

# Principals of Cooperative Taxation

August 6, 2017



# Learning Objectives

- Apply the cooperative tax rules to a tax provision and tax return
- Identify common tax issues for cooperatives
- Identify common areas of risk and how to address them with cooperatives.

# Agenda

- Fundamentals of Cooperative Tax System
- Taxation of Cooperatives
  - General
  - Patronage vs Nonpatronage business
  - Patronage Refunds
  - Written Notices of Allocation
  - Handling of Losses

# Agenda

- Taxation of Cooperatives continued
  - Redemption of Patronage Equity and Equity Accumulation
  - Section 521 Cooperatives
- Taxation of Patrons
- Tax Return Considerations
- Section 199 – Domestic Production Activities Deduction

# FUNDAMENTALS OF COOPERATIVE TAX SYSTEM

## Key Terms

- Income – All funds that flow into the cooperative from its business operations.
  - Patronage and Nonpatronage
- Earnings – Income less expenses
- Margins – Earnings on business conducted on a cooperative basis
- Patron – Any person with or for whom the cooperative associations does business on a cooperative basis, whether a member or nonmember of the cooperative association

## Key Terms

- Member – A person who has the right to vote on issues decided by the membership
- Patronage refund – Net earnings from business done with or for patrons that are allocated or distributed to patrons on the basis of business done with or for such patron under an obligation to pay such amount
- Dividend – Earnings that are returned to investors based on the amount of investment in the company

# Characterization as a Cooperative

- May be formed under a specific state cooperative statute, general for profit or not-for-profit corporation, or LLC taxed as a corporation
  - Rural electrification act
  - Agricultural marketing act
  - General for-profit corporation statute
  - Not-for-profit statute
- Key is operation on a cooperative basis
- No Code definition
- Judicial and administrative guidance



# General Requirements for Cooperative Status

- I.R.S. Code, rulings, and case law have set forth cooperative principles. The basic principles are generally
  - Subordination of capital
  - Democratic control
  - Vesting and allocation of benefits

# Subordination of Capital

- In a cooperative, the capital is subordinated
- Unlike a normal for-profit corporation, stock ownership determines participation of corporation's profit and voting rights
- In cooperative, profits based on business and democratic voting
- Members must provide equity, usually in proportion to use

# Democratic Control

- Owned and democratically controlled by the people who use its services
- IRS generally has stated that a cooperative should operate on a one member, one vote basis
- IRS recognized variances based upon
  - floor space in a housing cooperative
  - current patronage
- IRS rejected method based on past patronage

# Democratic Control

- Members exercise control by
  - Electing directors, usually members
  - Approving articles and bylaws
  - Voting on major changes in the business

# Vesting and Allocation of Benefits

- Benefits are distributed equitably on the basis of use
  - Services received
  - Earnings distributions
    - Limited return on equity
    - Patronage refunds
- Cooperative's income must be allocated and vest to the cooperative's member/patrons based upon use
- Most important element of a cooperative

## Fifty Percent Test

- Historically, IRS took the position that in order to operate on a cooperative basis had to do at least 50% of business with members/patrons
- In Rev. Rul. 93-21, IRS conceded that 50% test was not law
- If do inadequate amount of patronage business, it is not really a cooperative, but no set standard

# Benefits of Cooperation

- Access to quality supplies and services at reasonable costs
- Increased clout in the marketplace
- Share in the earnings
- Local economy enhanced and protected
- Help solve industry problems
- Political Action

# Historical Perspective

- Cooperatives have been around 160 years
- Rochdale Cooperative formed by 28 textile weavers for operating a retail store
  - Democratic Control (one member, one vote)
  - Open membership
  - Limited return on capital
  - Distribution of surplus on the basis of patronage
  - Cash trading only
  - Selling only pure, unaltered goods
  - Member education in cooperative principles
  - Political and religious neutrality



# Historical Perspective

- Granger Movement – 1870s
- Farmer Coops, 1890s to 1920s
  - Californians developed large, centralized coops
    - 1893 - California Fruit Growers Exchange (Sunkist)
    - 1912 - California Associated Raisin Company (Sun Maid)
  - Others followed suit
    - 1904 - Tillamook County Creamery Association (Oregon)
    - 1921- Minnesota Coop Creamery Association (Minnesota)
- IRS recognized cooperative through administrative rulings as early as 1922

## Historical Perspective

- Rural Electrification Administration
- Farm Credit Act of 1933 established the Farm Credit System
- The Code never addressed taxation of cooperatives or even recognized the deduction of patronage dividends until 1950s
- Cooperatives Today
  - 21,800 cooperatives in the United States
  - 154 million members
  - \$273 billion in annual revenues
  - 600K employees and \$15.5 billion annual payroll

# Types of Cooperatives

- Farmer
  - Agricultural Marketing - extend control of members products through processing, distribution, and sale (grain, dairy, fruit, nut)
    - Dairy - Land O Lakes, Dairy Farmers of America
    - Fruit and Nut – Sunkist, Sun-Maid, Blue Diamond
    - Grain - CHS
    - Tobacco - U.S. Tobacco Cooperative
  - Farm Supply and Service - Negotiate better terms of purchase for basic agricultural production inputs
    - CHS
    - Prairieland FS

# Types of Cooperatives

- Consumer Service
  - Organized to give members more control over the services that are offered
    - Housing - Cedarbrook Cooperative
    - Healthcare – Farmers’ Health Cooperative of Wisconsin
    - Child Care – Cooperative Children’s Center
    - Education – Bureau-Marshall-Putman Special Education Cooperative
    - Utility
      - Rural Electric - Touchstone Energy
        - Generation and Transmission
        - Distribution
      - Communications – Venture Communications

# Types of Cooperatives

- Business Supply Cooperatives
  - Allows members to gain access to affordable supplies and goods
    - Grocery Wholesalers – Wakenfern Foods, Associated Wholesale Grocers
    - Restaurant supply – Unified Foodservice Purchasing Coop
    - Hardware Wholesalers – Ace Hardware, Do-it-Best
    - Health Care – Group Health Co-op, Health Partners
    - Pharmacies - Partners In Pharmacy

# Types of Cooperatives

- Financial
  - Financial institution that is owned and operated by it's members
    - Credit Unions- Glacier Hills Credit Union
    - Farm Credit System – Farm Credit Services
    - Co Bank (Ag coops)
    - NCB (National Coop Bank)
    - CFC (Utility Coops)
- Worker
  - Businesses that are owned and controlled by the workers
    - Union Cab of Madison Cooperative

# Classifying Cooperatives

- Geographic Territory Served
  - Local, Super Local, Regional, National, International
- Governance System
  - Centralized – Individual members
  - Federated – Cooperative members
  - Mixed – Individual and Cooperative Members

# Classifying Cooperatives

- Functions Performed
  - Marketing – extend control of members products through processing, distribution, and sale
    - Assist members in maximizing returns from goods they produce
      - Handle, process, and sell
      - Grade, transport, bargain
      - Add value
      - Research new product development



# Classifying Cooperatives

- Purchasing – providing affordable, quality supplies and goods
  - Purchase in bulk to reduce costs and increase purchasing power
  - Provide direct ownership of refineries, plants, retail facilities, research facilities
- Service – provide needed, affordable, quality services
  - Meet many needs
  - Custom application of purchased supplies, transport of product, etc.
  - Provide utilities, credit, housing, health care, technology, etc.

# Legal Foundation

- A corporation
- Usually organized under a state cooperative law if their home state
- Legal documents
  - Articles of Incorporation
  - Bylaws
  - Board Policies

# Organizational Makeup

- Members
  - Control the Coop
  - Fund the Coop
  - Patronize the Coop
- Board of Directors
  - Establish Policies
  - Long range planning
  - Hire and fire the CEO

# Organizational Makeup

- Officers
  - Provide leadership to the directors, staff, and members
  - Same functions as officers in other corporations
- Employees
  - Understand coops
  - Fully perform duties
  - Represent coop favorably

# Industry Resources

- National Society of Accountant's for Cooperatives  
[www.nsacoop.org](http://www.nsacoop.org)
- National Council of Farmer Cooperatives  
[www.ncfc.org](http://www.ncfc.org)
- National Cooperative Business Association  
[www.ncba.coop](http://www.ncba.coop)
- State Associations
  - Cooperative Network (WI, MN)
  - Illinois Cooperative Coordinating Committee
  - Agricultural Cooperative Council of Oregon
  - Washington State Council of Farmer Cooperatives

# TAXATION OF COOPERATIVES

## *General*

# Tax Categories of Cooperatives

- Subchapter T cooperatives
  - Section 521 cooperatives
  - Non-exempt cooperatives
- Non-subchapter T cooperatives
  - Exempt cooperatives
  - Cooperatives providing electrical or phone service to persons in rural areas
  - Mutual savings banks or insurance cooperatives

# Sources of Cooperative Tax Law

- Internal Revenue Code
  - Subchapter T (Code Section 1381-1388)
  - Section 521 (“Exempt Cooperatives”)
  - Other Code Provisions
- Judicial Decisions
- IRS Administrative Determinations
  - Regulations
  - Revenue Rulings and Procedures
  - Private Letter Rulings and Tax Advice Memoranda
  - General Counsel Memoranda



## Subchapter T

- Congress enacted in 1962
- Contains most provisions directly related to cooperative taxation and the taxation of patrons
- Codified the Federal income tax treatment of patronage dividends for cooperatives and their patrons
- Basically required the timing of the cooperative's deduction and the patron's income to be matched.

## Subchapter T

- Does not address all of the Federal income tax issues for cooperatives and their members
- Many issues must be resolved by other Code provisions, some of which are designed for regular C corporations
- Application of general rules at times fail to make sense when applied to a cooperative

# Operating on a Cooperative Basis

- Any corporation operating on a cooperative basis may receive the tax benefits of subchapter T, except
  - Mutual savings banks
  - Insurance companies
  - Rural electric energy or telephone companies
- Nontax Statutes That Characterize Cooperatives
  - State Incorporation Laws
  - Federal Statutes
    - Capper-Volstead Act
    - Agricultural Marketing Act of 1929
    - Farm Credit Act of 1971

# Capper-Volstead Act

- Two key provisions
  - Permits farmers to get together to collectively market their products which, in the absence of such an enabling provision, could result in antitrust action against them.
  - Protects the general public against the possibility of undue price enhancements as a result of any monopoly position that a group of producers could legally achieve by getting together.

## Capper-Volstead Act

- Conditions association of producers must meet to qualify for such limited exemption
  - Must be operated for the mutual benefit of its members insofar as they are producers of agricultural products.
  - Must not deal in the products of nonmembers in an amount greater in value than such products that it handles for its members.

## Capper-Volstead Act

- In addition to the requirements, an association has a choice of conforming to one or both of the following requirements:
  - No member of an association is allowed more than one vote because of the amount of stock or membership capital owned.
  - The association does not pay dividends on stock or membership capital in excess of 8 percent per year.

## Capper-Volstead Act

- The Cooperative may find itself just as subject to prosecution for being in violation of the anti-trust laws as would any other firm that engaged in such practices if it:
  - Engages in predatory practices
  - Engages in price discrimination
  - Restricts members' agricultural output
  - Coerces competitors or customers
  - Colludes/conspires with third parties to fix prices
  - Combines with other firms to substantially lessen competition
  - Engages in boycotts

# Federal Income Tax Treatment of Cooperative

- Cooperative is a C corporation
- Subject to all of the other provisions of Subchapter C
- Operates as a pass-through entity for patronage sourced income
  - To the extent not passed through to patrons, taxable to the cooperative
- Cooperative pays tax on its non-patronage sourced income



# TAXATION OF COOPERATIVES

## *Patronage vs Nonpatronage Business*

# Patronage vs. Nonpatronage Business

- Characterizing business or income as patronage or nonpatronage can be approached in two ways
  - Distinction between business done with members and nonmembers (little controversy)
  - Distinction based on the nature of the transaction or operation that generates the income (much controversy)
- Importance
  - For non-section 521 cooperatives, only patronage-sourced income qualifies for single tax treatment
  - Nonpatronage income is subject to regular corporate double tax treatment

# Patronage / Nonpatronage Income

- Treas. Reg. 1.1382-3(c)(2)
  - “Income derived from sources other than patronage” means incidental income from sources not directly related to the marketing, purchasing or service activities of the co-op
  - For example, income derived from the lease of premises, investments in securities, or the sale or exchange of capital assets, is non-patronage income

# Patronage / Nonpatronage Income

- Rev. Rul. 69-576
  - Dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative
  - “Patronage sourced income (and expenses)” are those **directly related** to transactions that **actually facilitate** the primary cooperative function(s)
    - Facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities

# Patronage / Nonpatronage Income

- Rev. Rul. 69-576 continued
  - Income that merely enhances the overall profitability of the cooperative is nonpatronage sourced
    - Incidental to the association's cooperative operation
  - Income received from the Bank for Cooperatives that directly facilitates the accomplishment of the cooperatives purchasing activities is patronage-sourced income when allocation and payment is made to the patrons

# Patronage / Nonpatronage Income

- Rev. Rul. 69-576 continued
  - Interest income from bonds plaintiff held for liquidity purposes is patronage sourced because the transactions involved are directly related to plaintiff's services to its patrons.
  - They were a prerequisite to plaintiff's functions. Unless the bonds were held, plaintiff could not issue consolidated bonds, the primary source of loan funds for its patrons.

# Patronage / Nonpatronage Income

- Interest Income
  - Rev. Rul. 74-160 – interest income to key supplier is patronage sourced
  - St. Louis Bank for Cooperative – short term investment of temporary excess funds
- Dividends
  - Linnten Plywood – dividend from non-coop sub
  - Land 'O Lakes – patronage dividend from coop bank
- Rental Income
  - Cotter – temporary excess space

# Patronage / Nonpatronage Income

- Capital Gain
  - Farmland Industries – gain on subsidiary stock sale
- Section 1231 Gain
  - Rev. Rul. 74-84 – section 1245 was patronage sourced but section 1231 was not
  - Farmland – section 1231 gain was patronage sourced
- Blended Products
  - TAM 9143002 if blended product is insignificant portion, then all is patronage sourced



# Patronage / Nonpatronage Income

- Partnership Income
  - Aggregate and Entity Theory of Partnership
  - Private letter rulings
    - Profac/Curtiss Burns
    - 9033006 – supply coop refinery
    - 9846022 – agronomy supply coop
    - 199920034 – sugar marketing coop (processing and sales operation)
    - 200244013 – marketing coop (purchase activity and processing operation)
    - 201601004 – taxpayers distributive share attributable to grain marketing activities is patronage sourced

# Patronage / Nonpatronage Income

- IRS: Income from the three examples in the Regulation is always nonpatronage
  - Rent
  - Interest
  - Gains on the sales of assets
- Co-ops and the courts: Non-operating income, including rent, interest, and gains on the sale of assets, is patronage sourced if it is **directly related to and actually facilitates** cooperative activity

# TAXATION OF COOPERATIVES

## *Patronage Refunds*

## Patronage Refund

- Distribution of earnings from a cooperative to a patron
- Based on the patron's pro rata share of all business conducted with patrons during the year
- Example
  - If ABC Cooperative earned \$500 last year, and
  - ABC Cooperative did 8 percent of its business with Mr. Jones, then
  - Mr. Jones is entitled to a patronage refund of \$40 ( $\$500 \times .08$ )

## Patronage Refund

- Statutory definition - Code Section 1388(a)
  - “..an amount paid to a patron by an organization to which part I of this subchapter applies
    - On the **basis of quantity or value of business** done with or for such patron,
    - **Under an obligation of such organization to pay** such amount, **which obligation existed before** the organization received the amount so paid, and
    - Which is determined by reference to the **net earnings** of the organization from business **done with or for its patrons.**”

# Patronage Refund

- Must pay based on volume or value
- Preexisting Legal Obligation to Pay
  - Legal obligation created by articles of incorporation and by-laws
  - Only effective after creation of obligation
  - Impact on creation of reserves
- Net Earnings
  - Book vs Tax Earnings
- May pay different portions in cash vs written notices of allocation

# Patronage Refund

- Equitable Allocation
  - Equitably distributed among the patrons who have transacted business with the cooperative.
  - Does not preclude the use of separate pools; however each patron within each pool needs to be treated on an equitable basis.

## Pooling

- Farmers sign marketing contracts with cooperative that guarantees delivery of all or part of their production.
- Cooperative makes all marketing decisions.
- Initial advance is paid to members upon delivery of product.
- After all product has been sold, generally within 12 months of delivery, the pool is closed.
- A total value, including an estimated inventory value remaining is determined; expenses and advances deducted; any remainder is distributed to patrons.



# Pooling

- Pools of Income
  - In allocating patronage, the cooperative may separate operations in multiple pools for allocating patronage income
  - Separate computations of patronage refunds for the separate pools
- Netting Income
  - Section 1388(j) allows a cooperative to net losses from one pool against other pools
  - Cooperative must provide notice to members of netting
    - 8 1/2 Months
    - Identity Units/Rights
  - If fail to, the remedy is?
- Completed Pool Method - Not Available Per IRS

# Patronage Refund

- Tax Treatment
  - In determining the taxable income of a cooperative, Code section 1382(b) provides
    - ...there shall not be taken into account amounts paid during the payment period for the taxable year patronage refunds to the extent paid in money, qualified written notices of allocation, or other property.
  - Essentially receive a deduction on your tax return for the patronage refund actually paid
    - Payment period - Period beginning with the first day of the taxable year and ending on the 15<sup>th</sup> day of the ninth month following the close of the taxable year

## Per Unit Retain (PUR) Allocations

- Distribution by a cooperative to a patron based on the quantity or dollar value of products marketed through the cooperative by the patron
- Typically used to generate capital
- Comparison to Patronage Refunds
  - Similar - Can be qualified or non qualified
  - Different – PUR based on volume (or dollar value), while patronage is based on earnings

# TAXATION OF COOPERATIVES

## *Written Notice of Allocation*

## Written Notice of Allocation

- Certificate or other form of written advice to patron reflecting dollar amount allocated by cooperative
- May be either
  - qualified written notice of allocation (deductible currently)
  - nonqualified written notice of allocation (not presently deductible)
- Non subchapter T Cooperative not subject to

# Qualified Written Notice

- Redeemable notices (on demand)
- Qualification based on patron consent
  - Written consent - effective for all patronage occurring during the year in which consent is given
  - Bylaw consent - effective for patronage occurring after the patron has received written notice of the by law provision
  - Qualified check - effective upon endorsement of check with 90 days after the payment close of the payment period

## Qualified Written Notice

- Pre-existing obligation
- 20% Money Requirement
  - At least 20% of the total patronage refund must be paid in money or by qualified check Regulations prohibit certain noncash payments in lieu of money
    - Offsetting a debt
    - Paying membership fee
    - Constructive receipt
- Payment/notice in payment period

# Qualified Patronage Refund

## Example

<u>Cooperative</u>			<u>Patron</u>	
Income		\$1,000		
Expenses			Income	
Milk	\$600		Milk	\$600
Other	<u>300</u>	<u>900</u>		
Margin		100		
Qualified Patronage refund		<u>(100)</u>	Refund	<u>100</u>
Taxable Income		<u>\$ 0</u>	Taxable Income	<u>\$700</u>



## Nonqualified Written Notice

- Generally follows same rules as qualified notices, except 20% cash minimum and consent is not required
- No cooperative deduction until the written notice is “qualified” by payment or consent

# Nonqualified Patronage Refund

## Example

<u>Cooperative</u>			<u>Patron</u>	
Income		\$1,000		
Expenses			Income	
Milk	\$600		Milk	\$600
Other	<u>300</u>	<u>900</u>		
Margin		100		
Nonqualified Patronage refund		( <u>-</u> )	Refund	<u>-</u>
Taxable Income		<u>\$ 100</u>	Taxable Income	<u>\$600</u>

# TAXATION OF COOPERATIVES

## *Handling of Losses*

# Handling of Losses - Netting

- Nonpatronage losses, patronage earnings
  - IRS prefers that nonpatronage losses be carried back and forward under Section 172 to offset nonpatronage earnings in other years
  - If a co-op chooses to net, the amount of patronage refunds paid to patrons and the accompanying tax deduction is reduced (rarely claimed)
  - No definitive court rulings on this issue

# Handling of Losses - Netting

- Patronage losses, nonpatronage earnings
  - If this strategy is used, the amount of nonpatronage income realized and the tax due on the nonpatronage earnings is reduced
  - The courts have supported the IRS and held cooperatives may not net patronage losses with nonpatronage earnings and thereby reduce the tax due on the nonpatronage income
- Bylaw Netting Provisions - Cooperative may build flexibility to offset

# Losses

- Section 277
  - Not applicable to subchapter T cooperatives
  - Might be applicable to non-subchapter T cooperative
- Pass Through of Losses
  - Cancellation of patronage equity
  - Qualified and Non-Qualified Written Notices of Allocation
  - Ordinary loss v. Capital loss

## NOL Carryforwards

- Farm Service – Patronage losses are not allowed to offset non-patronage income
- Counter to Farm Service – A cooperative is a single taxable entity and the Code does not separate a single taxpayer into two entities of patronage/non-patronage
- Ford-Iroquois – IRS has challenged coop's ability to carry NOLs to offset future patronage income on the basis of changed membership. This has been rejected by the courts.

# TAXATION OF COOPERATIVES

## *Redemption of Patronage Equity & Equity Accumulation*



# Redemption of Patronage Equity

- Returning equity to members and other patrons who have previously invested it, in the form of cash or other property.
- “Systematic” plan (FIFO)
- Base capital plan
- Other (loss of member status, estates, age, etc.)

# Redemption of Patronage Equity

## Tax Treatment of Redemptions

- Redemption of **qualified** patronage equity
  - No tax impact
- Redemption of **nonqualified** patronage equity
  - Cooperative reduces taxable income
  - Patron recognize ordinary income

# Redemption of Patronage Capital

- Redemption of Patronage Equity at a discount
- Tax Benefit rule
- Gold Kist
  - 11<sup>th</sup> Circuit – treated as transaction separate from patronage dividend

## Equity Accumulation

- Challenge faced by cooperatives since they cannot attract equity from outside sources to the same extent as investor
- Sources of Equity Capital for Cooperatives
  - Direct investment
  - Margins retained
  - Per-Unit Retains
  - Nonmember/Nonpatronage Earnings

# Equity Accumulation

- Financial Planning Options
  - Cash refunds
  - Qualified investments
  - Nonqualified investments
  - Unallocated reserves
- Equity Redemption
  - Revolving fund plan
  - Base capital plan
  - Special plans

# TAXATION OF COOPERATIVES

## *Section 521 Cooperatives*



## Section 521

- In 1926, farmer co-ops were granted tax exempt status as a way to help farmers during the depression
- In 1951, the exemption was curtailed in response to vigorous attacks on cooperative tax treatment by for-profit competitors
- Section 521 appears in Subchapter F, the exempt organizations portion of the Code, but it does not provide true tax exempt status

## Section 521

- Farmer cooperatives that comply with a number of restrictions on their operations may deduct two items in addition to their Subchapter T deductions
  - Dividends on capital stock
  - Patronage-based allocations of nonpatronage income



# Statutory Requirements

- Organization Attributes
- Capital Stock
- Patron Composition
- Producers
- Distribution of Net Margins

# Organization Attributes

- Farmers', Fruit Growers', or Like Association
- Organized and Operated on a Cooperative Basis
- Organization Purpose
  - To market products or purchase supplies and equipment for patrons
  - May have supply and marketing departments
  - Limited marketing of non-producer goods is permitted in special situations
    - Emergency purchases
    - Ingredient purchases
    - Incidental purchases

# Capital Stock

- Common Stock Ownership
  - Substantially (85%) all voting stock held by active producers
- Preferred Stock
  - May be issued to public if nonvoting and does not participate in profits beyond fixed dividend rate
- Dividends on capital stock may not exceed the legal rate of interest in the State of incorporation or 8 percent per year, whichever is greater
- Voting

# Patron Composition

- Marketing Cooperatives
  - Member/Producers - value of products marketed for member/producers must be at least 50%
  - Nonmembers - may market as long as does not overshadow
  - Nonproducers - emergency purchases, ingredients to produce marketable product or facilitate product line

## Patron Composition

- Supply Cooperative
  - Member/Producers - value of supplies should be at least 50% of total sales, although not required
  - Nonmembers - may market as long as does not overshadow
  - Nonmember/Nonproducers - may sell up 15%, potential look-through issue
- Business done for the United States government is disregarded

## Producers

- Generally an owner or tenant who bears the risk of production - sharecropper is a producer, while a landlord receives fixed rate rent is not

## Distribution of Net Margins

- Marketing cooperative - must “turn back” proceeds less necessary marketing expenses
- Supply cooperatives - must sell at cost plus operating expenses
- Margins must be returned to both member and nonmember users on the same patronage basis
- Reserves must be required by State law or reasonable and for a necessary purpose

## Section 521 & Securities Law

- The Federal Securities Act of 1933 contains an exemption for section 521 farmer cooperatives from its registration and prospectus requirements covering the initial offering and sale of securities
- The exemption is limited and doesn't apply to incidences of fraud or misleading disclosure of information



## Securing Section 521 Status

- IRS must determine a cooperative qualifies for Section 521 status before it can take advantage of its provisions
- Applications are filed on Form 1028 with the district director for the location of the co-op's home office
- If the application is approved, IRS will issue a determination letter granting access to Section 521

## Federated Cooperatives

- Look-through theory in determining whether section 521 satisfied
- Taxable year does not have to correspond to that of members or vice versa
- Supply - may treat non-qualified as part of the 15%

# Subsidiaries

- May own subsidiary
- Can't carry on activity through subsidiary which section 521 cooperative may not do

# TAXATION OF PATRONS

## Taxation of the Patron

- Recipient of patronage refund must include amount in taxable income
  - Supply cooperative – reduction of cost of item purchased
  - Marketing cooperative – increase in sales proceeds
- Qualified - In year received
- Nonqualified – In year paid
- Patronage refund paid with respect to capital asset is a basis reduction
- No income on patronage refund on personal use

## Taxation of the Patron

- Recipient of patronage refund must include amount in taxable income in the taxable year received
  - Supply cooperative – reduction of cost of item purchased
  - Marketing cooperative – increase in sales proceeds
- Qualified - In year received
  - Included in ordinary income (subject to SE tax); exceptions
    - When distribution is attributable to personal, living, or family items
    - Redemptions of nonqualified written notices of allocation which were received as patronage refunds with respect to purchases of supplies or services which are not deductible in the trade or business

# Form 1099-PATR

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Patronage dividends	OMB No. 1545-0118  <b>2016</b>  Form <b>1099-PATR</b>
		\$	
		2 Nonpatronage distributions	
		\$	
		3 Per-unit retain allocations	
		\$	
PAYER'S federal identification number	RECIPIENT'S identification number	4 Federal income tax withheld	
		\$	
RECIPIENT'S name  Street address (including apt. no.)  City or town, state or province, country, and ZIP or foreign postal code		5 Redemption of nonqualified notices and retain allocations	6 Domestic production activities deduction
		\$	\$
			7 Investment credit
		\$	\$
		8 Work opportunity credit	9 Patron's AMT adjustment
		\$	\$
Account number (see instructions)		10 Other credits and deductions	
		\$	

**Taxable  
Distributions  
Received From  
Cooperatives**

**Copy B  
For Recipient**

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-PATR**

(keep for your records)

[www.irs.gov/form1099patr](http://www.irs.gov/form1099patr)

Department of the Treasury - Internal Revenue Service



# Tax Return Considerations





# Tax Return

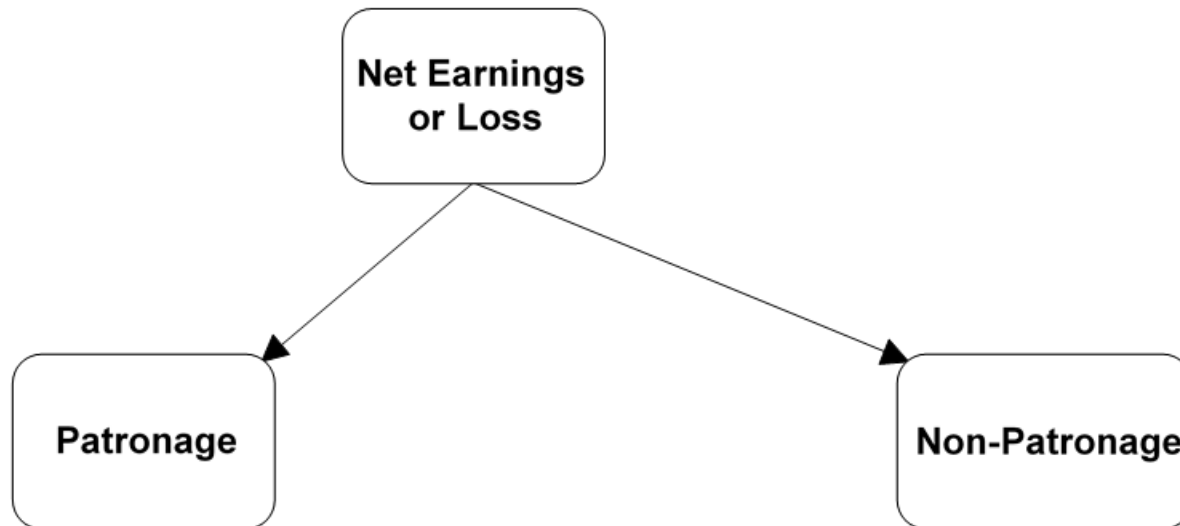
- File Federal Form 1120-C for exempt and nonexempt farmer cooperatives
  - Schedule G
    - Page 3 of Form 1120-C
    - Complete Patronage and Nonpatronage columns
    - Maintain appropriate schedules
  - Schedule H
    - Deductions under Section 1382
    - Page 3 of Form 1120-C
- File Form 1028 for exemption (Exempt Cooperatives)

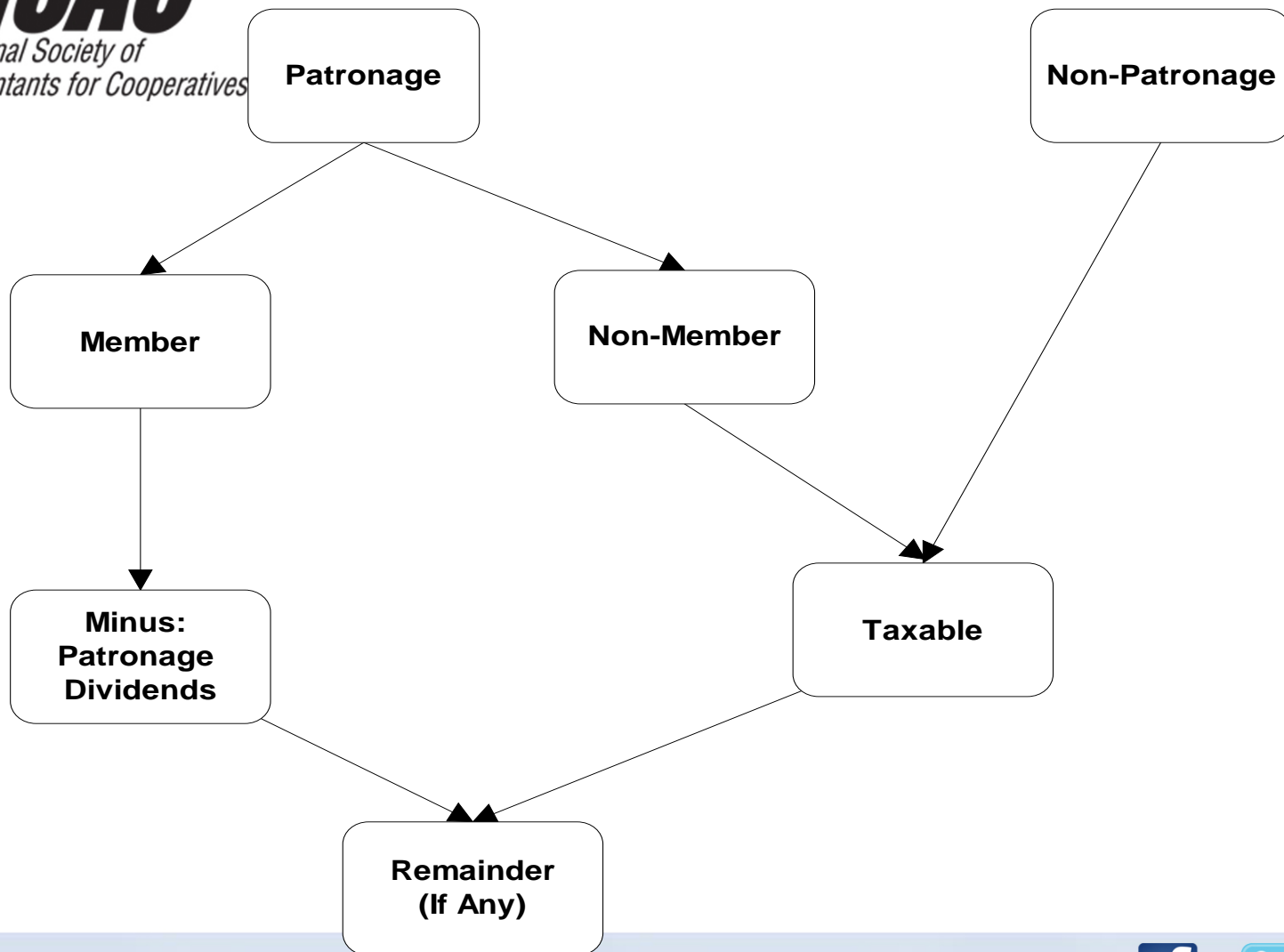
# Tax Return

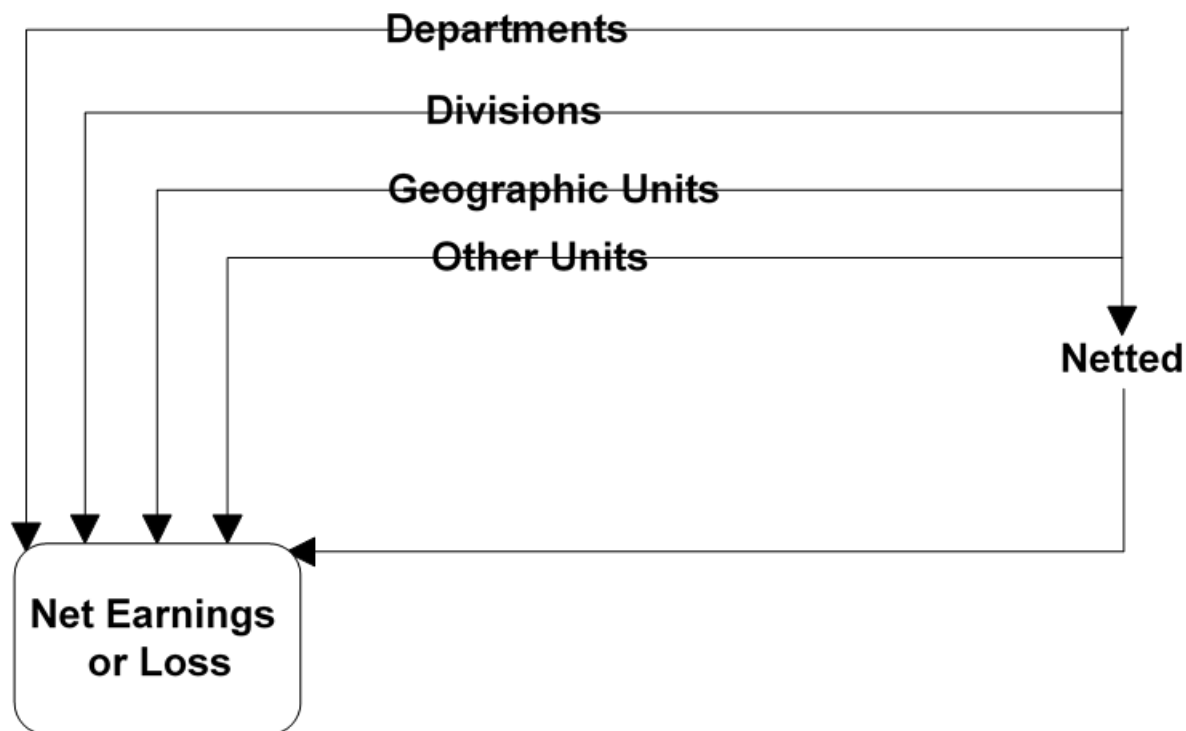
- Original due date: 15th Day of 9th Month
- A Six-Month extension is allowed
- Taxable Income - Computation
  - Regular Corporation Rules
  - Cooperative deductions
    - Patronage Refund
      - Qualified Written Notices
      - Consent
      - Cash Payments of 20%
    - Nonqualified Written Notice
      - Not Deductible When Issued, Deduct When redeemed
    - Per Unit Retains

# Tax Return

- Flow of Cooperative Income
  - Netting/Separate
  - Patronage vs Non Patronage
  - Member vs Non Member
  - Patronage Deduction
  - Taxable Income
- Flow of Cooperative Taxable Income
  - Allocation Unit
    - Department
    - Division
    - Geographic
    - Function
    - Other







## Exempt vs Non Exempt

	Returns	Patronage Refunds	Business Volume	Capital Stock	Dividends on Capital Stock	Non Patronage Income
Exempt	1120C	100% Coop	15%	Producers	8%	Distribute/ Exclude
Non Exempt	1120C/ Consol	Distribute to Members Only	Any Amount	No Requirement		Cannot Distribute

## Filing Consolidated Returns

- Non-exempt cooperative and regular corporation subsidiaries can file consolidated return if consolidated return requirements are met
- Exempt cooperative cannot be included in consolidated return



# IRS Examinations

- Exempt v. non-exempt coops
- IRS restructuring of exam division based on type and size of entity
- Coops file Form 1120-C and are assigned to IRS audit division based on asset size
- Coop issue – any change to patronage taxable income may mean tax on otherwise allocable patronage income

# Information Returns

- Reports to Patrons
- Forms 1096, 1099-PATR
- Cash, Written Notices, Redemptions

# Section 199 – Domestic Production Activities Deduction

## Section 199 – Domestic Production Activities Deduction

- Law effective for tax years beginning after 12/31/05
- Purpose: provide tax benefit to U.S. manufacturers
- Cooperatives got special provision because of repeal of Foreign Sales Corporation and Extraterritorial Income Exclusion rules that Section 199 replaced
- Cooperative perspective
  - Marketing Ag Coops & Manufacturing Supply Coops qualify
  - Marketing Coops have special “attribution” rule
    - Activities of member/farmer is attributed to cooperative for Sec 199 purpose
  - Benefit can be retained or passed through to members

## Section 199 – Domestic Production Activities Deduction

- Section 199 calculation
  - Deduction = percentage of taxable income attributable to Qualified Production Activities Income (QPAI)
  - QPAI = “domestic production gross receipts” less related cost of goods sold and other expenses
- Formula is lower of QPAI or taxable income times the deduction percentage:
  - For fiscal years beginning in 2010 and after, percentage is 9%
- Deduction limited to 50% of the taxpayer’s wages paid during the year in connection with qualified production activities and cannot create or increase a net operating loss

## Section 199 – Domestic Production Activities Deduction

- Taxable income and QPAI of the coop is computed without regard to any deduction allowable under § 1382(b) and (c)
  - All cash and qualified written notices of allocation – per-unit retains (includes advances) and patronage dividends
  - All non-patronage distributions from § 521 coops
- Per-unit retain paid in money (PURPIM) or certificates
  - Payments/distributions not based on profits
  - PURPIMs came into the law in 1969 to solve the marketing cooperatives' problem with prior law
  - ALL PAYMENTS TO MEMBER/PATRONS FOR THEIR PRODUCT MEETS PURPIM DESIGNATION

## Section 199 – Domestic Production Activities Deduction

- Most coops, pooling and non-pooling, treated PURPIMs as inventory costs for book purposes
  - Form 1120-C and old Form 990-C showed them in Cost of Goods Sold section
- Many pooling coops adjust their tax reporting to deduct these payments within 8 ½ month “payment period”
- Most non-pooling coops (e.g. grain) do not

## Section 199 – Domestic Production Activities Deduction

- 2007 – IRS Technical Advisor asked IRS National Office how to compute the Sec 199 deduction for pooling and non-pooling coops
- ILM 200806011 – Chief Counsel replied that PURPIMs should be added back along with patronage dividends for pooling and non-pooling coops



## Section 199 – Domestic Production Activities Deduction

- Coops began requesting rulings to confirm this position for their coop
  - Dollars are too big to risk being wrong
- Many private letter rulings have been issued for all types of cooperatives consistently holding that payments to member for their crop are PURPIMs and are therefore added back for purposes of Section 199

## Section 199 – Domestic Production Activities Deduction

- Other issues
  - Can you use patronage based DPAD against nonpatronage income?
  - Can a supply coop use Section 199? Is it a “manufacturer” for this purpose? Treasury Regulations are not clear on this
  - Form 8903 (DPAD calculation) – instructions raise questions on how the coop should do the patronage vs non-patronage computation

# Questions



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