Federal taxation of agricultural cooperatives

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FEDERAL TAXATION OF
AGRICULTURAL COOPERATIVES

by

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PREFACE

This paper examines the various bases for the present Federal Income Tax Policy toward farm cooperatives, and suggests changes in policy which would be in accord with basic standards of taxation equity. The above examination and policy proposals involve two goals. First, the several conceptual frameworks: rebate or cost adjustment theory, agency theory, and departmentalization theory - upon which the present tax policy is based - are examined. Second, these conceptual bases for the present tax policy are measured against the following principles of taxation:

1. Like enterprises must be treated alike.

2. Unlike enterprises must receive differentiated treatment which is consistent with optimum allocation of resources.

The rebate and agency theories have been strongly challenged by many economists outside the field of agricultural economics and these challenges have been inserted in this paper in a minimally altered form. No claim to originality is intended with respect to those arguments. Since the recent rejection of the rebate or cost adjustment argument by the U. S. Treasury, the departmentalization concept has taken on new importance. The burden of support for the present tax policy toward farm cooperatives has shifted from the legal profession to the economist. However, to the author's knowledge, no serious case has been made against the departmentalization argument. Some non-farm economists have suggested that there is great enough separation of control and ownership in farm cooperatives to make the departmentalization position untenable. However this appears to have little force since many writers including

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the author believe that cooperatives, like unions, are not purely eco-
nomic institutions and that industrial democracy is found in a greater
degree here than in large proprietary enterprises. Since the separa-
tion counter-argument has little a-priori value, the departmentaliza-
tion argument appears to stand undaunted. Yet it is in reference to
this conceptual support of present tax policy that the economist is
working in his appropriate role. This thesis attempts to fill this void
by challenging the major prop of the departmentalization argument; that
a department or firm can be defined on the basis of static goals. Co-
op goals do change and to the extent that these changes allow such
organizations to operate from the standpoint of firms, they should bear
a like tax burden. Under an economic system considered to be in static
equilibrium such a policy of taxation allows for optimum allocation of
resources and equity in taxation. However it can be validly argued that
in the more realistic case of an economic system undergoing dynamic
change, like businesses, from the standpoint of immediate goals, should
not necessarily receive like tax treatment. Only through a differen-
tiated tax pattern will optimum allocation of resources be brought about.
Here again the present tax treatment toward farm cooperatives cannot be
justified. There are strong a-prior reasons based upon observed para-
meter shifts that co-ops should be taxed more heavily than other firms
in the present farm economic environment. Such taxation would increase
the rate of adjustment toward competitive general equilibrium. In sum-
mary, the departmentalization position does not justify the present fed-
eral tax treatment of income from farm-cooperative enterprise. Since
the other conceptual frameworks used in support of the present tax treat-
ment of farm-cooperative earnings are found lacking, the conclusion is
that the present policy works toward a sub-optimal allocation of resources. Appropriate policy proposals are suggested.
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CHAPTER I

THE AGRICULTURAL COOPERATIVE: ITS ROLE AND ECONOMIC NATURE

The Setting

Historically, cooperatives have been non-enterprise associations created to benefit from economies of scale. In the United States the associated entities are predominantly enterprises, particularly farm enterprises. These enterprises benefit from cooperative association in the following ways:

1. They provide services of a kind and quality theretofore unavailable.
2. They lower costs of services previously available.
3. They influence the prices received for the participants' output.

The Associated Press and Railway Express Agency are examples of the first case. Citrus cooperatives were formed primarily to influence prices, while grain cooperatives were formed primarily to lower costs. However with farm cooperatives the benefits were generally mixed.

American farming has never matched other industries in purchasing and marketing efficiency. As Davis stated:

Although the small farm is efficient in the production of crop and livestock products, it is at a great disadvantage when it comes to buying farm supplies, marketing farm products and providing services related to farming which operations can normally be performed more advantageously on a

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The reasons for the dichotomy are geographical and historical. In any given locale, land generally has mixed characteristics. A pasture and crop mix is typical. Where land approaches homogeneity, crop rotation is necessary for maintaining fertility. The farm-type of enterprise was easily adapted to family organization. Consequently a discount was placed upon specialization. As a reinforcing factor the epic of settlement in this country was simultaneously one of subsistence farming. The Homestead Acts are political homage to this fact. Some practical knowledge and a strong back often earned their highest returns in farming. With land relatively cheap and available, families with little capital created what we know today as the family farm. Out of the family farm's inefficiencies in marketing and purchasing, coupled with monopsony and monopoly powers which it faced, the agricultural cooperative movement was born.\(^2\) The following quotation is entered as an applicable exhibit.\(^3\)

Grain cooperatives began in the 1880's. Laws had been passed chartering the grain exchanges, and farmers came to the conclusion that as these exchanges grew stronger the farmer's bargaining power was weakened. They felt that prices for their grain were being set without their having a voice in the matter, often by a small group of traders with no real interest in the economic welfare of farmers.

Perhaps one of the most eloquent statements regarding the historical role of agricultural cooperatives was made in House Report No. 188, 79th

\(^2\)For excellent historical material on the agricultural cooperative movement see: James H. Shideler, Farm Crisis 1919-1923 (Berkeley and Los Angeles: University of California Press, 1957) and: Theodore Saloutos and John Hicks, Agricultural Discontent in the Midwest 1900-1939 (Madison: University of Wisconsin Press, 1950)

\(^3\)U. S. Congress, House, Committee on Ways and Means. Hearings, Revenue Revisions of 1951, 82nd Cong., 1st Sess., p. 1273
The hearings before the committee did develop one positive and irrefutable conclusion. That conclusion was predicated upon evidence submitted personally by many farmers who had been instrumental in the original formation of agricultural cooperatives. It was definitely apparent, after listening to these witnesses that conditions in the early days were such that these particular farmers were forced to the creation of cooperatives to correct the evils in the marketing of their products and to improve their own agricultural industry generally. Farmers historically were forced to sell the products of their labor at a price the market was willing to pay and to buy the goods required for the production of these products at prices established by the seller. Operating as an individual the farmer had no bargaining power and was always subject to the whims and fancies of the market speculator.

There can be little doubt that the historical role of agricultural cooperatives was to countervail imperfections in the farm-sector of the economy. Agricultural cooperatives were formed to eliminate monopsony and monopoly profits, thus turning these revenues back to those people from which they had been extracted; namely the farm producers.

Integration

All cooperatives are formed either to maximize consumer satisfaction or producer returns. Agricultural cooperatives are formed by producers. They can maximize returns from production in the following three ways:

1. They can lower production costs.
2. They can lower marketing costs.
3. They can increase prices.

Through increased scale resulting from association, the cost of

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factors of production decrease, while the efficiency in combining such factors increases, thereby lowering production costs. Mere size, ignoring monopsony possibilities, enables the farm producer to efficiently utilize specialized marketing equipment and personnel. The unassociated farm producer generally is denied such benefits. Size also increases the communication between the farm producer and the producer of industrial services and goods used in agriculture. Thus the cost of an inefficient distribution system is reduced. These cost reductions are available without resorting to monopsony strategy. However many cooperatives do utilize monopsony power, which results in additional savings.

Similar advantages accrue to farm marketing associations. In graphical terms the advantage of a marketing association is a lowered Average Marketing Cost Curve (amc) of a relatively constant cost nature.\(^5\) A single farm firm operating on a non-co-op basis would build into a processing plant a certain degree of flexibility. Hence the producer could process for the same unit cost slightly different amounts of farm production. However flexibility raises minimum costs and through association this cost can be lowered. By associating, previously independent farm producers can process products at a lower unit cost (no internal accommodation for flexibility is made) relying upon many coordinated least-cost plants for flexibility. Unpredictable changes in farm output can be distributed equally among the coordinated plants once their respective least cost points are reached. Such a policy results in a slightly rising amc curve. However if many plants are operated, which

is the typical case, the rise will be so insignificant that the amc
curve reflects approximate constant costs. If production falls below
the number of units necessary to operate all plants at least cost ca-
pacity, the excess plants can be closed down. Since fixed costs for any
particular plant are negligible the cooperative's amc curve will slope
downward only slightly, until optimum capacity is reached. The result
of such coordinated operations is an approximate constant cost long-run
and short-run, marginal and average marketing cost functions. All of
which will be lower than those available to the unassociated farmer.
Therefore, within broad limits, whenever the cooperative maximizes pro-
fits it also is minimizing average costs. Like the purchasing coopera-
tive, if monopsony power is considered, unit costs are further reduced.

Cooperatives also increase returns by raising farm prices. Such
outward shifts in the agricultural industry's demand function are brought
about by the following factors.

1. Increased multiple utilization of farm products.

2. Countervailing monopsony power.

The first factor is often overlooked. Prior to cooperation many farm
products were "underemployed." This was particularly the case for per-
ishable products. Middlemen were interested in short-term investments
and speculative gains. Both interests worked against the farm producer.
Grading was haphazard, storage and transportation arrangements of a
similar quality. As a result the customers in the eastern markets pur-
chased day by day vastly different qualities of various perishable goods.
Obviously the total demand for such products was small. Proper grading,
storing, transportation and better market information could push the
industry demand curve to the right, resulting in higher prices. This
the cooperatives did. Price fluctuations were ironed out through the utilization of a more expensive but more profitable distribution system. Higher and more stabilized farm profits resulted. In addition as the improved farm products reached the metropolitan markets, their increased uniformity within classes and increased availability unleashed dormant consumer demand. Profits were increased again.

The above price effects resulted from a superior utilization of marketing factors than had theretofore been developed. The problems of the perishable-product producers was partially unavoidable. New industries often go through an initial adjustment period. To a degree even the most progressive middleman would have failed to pacify the specialized-product-farm producers. A new set of problems had to be solved and time was needed. It is not unprecedented that producers take the initiative in such circumstances. Producers before and since have often initiated solutions to their particular distribution problems. However it is equally fair to state that many farm-connected enterprises made an inherently trying problem, nearly incapable of solution. Few new problems were faced in the marketing of staples, yet these producers also complained of low and unstable prices. Here monopsony power was the heart of the problem. Consequently producers of staples also organized cooperatives. Like unions, such cooperatives found strength in large bargaining units. Locals affiliated with districts and districts with central exchanges. As a result the commission houses found representatives of cooperatives sitting on previously producerless boards of trade. A simple case of cause and effect was altered; farm prices increased and monopsony profits decreased.
Although co-op integration benefited the farm sector, it is essentially an inferior type of integration. Inferior or superior integration refers not to the extent that different processes of production and distribution are combined, but rather to the ease of coordination of those processes by the integrators. In many cases farm producers have gone just as far as other producers regarding the extent of combined processes. Superior non-farm integration has for the most part come about through expansion, merger and consolidation. These methods of integrating have created new independent firms or expanded old ones. Production and marketing decisions are still made in tandem. Such methods have generally not been available to farm enterprise. The volume necessary to achieve economies of scale in marketing or purchasing can seldom be achieved through farm mergers. Ownership is too widely spread. Lack of capital has stymied expansion to an economical volume. In brief, the economies to be found in expansion, merger and consolidation are insignificant in the farm sector.

The weakness of farm integration through cooperative association is the line drawn between production and marketing decisions. The following quotation in reference to the Challenge Cream and Butter Association of Los Angeles aptly illustrates this point:

What may appear to be a highly integrated firm in reality suffers from some handicaps which are typical to many cooperatives. Although each local association is bound by contract to deliver its commodities to Challenge, which is the locals' sales agent and has no influence on the production plans of the locals, each local decides on its own what, how

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7Hirsch

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much and when to produce. This leaves to the cooperative's headquarters the function of maximizing net returns to members under given production policies.

Non-farm firms as a rule openly associate only to provide informational services. Such an association does not dilute the decision making function of the individual firms. The firms remain independent, making simultaneous marketing and production decisions. Only cartels or industry policies characterized by tacit collusion structurally resemble a cooperative association. Even here if the arrangement has long been established, production and marketing decisions will not be separated. In such a case the firms form a multilateral monopoly. However, the typical cartel is probably not well integrated since participating firms can disassociate in an instant. On the other hand the associated enterprise members of a farm cooperative are contractually bound to one another. Failure to carry out terms of the multilateral contract running among the participants will result in legal enforcement either by liquidated damages or specific performance. 8

In summary, the efficiency of integration in the non-farm sector is far superior to its counterpart in the farm sector. The inefficient cartel relationship must be resorted to at the initial level of integration by associating cooperators, while integration in other industries need never be supported by this mechanism. This brings us to the question, what kind of a business unit is the agricultural cooperative? If cooperative associations are to receive equitable tax treatment one must know what kind of business units they constitute. Departments of firms

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are not taxed, subsidiaries (80 percent owned by the parent) have a two percent tax levied on their "earnings" before they appear on the consolidated income statement, and non-profit institutions pay no tax at all. 9 Structurally where does the farm cooperative fit in?

Economic Nature of Agricultural Cooperatives

In determining the tax liability of agricultural cooperatives much effort has been spent differentiating between the economic nature of agricultural cooperatives and that of firms. Many agricultural economists concur that farm cooperatives are jointly operated departments of independent farm-firm patrons. Emelienoff, Robotka, Nourse and Phillips are the major sponsors of this position. The following quotations point up their positions. 10

Emelienoff

The cooperative represents the associated economic units in their functioning and not their association as a separate economic entity; an association or aggregate is functioning only as a branch or part of associated economic units, in that respect it is perfectly identical with the special departments or branches of single economic units.


Nourse, The Legal Status of Agricultural Cooperation, 81.
The conception of an aggregate of economic units is a strangely difficult concept. It cannot be comprehended precisely unless it is clearly understood that an aggregate of economic units is not an independent economic unit but the group of functioning economic units—acquisitive (enterprises) or spending (households) and therefore all the functions of the aggregate are ultimately the functions of the aggregated economic units and not of the aggregate itself.

The aggregate consists of a technical unit (establishment) but not an economic unit enterprise.

Robotka

...a cooperative...is...a federation of autonomous economic units whose avowed purpose it is to function in their individual capacities but in a co-ordinate manner with respect to specific activities integrally related and common to their individual economic pursuits.

Phillips

The jointly conducted activity of the cooperative association is not a corporate firm which shares earnings over and above costs with those who patronize it. It is instead a jointly operated economic plant, set up and conducted as an integral part of the individual business activities of the economic firms...which participate in it. The participating firms function coordinately in that part of their total business activity which they conduct through their common plant. Participation in the joint activities involves more than patronizing it. It involves also (1) allocating resources to the joint activity; (2) assuming the entrepreneurial responsibilities of the residual uncertainty bearing and ultimate decision making for the joint activity; (3) bearing of all costs, including costs of risks, in the joint plant; and (4) receiving the economic benefits, if any, of the joint plant...All net operating proceeds from the joint plant accrue to the participating firm which own and operate it...

Nourse

The phrase not conducted for profit is one that has been misunderstood...It does not mean that the members of a cooperative association do not expect to receive economic benefits from its operations...it does mean that these benefits, even though measurable in pecuniary terms, shall accrue to participating members to enhance the returns from their own operations as producers, rather than going
as profits to those persons who furnish capital to the joint enterprise.

The above statements, although differing in particulars are compatible in principle. All of the authors differentiate between self-sufficient and dependent economic units. Trade associations, cartels, departments, plants and cooperative associations all fit into the dependent category. In recognition of the dependent character of the cooperative association, Emelienoff calls the cooperative an aggregate or technical unit. Robotka speaks of coordinated functioning with respect to common individual economic pursuits, while Nourse refers to enhancing the returns of the associators' own operations as producers. Phillips gives the briefest definition, calling the cooperative association a jointly operated plant. In the infancy period of agricultural cooperation there would be no argument with these common positions, which will henceforth be referred to as the departmentalization position. However it must be remembered that a cooperative has economic significance only as it is related to the associators' intent. There is no reason why agricultural cooperatives cannot use the same economic and legal relationships at one point in time to operate a joint-plant of independent farm firms and at another time, to operate a firm. This is the all-important fact that has often been overlooked. In order to show this evolutionary possibility we will first define a firm, and then compare the evolving economic nature of agricultural cooperative associations to it. In defining the economic nature of a firm the following three premises will be used.

Premise 1: Households maximize satisfaction over their planning periods by equating the marginal satisfaction from present consumption, idle balances, and working balances.
This relationship is based on the assumption that the end goal of all economic activity is want fulfillment. Households, in maximizing satisfaction, weigh the satisfaction from present consumption against the anticipated satisfaction obtained from a possible larger future consumption and lower present consumption.

Premise I: Present working balances are allocated among various enterprises according to anticipated adjusted returns, subject to a maximum-risk constraint.

Adjusted returns rates are monetary returns from which a differential risk has been deducted. Several enterprises may offer the same gross returns, yet all may have differing risks associated with an identical earning potential. Their adjusted returns would, therefore, differ. The household will allocate its working capital to those enterprises that will give it the largest adjusted rate of return subject to its maximum-risk constraint. This latter constraint simply means that some investments are unacceptable, whatever the return, because the risk associated with them is in excess of some acceptable limit.

Premise III: Portfolio allocation of present working balances may be essential to minimize uncertainty.

The householder is not merely interested in maximizing his rate of return, he is also interested in minimizing uncertainty. Hence investments will be distributed among several enterprises, so as to maximize the mathematical expectation of the returns available in an uncertain world. This uncertainty minimization or portfolio allocation of working balances is the rationale used by mutual funds and other investment operations in "assuring" clients a given adjusted rate of return.

The minimization of uncertainty and the maximization of adjusted
returns create a special relationship between entrepreneurs and enterprises. The goal of constrained maximization of returns tends to gather into any going concern investors having common expectations of adjusted returns rates. Perfect homogeneity of returns expectations may never be reached, but such homogeneity will serve as an equilibrium position. Since the desire of an investor to minimize uncertainty through portfolio allocation requires that the risks and returns of all his investments be approached on an aggregate basis, another basic relationship between enterprises and entrepreneurs exists. This is, the entrepreneur is interested in maximizing profits only within his risk limitation. This is understandable since any major change in a concern's policies will require, with only accidental exceptions, a complete reallocation of the investor's working capital. Hence the following definition of a firm can be formed.

A firm is an aggregation of investors whose risk-return expectations tend to be homogeneous with respect to investment in an enterprise whose given goal is to maximize profits subject to some maximum permissible risk.

It is now possible to analyze the economic nature of agricultural cooperatives. Since it has already been established that cooperative associations are dependent economic units, three conclusions are possible regarding their present economic nature.

1. Contemporary agricultural cooperatives are operated as farmer-owned firms.
2. Contemporary agricultural cooperatives are operated as departments of farm firms.
3. Contemporary agricultural cooperatives are operated simultaneously as firms and as departments.

The third possibility is related to the dispersion of equalized adjusted
returns points among an association's patrons. Where all patrons receive adjusted returns no greater than those available in a pre-monopoly-monopsony environment, henceforth referred to as the pre-entry period, the cooperative functions as a dependent economic unit. On the other hand, if a cooperative's members increase their returns beyond the pre-entry level, the association is structurally analogous to a firm. However, since patrons probably did not have common adjusted returns in their independent operations during the pre-association period the cooperative's economic structure must be defined in view of the individual patron's relationship to his association. By analyzing its economic structure in this manner, one finds the cooperative functioning as a department for some members and as a firm for other members. The crucial point is that a farm cooperative's structure and role cannot be properly determined on an aggregate basis. An aggregate analysis of a cooperative's economic structure is static in nature and leads to gross misconceptions. In order to determine which of the three possible conclusions is valid, one must trace the evolution of agricultural cooperatives. By comparing over time the basic characteristics of farm cooperatives with our definition of a firm, the changing economic nature of farm cooperatives will become explicit.

The first stage will be named the organizational stage. As noted above, farmers organized cooperatives to eliminate monopoly and monopsony

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11 The pre-entry period refers to that historical time when large aggregations of non-farm capital were not operating in force in the farm sector of the economy. For example the large farm implement manufacturers, commission houses and railroads. That is, the economy was more properly defined as a perfect competitive structure rather than a workable competitive structure.
profits. By eliminating these profits they obtained higher and more stable incomes. The means for accomplishing this goal was risk substitution. The associating farm entrepreneurs substituted the new risk of uncoordinated action for the old risk involved in selling to and buying from outsiders. By accepting the new risk their incomes became higher and more stable provided the cooperative was efficiently operated. Each participating farm entrepreneur became engaged in a community effort to eliminate monopsony and monopoly profits, and to turn these profits back to himself and fellow farmers to whom they would have accrued in a more competitive economy. The association may decide to market the products and purchase supplies for outsiders since unit marketing and purchasing costs will be lowered. Assuming that these additional risks still leaves the individual farm entrepreneur's adjusted returns no higher than the pre-entry returns, the association, although maximizing net revenue, is operated as a department. The association maximizes profits, yet its operations are conducted to maximize the returns from farm production and not from farm-owned marketing and purchasing firms. This, as Cook implies, is the type of economic environment Phillips uses to construct his theory of cooperation. Dr. Phillips does not deny the existence of the entrepreneurial function of uncertainty bearing, but

12Frank Robotka, *Journal of Farm Economics*, XXIX (Feb.-May 1947), p. 103. The risk of uncoordinated action refers to scabbing which took place during the inception period of farm cooperation. Plant facilities were built to meet the needs of all member patrons. Costly excess capacity resulted when members withdrew their support to capitalize on the price-war returns offered by non-co-op enterprise.

he insists that entrepreneurship is limited to the farm.

The second stage will be called the growth stage. Since pre-association adjusted returns differed among the associating farmers, post-association returns will also differ. Pre-association returns differed because, as a rule of thumb, larger and/or better farmers received the best prices from outsiders. Hence the possibility of obtaining a normal pre-entry profit in the pre-association period was smallest for the smaller and/or inefficient farmer. With the associated risks and returns shared in proportion to use, adjusted returns are heterogeneous. As the association continues to add departments (vertical integration) and to solicit business with non-members (horizontal integration) the point will be eventually reached where for some farmer pre-entry and post-associated adjusted returns are equalized. If one more unit of business is performed for non-members, or if one more step toward vertical integration is taken the cooperative has become a firm for the mentioned farm entrepreneur. From that point on he is interested in profits from marketing and supply activities and not in profits from farm production. In this case the association operates as a firm for a portion of the members and as a department for others. Since the larger farm producers upon which the continued success of the cooperative may depend will generally be the first to obtain equalized returns, the co-op may intentionally become a firm. That is, in contrast to the wishes of the less important members, the co-op may expand its operations into riskier fields. Risks will be taken which are incompatible with the maximum risk desires of the smaller farmers. Consequently intra-cooperative strife may develop, one group preferring
to take on additional risks, the other preferring a slower pace of
growth and a larger allocation of resources to the farm firm rather than
to the association. The volume and type of business at which the intent
to operate as a firm becomes effective will depend upon such factors as
the voting rules (proportional and/or one vote per member) and the
adjusted returns composition of the members. Therefore, some very
large cooperatives may intentionally operate as departments while some
very small associations may intentionally operate as firms.

The third and final stage is the maturation stage. In this stage,
all member-farm entrepreneurs have returns equal to or greater than
their respective pre-entry returns. Every member-patron is now enjoy­
ing at least as high an adjusted return as was available from his par­
ticular farming operations before monopoly and monopsony elements
entered the farm economy. The policing ability of the cooperative is
operating at maximum strength. Monopsony and monopoly profits of the
non-farm firms have been eliminated. Assuming no shifts in other eco­
nomic parameters normal-farm returns have been reinstated. Now the
cooperative is increasing all members' risks and distributing the con­
sequent monopoly profits not from farm production but from marketing
farm products and purchasing farm supplies. The cooperative has become
a bonafide firm. Since it is now possible for farmers to scab while
receiving normal returns, co-op members have common adjusted return
anticipations or they will invest their funds in other enterprises. The
only economic difference between the mature cooperative and the non-farm
firm is a profit-sharing relationship. Returns from marketing and pur­
chasing operations are distributed on the basis of member patronage and
the coincident capital contribution rather than to "unidentified capital." In sum, a profit relationship has been created which increases entrepreneurial profits in relation to the entrepreneurs' output in another enterprise, farm production. One farmer-member does not gain at the expense of another farmer-member, but all gain at the expense of non-farm firms. Thus the mature farm-cooperative economy has significant policy implications, to which we now turn.

Policy Implications

The confusion surrounding the cooperative tax controversy is due to the failure to recognize the changing economic nature of agricultural cooperatives. Rational government policy toward agricultural cooperatives in one period may be irrational policy in another period. This fact was recognized in House Report 1888:

In order to intelligently appraise the tax position of the agricultural cooperatives, it was first necessary for the committee to review the economic background which resulted in the formation of these cooperatives. The Congressional treatment originally afforded agricultural cooperatives must naturally have been predicated upon the economic conditions then existing. It is conceivable that the premise upon which this original action was taken may have been wrong, or that evolutionary changes in the economic structure of our nation may have erased the necessity for similar consideration today.

The divergent positions taken by spokesmen in the controversy reflect two different economic periods. These periods approximately correspond to the organizational and mature stages of the agricultural cooperative's development. The cooperative interests argue from the economic environment of the Twenties while the tax proponents argue from our contemporary economic environment. Obviously the latter group is closer to reality.

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14 House Report 1888, 11.

Note: Underlining is the writer's.
The economic arguments used by cooperatives to justify their present tax status we have previously termed the departmentalization position. The argument is as follows:

Premise 1. Departments of firms are not taxed.
Premise 2. Cooperative associations are jointly operated departments of associated farm production units.
Conclusion: If agricultural cooperatives are taxed discrimination will result.

There is a major fallacy in this syllogism. There is good reason to suspect that contemporary cooperatives do not operate as departments. Their success and the great increase of governmental regulation since their inception have changed the economic role and nature of farm cooperatives. Farm cooperatives no longer depend for success upon their efficiency in policing monopoly and monopsony profits. In fact, in some cases they have developed the very characteristics that they initially attempted to eliminate. The contemporary farm cooperative serves to maximize farm-connected rather than farm-production returns. Contrary to Phillip's position the cooperatives' entrepreneurship has left the farm. Contemporary farm cooperatives are merely a special type of firm. The patron invests his products as well as his working balances in the cooperative enterprise. Beyond this moot difference farm cooperatives are structurally analogous to firms.

To refuse to levy a corporation income tax upon cooperatives because they are superficially related to the operations of unincorporated farm firms is economic nonsense. In contrast to the departmental relationship found in closely held subsidiaries which are not taxed, the full benefits of incorporation are received by incorporated cooperatives.
Closely held subsidiaries are dependent economic units whose operations have no meaning outside of the parent's economic goals. Since the parent is incorporated, the value of incorporation of the subsidiary is negligible. The same economies of scale could be achieved by operating unincorporated divisions, as General Motors does.

Modern farm cooperatives on the other hand could not function successfully without being incorporated. The privileges of artificial existence, limited liability and ease of attracting capital are real advantages to them. In fact these advantages especially when they are not paid for constitute the life line of the present success of farm cooperatives. In brief, since contemporary cooperatives are incorporated firms, optimal allocation of resources under a general competitive equilibrium, requires that they bear a corporate income tax.

Some co-op spokesmen claim that the important fact in determining whether farm cooperatives should be taxed depends upon whether or not farmers are receiving parity of income. This position is held by past Assistant Secretary of Agriculture, Charles F. Brannan, in the following statement:15

It has long been public policy in this country to encourage farmers to help themselves through cooperatives, thus solving complex economic problems on a group basis. By lowering production costs, increasing marketing efficiencies, and providing a means through which farm families can supply themselves with goods and services not otherwise adequate or available, cooperatives can be an important aid in bringing to rural areas parity of income and parity of facilities.

Since this thesis assumes that farm cooperatives have more than succeeded in policing monopoly and monopsony profits, below normal returns can be

created only by other parameter shifts. The major parameter shift effecting the farm population in the last fifty years has been that change in farm technology commonly referred to as the agricultural revolution. As a consequence of this worthy change in technology a smaller percent of our nation's population is needed to meet the demand for food and fiber. If this is the parameter change which has decreased the farmers' percentage of national income, it cannot support the present tax position of farm cooperatives. The surplus of labor in the farm sector could be employed to better advantage elsewhere in the economy. Rational tax policy in such a case requires that cooperatives which serve to decrease the mobility of a part of our labor force, should bear a higher tax burden than other incorporated firms. This policy would speed up the adjustment to a new equilibrium position. In conclusion there is no economic basis which supports the present tax policy toward farm cooperatives.
CHAPTER II

OPERATIONS AND ORGANIZATION

Introduction

In chapter one, the following propositions were developed:

1. Agricultural cooperatives were organized to eliminate monopoly and monopsony profits.

2. Associated farmers change from farm entrepreneurs to marketing entrepreneurs as monopoly and monopsony profits decrease.

3. The social utility from subsidizing agricultural cooperatives is related to the degree in which monopoly and monopsony profits are eliminated.

The third proposition must be the ultimate standard in creating equitable tax policy. However, as shall be seen in chapter four, the various tax proposals center around the following questions:

1. Do agricultural cooperatives make profits?

2. If cooperative profits exist, what is the measure of these profits?

In order to answer the above questions a knowledge of cooperative operations and structures is essential.

In the literature of agricultural cooperation it is evident that from one point of view agricultural cooperatives are not structured or operated as profit making enterprises. From their inception, agricultural cooperatives have constantly changed their structure and operating methods in order to maintain a non-profit status. Methods of financing, settlement operations, and distribution of control, on the whole exem-
plify a dominating desire to operate on a non-profit basis. However, the crucial question is: What is meant by non-profit operation? Does non-profit operation preclude farm entrepreneurs from receiving non-farm profits from cooperative operations; or does it mean that a cooperative is a multi-firm plant serving to maximize profits for its enterprise patrons, but an economic unit which does not exist to maximize profits in its own operations? There can be little doubt that the latter is what cooperators call non-profit operation. Any profits accruing to the association as such are merely incidental to the primary non-profit goal.

Phillips gives the most complete explanation of the non-profit relationship. He recognizes the cooperative as a dependent economic unit. The association is composed of firms interested in enhancing returns from their independent operations. These firms agree to jointly operate a plant in order to reduce market imperfections. This reduction leads to lower unit costs and higher stabilized profits for the associated farmers as the following list indicates.

1. By reducing the number of relevant markets facing the participants, vertical integration stabilizes profits.
2. Departmentalization of jointly operated plants tends to stabilize profits.
3. Profits may be stabilized by pooling uncertainties intertemporally and interdepartmentally.
4. Coordination of integrated processes makes participating

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16 The co-op's raison d'être is not to maximize returns on funds allocated to the association but rather to maximize returns on the patron's farm investment.

firms more adaptable to changing economic and technical conditions. This tends to lower costs and stabilize profits.

Each associating firm relates the activities of the cooperative to its own independent operations, in arriving at production equilibrium. The percentage of the total plant considered a part of any participating firm is defined by the relative size of that firm. This method of sharing reflects the desire of cooperators to jointly operate the facilities on a non-profit basis. In absence of proportional sharing, some firm or firms would profit from other associates. Or in the words of Phillips: 18

In order to achieve a static optimum allocation of resources among the participating firms, the entrepreneurial decisions, the bearing of uncertainties, the financial responsibility, the economic use - the costs and the economic benefits in connection with the joint activity must be shared on the basis of this proportionality.

Dropping the assumptions of perfect knowledge and certainty, proportionality still determines the sharing of economic functions in the joint activity. However it is now planned proportionality rather than actual proportionality which governs. In addition, under the altered assumptions it may be economic to share operations which are specific to a given department or time period, interdepartmentally or intertemporally; as the following comment suggests. 19

Given (1) the production plan which maximizes the discounted value of the expected stream of profits, and (2) the production plan which minimizes the expected dispersion around the most probable profits over time...the task is resolved into the selection of the best compromise position between the two.

18 Ibid., p. 77.
19 Ibid., p. 83.
Accepting the above explanation of cooperative activity, which is valid at least for the organizational period, one should be wary of categorizing cooperatives as profit maximizing firms simply because their operations and structures are more complex than is allowed by a simple agency relationship. The fact that some farm cooperatives pool expenses and revenues is not alone justification for taxing interest paid on capital as dividends. The interest may simply account for disproportionalities in capital contributions among the associated firms. Also, even though patronage margins are seldom rebates as cooperators state, on the other hand they are often not dividends distributed on a patronage basis as the NTEA claims. These oversimplifications will disappear as we investigate the historical evolution of financing, control, and proceeds distribution policies of farm cooperatives. Such an investigation will show that cooperatives are non-profit economic units in the sense that any department, plant or subsidiary does not make profit for itself from other departments or business units, but rather obtains revenue from unrelated parties and by applying the aggregate costs of the integrated units; profits or losses result. Only in this sense is a cooperative a non-profit economic unit. We now turn to a historical and descriptive study of cooperative non-profit relationships.

Financing and Control

Throughout the evolution of cooperative financial structures and operations two major periods are distinguishable. One might add periods by speaking of the contemporary scene and the period of informal capital structures during the middle 1800's, but for analytical purposes only two periods are significant. They are the Rochdale Period and the Non-
stock Period. Although many experiments with cooperation had been tried in American agriculture before 1875, that year is the first real benchmark. In 1875 the Grange or Patrons of Husbandry adopted the English Rochdale Principles which were to revolutionize the activities of farm producers.20

1. Co-operative associations to be organized as stock companies with shares of $5.00 each.

2. Shares transferable only to members of the association.

3. Ownership of one share or more to constitute membership in the association.

4. Each member required to sign the rules of the association.

5. Each member required to purchase at least $20 worth of goods from the association each year.

6. All members must be members also in good standing of the Patrons of Husbandry.

7. No member allowed to hold more than 100 shares of capital stock in the association.

8. All sales to be made for cash.

9. Prices to be those prevailing in the community. (Note: The prevailing price concept originally intended for consumer cooperatives was adapted to marketing operations also.)

10. Interest on capital limited to 8 percent.

11. Profits to go, after payment of interest and depreciation either to increase the capital or business of the association, or for any educational or provident purposes authorized by the association, and the remainder shall be divided among those who have purchased goods from this association during the preceding quarter (to non-members one-half of the proportion of members), in proportion to the amount of purchases during the quarter.

The Grange had little success with cooperation; nevertheless

20Nourse, p. 81
these principles were widely promulgated and served as a guide for forming farm cooperatives during the boom period following World War I. Some of the principles were meant for cooperative stores but when adaptable to cooperative marketing were so adapted. Four principles stand out:

1. Limitation of capital holdings.
2. Dividends on the basis of patronage.
3. Democrating voting.
4. Prevailing prices.

Of these four major principles, two really created the distinctive Rochdale pattern of cooperation:

1. Prevailing prices.
2. Loose limitations on capital holdings.

The Rochdale pattern of paying prevailing prices was related to the following two assumptions:

1. Capital could more easily be accumulated from current operations if prevailing prices were paid.
2. Members could more easily measure the gain from cooperative activities if prevailing prices were paid.

Both assumptions were unfounded. The benefits received from paying prevailing prices were limited, the disadvantages significant. If a cooperative association was to pay prevailing prices for farm products, even in the simplest type of operation a speculative element was introduced. Just as a private company might pay too much for products even though it bought at prevailing prices so could cooperative associations, and they often did. When resulting losses were incurred they were made up through a reduction in capital. As a result the wealthier members would
pay part of the lesser members way. Of course this need not happen if capital contributions and use of the association were proportional. Under the Granger Rochdale formula such proportionality was doubtful. The injustice of this pattern of cooperation is substantiated by the following quotations:21

...It is apparent that neither profits as such nor capital as such were eliminated. Neither would negative profits, that is losses, be precluded, and the losses incurred on the transactions with certain members would be recouped from gains upon others or be made good out of the contributed capital.

Certain...(elevators) were taken over by small groups of farmers and operated as farmers' (cooperative) companies, when in reality the majority of the stock was owned by one or a few farmers. As indicated...such distribution is inconsistent with the present-day conception of farmers' cooperation.

Facing the above problem the larger and wealthier growers demanded a greater and more equitable share in the revenue of the association than could be justified on the basis of their use of the association's facilities. Paper rules providing for "democratic" control (one man - one vote) had little significance when faced with the economic facts of life. The wealthier farm producers were often necessary in order to form a cooperative.22

Sometimes large and influential growers, in localities where their volume of fruit is needed to insure the success of a proposed organization, declined to support such an organization if the voting is to be by individuals, for fear of being overruled in important matters by a majority composed of the lesser growers.

21 Ibid., p. 51.

If they demanded returns on their capital to compensate for disproportionate bearing of risks and supplying of funds who was to begrudge them? On the other hand what rate of interest or differentiated proceeds distribution policy would allow proportional assumption of risks, financing and sharing of benefits? Given this inextricable situation many cooperatives turned into joint stock companies. Farmers made profits from other farmers, the proportionality necessary to operate a common plant rather than a firm could come about only by accident under the Granger Rochdale plan of operation. The following excerpts set the tone for Granger Rochdale cooperation.23

Throughout the Rochdale period membership was identified with the ownership of capital stock, and restrictions were placed on the transferability of such stock certificates. This practice has the merit of emphasizing the co-operative principle that contribution of permanently invested capital is one of the obligations of the member in the co-operative association. It has, however, two distinctive drawbacks. In the first place, since it makes the amount of stock purchased (between the minimum and maximum limits) a matter of personal choice, it has been responsible in no small degree for the under-capitalization of farmers' elevators and similar cooperative enterprises. In the second place, it has tended to perpetuate the ordinary corporation idea that capital stock is the primary claimant to benefits from the operations of the organization and to make the payment of a rate high enough to attract investors the chief concern of the business management.

The plan of the grain producers is simple. The farmers in a locality form a buying and selling association with capital stock varying from $2500 to $20,000. The shares of stock, varying from $10 to $100 each, are held exclusively by producers, and the amount an individual may own is usually limited to prevent the control of the association incorporated under the joint-stock company laws of the states. The earnings are generally distributed on the basis of capital, the dividends sometimes running as high as one hundred

In the above discussion of Rochdale Cooperation a major deficiency was found in the possible non-proportional sharing of costs, risks and benefits. Although disproportional sharing was possible, its significance should not be overemphasized. Rochdale Cooperation was centered in the Midwest where farm size was rather homogenous. Given members with homogenous amounts of farm production and wealth, capital contributions on a random basis might more often than not be maintained in proportion to the use of the association facilities. However in California and the Pacific Northwest this homogeneity was largely absent. Therefore, it should not come as a surprise that the non-stock association was developed in the latter regions. California was the leading state in this development.

Non-stock associations were operated on the basis of the following three principles:

1. All invested capital was on a loan basis.
2. A net returns settlement was substituted for the Rochdale competitive price relationship.
3. Transactions were restricted to members with the assumption of definite responsibilities as a condition to claiming the common benefits of the association.

The crucial non-stock principle from which the others naturally follow is the net returns settlement. Chapman and Lloyd indicate the pivotal role of the net returns settlement as follows: 24


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The upholders of the California plan claim that it is the only true cooperative. In the Rochdale System there is a speculative element. The association buys at the days price and attempts to sell for a higher price so that dividends may be declared for the stockholders. In this manner the profits are not returned to the producers unless he is a stockholder and shares in dividends. But in the California Type Cooperative the association pays the producer a certain amount when the commodity is delivered, paying the difference between the advance payment and the actual selling price less the cost of handling when the commodity is sold. The advance payment enables the farmer to pay off any liens made on his crop.

A common plan employed in operating such associations is as follows: The expenses are estimated as closely as possible and a sufficient amount per package or pound to create a revenue which will surely cover all expenses is retained by the organization when making remittances to the growers. At the close of the season, when the total expenses for the year are definitely known, the actual average cost of handling each package or pound of product can be determined and any excess which may have been charged to the growers is returned to them in proportion to the number of packages or pounds handled for each, unless the members vote to have this sum retained in the organization as a reserve fund for extending the equipment or defraying expenses at the beginning of the next season. In either case, the grower has received benefits from the organization in proportion to the value of his products, for the cost of marketing has been upon a package or pound basis...

If prevailing prices are not paid, the commodities processed, purchased and sold can serve as adequate security to cover variable costs. At the end of the pooling period a proportionate net returns settlement will be made as Chapman and Lloyd indicated. In essence the commodities flowing through the plant provide the working capital for the association's operations.

However the demise of capital stock financing created an additional need, fulfilled by the third non-stock principle. Although working capital can be supplied from members volume, increasing and decreasing in tandem with its usefulness, permanent capital needs cannot be
satisfactorily met in this fashion. Buildings, processing equipment and other fixed assets require initial amounts of capital or security for the borrowing of such capital. To fulfill this need strict membership agreements or marketing contracts were drawn up. The following quotations are related to the purpose of marketing contracts. 25

...The California plan, is that in which there is no capital stock. This is distinctly a producers' organization. With this type it is necessary to sign up a large proportion of the growers in the section before the association can begin its work. The growers pay small membership fees. The contract between the grower and the association is very rigid. The grower pledges himself to market through the association for a certain number of years, the average is about five; in fact he usually gives the association title to his product.

Since a large number of the cooperative marketing associations are organized on a purely cooperative basis without capital and with an established policy against profit-making, it is absolutely necessary to give the lending institutions financing the cooperative some form of security. This situation has been met by the association and its members by placing in their standard marketing contract a provision by which title passes to the association on delivery of the commodities. The commodities produced by the members and turned over to the association become the security or collateral which the association may pledge to banks in securing funds to make advance payments or loans to growers.

As noted above the non-stock associations used a guaranteed volume of business as collateral in borrowing funds for fixed assets and for making advances to growers. Taken as a whole the three non-stock principles created a method whereby heterogenous farm enterprises could associate on an equitable basis to process and market farm products and to purchase farm supplies.

In measuring the contributions of Rochdale and non-stock (Cal-

fornia) cooperation it must be recognized that these movements have significance only when put into a historical setting. Rochdale was the earlier of the two patterns. It was a pioneer effort combining competing goals and facing an inflexible business law. The concept or principle of democratic control borrowed from ideological European Cooperation conflicted with proportional sharing which is necessary for successful cooperative operations. In fact not until the 1950's, 100 years later, did the proportional relationship become recognized as the essence of cooperative operations. Democratic control and non-proportional capital contributions were the downfall of many farm cooperatives. In addition the sparseness of states providing non-stock business charters limited attempts to break away from the Rochdale pattern. It took an economic environment which plainly showed the inequities of the Rochdale pattern before significant pressure was exerted upon various states to adopt non-stock laws. This environment was found in California and the resulting non-stock pattern of cooperation was a major turning point. Its success proved two major points.

1. Economic realities rather than ideology must determine cooperative structures and operations.

2. Proportional sharing of costs and benefits is an irrefutable principle which must be followed if cooperative activity is to fully succeed.

Once these two principles were recognized the way was opened to contemporary practices.

The equitable methods of financing cooperatives are nearly unlimited. There are as many equitable methods as there are differing economic environments and business customs. Stock cooperatives may raise fixed capital through proportional stock subscriptions and use a net
returns settlement to obtain working capital. The same business might take title to goods and pay prevailing prices, thereby using warehouse receipts for working capital. A non-stock cooperative might not take title and would use a rigid marketing contract as security for obtaining working capital. In some cases both types of cooperatives may use notes signed by officials of the association in order to obtain capital; the previous success of the co-op serving as collateral. Proportional sharing of benefits and costs is the important characteristic of successful cooperatives; how this proportionality is obtained is an incidental problem.

However, one of the incidental details of the older cooperative structures is significant. All of the older cooperatives were organized and operated on a permanent capital basis. In the words of Davis,\(^{26}\)

> Stock or other evidences of investment were issued without providing any plan for retirement except upon liquidation of the corporation...Subsequent additions to capital were made through the further sale of stock or certificates and the retention of savings which frequently were also retained with no commitment for retirement except upon dissolution, in which event they usually were to be prorated among patrons in proportion to patronage.

Since the associations were obligated to return net receipts back to patrons in proportion to use, mobility of a cooperative's members posed a problem. The member who was retiring from participation in the association could obtain only par value for his stock or membership certificate. Equities accruing to him beyond the initial equity contribution, were non-transferable. Either the retiring farmer lost a part of his equity in the cooperative or it would have to be dissolved. Obviously

\(^{26}\)Davis, p. 41.
a third alternative was created. This alternative is commonly known as revolving fund financing.

Under the revolving fund plan, new equity capital is retained from current operations each year and older equity capital (securities, memberships, certificates of equity, allocated credits, etc.) are retired systematically. For example:27

Assume a non-stock cooperative.
At the date of its organization it obtained $100,000 of permanent capital from membership subscriptions (equity capital) and from borrowings. (loan capital)

In the following ten years the association retained $10,000 annually from member proceeds with which to retire its original loan and equity capital. At the end of the eleventh year the initial capital has been repaid, the new $10,000 retained is used to retire the monies retained during the first year of operation. This procedure continues as long as the co-op is a going concern.

The revolving fund plan which operates like the hypothetical plan in the above example, meets the needs of a jointly operated plant in the following ways:28

1. Investment capital is kept in proportion to use.
2. Investment capital is kept in the hand of current users.
3. It provides a dependable method of financing.
4. It is adapted to gradual expansion of capital to meet expanding volumes of business.

The present trend is to decrease the amount of permanent cooperative capital and to utilize the benefits of proportional sharing found in revolving fund operations. Non-stock units have used small membership fees, while stock units have gradually decreased the par value of

27 Davis, p. 43.
28 Davis, p. 43.
their common stock shares. Both practices tend to establish revolving capital as the significant portion of a cooperative's capital structure. Hence the benefit gained from differentiating between stock and non-stock cooperatives is minimal.

In a recent representative sample taken by the Farm Cooperative Service the relative importance of the different forms of equity financing were ranked as follows:\textsuperscript{29}

<table>
<thead>
<tr>
<th>Percentage of Equity Capital Financed by Various Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Allocated capital credits without definite maturity dates. 39.1%</td>
</tr>
<tr>
<td>2. Preferred Stock. 21.9%</td>
</tr>
<tr>
<td>3. Common Stock. 19.2%</td>
</tr>
<tr>
<td>4. Unallocated Reserves. 10.1%</td>
</tr>
<tr>
<td>5. Certificates of Equity with Definite Maturity Dates. 8.3%</td>
</tr>
<tr>
<td>6. Miscellaneous. 1.2%</td>
</tr>
<tr>
<td>7. Membership Certificates. .2%</td>
</tr>
</tbody>
</table>

\textbf{Allocated Capital Credits Without Maturity Dates}

These credits were either allocated on the books of the association, allocated and notice of such allocation given to patrons, or allocated and certificates of equity issued as evidence of such allocation. Regardless of which one of the above procedures was resorted to, these credits represent temporary capital contributions which will

be revolved back to the members at some later date.

**Preferred Stock**

The second most popular form of equity financing was preferred stock. The cooperative may issue preferred stock to non-producers in order to obtain outside funds. This category of preferred stock will not be revolved. Preferred stock may also be used to evidence the equity interests of non-member patrons, in this case the shares will probably be revolved. Such a procedure forces non-member patrons to ratably furnish capital on the same basis as members, yet keeps control in the hands of the members.

**Unallocated Reserves & Certificates of Equity With Definite Maturity Dates**

These categories of equity capital are ranked fourth and fifth behind common stock. Some cooperatives issue certificates of equity with definite maturity dates. As a rule these maturity dates are advanced far enough into the future to enable the cooperative under normal conditions to pay such obligations on time. If the maturity date is passed, the unpaid certificates would more reasonably be classified as liabilities rather than as net worth items. Generally they are temporary revolving equity capital.

Fifth in importance was unallocated reserves. These reserves generally arise from non-member business which the cooperative has decided to pay tax on rather than limit its non-member business and credit those equities to non-member patrons. This choice is explained in more detail in Chapter Three.

In summary, temporary revolving fund capital bears the major burden of equity financing at present. Equity funds may be fixed date
or non-fixed date. As these funds increase in importance the opportunity for equitable sharing of costs and benefits in the joint cooperative plant also increases. However, one kind of disproportionality is still possible under present cooperative operations and structures. This disproportionality problem has resulted in much discussion which will be explained in some detail in Chapter Three. We will briefly mention it here.

In a 1958 FCS study 71% of all revolving equity capital was found to be non-interest bearing. Funds left by past members in the cooperative operations until their revolving dates were reached received no compensation for this contribution. Since these past members are not using the association it would seem to be a more equitable policy if the current members paid interest on this equity capital which has now evolved into loan capital. However there is another side of the issue. The past member, to the extent that his volume of business was anticipated in acquiring association facilities, caused additional costs to be borne by the associating farmers. The solution to the problem involves a weighing of the latter costs against the value of the loan funds to the present members of the cooperative. What rate of interest will equitably solve this dilemma is difficult to ascertain. Consequently the rates of interest paid for such capital vary among associations. In the 1958 FCS study it was found that 16% of the revolving fund capital paid a rate of 4%. Thirteen percent paid rates varying from one to seven

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From the above analysis of equity financing operations it is evident that contemporary cooperatives have more nearly approached a non-profit type of operation than that of their predecessors. The sharing of control and the financing of operations has tended more and more to be based on the members use of the association's facilities, thus corresponding to Phillips' concept of the cooperative association. When cooperative associations are operated as Phillips claims a "true" cooperative to be operated, it can be validly held from one point of view that they operate on a non-profit basis.

Settlement Operations

A review of the various types of cooperative settlement operations will enable two important questions to be answered.

1. How can income attributable to joint plant operations be measured?

2. Are benefits distributed in proportion to the member patron's use of the association?

The first question is important when various tax proposals are examined in Chapter Four. The second question is related to the primary problem at hand, the non-profit operation of farm cooperatives.

The previous discussion in this chapter has concentrated on the sharing of control and the sharing of intertemporal costs. For example, the problem of determining an equitable interest rate to pay past members

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31 Ibid.,

32 This portion of Chapter Two is based upon Cook's and Davis' description of settlement operations. Pages 23-25 in Davis' work and pages 64-68 in Cook's work.
for their equities left in the association is an intertemporal cost allocation problem. In a review of settlement operations it can be seen that many cooperatives pool costs interdepartmentally as well as intertemporally. In fact the latter type of pooling or averaging has always been common in cooperative associations. Of course, pooling costs need not change the economic nature of a cooperative, but it does negate the agency relationship which some co-op proponents vehemently support. As we shall see, only one particular type of cooperative settlement operation is compatible with an agency relationship. Not only do associations pool costs, they may also choose to pool sales revenues. The degree to which costs and especially revenues are pooled have led some writers, erroneously in the view of the author, to use this as a criteria for defining the cooperative as a firm. As long as control of a cooperative's policies is on a proportional basis, the extent to which costs and revenues are pooled is related only to the convenience achieved thereby and the relative desire of the members for a more stable income over time.

In this study of settlement operation, revenues distributed to members will be termed margins. These revenues have been termed patronage refunds, patronage rebates, patronage dividends, etc., by different writers. However, using any one of these terms implies a certain legal or economic nature. Since the economic nature, in particular, changes as different types of settlement methods are used, we will call all such funds margins.

**Purchase and Sale Marketing Cooperative**

This type of settlement operation is used where the commodities
to be processed and marketed are staples; for example, cotton and grains. Such commodities are sold in well established markets. Spot prices are paid to patrons at the time that their products are delivered to the association's plant. Quality differences are taken into consideration in choosing the applicable prices to be paid for the commodities. Like commodities are then co-mingled for storage, processing and/or marketing. Obviously the initial payments to the patrons are not pooled, but sales revenues are pooled to the extent that speculative gains are averaged on an interdepartmental basis. As a general practice costs from like products of differing grades are pooled. Costs attributable to particular types of products may or may not be pooled. To the extent that prevailing prices are paid, any margins accruing to patrons, not including advances, are perfectly analogous to profits in a non-integrated firm.

**Tabulation**

1. Costs from like products of differing qualities are pooled. Costs from unlike commodities may or may not be pooled.

2. The extent to which sales revenue is pooled, depends upon the amount of speculative gain or loss involved and the degree to which interdepartmental pooling of sales revenue is carried out.

3. As long as prevailing prices are paid, margins remitted to patrons are perfectly analogous to profits in a non-integrated business.

**Note:** in general, in all co-ops once pooling policies have been decided upon, patrons in the same category are remitted margins in proportion to their percentage of total business for the applicable department or departments.

**Purchase and Sale**

**Supply Cooperative**

1. Costs from different departments are generally pooled.

2. The extent of revenue pooling depends upon the amount
of speculative gain involved and the degree to which interdepartmental revenues are averaged.

3. As long as prevailing prices are paid, margins remitted to patrons are perfectly analogous to profits in a non-integrated business.

Bargaining Association
Marketing Cooperative

These associations have little investment, receive no sales proceeds and oftentimes have no paid employees. Since the bargaining is often accomplished during a short period of time, an unpaid bargaining committee made up of executives of the various participating firms may accomplish the association's purpose. However, outside legal help may have to be paid and the bargained agreement will have to be drawn up. This kind of expense normally exhausts the association's need for revenue. Milk bargaining cooperatives are the most common examples of this type of association. Growers of certain perishable fruits and berries also use bargaining type associations. The association pays costs either through levying deductions before the bargaining begins and distributes the residual funds back in proportion to the size of the deductions, or levies assessments in proportion to anticipated benefits after the bargaining has been accomplished. Obviously no revenue pooling is possible. Costs are pooled only if cost accounting is not perfect, a minor problem. Margins are refunds of over-payments and in no way resemble profits. Profits can be measured only by comparing non-bargained prices with bargained prices. In a strict economic sense the difference in prices probably could not be classified as profits.

Tabulation

1. No pooling of revenues and no significant pooling of costs.
2. If assessments are made after bargaining is completed, no margins exist.

3. If margins do exist, they in no way resemble profits.

4. This type of cooperative operation resembles an agency relationship more than the joint plant operation of Phillips.

**Lot by Lot Commission Basis**
**Marketing Cooperative**

In this type of operation, each patron's products are sold separately on a commission or fee basis; hence there is no revenue pooling. However, in the event of commissions in excess of costs, costs are prorated on a pooling basis in computing refunds due patrons. This cooperative settlement method is analogous to the bargaining method, except that the association does receive the sales revenues and distributes them back to patrons after prorating costs and deducting same. The lot by lot method is used mostly by livestock shipping associations.

**Tabulation**

1. Sales revenue is not pooled.

2. Costs are pooled only to the extent that commissions charged more than cover cost of operation.

3. Margins are not analogous to profits.

**Multiple Pooling With Progressive Payments**
**Marketing Cooperative**

In this type of association, uniform prices are paid throughout the pooling period for like products of similar grade and quality. In all kinds of pooling associations, the time period which the pool covers may vary. Some pools are for only a few days, others where staple commodities are warehoused may last for several years. A percentage of anticipated price is advanced at time of delivery. Successive payments
are made as the products comprising the pool are sold. Inter-pool costs may or may not be pooled. To the extent that different portions of the pooled commodities are sold at different times in different markets, sales revenues are pooled. However revenues from unlike commodities are not mixed. Under this type of settlement method, the final margin may represent the final part of the sales revenues received, the final part of the sales revenues received plus the refund of an overcharge, or just a refund of an overcharge, depending upon the accounting procedures used by the association.

Tabulation
1. Costs may or may not be pooled.
2. Revenues from unlike commodities are not pooled.
3. Margins are not a measure of marketing profits.

Multiple Pooling Without Progressive Payments Marketing Cooperative

Here an advance is made at the time of delivery and a final payment is made at the end of the pooling period. Like the previous case the final payment may be of three different natures. If the margin is the final installment of total price it is akin to a progressive payment plan with all non-initial payments combined into one. The margin may be a refund of an overcharge thus resembling margins found in a purchase and sale operation. However since prevailing prices are not initially paid, the margin cannot measure profit.

Tabulation
1. Costs may or may not be pooled.
2. Revenues from unlike commodities are not pooled.
3. Margins do not measure profits.

In the examples for progressive and non-progressive payment pools we dealt solely with multiple pooling operation. Single pool cooperatives mingle revenues derived from unlike commodities thus approaching the purchase-and-sale arrangement. The degree to which a single pool co-op approaches a purchase-and-sale co-op in averaging revenues is dependent upon the extent of speculative margins in the latter and the degree of aggregate pooling in the first. Even where like products are kept together (multiple pooling) revenue may be pooled from unlike products. In this situation, whether or not sales revenues are pooled is decided by the board of directors. Thus in one year, revenues will be thoroughly pooled and in another year sales revenues will be pooled only for like products of similar quality and grade. The above situations are tabulated under the following heading, Single Pooling With Progressive Payments, Single Pooling Without Progressive Payments, and Multiple Pooling with Directors' Discretion.

Single Pools With Progressive Payments
Marketing Cooperative

Tabulation

1. Costs are pooled.
2. Revenues from unlike commodities are pooled.
3. Margins do not measure profits.

Single Pools Without Progressive Payments
Marketing Cooperative

1. Costs are pooled.
2. Revenues from unlike commodities are pooled.
3. Margins do not measure profits.

Multiple Pooling With
Director's Discretion
Marketing Cooperative

1. Costs are pooled.

2. Revenues from unlike commodities may or may not be pooled.

3. Margins do not measure profits.

Summary

In the preceding review of settlement operations, the following propositions were substantiated.

1. Few cooperatives operate on an agency basis.

2. Seldom do margins measure profits derived from cooperative operations.

The above propositions have been, but should not be, ignored if equitable tax policy is to be legislated.

Profits from cooperative operations should be taxed, but taxing margins from all the various kinds of operations is extremely inequitable. Only in the case of a purchase and sale cooperative where prevailing prices are paid would such a policy be just. On the other hand it is obvious that only an insignificant amount of cooperative activity can function on agency basis. Hence the coop argument that to tax cooperatives is to tax agents is not very relevant.

Of course one should not make the mistake of ignoring joint plant relationships and defining a cooperative association as a farm related firm on the basis of superficial similarities. Granted products, revenues and costs may be pooled in a cooperative association but this does not a-priori create a firm. It is also obvious after analyzing coopera-
tive structures and operations that associations have evolved continuously toward one type of non-profit operation. When cooperative spokesmen claim that their associations operate on a non-profit basis there can be no logical disagreement, just semantical disagreement. However their non-profit operation is related only to the associated farmers. That is, one patron does not profit from another patron's activities in the cooperative association. This is an entirely different idea, than to say a cooperative does not make profits. The following quotation from Chapman brings this important difference out quite distinctly.\[33\]

In discussing the advantages and disadvantages of cooperative marketing, it should not be assumed that the functions performed by the middlemen can be abolished. In the past the middlemen have been rendering a real economic service by storing, shipping and financing goods in the process of distribution to the consumers. It may be and, no doubt is true, that profits of some middlemen have often been too large in proportion to the economic services rendered, but that is an entirely different thing from saying that they perform no real service. If the producers feel that they are not getting their proper share of the consumer's dollar and they turn to cooperative marketing for larger shares, they must realize that they themselves are, to a certain extent, performing the functions of the middlemen.

And to the extent that marketing functions are performed by farmers, the related risks and profits must necessarily accrue to farmers. The profits from cooperative operations are measured by the difference between pre-association revenues and post association revenues. It was a legitimate goal of the early associations to recover these profits, most of which had been extracted through monopoly and monopsony powers, powers that harmed farmers as well as society as a whole. However economic conditions change and to the extent that such changes have eliminated these market imperfections, tax policy toward cooperatives must also change.

\[33\]Chapman, p. 594-595.
With two chapters devoted to cooperative operations, structures, and goals we now turn to the task of applying this knowledge to the problem of taxing agricultural cooperatives.
CHAPTER III

TAXATION OF AGRICULTURAL COOPERATIVES

Exclusion of Patronage Margins

Without a doubt the most important issue in the farm co-op tax controversy is not the statutory exemption of Section (101) 12 of the Internal Revenue Code. Rather the major issue is the exclusion of margins distributed on a patronage basis, from the taxable income of the cooperative corporate entity. Are patronage margins patronage refunds or are they patronage dividends and hence a distribution of corporate profits? It is obvious that until quite recently the courts and the Treasury Department have considered patronage margins to be refunds, that is, rebates or additions to the patron's cost of goods sold and hence not taxable. It is this assumption which led Bradley to state:

...The right to exclude patronage refunds from gross income in the determination of the taxable net income of the taxable entity is not a matter of statutory right but rather solely one of contractual right recognized by the courts whether the organization be set up to function as an agricultural cooperative or to serve the needs of strictly proprietary commercial organizations.

One may take issue with Bradley for using the term patronage refund and

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34 Section (101) 12 of 1939 Internal Revenue Code. Now changed to Section 521 of the 1954 Internal Revenue Code.

35 G. C. M. 17895, 1937-1 C. B., p. 56.

for distinguishing between cooperative and proprietary business but his statement does serve to point up the official position regarding the exclusion of patronage margins from the taxable income of the cooperative corporation. As long as margins are considered rebates in the case of a purchasing cooperative or additions to the farmer-patron's cost of goods sold in a marketing cooperative, one cannot deny the contractual right of a cooperative or any other form of business to minimize its tax liability through refunds. Nowhere in the Internal Revenue Code will one find patronage margins mentioned as a deductible expense. The basis for excluding cooperative margins are the rulings of the Treasury Department (Internal Revenue Bureau), and court decisions. Treasury decisions have recognized the propriety of such exclusions. For the most part, the courts have followed, deciding only upon the facts in each case and not on the appropriateness of Treasury Decisions.37


Where Treasury Department administrative practices have gone unchallenged for a long period of time they are considered to have Congressional sanction.

37 Farmers Co-operative Co. v. Birmingham, 86 F. Supp. 201 (D.C. Iowa 1949); American Box Shook Export Association v. Commissioner of Internal Revenue, 156 F. (2d) 629 (9th Cir. 1946); People's Gin Co. v. Commissioner of Internal Revenue, 118 F. (2d) 72 (5th Cir. 1941); and Midland Cooperative Wholesale v. Commissioner of Internal Revenue, 44 B.T.A. 824 (1941).
tion and will not be overturned except for very cogent reasons.38 Farmers Cooperative Co. v. Birmingham. The only fact that the courts have decided upon is whether or not the refunds were made pursuant to a prior obligation to pay such refunds and therefore are legally excludable.39

1. American Box Shook Export Ass'n. v. Commissioner of Internal Revenue.
2. People's Gin Co. v. Commissioner of Internal Revenue.
3. Fountain City Co-op Creamer Ass'n. v. Commissioner of Internal Revenue.
4. Druggists' Supply Corp. v. Commissioner of Internal Revenue.
5. Associated Grocers' of Alabama, Inc. v. Willingham.

The Treasury Department and courts view a cooperative as a firm dealing with bonafide customers. Prior obligation is required presumably, to disallow the firm from minimizing taxable income by the juggling of brackets through strategically timed rebates.40

Another interesting aspect of the exclusion determination arises from the administrative decisions by the Bureau of Internal Revenue, followed by most courts, that co-op "rebates" need not be made in cash.

39American Box Shook Export Ass'n. v. Commissioner of Internal Revenue, 156 F. (2d) 629 (9th Cir. 1946); People's Gin Co. v. Commissioner of Internal Revenue, 118 F. (2d) 72 (5th Cir. 1941); Fountain City Co-op Creamery Ass'n. v. Commissioner of Internal Revenue, 172 F. (2d) 666 (7th Cir. 1949); Druggists' Supply Corp. v. Commissioner of Internal Revenue, 8 T. C. 1343 (1947); Associated Growers' of Alabama, Inc. v. Willingham, 77 F. Supp. 990 (1946); and United Butchers Abatoir, Inc. v. Commissioner of Internal Revenue, 5 T.C.M. 40 (1946).
40Davis, p. 56.
This ruling follows logically from the official concept of a cooperative. If cash margins are not distributions of corporate profit, then equity or liability instruments issued in lieu of cash are not distributions of corporate profits and therefore not taxable. This line of reasoning is called "the constructive receipt and reinvestment theory". Since most cooperatives have in their charters, bylaws or marketing agreements, a clause which contracts with the patron to issue scrip in lieu of cash, there can be no argument with the position that such funds are not taxable provided one accepts the rebate or cost adjustment theory. Applying the rebate concept, the exclusion of such "reinvested" or loaned funds from taxable income, as Davis points out, is compatible with the following three basic accounting and tax principles.\[41\]

1. Funds received by a corporation from the sale of stock or equity capital do not constitute income to the corporate entity.

2. Funds received by a corporation through the process of borrowing...do not constitute income to the corporate entity.

3. ...Earnings by a corporation applied to the payment of dividends on capital or retained by the corporation as capital reserves or surplus do constitute income to the corporate entity.

Given the above concept of patronage margins and these three principles of corporate accounting, the excludability of all scrip and cash distributed on a contractual patronage basis naturally follows. This philosophy was sanctioned completely on November 23, 1943, when Deputy Commissioner T. C. Mooney stated the official position in answer to a request for such a statement by the National Council of Farmer Cooperatives.\[41\]Davis, p. 44.
The ruling validated the whole spectrum of cash and non-cash patronage margins as excludable from gross corporate income. The ruling stated that capital stock when used as non-cash patronage margins is excludable from the gross income of the cooperative whether or not it has readily realizable market value. In addition certificates of equity or indebtedness when distributed on a patronage basis pursuant to a prior obligation do not constitute an allocation of corporate income and are not taxable. Whether or not such certificates have a definite due date or realizable market value was considered irrelevant to their excludability.

In brief, the official position has been that non-cash patronage margins constitute additional investment in the cooperative corporation out of patron "savings" not earnings and hence cannot constitute taxable income to the cooperative. Actual cash payment of the margins may be deferred until the dissolution or liquidation of the association. Even though no definite plans have been made for payment of the funds represented by the various types of scrip, as long as the intention exists to redeem in cash, such funds are either loaned funds or additional investments of the patrons.\textsuperscript{43}

2. Farmer's Union Co-operative Association v. Commissioner of Internal Revenue.

\textsuperscript{42}Ibid., 85-86.

\textsuperscript{43}I.T. 3208, 1938-2 C.B. 1271; Farmers' Union Co-operative Association v. Commissioner of Internal Revenue, 42 B.T.A. 1200 (1940); Home Builders Shipping Association v. Commissioner of Internal Revenue, 8 B.T.A. 903 (9th Cir. 1943); San Joaquin Valley Poultry Producers' Ass'n v. Commissioner of Internal Revenue, 136 F. (2d) 382 (9th Cir. 1943).
3. Home Builders Shipping Association v. Commissioner of Internal Revenue.

4. San Joaquin Valley Poultry Producers' Ass'n v. Commissioner of Internal Revenue.

In conclusion by paying patronage margins, cash or scrip, the maximum tax burden of any farm cooperative is as follows:

1. Income tax is paid on amounts available for the payment of dividends on outstanding stock.44

2. Income tax is paid on non-member margins which are not distributed to non-members.

Note: As a rule dividends on capital stock will be paid from non-member margins.

As long as patronage margins are considered rebates or additions to the patron's cost of goods sold there can be no quarrel with the position of co-op spokesmen that such funds or scrip are either liabilities of the corporation or additional investment in the corporation by members and not corporate income. If patronage distributions are distributions of rebates, co-op spokesmen can validly claim that non-exempt co-ops receive no preferential treatment over other kinds of business and can recommend the removal of Section 101 (12) as the total solution to the co-op tax issue. However to the extent that patronage distributions are distributions of corporate income, removal of the exemption section will do little to satisfy non-cooperative business interests.

Exemption Section (101) 12

In the above review of exclusion rulings and decisions we found that any unallocated non-member margins and incidental income items of a non-exempt cooperative are taxable. Non-exempt cooperatives ordinarily

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44 United Cooperatives, Inc. v. Commissioner of Internal Revenue, 4 T.C. 93 (1944).
use margins from non-member business, which are not "refunded" to the non-members on a patronage basis, for building reserves and paying dividends on stock. To the extent that non-members do not receive patronage margins attributable to their volume of business with the association, the co-op is being used by owner-members as a firm to make profit from the services performed for non-members. According to the rebate concept, this is the extent of the non-exempt cooperative's profit.

When Congress exempted certain cooperatives it was the rebate concept that the exemption requirements were predicated upon. If patronage "refunds" are not distributions of profits, the most direct way to achieve "non-profit" operation of a cooperative is to require that all margins be distributed on a patronage basis pursuant to a prior contractual obligation to make such distribution. This is exactly what the Congress did require for exemption. The following requirements achieved "non-profit" operation:

1. Members and non-member patrons must be treated alike in all respects as to price, conditions of the transaction and patronage refunds.

2. The association must maintain permanent records of the volume of patronage and of the equity interests of all patrons, whether they be members or non-members.

3. Financial reserves which may be accumulated are limited to those which may be required by the cooperative statutes of the several states or to those which in the sole judgement of the Commissioner of Internal Revenue are for a purpose necessary to the business and are reasonable in amount in relation to such necessity.

4. The dividend rate on capital shares must not exceed the legal rate of interest in the State of incorporation or eight percent per annum, based upon the value of consi-

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deration for which the capital share was issued, whichever is greater.

5. Voting control of the association whether it be in the form of capital shares or memberships, must substantially be held by producers who are currently patronizing the association.

Requirements one and two created an obligation to the association whereby all funds with the exception of those earmarked for reasonable and necessary reserves, must be distributed among the patrons on a patronage basis. The need for limitation of reserves may seem doubtful, considering that upon dissolution a cooperative's net worth is distributed on a patronage basis and hence all active patrons would receive the "frozen" margins in proportion to their patronage. However one must consider the possibility that non-members may form a more mobile farm population than members. Since co-op stock does not increase above book value one must be a patron of the cooperative at time of its liquidation if all investment in the association is to be recouped. Therefore the reserve requirement did not completely eliminate this problem. Consequently a 1951 amendment requires that an exempt cooperative's total reserves must be allocated, and hence no matter how long it is before these margins are turned back the patron responsible for the margins receives his margins.

Requirements four and five also are aimed at creating mandatory non-profit operation. However, in this case the profit relationship which is eliminated is not that between members and non-members but rather between farm and non-farm members. By allowing voting stock to be held only by farmers, the association stands a better chance of being operated to reduce costs and increase profits of members as farmers,
rather than being operated by non-farmers to earn income for performing farm-connected services. The eight percent limitation on dividends on capital stock serves a like purpose. It keeps the wealthier farm members in the cooperative association from making profit from fellow farmers, while it allows a return to compensate for disproportionalities between investments made and services received by such members.

In addition to the five initial requirements already mentioned one other exemption requirement has economic significance. This is the business restriction requirement:

The value of business done with non-members must not exceed the value of business with members whether the business be marketing or purchasing, with the further provision that in the instance of a purchasing cooperative the value of purchases of supplies and equipment for persons who are neither members nor producers shall not exceed 15% of the value of purchases made for all patrons.

This requirement simply does not fit the rebate concept of cooperative operation. In fact it seems to indicate that the Congress thought the rebating of all margins might not constitute non-profit operation. If it was required that all margins be allocated except those used in establishing reasonable and necessary reserves, and if patronage margins are not distribution of profit, why should there be any limitation on non-member and non-producer business? This is an analogy difficult to comprehend. In any event these six requirements and the amendment of 1951 are the important conditions which must be met to qualify for exemption under Section (101) 12 (redesignated Section 521 of the Internal Revenue Code of 1954).

We now turn to the aggregate of privileges allowed under Section

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521. The privileges allowed to qualified cooperatives under this section are:

1. Employment taxes need not be paid on any employee whose total remuneration does not exceed $45 in any quarter.

2. The cooperative is exempt from paying capital stock transfer or issuance taxes.

3. Capital gains are exempt provided the transactions involved are incidental to the principal activity of the cooperative.

4. Extraneous income is exempt if paid out in the form of patronage dividends.

5. Income paid out in the form of limited dividends on capital stock is exempt.

The advantages of exempt cooperative activity over the non-exempt method of operation would seem to be rather paltry. The stamp tax and employment tax exemptions are insignificant. Exemptions three and four probably are not important except in those cases where a co-op does considerable business with the government and pays no tax on such business. Exemption five is the privilege most often discussed. However the privilege of paying tax-free income in the form of dividends on capital stock is not as great an advantage as is often supposed. Since the major proportion of equity financing is accomplished on a revolving fund basis the need for a non-exempt association to distribute returns openly is rather minimal. In addition the value of all the privileges must be weighed against the restrictions on non-member business. This restriction is particularly important for purchasing cooperatives, where it may be difficult to obtain an economical volume of purchases from only producers and members. In summary, the advantages received for complying with the requirements of Section 521 are limited when balanced against
the non-exempt method of operation. This is testified to by the fact that nearly half of our agricultural cooperatives are operated on a non-exempt basis. If farm cooperatives have any important tax advantage it is in the distribution of corporate income on a tax-free basis and to a significant degree this privilege is available to both exempt and non-exempt co-ops through contemporary exclusion rulings and decisions.

Taxation At The Individual Level

As was pointed out in the preceding sections of this chapter, it has been the intent of Congress to create complete non-profit operation of cooperatives by requiring complete allocation of all patronage margins. Only incidental income deviates from this concept of "non-profit" operation. The amounts of incidental income are insignificant enough to be ignored. In the case of non-exempt cooperatives, the only kind having non-incidental unallocated margins, such margins are taxed at the applicable corporate rate. Exempt cooperatives must allocate all of their margins. This was required by the 1951 amendment. From a practical standpoint the amendment also guaranteed that all co-op margins would be either unallocated to the patrons responsible for such margins and hence would be taxable at the corporate level or margins would be allocated to the responsible patrons and would be taxed at the personal level. This at least was the intent of the 1951 legislation. However a change in judicial attitude has made the intent non-operational.

48 Albert W. Adcock, The Taxation of Co-operatives, (A paper delivered at the 1951 Summer Institute, University of Michigan Law School) p. 13. Writer's copy was received from the National Tax Equality Association, 208 LaSalle Street, Chicago 4, Illinois.
Following a series of court decisions in which the constructive receipt portion of the reinvestment theory was challenged, 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 two most significant decisions bearing upon the reinvestment theory were the Long Poultry Case and the Carpenter Case decided in 1957 and 1955 respectively. Whether or not one agrees with the courts' emphasis on the need for market value regarding non-cash patronage refunds, these decisions have led to a situation aptly described by the Assistant to the Secretary of Treasury, Jay W. Glassman.

...Under existing law it is possible for a cooperative to exclude from its taxable income certain non-cash patronage dividends paid to its members which, at the same time, are not taxable to the members who receive them.

In the author's judgment the aforementioned tax evasion on the personal level, although important in understanding the extent of the co-op tax issue, is not the major problem. The real issue always has been and still is, should allocated margins (regardless of form) be subject to the corporate income tax. This question would be applicable even if all patronage margins were distributed in cash, thus avoiding the problem that the courts are presently wrestling with. This very important question really asks, what is the incident of cooperative

49House Committee on Ways and Means, Hearings, 1960, 10.

50Long Poultry Farms, Inc. v. Commissioner of Internal Revenue, 249 F. (2d) 726 (5th Cir. 1957); and Commissioner v. Carpenter, 219 F. (2d) 265 (5th Cir. 1955).

51House Committee on Ways and Means, Hearings, 1960, 5.
income? Is cooperative non-incidental income corporate income or is it income not attributable to the corporate entity but rather solely to the participating associated firms? It is to this question that we now turn.

Co-op Corporate Income

Co-op interests base their arguments for not taxing margins upon what they consider to be the incident of a cooperative's income. Whether they support the present tax policy via rebate, agency or departmentalization positions all such arguments choose to ignore the corporate entity. Yet there can be no doubt that the advantages gained through cooperative activity would be unobtainable on a non-incorporated basis. However co-op spokesmen claim that the income tax should be levied on the final recipient of co-op income only, that is, the patron. There is little legal precedent and no economic reasoning available to validate the co-op position. A more logical and precedented position is that taken by the decision in Commissioner of Internal Revenue v. Francis E. Tower, where the Commissioner cited the Supreme Court Case, Lucas v. Earl.53

"A person may be taxed on profit earned from property where he neither owns nor controls it."

"The issue is who earned the income."

Where an incorporated cooperative is operating as a going concern, the artificial person, that is the corporation, earns the income. In fact no other entity is capable of earning such income. This is precisely

52 Clive Harston and Edward H. Ward, Mimeo Circular 85, Jan. 1955, Montana State College Agricultural Experiment Station.

why cooperatives are incorporated. To speak of an incorporated cooperative as a conduit through which income flows, but which is not responsible for the income is to ignore reality. In any corporate enterprise, cooperative or otherwise, profits eventually accrue to the owner-investors, but this conduit of profits is ignored in non-co-op corporations. From the standpoint of equity there is no reason why the conduit relationship should not be ignored in the case of agricultural cooperatives also. This point was made very explicit in the Wisconsin Cooperative Milk Pool Case, where the court of appeals held:

Such corporations differ from others not in corporate function but only in that the profits instead of being distributed to stockholders are allocated to patrons ratably in proportion to the amount of business transacted with the latter.

The court could have reasonably added, since investment in the cooperative enterprise tends to be held in proportion to ones volume of business in the same, the method of distributing profits does not differ from other corporate distributions of profits. Note the court’s emphasis on corporate function. Cooperative corporations exist to create income for their farmer-investors. Whether or not the entrepreneurship is farm or farm connected has no effect upon the existence of such profits, as Phillips would have one believe. Patterson emphasizes the profit orientation of agricultural cooperatives in the following words:

"The usual source of a cooperative's gain is its transactions with outsiders whose interests are adverse to those of the owner-patrons. Likewise it is through transactions of this kind that most of the income of...

54 Wisconsin Co-operative Milk Pool, 119 F (2d) 999 at 1000 (7th Cir. 1941).
55 House Committee on Ways and Means, Hearings, 1960, 98.
proprietary corporations is achieved."

In brief, cooperatives do make profits and like other profit corporations income flows through the corporate entity (conduit) to its investors. All other profit making enterprises must be taxed at the corporate level. The Treasury Department and courts now realize this inequitable fact. The rebate, agency and departmentalization arguments have been "vetoed" for years where agricultural cooperatives were not involved. Since an agricultural cooperative is perfectly analogous to other profit-making enterprise from the standpoint of economic goals, ample precedent exists for taxing such cooperatives in an equal degree. We now turn to the co-op arguments and the body of legal precedent which refuses to recognize these arguments.

The most influential argument used by cooperative interests is the price adjustment or rebate argument. The co-op interests argue that patronage margins being in the nature of price rebates cannot be considered income within the meaning of the sixteenth amendment. One co-operative attorney stated the rebate position as follows:56

...In order for a cooperative or anyone else to qualify for an exclusion, the contract relied upon must meet two tests, namely:

1. The contract must be a legally binding contract at the time of the transaction from which the margin arises.

2. The contract must be between the parties to the transaction from which the margin arises.

Although these two tests correctly assess the present requirements for excluding patronage margins from cooperative income they do not apply

to non-cooperative businesses as we shall soon see. In order for non-cooperative enterprises to qualify for the exclusion of income from its corporate tax liability a third and crucial test must also be met:

3. The parties to the contract must have adverse interests. Or in other words a rebate is a bonafide rebate only if paid to a person whose interest is adverse to that of the business paying it. The need for the third requirement is obvious. Without it businesses could distribute profits in the form of rebates, bargain sales and various sundry ways thus escaping a proper tax liability. The accepted principle is that when parties are not dealing with each other at arms length the names attached to such distributions shall not be accepted at face value.

The tax court has long recognized the peculiar nature of transactions between corporations and shareholders. The courts have steadfastly (farm co-ops excepted) refused to ignore the possibility that the identity of interest between a corporation and its stockholders may obscure the true income of the corporation. Hence in the case of *Eastern Carbon Black Co. v. Brast*, a bargain purchase (i.e., for less than full value) by a stockholder from the corporation was treated as a dividend.\(^57\) Nor have the courts allowed income to be excluded from the gross income of the corporation merely because the business entity was obligated to distribute net margins to a class of stockholders.\(^58\) In addition the courts have not allowed income to be excluded from a corporation's tax liability merely because the revenues were obligated to third parties, parties who

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\(^{57}\) *Eastern Carbon Black Co. v. Brast*, 104 F. (2d) 460 (C.C.A. 4, 1939).

were not stockholders in the corporation. Such was the situation in *Fontana Power Company v. Commissioner of Internal Revenue*, where the corporation was required to pay taxes on its income, even though under a preexisting agreement it was obligated to transfer such funds in payment for purchased properties.⁵⁹ Again the issue was, who earned the income? In the above citations a preexisting contractual obligation, or the distribution of profits called by the corporation some type of non-profit distribution, did not reduce the tax liability of the respective corporations.

Not only have the courts recognized the importance of adverse interests in non-cooperative business, they have also recognized its importance in non-farm cooperative businesses. The three cases cited below are applicable to the cooperative form of business operation.⁶⁰

1. *Cleveland Shopping News v. Routzahn*


3. *Druggists' Supply Corp. v. Commissioner of Internal Revenue.*

In all of the above cases exclusion requirements for agricultural cooperatives were met, yet distribution of patronage margins was taxed at the corporate level.

1. In each case the participating firms were associated to

⁵⁹ *Fontana Power Company v. Commissioner of Internal Revenue*, 127 F. (2d) 193 (9th Cir. 1942).

⁶⁰ *Cleveland Shopping News v. Routzahn*, 89 F (2d) 902 (6th Cir. 1937); *Railway Express Agency, Inc. v. Commissioner of Internal Revenue*, 169 F. (2d) 710 at 713 (C.A.D.C. 1967); *Druggists' Supply Corp. v. Commissioner of Internal Revenue*, 8 T.C. 1343 (1947).
reduce the cost of goods needed in their business activities or to increase the saleability of services performed by their businesses.

2. The cooperative was obligated contractually in all cases to turn back to the participating firms all margins after the cost of operation was deducted.

3. Stock in the cooperative association was owned only by the patrons of the association.

4. Margins were distributed on the basis of patronage not on the basis of stockholdings.

In holding the revenues distributed by the Druggists' Supply Corporation on a patronage basis to be taxable the Tax Court said: "The circuitous method adopted for distributing what is in fact taxable income of the petitioner does not permit it to escape its Federal Tax Liability."

Co-op spokesmen in defending the present treatment of agricultural cooperative earnings choose to ignore the cases previously cited. They argue instead from ostensibly analogous cases, such as the Ford Motor Case. Here revenues distributed to the corporation's customers under a preexisting contract were excluded from the firm's corporate earnings. However such an example is not analogous to the distribution of patronage margins by agricultural cooperatives. True, a firm may choose during its life to give rebates to some or all of its customers, some or all of the time but such a practice exists to maximize profits not to distribute or assign profits. Likewise it is a common practice for businesses to give trade discounts for prompt payment of receivables. Rebates may be made on the assumption that a lower price will increase total profits. Trade discounts help to maintain liquidity at a low cost through internal rather than external financing. However both practices

vary in importance with the changing economic environment and serve to maximize profits not to distribute profits.

Only cooperatives purport to turn back year after year all of their net revenues. If a cooperative is a firm dealing at arms length with customers (not investor-customers) it is extremely doubtful that a perpetual practice of turning back all profit to its customers would contribute to the growth and success of the enterprise. Its investors would not stand for a policy whereby no return was paid for the assumption of risks. The only solution to this hypothetical situation is the conclusion that it cannot and does not exist. The price adjustment, rebate position or contract theory and the like which envisage revenues distributed to a cooperative's patrons to be analogous to rebates simply will not stand up. It is only because a cooperative's "customers" are also its investors and that residual revenues (profits and price adjustments) are distributed in proportion to the patron's investment in the enterprise that profit exhausting "rebates" exist only among cooperatives. The conclusion must be that patronage refunds are not solely rebates and a cooperative is not a firm dealing with bonafide customers.

Patronage margins are in part a distribution of profits. Profits are measurable as explained in chapter two. If no corporate income tax is levied upon the profit portion of the distributed margins, the cooperative enterprise is being subsidized to the extent of such tax advantage. Cooperative spokesmen have chosen to emphasize the role of the patron as "customer" out of proportion to his role as an investor, all in the interest of maximizing after-tax corporate cooperative profits. It is only because as an owner he is not dealing with himself at arms
length as a patron; that a patron is able to realize profit in the form of a price adjustment. Therefore the moot fact that cooperative gains are distributed according to patronage pursuant to a prior contractual is not in itself a reason for concluding that such gains are not profits, thus excluding them from a corporate income tax liability.

A second argument used by co-op interests, is that the cooperative is an agent for patron-principles. Here patronage margins are viewed as the final settlement portion of a firm price in which the agent accounts to its principal-patrons for transactions which it has undertaken. There can be little doubt that some cooperatives operate as agencies, as was pointed out in chapter two. However it is extremely doubtful that the more significant cooperatives operate in this manner. The demands of commercial efficiency seem to require that several of the principal tenets of agency are violated.

As Magill points out, the essence of agency to sell:\textsuperscript{62}

\textellipsis is the delivery of the goods to a person who is to sell them, not as his own property but as the property of the principal, who remains the owner of the goods and who therefore has the right to control the sale, to fix the price and terms, to recall the goods and to demand and receive their proceeds when sold...but who has no right to a price for them before sale or unless sold by the agent.

Accepting the above definition of agency we find the following principles necessary for a valid principal-agent relationship.

1. The goods remain the property of the principal until sold.

2. The principal has the right to control the disposition of the goods.

3. The principal has the right to all the proceeds from his goods sold by the agent.

4. The principal has no right to a price for the goods before they leave the agent's hands.

None of the above essentials of agency are adhered to by most cooperatives.

Generally the farmers' products do not remain the property of the principal-patron. True, an agent could take legal title to such goods as trustee while the member-patron retained a beneficial interest but this does not happen in most cooperatives. What is more significant is the violation of the pricing principle which is integrally related to the first and third principles. If actual prices are paid in either a marketing or purchasing cooperative the relationship is definitely one of buyer and seller not of principal-agent. The co-op interests argue that such prices are only tentative prices and that the patronage margins constitute the final portion of a true firm price. This is simply not true. If patronage margins are true price adjustments, overpayments or undercharges would require retroactive assessments on the part of the association. Few associations make such assessments. Instead they choose to charge off such costs to surplus accounts. They state that such charges, by creating a reduction in member equity in proportion to patronage, perfectly adjust prices to agency prices. However this argument is untenable. First, because not all monies of all co-ops are allocated and secondly because revenues and costs are often pooled interdepartmentally. In summary, the following principles are applicable to typical cooperative operations.
1. The goods do not remain the property of the principal until sold.

2. The principal often does receive a firm price in the form of a minimum or maximum price before the goods leave the association's hands.

3. The principal does not necessarily receive all the proceeds from the goods sold by the cooperative.

The most significant requirement of agency from a structural standpoint is the second requirement:

The principal has the right to control the disposition of the goods.

This requirement implies that an agent must have as his foremost duty the getting of the best price for his principal's products or the securing of goods for the principal at the lowest possible cost. The principal, through controlling the disposition of his products or the purchasing of products, serves as a check upon the integrity of the agent. The agent cannot legally perform acts which are incompatible with the interest of his principal. For example, he cannot be an agent for a buyer of item A and at the same time serve as an agent for the seller of the same item. From an economic standpoint this means that a selling agent for an enterprise must have no economic interests outside his employment which are incompatible with his duties.

A cooperative association does not act as an agent from an economic standpoint. It carries on operations related to hundreds of competing firms. It pools revenues and costs over its total operations or at least over the multiple activities of each separate department. Farmer A may want to sell eggs in May yet the cooperative may not place his eggs on the market until June. A quarter of the associated farmers may not choose to go into petroleum refining but majority rules and the
association adds another operation. Such facts of cooperative operations serve to emphasize that co-ops exist to minimize the competition among its patrons. Uncertainties are reduced and higher, more stable profits are created in the long run. In other words, generally a cooperative is not an agent for multiple farm principals. The interests of the associated are incompatible in the market period. The interests are compatible only when the association serves to reduce competition, and uncertainty thereby raising the individual patron's profits in the long run. The facts of cooperative operation fit better into Phillip's mold of a jointly operated plant than in the normally conceived concept of agency. Cooperatives exist to reduce competition among their patrons; agency exists to carry out competition among competing principals, whose interests must coincide with the interests of their respective agents.

Few cooperative attorneys rely upon the agency theory to support the present tax-treatment of cooperative margins. Some cases have been argued on the agency basis but for the most part the rebate arguments have prevailed. In the two cases cited below the courts did not accept the agency theory.63

Lake Region Packing Association v. United States.

Maryland & Virginia Milk Producers' Association, Inc. v. District of Columbia.

The comment delivered in the latter case is quite significant. In this case undistributed earnings had been placed in a revolving fund. The court decided that:

63Lake Region Packing Association v. United States, 146 F (2d) 157 (5th Cir. 1944) and Maryland & Virginia Milk Producers' Association, v. District of Columbia, 119 F (2d) 787 (D.C. Cir. 1941).
The fund is the corporations' property, and the member's interest in it is much like the stockholder's interest in the surplus of a stock corporation.

This decision serves to point out that a patron's control over a cooperative's activities is not significant enough to qualify as a principal-agent relationship.

The final argument used by co-op spokesmen is the departmentalization or partnership argument. This concept of a cooperative association has certain tax implications which vary in importance over time. It claims that a cooperative is a jointly operated department of participating farm firms. The incorporated cooperative has no income of its own, since it is a department of many farm firms. The only entrepreneurship is farm entrepreneurship and hence the only income is farm income. Therefore any tax should be levied at the farm level which is responsible for that income. In brief the incorporated association is assumed to be responsible for little or none of the income accruing to the farm firms.

The cooperative department is presumed to be analogous to the unincorporated departments of large industrial firms. Since such departments do not pay taxes why should the departments of farm firms pay income taxes? An unsophisticated answer is that one department is incorporated, the other is not. However this answer falls short, for it cannot be denied that all incorporated entities do not receive the same benefits or extent thereof from incorporation. Some incorporated concerns do operate as departments and the benefit of incorporation in such instances is not nearly as great as when a firm is incorporated. This fact is recognized by the Bureau of Internal Revenue through providing for the filing of consolidated returns.
parent firm holds at least an eighty percent controlling interest are
presumed to be operated as departments of the parent. A consolidated
return can be filed by paying a nominal two percent penalty charge.
Thus the departmental nature of such subsidiaries is recognized.

A cooperative association could logically be treated in a similar
manner thus taxing profits at the farm-firm level. This is precisely
what the cooperative interests believe should be done. The following
comment of a cooperative attorney is in this vein:

You take an oil company or a steel company, those oil com-
panies and steel companies try to integrate their operations,
do they not? They try to be able to supply their own needs
by establishing various chains in the link so they can supply
themselves with raw materials down to the finished product.
When they do that, nobody complains because it is a nonprofit
distribution from one department of that great corporation to
the other. You do not say something unfair has been done be-
cause the United States Steel Corporation does not pay Income
taxes on what it may have charged for its iron ore to its
smelters. You take it for granted that will be a nonprofit
line of dealings. Here is a bunch of farmers over here who
are carrying on agriculture and who need tractor fuel to do
the job. Now they have started to distribute gasoline to
themselves and tractor fuel and they find out they could not
get it. Then they established refineries. They found out
that they could not get crude oil for their refineries. They
went back and owned some oil wells. All in the world
they have done is exactly the same as every big corporation in this
country has done. They have tried to integrate their agricul-
tural operations and protect their economic position.

There is little doubt that incorporated entities derive differing ben-
fits from incorporation. This fact has been recognized by our tax poli-
cies as mentioned before. However there are two good reasons why coop-
erative associations are not considered incorporated departments of
their patron's farm firms. First, there is no a-priori reason for assum-
ing that a cooperative operates as a department. Second, there is much

64Revenue Revisions of 1951, 1236.
evidence that cooperatives do not operate as departments.

A non-cooperative parent firm that controls at least eighty percent of a subsidiary is much more liable to have integrated economic relations with its subsidiary than a farmer will have with his association. First, there is little separation of ownership and control. A division manager or subsidiary president will quite probably have goals for his unit come down from above. In the case of a cooperative association separation of control and ownership is much more possible. In the latter case one is dealing with stockholders and professional managers. In the first situation we are dealing with controlling managers and subservient managers. Granted separation of ownership and control exists in the non-agricultural sector but this is anticipated by the levying of a corporate tax upon the parent corporations. In brief, a cooperative's patrons are more akin to stockholders of a corporation than they are to a parent corporation. Such structural differences need not eliminate a cooperative from operating on a departmental basis, however it does negate the validity of an a-priori assumption that such operation does exist.

The second reason for not recognizing integrated farm-cooperative operations is that there is good reason to suspect that such operations do not exist. Contrary to Phillip's belief, a cooperative's entrepreneurship need not end at the farm. In the beginning, farmers associated not to take on additional uncertainties but rather pooled uncertainties and thus increased the stability and levels of their farm incomes. However, due to the very nature of agricultural cooperatives, if they are successful uncertainties decrease and the need to "go" cooperative to
achieve a competitive share of the nation's total product decreases. Once non-associated adjusted returns are equal to associated adjusted returns, further attempts at integration create a firm out of the former cooperative department. From this point forward farmers decide to market and purchase cooperatively not on the basis of integrated operations. Instead they trade with the concern that gives them their best return on investment, not just on farm investment. In the words of Cook such returns are best described as farm-connected returns, not as farm returns.65

Once the incorporated cooperative ceases to operate as a multi-firm department or plant there can be no equitable reason for not taxing for the privilege of incorporation at the usual rates. In the latter stages of a cooperative's evolution the advantages of incorporation become very important. No longer does the incorporated cooperative differ in corporate function from other incorporated firms. The privileges of allowing the artificial person to own property, enter into contract, incur debt, limited liability and ease of capital attraction are just as important to the cooperative as they are to any incorporated firm.

A variation of the departmentalization argument is the partnership concept. Like the first argument it states that not all incorporated entities are alike in corporate function or at least in the degree of corporate function. Here the cooperative is compared to limited partnerships. Limited partnerships are those in which a silent partner enjoys limited liability for the debts of the partnership. With the exception of this one benefit of incorporation, a limited partnership is perfectly analogous to other partnerships. The ownership and control are

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65 Cook, p. 56.
are not separated. The incorporated firm does not exist artificially. In such a partnership a general partner who has unlimited liability must manage its operations. This hedges against the possibility of turning control of the operations over to professional managers. Incorporation serves merely as the alter ego of the partners. It is obvious that the economic structure of a limited partnership is not analogous to the economic structure of a cooperative association. Hence its application to the development of tax policy is not appropriate.

Neither the departmentalization or partnership arguments are applicable to contemporary cooperatives. In the inception period of cooperation one could speak of the cooperative as a department or plant. Only members who would fit into the departmental scheme of operations were allowed to participate in the associated activity. Today anyone can trade with a cooperative. Membership is a mere formality. Any patron who trades to any extent with a cooperative automatically becomes a member. In fact in some instances he may become a member against his will. In addition, professional managers have taken over from part-time farm managers. In the interest of protecting their jobs they attempt to satisfy all patrons. Both costs and revenues are pooled, the goal being to achieve successful operation on an aggregate not departmental basis. Although the last operation is not per-se incompatible with departmental operation, taken to a significant degree it does become incompatible. The one-man, one-vote rule serves to water down the importance of patrons' specific interests and allows control to rest in the hands of professional managers. And most important, co-op patrons trade with a cooperative with the goal of maximizing gross returns not just farm returns.
take non-farm risks to make non-farm profits.

In conclusion Phillip's concept of a cooperative association is static from a historical standpoint. If the economic environment which his theory was predicated upon existed today there would be some basis in equity for taxing cooperatives as departments; thus levying a tax on the farm-firm level. Today the very success of cooperative operations has changed the economic environment. Consequently it has also changed applicable tax policy toward agricultural cooperatives.

No matter which of the three basic arguments are used none of them successfully eliminate the corporate income of cooperatives. The agency argument when applicable, which is seldom, does eliminate a corporate tax liability. However, little cooperative business is performed on a true agency basis. The rebate point of view (price adjustment or contract theory) which envisages an arms length relationship between patron and the corporate entity is not valid and does not eliminate corporate profits. Finally the departmentalization position which correctly describes the economic structure of cooperatives (multi-firm plant) during their inception period is of moot significance in developing equitable tax policy in the contemporary setting.

If non-farm incorporated firms pay for the privilege of incorporation there would seem to be no reason in equity for exempting incorporated cooperative firms from paying the same cost for the same privilege. In conclusion the traditional arguments used by cooperative interests to justify the exclusion of patronage margins from corporate taxation do not accomplish the task set before them.
CHAPTER IV

PROPOSALS AND CONCLUSIONS

Evaluation of Proposals

Before the benefits and deficiencies of any proposed change in public policy can be evaluated one must show a need for change. The need becomes an end while various proposals serve as means of differing competence. A need can be demonstrated in two basic ways.

1. One can show that the original policy was inappropriate.

2. One can show that new conditions have outdated once appropriate policy.

It is the latter possibility which is most applicable to the problem at hand. However since it is a changing economic environment which requires a change in public policy toward farm cooperatives, economists are faced with a very thorny perennial problem. That is to say, they are faced with the problem of measurement. Not only is it difficult to measure cooperative profits, it is even more difficult to measure changes in market structures. It is this two pronged problem of measurement which has led to much confusion in the cooperative tax issue.

The problem of measuring cooperative profits was examined in Chapter Two. Likewise the measurement of benefits attributable to incorporation has been discussed. The one measurement problem which has not been emphasized is the measurement of resource allocation. Before examining the various proposals a word on optimal resource allocation seems appro-
In a series of articles appearing in the 1952 Journal of Farm Economics the latter problem was attacked by two economists, Clark and Aizsilnieks. Clark examined four different types of markets to determine whether on an a-priori basis cooperatives, in contrast to private firms, led to optimal resource allocation. Clark's score sheet for cooperative operations is reproduced below.

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**Case 1. Pure Competition in Buying and Selling.**

Purch: Private Firm:  
Mkt: Private Firm:

**Case 2. Monopolistic Selling, Competitive Buying.**

Purch: Indeterminate:  
Mkt: Indeterminate:  
(More probable that firm leads to optimum allocation.)

**Case 3. Competitive Selling, Monopsonistic Purchasing.**

Purch: Private Firm:  
Mkt: Indeterminate:  
(More probable that co-op leads to optimum allocation.)

**Case 4. Monopolistic Selling, Monopsonistic Purchasing.**

Purch: Indeterminate:  
Mkt: Indeterminate:  
(More probable that firm leads to optimum allocation.)  
Indeterminate:  
(Same as above.)

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Aizsulneiks challenged Clark's assumptions regarding rational cooperative operations and market structures, concluding that none of Clark's conclusions were valid. In the writer's opinion Aizsulneiks made some serious mistakes and Clark won the debate. However, regardless of who won, Clark did realize the limitations of his armchair analysis. He points out that one must assume that contemporary cooperatives operate to maximize farm returns, if his analysis is to be useful. Secondly, even if this assumption is valid, not all cooperatives operate in similar market environments. Therefore Clark's tally sheet of firm and co-op operations has differing meaning depending upon the assumed dispersion of co-op operations among differing market situations. Since this series of articles constitutes a large portion of published works on cooperatives and welfare economics, it would seem that the literature contributes little in a form which is adaptable to policy formulation. Cooperatives may or may not operate in a manner consistent with optimal allocation of resources. The markets in which they operate determine the degree to which cooperative operation is consistent with optimal allocation of resources.

But Clark does touch upon an assumption which is particularly significant to the writer. He points out that contemporary cooperatives need not operate in a manner differing from the operations of private firms. To the extent that this practice persists there can be no reason on social grounds for taxing cooperatives at a lower rate than that applicable to incorporated firms. In short, he hits upon the idea which has been emphasized and extended in this thesis.

If the very success of cooperative operations over the last half
One century has changed the goals of cooperators from bonafide co-op goals to non-co-op goals, there is good reason to adopt tax policy toward cooperatives which is more akin to non-co-op tax policy. The writer's thesis is that the very success of co-op operations has changed their original function. In the past, cooperatives maximized farm profits; today this need not be true. Probably many cooperatives, depending upon market environments, operate as firms maximizing farm-connected rather than farm profits. The degree to which this change has swamped bonafide co-operative goals is unknown. Adequate data is not available. However, in observing general trends, fair minded men must admit that two significant changes affecting cooperatives have taken place in the last half century. First, cooperatives have experienced success and therefore have expanded the extent of their operations. Second, much of the monopsonistic and monopoly power previously faced by farmers has been mitigated through the expanded role of government regulation. Given the assumptions of this thesis regarding adjusted returns relationships in firms and non-firms it would appear that tax policy toward cooperatives should be altered. The proper degree of change depends upon data not presently available. It is with this important fact in mind that alternative tax proposals should be examined. The present tax treatment of agricultural cooperatives' earnings is unfair. The precisely proper tax policy toward farm cooperatives is necessarily an unknown factor. But on an a-priori basis the economic fact of a changing economy strongly suggests the need for policy changes. The attempts that have been made to create a more equitable tax policy will now be appraised.
Analysis of Proposals

None of the more practical proposals, the removal of Section 521 excepted, are completely consistent with the economic nature of the cooperative association. Neither do such proposals guarantee a complete solution to the present inequitable tax subsidization of farm cooperatives. From a rather negative approach, the elimination of the corporate income tax would be consistent with the cooperative's economic structure and would end the present discrimination toward non-cooperative corporations. However the writer is of the opinion that corporations will continue to be taxed. Certainly public opinion is a force of no mean importance when considering policy problems; therefore the elimination of the corporate income tax will be considered a moot possibility. For two reasons, only positive approaches will receive attention. First, they will create a more equitable situation than that presently existing. Second, it is more feasible politically that such proposals may be adopted.

A cardinal principle of equity is that likes be treated alike. Therefore, since the value of incorporation appears to be equal between cooperatives and other corporations, both types of enterprise should be taxed at the same rates on profits attributable to this privilege. The principal is clear cut, its application difficult. Cook recognizes the problem of application thus.67

Because of the methods of organization and operation inherent in the cooperative way of doing business, it must be conceded that it would be administratively impracticable to attempt to tax effectively cooperatives in such a way as to make taxation

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67 Cook, p. 264.
of their profits equivalent to the taxation of the profits of an ordinary corporation.

Since a cooperative's stockholders are also its "customers" it is nearly impossible and certainly impracticable to determine where price adjustments end and corporate profit begins. Consequently the two types of positive proposals that will be discussed do not attempt to precisely tax a cooperative's income. One type would tax all margins, retained and distributed, as if they were akin to corporate profits. The other type would tax only undistributed margins. The latter proposal is based on the assumption that retained margins are more akin to corporate profits than non-retained margins.68

Both groups of proposals do not attempt to completely segregate profits from price adjustments. However, both sets of proposals are aimed at squelching the present expansion of farm cooperatives on tax-free profits.

In order to acquire an adequate appreciation of the problems inherent in finding a proper cooperative tax base, the proposed elimination of Section 521 will be the initial proposal examined. This is the only proposed change which has any bilateral support. The cooperative interests have frequently recommended its removal in order to steer controversy away from the main issue, patronage margins. The "anti-co-op" interests have recommended its removal, since Section 521 clearly provides a tax loophole. Extraneous revenues are clearly income to the cooperative, not rebates or cost adjustments to member-patrons. Consequently such revenues should be taxed in a manner analogous to the taxation of ordinary corporate income. Also dividends paid on capital stock more closely

68Cook, p. 271.
resemble a distribution of profit than interest payments, an operating expense. Generally such payments are distributed only upon the decision of either the board of directors or the cooperative manager.\textsuperscript{69} Hence they are not analogous to fixed interest payments which rightfully are a deductible item for all businesses. Co-op spokesmen often claim such payments are merely distributions to minimize disproportionalities in capital contributions of co-op patrons. If this is so, a-priori, the payments would have to be made on a continuing basis. This practice is not notable in many cooperative operations. In brief, both dividends on stock and extraneous income are cooperative corporate income. In both examples the income is measurable on a cardinal scale, therefore no problem arises in applying our basic principle of equity; likes must be treated alike. However, it is obvious to anyone who has studied the co-op tax controversy that the specific exemption is but a minute portion of the tax issue. Once one moves into the world of non-adverse interest, a cardinal tax base no longer exists and equitable proposals become extremely difficult to draft.

Although patronage margins do not necessarily measure profits, some lobbies have suggested that patronage margins be taxed at the corporate, or corporate and personal levels. Such proposals are made on the assumption that taxing cooperatives is more a matter of strengthening competition than of enlarging the sources of federal revenue. The important goal, here, is to separate from the cooperative's control (manager and/or

board of directors) corporate tax-free margins. The National Association of Manufacturers, the National Tax Equality Association and Professor Guthmann are adherents of this position. It is the capitalization of tax-free profits rather than the actual earning of cooperative profits that these people object strenuously to. Looked at from the goal of maximizing federal revenues, taxing patronage margins is a second rate proposal as Bradley has emphasized. There can be little doubt that farm cooperatives faced with the proposed taxation of patronage margins could and would price away these margins to a large extent. If a purchasing cooperative precisely estimates its inventory and operating costs the patron would receive his profit through a reduced cost of goods purchased. On the other hand the marketing association could pay higher than prevailing prices thus distributing profit through initial rather than final payments. By adopting such tactics no significant amount of margins would appear and the patron's corporate profit would be dovetailed into personal income to be taxed at presumably lower personal rates.

On the surface such a taxation policy would seem to be self defeating. By attempting to tax margins, the margins are eliminated and consequently the cooperative still has tax-free income to expand on. But as previously implied there is a major fallacy in this conclusion. Under the constructive receipt and reinvestment theory farm patrons were presumed to voluntarily associate and agree to the policies of their elected board of directors and manager. If ownership and control are separated,

which is undoubtedly the case in some cooperatives, voluntarism is a fiction. Consequently if the cooperative is forced by the threat of corporate taxation to minimize margins, the patron has increased his control over his corporate earnings. In economic markets where the cooperative has powers associated with imperfect competition, it would no longer be able to force patrons to pay personal taxes on funds which remained involuntarily in the association's hands. More important, those responsible for the association's policies would have to go before the members and secure approval of assessments if growth was desired. All members would actually have the choice of deciding where the return on such funds was the highest - at the farm, in the cooperative or in non-farm investments. It is precisely this choice which is essential to Phillips' theory of cooperative operations. He assumed a non-monopsonistic cooperative where the desires of patrons were automatically transmitted to and made operational by co-op directors and managers. Certainly many cooperatives have evolved into a stage less indicative of this "pure democracy" than was presumed by the Treasury previous to 1960. In summary, the above proposal would tend to force cooperatives to operate on a more equitable basis, and to the extent that the tail wags the dog, growth on tax-free earnings would be slowed down.

Contrary to Cook, Guthmann views the above proposal as an equitable solution to the present discrimination in favor of cooperatives. To the extent that cooperatives succeeded in pricing out margins, members would gain direct control over their co-op's operations. In addition, initial prices would become final prices and competition would be less discreet than at present. In sum, competition is at the corporate
level, not at the personal level. Taxation of margins would more effectively eliminate subsidized competition than any more complex proposal.

Guthmann presents this position as follows:72

The direct lowering of the cooperative selling price rather than the payment of patronage dividends would, as a matter of fact, make for fairer and more straight-forward competition and a clearer demonstration of the relative efficiency of the cooperative and other competing business units. Consumers would make direct comparisons of the prices paid when dealing with the two types of organization. Under the present system, the cooperative member never knows the exact price he is paying at the time of purchase because the patronage dividend is in the future and, of course, it may never actually materialize. This element of doubt comes very close to an unfair trade practice in that it holds out uncertain future patronage dividends as a lure for business. Direct price reductions by cooperatives will make for clearcut competition.

Guthmann is one of few who is willing to face the pricing out problem. He does not believe that initially adjusted cooperative prices will be ruinous to competing enterprise. On the contrary he believes that pricing out of margins will eliminate the present unfair "product differentiation" used by cooperatives. However, there exists a much more dominant opinion that the pricing out phenomena should be avoided. In order to bypass this problem, a corporate tax would be levied only on undistributed margins. This type of policy has been proposed by the United States Treasury Department and by Cook.

The Treasury Department's H. R. 7875 is the most recent proposal for changing the tax status of farm cooperatives. The bill has three objectives.

1. Decrease the extent of cooperative expansion on corporate tax-free earnings.

2. Guarantee the relatively current taxation of margins either

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at the personal or corporate level.

3. Avoid the pricing out tactic by taxing only undistributed margins.

The treasury proposal is obviously a compromise. It attempts to weaken the discrimination against non-cooperatives but goes only far enough to tone down the controversy. It is essentially an attempt to make the 1951 law effective. The intention of compromise is clearly brought out by the following statement of the Assistant Secretary of Treasury, Jay W. Glassmann.73

The Treasury proposal seeks to strike a fair balance by imposing one single tax on cooperative earnings and by permitting cooperatives to retain earnings for 3 years with no tax at the cooperative or patron level. We believe that it provides sufficient opportunity to accumulate a reasonable reserve out of tax-free earnings. Thus, if a cooperative earns 10 percent per year on its equity, before taxes and patronage refunds, it could continually retain as much as 30 percent of its beginning equity by a 3-year rotation of its noncash patronage refunds.

Not only is a three year revolving period of tax-free funds allowed, but in addition the specific exemption is only insignificantly amended. Dividends on stock and extraneous income when distributed to patrons within three years are not taxable to the cooperative.

Under the treasury provisions margins are excluded from the cooperatives' income if paid in cash at the end of the fiscal year; or if paid in scrip containing an unconditional promise to redeem in three years or less at face value with interest at no less than four percent. This requirement allows a cooperative three years to expand on tax-free earnings rather than the eight to ten years found in many cooperatives at present. It is definitely a step in the right direction. It is also

more equitable toward the farm-patron than the present system is. The "captive" patron must receive his margins immediately or be paid interest on such revenue, which interest and principal will be returned within three years. Patrons pay tax only upon cash distributions. When "negotiable" scrip is issued the personal tax liability is suspended until the scrip is redeemed. If not redeemed within three years, the cooperative must pay a corporate tax on such retained revenues. Consequently the patron pays a tax only on funds completely under his control, and the problem of determining market value is avoided.

Finally, at the expense of allowing the cooperative to use tax-free funds for three years, the pricing out problem is avoided. There can be little doubt that this proposal would insure the approximate current taxation of cooperative margins either at the personal or cooperative level. The extent to which this proposal is superior or inferior to a direct tax on all patronage margins depends upon the degree of separation of control and ownership in cooperatives and the ability of cooperatives to price out their margins.

Cook's proposal is a pioneer work preceding H. R. 7875 and is not as externally oriented as the Treasury Bill. That is, more leeway is allowed for cooperatives and their patrons to equitably work out their own solutions to the problem of control. But, in essential goals it does not differ substantially from the Treasury Proposal.

In contrast to H. R. 7875 it would levy a personal income tax on margins on an absolute current basis. All negotiable scrip would be taxed during the year in which earned. Bonafide preferred stock would also be taxed when issued. Disparities between face value and redemption
value would be picked up through capital gains or losses. Unlike the Treasury Proposal, margins would not have to be recognized by a 4 percent, 3-year debt instrument. Debt instruments negotiable within the meaning of the Internal Revenue Code 118, Sec 39.42-1-2-3- would be excluded from gross corporate income. In addition, if the option to receive cash or bonafide preferred stock is given, the issuance of such securities will exclude the represented margins from a corporate tax liability, provided a like amount of securities is retired. The last difference between the Cook and Treasury Proposals is that Cook would repeal Section 521.

Like H. R. 7875, Cook's proposal would give the patrons more control over the allocation of their funds. In contrast to the Treasury Bill no arbitrary floor is set for interest rates or maturity dates. However, cooperatives could exclude revenues from their gross income only if bonafide debt and equity instruments are issued in lieu of those revenues. Since the revolving period is left to the patron's discretion, Cook's proposal is more applicable to the economic nature of a cooperative than H. R. 7875. Of course this virtue is somewhat weakened by a possible larger evasion of corporate taxes than would be possible under the Treasury Plan. In some instances the removal of the specific exemption section might decrease to a substantial degree the importance of this possibility. However, to the extent that separation of control and ownership is a major issue, Cook's plan would reduce by a similar amount the expansion on tax-free earnings which H. R. 7875 attempts to stymie.

Faced with the problem of an unsatisfactory income tax base several non-income bases have been suggested. Two such bases have little
to recommend them. Both a gross receipts tax and a tax on investment would create serious inequities. Gross receipts of a cooperative are not equivalent to sales in other enterprises. Hence the tax would clearly be inequitable toward cooperatives. In addition it would create inequities among different types of farm cooperatives. Likewise a tax on cooperative investment in contrast to a tax on ordinary corporation income would be inequitable. For example citrus cooperatives with high investment per dollar of profit would bear a tax load disproportionate to that of a livestock association. Needless to say, such proposals have not been taken seriously. No bill in Congress has ever been drafted along the above lines. The following statement expresses the ineptness of such proposals.\textsuperscript{74}

\textit{It would...be impossible to select any one rate of tax on gross sales which would be approximately equivalent to a corporate income tax on the economic income earned by cooperatives. The amount of net income earned on a dollar of gross sales varies widely among manufacturers, wholesalers, and retailers in different lines and among firms in the same line. Attempts to select different rates for different types of cooperatives would result in great difficulties and would still leave the equity problem unsolved in borderline cases. Moreover, it is generally agreed that a gross receipts tax is more likely to be passed on to consumers than is a net income tax, and, at least in the case of larger marketing associations, the tax might fail to achieve its objective.}

Another alternative tax is one based on invested capital. As in the case of a gross receipts tax, the selection of a rate that would approximate a tax on net income would be difficult, if not impossible. Moreover, a tax on invested capital would bear more heavily on weak cooperatives than on strong and successful associations. Such a tax would give rise to serious administrative and legal problems in

\textsuperscript{74}The Taxation of Farmers' Cooperative Associations, U. S. Treasury Department, Division of Tax Research, Mimeographed October 1947, p. 7. 'Cited by' Patterson, The Tax Exemption of Cooperatives, p. 99.
connection with the definition and valuation of invested capital.

No method seems to exist whereby the profits of a cooperative corporation could be precisely measured. Since only some cooperatives charge and buy at prevailing prices, margins are not always perfectly analogous to corporate profits. However a portion of such margins do represent profits. To segregate such profits from price adjustments is impossible. Taxing all margins as if they are profits leads to the pricing out phenomena. On the other hand by taxing only non-qualified retained margins cooperatives are directly allowed to expand on the tax-free income integrated in such retains. A perfect method of taxing cooperative income cannot exist. However, all of the practical proposals discussed would decrease the present subsidization of cooperative operations. Which method is best is an open question which the writer is not prepared to answer.

Thesis Summary Statement

Without question farm cooperatives are non-profit businesses only in a very limited sense. For the most part they were not organized to profit from patron business. The various limitations on ownership of stock, withdrawal, and dividends on stock testify to this statement. Farm cooperatives, however, were organized to make profit. Initially such profits were extracted by farm-patrons from the non-farm monopolists and monopsonists. Since this extractive process resulted in a healthier farm economy plus a better and cheaper distribution of foods, the cooperative movement was encouraged. Cooperatives were allowed to operate under a unique set of tax regulations not because they were non-profit
enterprises but because they seemed to contribute more to the nation's welfare than non-farm enterprise operating in the same sector of the economy. Tax subsidization was considered to be in the public interest. Today this original function has greatly diminished, the association is no longer a multi-firm plant operating to eliminate market imperfections. Instead it has evolved into a farm-connected enterprise no different in goals from any other enterprise.

Like the public interest and departmentalization arguments which are integrally tied together, other co-op arguments have become outdated. Farm cooperatives can but seldom do function on an agency basis. The expansion of cooperatives into every line of activity conceivably connected to agriculture has confronted a basic diseconomy of scale. Management can be extended only so far, and more important a true agency relationship has size limitations. Consequently the separation of ownership and control which characterizes large corporate enterprise is found in like degree in the larger cooperative structures.

Finally the co-op interests have resorted to a specious legalistic argument called price adjustment to justify their present tax position. Again the economic facts do not support the validity of the co-op position. Here the cooperative is viewed as a firm which distributes all profits to its "customers." However, this argument ignores the important fact that a cooperative's "customers" are also its investors. Hence the distributive process is more like a tax-free profit distribution to investors than a rebate or cost adjustment to customers. No bonafide firm adopts a permanent policy of profit exhausting rebates or cost adjustments. Obviously the co-op's investors must obtain a return
on their investment if the business is to succeed. The fact that such returns are disguised as price adjustments in no way reduces the tax liability of such returns.

In brief, cooperatives are presently subsidized through corporate tax-free profits. This subsidization cannot be justified on the grounds of public interest. Of the practical modifications in tax policy which have been suggested none are free of imperfections. None of the proposals would levy a tax which falls directly on only co-op corporate income. None affect the cooperative's ability to accumulate funds in the same way the corporate income tax affects non-cooperative corporations.

But, they would aid in ending the present discrimination against non-co-op enterprise operating in the rural economy. It is suggested that any one of these proposals would be superior to the present tax regulations under which cooperative operations are carried on. No one can deny that farm cooperatives have performed a real service for this country. However, the economic world does not stand still. It is no more inappropriate to end the subsidization of cooperatives once they have matured than to remove tariffs once infant industries have come of age. In both cases the public interest can be best served by the alteration of once appropriate policy. New tax policy toward cooperatives is a must if they are to perform their proper role in the economy. Cooperatives as well as non-farm enterprise must be forced to compete in a free enterprise economy. This has been recognized by economists regardless of their positions in this controversy.75

To perform their role in the economy most effectively, cooperatives themselves need the stimulation of private competition. Successful cooperatives owe a great deal to their competitors. Efficient competitors present a continuous challenge to cooperative management to try to render a better service at lower cost. The reciprocal competitive action of efficient cooperative and efficient private business firms is a most desirable goal for the economy. It is a means of assuring to farmers and others a more effective and productive economic system than one in which government plays a larger part.

Or, in other words, the cooperative economy serves as a measuring stick for the private enterprise economy and vice versa. The only problem is, that with subsidization the measuring stick no longer measures.
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