediately upon the conclusion of the transaction.

Would anyone seriously contend that the excess over and above the price paid by the Syndicate for the tractors was income to the Syndicate? Obviously, neither the Syndicate nor its individual members enjoyed an income under the provisions of the sixteenth amendment to the Constitution of the United States nor under any accepted accounting definition.

It is true, of course, that each one of the members will have sustained a lower gross operating cost on his individual farm operations for the year to the extent of the reduction in the cost of his tractor, or the percentage of it he can depreciate in any one year. Thus, all of his other operating factors being unchanged, each individual would have to pay some higher income tax as a result of his participation in this group transaction. Let me emphasize that there was a firm obligation on the part of the Syndicate to return the excess of the sum advanced, less expenses, when the transaction was completed.

There can be no question about the tax principles applicable to this simple example. But suppose in place of ten participants there were ten thousand participants. And suppose that in place of tractors the members were buying gasoline and oil from time to time throughout the year to operate those tractors, paying to the Syndicate the going market price in the community for the gasoline and receiving back at the end of the year a patronage rebate consisting of their proportionate share of the funds remaining in the hands of the Syndicate after it had paid all costs of procuring the gasoline and oil and delivering it to the members. Would anyone seriously contend that the increase in the number of participants or the increase in the number of the members' transactions with the Syndicate

Nor is there any fundamental difference in the relationship if, in lieu of withdrawing all of their patronage rebate in cash annually, the membership amended their contract with the Syndicate to permit all or a portion of the annual rebate to be temporarily withheld by the Syndicate and used to expand or improve the facilities or services to the membership. Clearly, a delay in refunding the patronage rebate would not alter the fundamental principles involved.

Then, let us further assume that the Syndicate became incorporated under the general corporation laws of the statutes of any state authorizing the creation of cooperatives, but continued to conduct its business in precisely the same manner and under the same unequivocal contract to rebate the surplus funds in its hands at stated times to the members on a patronage basis. Can it be seriously contended that the mere fact of incorporation materially changes the relationship or nature of the transaction?

This example has involved a consumer type cooperative. To round out the picture, suppose at the end of the crop season these ten lawyer-farmers shipped their grain to the Syndicate, which again contracts to pass back to the farmer members all gains from volume marketing less expenses, with the result that each of them received two cents more per bushel than the going market price in his community. This two cents is clearly not income to the Syndicate, even though the Syndicate withholds the gain from the first remittance to the producers and sends it along at the end of the year after the expenses of operation are determinable. This time, the farmer's gross income will be higher by two cents multiplied by the number of bushels he marketed and, all other factors being equal, the individual income tax obligation of each would be correspondingly higher.

Again, even if the number of participants be increased many fold, or the volume of bushels marketed is increased, or the Syndicate incorporates, or all of these take place, the fundamental nature of the transactions and the resulting tax situation will not have changed.

One of the earliest cases to deal with this problem, following the adoption of the sixteenth amendment, was the case of *Paducah and Illinois Railroad Company*.³ This controversy involved a bridge company formed by three railroads to build and operate a bridge for their joint use at Paducah, Kentucky. The bridge company issued bonds and the railroads underwrote them. With the money it received from the sale of the bonds the bridge company built the bridge. Each of the three railroads paid a predetermined toll or a charge each time it used the bridge. The income was first used to pay off current installments on the bonds. The excess that remained at the end of the year after meeting operating costs and expenses was retained by the bridge company, but its equivalent was paid to the railroads on a patronage basis in the form of preferred stock. Throughout this operation the bridge company filed income tax returns showing that it had no taxable income. The Tax Court of that day held that in view of the firm obligation on the part of the bridge company to return excess amounts in its hands after expenses at the end of the year in preferred stock, this ex-

cess did not acquire the status of income and, as the company had no income, the bridge company had no income taxes to pay.

This has been the view of the Treasury Department during a long course of rulings on the subject. In 1922 the department ruled:³

This office has consistently held that, under the Treasury decision and articles of the regulations referred to [T.D. 2737, 1918; Treas. Reg. 33, art. 75 (Revenue Act of 1913, income tax)], cooperative associations, even though not exempt from taxation, may deduct from gross income for the years 1917, 1918, 1919, and 1920 the amounts returned to their patrons, whether members or nonmembers, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons *goods at cost* or for *obtaining the highest market price* for the produce furnished by them. In the case of purchases, *instead of allowing a discount at the time of the purchase*, the full price is collected and the discount is allowed by way of rebate. In the case of sales of produce furnished by patrons, the refunds based upon the quantity of produce furnished are in reality only part payment for the produce furnished. If the association is organized in accordance with the laws governing *farmers' and other cooperative associations* in the State in which it operates and if its constitution or by-laws provides for refunds or rebates to its patrons, whether members or nonmembers, *upon the basis of goods purchased or produce furnished*, or if it actually conducts its business upon such basis, the *refunds or rebates* so made may be deducted by the association in computing net income under the Revenue Acts of 1917 and 1918. (Emphasis added).

And further in 1937 the Department said:⁴

So-called patronage dividends have long been recognized by the Bureau *to be rebates* on purchases made in the case of a cooperative purchasing organization, or an *additional cost of goods sold* in the case of a cooperative marketing organization, when paid with respect to purchases made by, or sales made for the account of the distributees. For the purposes of administration of the Federal income tax laws, such distributions have been treated as *deductions* in determining the taxable net income of the distributing cooperative organization. Such distributions, however, *when made pursuant to a prior agreement* between the cooperative organization and its patrons are more properly to be treated as *exclusions* from the gross income of the cooperative organization. (I.T. 1499, C.B. I-2, 189; S.M. 2595, C.B. III-2, 238; G.C.M. 12393, C.B. XII-2, 398.) It follows, therefore, that such patronage dividends, rebates, or refunds due patrons of a cooperative organization are not profits of the cooperative organization notwithstanding the amount due such patrons can not be determined until after the closing of the books of the cooperative organization for a particular taxable period. (Emphasis added).

From the foregoing cases and many others it is clear that, as a matter

³I.T. 1499, I-2 CUM. BULL. 189 (1922).

⁴G.C.M. 17895, 1937-1 CUM. BULL. 58.

of constitutional law, the amounts which a cooperative or corporation or any other entity is obligated to turn over to the patron are not income to the cooperative. This is consistent with the definition of the term "income" as interpreted by the United States Supreme Court in *Eisner v. Macomber*⁵ and *Commissioner v. Wilcox*.⁶ In the *Wilcox* case, Justice Murphy, speaking for the court stated:⁷

The very essence of taxable income . . . is the accrual of some gain, profit or benefit to the taxpayer. . . . Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of § 22(a) [Internal Revenue Code of 1939].

Thus it will be seen that we are not concerning ourselves here primarily with a tax related to the character or legal status of a particular entity, such as a farmer cooperative, but in reality are discussing a method of doing business. This method is available to any corporation or other type of operating or servicing entity. It is not a special privilege granted to cooperatives.

This is further evidenced by the fact that some of the very largest business enterprises in this nation chose to operate under agreements by which the corporation would make no profit or gain but would perform a service for a group of corporations or individuals engaged in a similar business at precisely the cost of performing that service.

The corporations by means of which railroads join in operating common terminals almost uniformly take advantage of this method of doing business. The terminal corporations make no profit and pay no income tax. If the predetermined contributions from the member railroads for operating the terminal prove to be in excess of the actual costs of operating the terminal, the excess is rebated.

The Associated Press operates in this manner, and its right to do so was recognized by the Supreme Court of the United States in *Associated Press v. U. S.*⁸ This case dealt primarily with a violation of the Sherman Anti-Trust Act, but in the opinion of the Supreme Court it was said:⁹

The publishers of more than 1,200 newspapers are members of the Associated Press (AP), a cooperative association incorporated under the Membership Corporation Law of the State of New York. Its business is the collection, assembly and distribution of news. The news it distributes is originally obtained by direct employees of the Association, employees of the member newspapers, and the employees of foreign independent news agencies with which AP has contractual relations, such as the Canadian Press. Distribution of the news is made through interstate channels of communication to the various newspaper members of the Association, who pay for it under an assessment plan which contemplates no profit to AP.

⁵252 U.S. 189 (1920).

⁶327 U.S. 404 (1946).

⁷*Id.* at 407-08.

⁸326 U.S. 1 (1945).

⁹*Id.* at 10-11.

Another enterprise, similar to the Associated Press, came under judicial scrutiny in *Uniform Printing and Supply Co. v. Commissioner*.¹⁰ In this case the business association was composed of a group of insurance companies which, in order to secure as economically as possible the large volume of printing required in their respective businesses, organized an Illinois printing corporation. It was not a cooperative, but was organized expressly as a profit making organization with the insurance companies as stockholders. The by-laws required distribution to the participating insurance companies of any net amount in excess of costs in proportion to the gross amount of business done for each participant. The Board of Tax Appeals held that this net amount when paid to the stockholders was a dividend and therefore taxable while in the hands of the Printing Company. The Court of Appeals in reversing this judgment stated:¹¹

Both the Commissioner and the Board found the so-called refund was a dividend. The precise and only question before us is the soundness of this finding or conclusion. Perhaps it would be better to call it a mixed finding of fact and conclusion of law. If the payment of this sum is a dividend, it should have been included in petitioner's taxable income for 1930. If it was a refund or rebate to customers, it was not part of petitioner's taxable income, for the sum should have been included in the stockholders' taxable incomes.

After stating its reluctance to differ with the Board of Tax Appeals, the court went on to say:¹²

Had the taxpayer given a customer (whether stockholder or outsider) a discount promptly after filling the order, no one would call it a dividend. If a rebate were given promptly upon the customer's business reaching a certain volume, the same conclusion as to its character would follow. To make cost estimates and adjust them at or near the end of each year returning the excess payment to the customer should not change the reasoning which leads to this conclusion. Nor should the fact that the customer is a stockholder materially affect the result.

Perhaps a single refund coming at the end of each year would lessen the irresistibility of the inferences, but the conclusion would still fit the facts better than one founded on a dividend assumption. It is true the taxpayer is not a nonprofit corporation in a legal sense. It is subject to a tax upon the profits by it made. Nevertheless, net profits in its case must depend upon the facts. Payments to the customers, who are also taxpayers, of sums called refunds based upon the volume of business transacted and in no way dependent upon stock ownership, is the determinative factor.

The American Railway Express Company has long operated under this principle. Many groups of retail grocers throughout the country who have found it necessary to consolidate their purchasing power in order to remain competitive with chain stores also operate through a corporation created expressly to make no profit for itself and to rebate funds in its possession

¹⁰88 F.2d 75 (7th Cir. 1937).

¹¹*Id.* at 76.

¹²*Id.*

and surplus to its needs from time to time to the retail grocer members. It is only when this method of operation is adopted by groups of farmers that it arouses the antagonism of such groups as the National Tax Equality Association.

Much has been made by the opponents of cooperatives about the decision in *Long Poultry Farms v. Commissioner*¹⁸ in which Judge Parker found that patronage rebates of cooperatives are taxable to the recipient of the rebate only to the extent of their actual market value. This circumstance arises when the cooperative, in lieu of making the refund wholly in cash, gives the patron some percentage in cash and a revolving fund certificate, certificate of indebtedness, or other form of notice that he will receive the balance of the cash due him on the current years operation at some future date. The money withheld by the cooperative is then used for capital improvements to enhance the service capabilities of the cooperative. Under this decision and several others which concur with it, the patronage dividend, which is clearly not taxable in the hands of the cooperative, also becomes non-taxable to the patron in the year received or until and unless it is paid in cash, if it can be shown that the certificate has no market value. This was probably not the intention of the Congress. In that event the Congress will rectify the situation.

The decision in the *Long Poultry Farms* case is in direct contradiction to the Treasury Department's regulations on taxation of patronage rebates. Section 1.61-5 of such regulations provides, in part, as follows:

Allocations by cooperative associations: tax treatment as to patrons. (a) *In general.* Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section. . . . The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association . . . shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolv-

¹⁸249 F.2d 726 (4th Cir. 1957).

ing fund certificates, certificates of indebtedness, letters of advice, retain certificates, or similar documents—

(a) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated.

. . .

(c) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in (a) of this subdivision. . . .

The vast majority of co-op leaders support the principle embodied in the Treasury Department's ruling. In Montana a bill designed to support the principle of the Treasury Regulations was recently adopted by the legislature with the support of its membership friendly to cooperatives. This bill was vetoed by the Governor.¹⁴

Except for the special privilege granted to some farm cooperatives to deduct dividends from gross income as hereinabove mentioned, cooperatives and private business corporations are treated alike for income tax purposes. The cooperative is in business solely to render a service to its members. It seeks to make no profit for investing stockholders. On the contrary, the private business corporation is concerned with gains for the benefit of its stockholders, most of whom are not its patrons, or only incidentally so. (You may be a stockholder of General Motors and also have bought a Cadillac, but there was little, if any, connection between these two transactions.)

Thus, again, the essence of our controversy does not involve the cooperative as an entity receiving special consideration, advantage, or benefit from its government, but rather a method of doing business which is available to any type of corporate entity and which is being used broadly by all types of free enterprises throughout the nation.

Those who would subject to federal income tax the funds accumulated by farmer cooperatives from which patronage rebates are made to their patrons attempt to equate such funds with the profits of corporations. They point out that corporate profits are exposed to so-called double taxation: first in the corporation's hands and a second time when received by stockholders as dividends. For the reasons above stated the analogy is without legal foundation because the patronage rebates were never income to the cooperative, although they raise the taxable income of the patron when received by him.

However, if those who advocate this so-called double tax for cooperatives would be logical, they would also contend that the income of partnerships should be taxable first to the partnership as a separate entity and

then be taxed a second time when distributed to the individual partners. The Congress, the courts and the Treasury Department have consistently held to the contrary. In fact, the Congress has recently reaffirmed its belief in the unfairness of such a double tax by providing for the treatment of corporate income as partnership income for tax purposes in limited cases.¹⁵ If any analogy exists in this area, it lies in the similarity of a patron member of a cooperative and a partner in a partnership.

The specific and limited income tax exemption which the Congress has granted to farmer cooperatives is applicable to the true income of only those farmer cooperatives which can qualify, and is to be distinguished from patronage rebates which cannot be subjected to income taxation.

The producers of agricultural products, operating individually, have traditionally bought the supplies they require in their farm operations from a market totally controlled by others, and they sell their products at the end of the season in a market and at prices also determined by others. This has long been recognized as one of the serious economic problems adversely affecting not only our farm economy but also on occasions the national economy as well. In fact, to overcome the severe disadvantages which farmers face at the time they offer their crops for sale in the market, the Congress adopted price stabilization measures in the mid-1930's.

But, farmers have also undertaken to improve their bargaining powers by forming both consumer and marketing cooperatives. For some crops, such as grain, the marketing cooperatives have served their membership well. Likewise, the consumer cooperatives have operated to the substantial benefit of their patron members. Yet the growth of these cooperatives has been far slower than the welfare of the farm population warrants. And if their position in the market place is measured against the great business enterprises with which they daily compete, the expansion of farmer cooperatives has been comparatively slow. It is in the belief that some encouragement and aid should be given to genuine farmer cooperatives, which are striving earnestly to equalize farmers' bargaining power in a business climate characterized by corporate consolidations and concentration of market controls, that this limited income tax benefit has been granted. It is submitted that the public welfare is properly served by this particular legislation.