



**AgEcon** SEARCH  
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

*The World's Largest Open Access Agricultural & Applied Economics Digital Library*

**This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.**

**Help ensure our sustainability.**

Give to AgEcon Search

AgEcon Search  
<http://ageconsearch.umn.edu>  
[aesearch@umn.edu](mailto:aesearch@umn.edu)

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*



AGRICULTURAL COOPERATIVE SERVICE

A truck belonging to CENEV—a regional farm supply cooperative headquartered in St. Paul, Minnesota.

# Taxing Co-ops

## Current Treatment Is Fair, But Not For Reasons Given by Co-op Leaders

by Richard J. Sexton and  
Terri Erickson Sexton

**T**here is a long-standing debate over how cooperatives are taxed in this country. As the controversy smolders it may be ignited by impending tax reform.

Some people have argued that the present treatment is unfair and causes co-ops to grow at the expense of ordinary corporations and the economy in general. The arguments are usually couched in the framework of comparing cooperative/patron relationships to the corporation/shareholder relationship.

---

*Richard Sexton is Assistant Professor at the University of California, Davis, and Terri Sexton is Assistant Professor at the University of Kansas and Visiting Assistant Professor at the University of California, Davis.*

We argue that the more appropriate analogy is with a vertically integrated corporation. This analogy, we believe, demonstrates that co-op tax rules are reasonable.

When cooperatives refund income to their patrons on the basis of patronage, only the patron pays tax on the earnings. Opponents call this co-op tax treatment unfair—that it represents single-taxation of co-ops while there is double-taxation on corporate earnings.

Proponents defending the present system stress the nonprofit nature of co-ops. They argue that refunds to patrons are merely price adjustments, not distributions of taxable income.

These arguments overlook the fact that vertically integrated corporations are now doing exactly what some peo-

ple argue co-op members should not be permitted to do. If it can be demonstrated that a vertically integrated enterprise gets virtually the same tax breaks as a co-op, then the argument over unwarranted favoritism of co-ops goes out the window.

### Rules of the Tax Game

The main regulation governing cooperatives' taxation is subchapter T of the tax code. It allows co-ops to deduct distributions of patronage refunds to members before calculating their corporate income tax. These refunds have to be based on business (patronage) with the co-op and originate from business conducted with patrons.

Patrons, in turn, are defined as those whom the co-op was established to benefit. For example, a dairy marketing co-

operative's patrons are the member and nonmember dairy farmers who sell milk through the cooperative. At least 20 percent of the refund allocation must be in cash.

Patrons include the entire allocation (both cash and noncash portions) in their tax reports. Income other than patronage refunds is taxable to the co-op at ordinary corporate rates. A patronage refund is deductible to the co-op and taxable to the patron in the year it is received.

Thus subchapter T places only a single tax on all cooperative earnings. Either the cooperative pays tax on it or the patron (co-op member) does. In contrast, corporate income is taxed twice—as corporate profit at a graduated rate up to 46 percent on amounts over \$100,000, and as shareholder income in the form of dividends or capital gains.

These rules imply that co-ops and their patrons have a tax advantage over comparable corporation-shareholder organizations. However, there are several points to keep in mind when considering the magnitude of the advantage:

—*How much corporations can lower their taxes through special deductions and credits.* Corporations usually pay much less than that implied by the statutory tax rate, and the effective tax rate typically varies considerably across industries. For example, among industries supplying farm inputs, the 1979 average corporate tax rate ranged from 17 percent in petroleum refining to 46 percent in farm machinery manufacturing.

—*The extent to which corporations plow their income into capital gains.* Income a corporation retains for investment adds value to corporation stock and enables its owners to take advantage of the special tax status afforded long-term capital gains. Presently, 60 percent of a long-term capital gain not offset by long-term capital losses is excluded from gross income, while the remainder is taxed as ordinary income.

—*Tax rates of shareholders of corporations.* Corporations may generally exclude 85 percent of dividends received from other corporations. Individuals are granted a \$200 dividend exclusion on a joint return and may also offset dividend income by interest expense in excess of \$10,000 on debt incurred from purchasing or carrying investment property. Otherwise, dividends are taxed as ordinary income to individuals.

A rough estimate of the overall tax rate paid on 1979 shareholder income is 19

percent. This reflects our estimate of 14 percent on capital gains and Pamela Peterson's estimate of 30 percent tax rate paid by individuals on dividends that appeared in the June 1985 issue of the *Journal of Financial Economics*.

—*The tax rates of co-op patrons.* Patrons must treat both the cash and non-cash portions of qualified refunds from cooperatives as ordinary taxable income. Most farm co-op patrons are sole proprietors, so their co-op refunds are taxed at the marginal rates on their individual returns, which may be less than the effective corporate tax rate.

For example, the mean marginal tax rate in 1979 for farm proprietors ranged from about 20 percent for dairy farmers to near 48 percent for fruit and nut

growers. The opportunity to substitute individuals' tax rates in place of the corporate rate is an advantage of cooperative taxation in addition to the more obvious single versus double taxation element.

#### Closer Look at the Numbers

Let us use an example to illustrate the effects of co-op-versus-corporation taxation in the dairy and fruit processing industries. Suppose a corporation and a cooperative are identical except for their organizational form. They each have identical plants, handle the same volume of product, pay the same costs, receive the same prices for the processed product, and consequently have the same net income of \$100,000 as specified in the table. The corporation in both the dairy

### Comparison of the Corporate and Cooperative Income Tax Treatment

	Corporation	Cooperative	
		Alternative A	Alternative B
<b>Dairy products manufacturing</b> (Dollars in Thousands)			
Net income	\$100.0	\$100.0	\$100.0
Corporate income tax:			
Rate	36%	36%	36%
Amount	36.0	0	18.0
Income available for distribution	64.0	100.0	50.0
Shareholder/patron tax:			
Rate	19%	20%	20%
Amount	12.2	20.0	10.0
Total income taxes collected	48.2	20.0	28.0
Maximum income available for corporate investment	64.0	80.0	50.0
<b>Fruit processing</b>			
Net income	\$100.0	\$100.0	\$100.0
Corporate income tax:			
Rate	32%	32%	32%
Amount	32.0	0	16.0
Income available for distribution	68.0	100.0	50.0
Shareholder/patron tax:			
Rate	19%	48%	48%
Amount	12.9	48.0	24.0
Total income taxes collected	44.9	48.0	40.0
Maximum income available for corporate investment	68.0	80.0	50.0



U.S. DEPARTMENT OF AGRICULTURE BUREAU OF AGRICULTURAL ECONOMICS, DIVISION OF AGRICULTURAL COOPERATIVES

*The first cheese cooperative in the United States was started in 1810 in South Trenton, New Jersey.*

and the fruit example pays tax at its effective corporate rate. We assume that its shareholders pay tax on both dividends and capital gains at the 19-percent average rate.

Note that we include two columns for the cooperative. For the first, "alternative A," we assume that the co-op management decides to transfer all of the \$100,000 earnings to patrons as "qualified allocations." Under IRS rules the co-op then does not incur any tax liability but can "retain" up to 80 percent of the allocations for reinvestment. Therefore, both the dairy and the fruit cooperatives have \$80,000 available for reinvestment.

The fact that ordinary corporations have less than \$80,000 available after taxes for investment is a big part of the co-op tax controversy. The taxes collected by IRS on the co-op earnings are geared to the tax brackets of the patrons. We used 20 percent for the dairy example and 48 percent for the fruit example—industry averages for 1979.

Now suppose as in "alternative B" of Table 1 that the co-op management decides to distribute only \$50,000 of the \$100,000 as qualified allocations. The tax and the "available for investment" numbers change, of course. The total taxes collected by the IRS in the dairy situation is higher with B than with A.

It is the opposite for the fruit situation. The difference is tied to the marginal tax rates of the co-op patrons in comparison to the rate paid by the cooperative. In fact, under A, more total taxes are paid

on the fruit co-op earnings than on the corporation earnings because of fruit growers' very high marginal tax rate.

Although these examples are oversimplified, they illustrate the co-op advantage. And they are consistent with computer simulation findings of Lee Schrader and Ray Goldberg of Purdue University and Harvard University, respectively. These findings also affirmed the proposition that co-op tax treatment normally confers an advantage to the co-op.

#### **The Traditional Debate**

Given that the tax code gives cooperatives a tax advantage, the question boils down to whether or not the treatment is consistent with the way other organiza-

---

**The question boils down to whether or not the treatment is consistent with the way other organizations are taxed. We feel that it is, but not for the reasons usually given by co-op leaders.**

---

tions are taxed. We feel that it is, but not for the reasons usually given by co-op leaders.

Traditional defense of the present treatment stresses cooperatives' non-profit character. A cooperative is normally legally bound by its charter to re-

turn earnings to its patrons in proportion to patronage. The simplest defense is that patronage refunds are not profit distributions but merely year-end price adjustments.

Proponents also offer the "pricing-out" argument: if necessary, co-ops could eliminate the appearance of profit and the need for refunds by setting prices to patrons at just break even.

These arguments have not impressed subchapter T's opponents. The most extensive criticism of the co-op tax treatment has been made by National Tax Equality Association spokesman and former IRS Commissioner Mortimer Caplin.

Caplin, attacking in turn each of the traditional defenses of the present treatment, argues that the no income-no tax defense is invalid because the tax ought to be levied on the income-producing entity (the co-op) and that anticipatory assignments of income between two taxing parties have been expressly ruled out by the Supreme Court in *Lucas v. Earl* (281 U.S. 111, 1930). Moreover, income created in any organization ultimately is "owed" to someone affiliated with the organization, so this fact of itself cannot justify the co-op treatment.

Caplin further contends that patronage dividends do not resemble tax-deductible price adjustments. First, price adjustments are normally tax deductible only if they represent valid business expenses, motivated by profit considerations. Since co-ops' allocations have no profit motive, they should not be deductible. Second, the rebates closely resemble ordinary taxable shareholder dividends because members' patronage is usually roughly proportional to their

---

equity holdings in the association. Third, a large part of the adjustment usually remains within the association to function like a taxable corporation's retained earnings.

Finally, Caplin assails the pricing-out argument, contending that the tax code



AGRICULTURAL COOPERATIVE SERVICE

A typical Midwest grain cooperative facility—Farmer Cooperative Grain Company, Haven, Kansas.

## The more fitting and effective analogy for the co-op/patron relationship is with the vertically integrated corporation.

would, without subchapter T, allow the IRS to adjust cooperative-patron dealings to reflect market prices.

In the context of his corporation/shareholder analogy, Caplin appears to present an effective criticism of the conventional arguments in support of the prevailing tax treatment for cooperatives.

There is another aspect of the debate to keep in mind. Perhaps due to Caplin's critique, the nonprofit arguments are now heard less frequently. Instead, the co-op proponents have begun to stress the similarity between cooperatives and "S corporations" (subchapter S of the tax code) or partnerships.

Like cooperatives, these organizations also enjoy most of the advantages of incorporation, but their incomes are usually taxed only at the shareholder level. Thus, S corporations, partnerships, proprietorships, and co-op corporations are taxed only at the owner level, and the double taxation of ordinary corpora-

tions is the anomaly, or so the argument goes.

However, attempts to compare modern co-ops to partnerships or S corporations are on shaky ground. Average membership in agricultural marketing and supply co-ops is currently about 660 and 1,160, respectively, while an S corporation has a legal maximum of 35 individual shareholders.

Under current rules, only about \$6 million in taxable corporate income could be divided among 35 individual shareholders before all reached the maximum 50-percent tax bracket, even if each filed a joint return and had no other taxable income. Hence, S corporations (and most certainly proprietorships and partnerships) are not effective ways to shelter large amounts of income from tax. Rather, most are family enterprises concentrated in the traditional small business sectors of construction, retailing, and services.

Average business receipts in 1981 for the 541,489 S firms filing tax returns were \$381,090. That is only 3 percent of the 1981 average sales volume for the nearly 6,200 agricultural marketing and supply co-ops.

### An Alternative Analogy

We believe that both Caplin's corporation/shareholder analogy and the proponents' comparison to S corporations are inappropriate. The more fitting and effective analogy for the co-op/patron relationship is with the vertically integrated corporation.

Imagine an oil refinery. Suppose the owners save or can borrow funds and buy a pipeline distribution system and retail gas stations. We consider this integrated arrangement to be perfectly legitimate even though the earnings of the parts of the corporation pass to the parent company without being taxed.

Similarly, a marketing co-op facilitates its members vertically integrating forward into transportation, processing and distribution. A supply co-op integrates farmers backward into manufacturing and sale of supplies used in farm production. Many modern co-ops conduct both marketing and supply activities.

Farmers form cooperatives instead of each simply individually integrating into

---

## Caplin's arguments hinge on the inappropriate comparison of a cooperative and its patrons to a corporation and its shareholders.

---

the production process for the sake of efficiency. By integrating jointly, by forming cooperatives, farmers are able to develop efficient plants in the vertically adjacent industries.

The cooperative-patron relationship is, therefore, more closely analogous to the stages of a vertically integrated business, than to the corporation-shareholder relationship. Consequently, the vertically integrated business is the appropriate model to evaluate cooperatives' present tax treatment.

Vertically integrated corporations under unified ownership ordinarily are allowed to file a single, consolidated tax return; thus, internal transactions are not taxed. The value generated by vertical subsidiaries is reflected in the parent company's taxable income via lower production costs or higher selling prices.

The corporation as a whole is considered to be the income-producing entity, not its individual parts. Similarly, transactions between a co-op (the vertical subsidiary) and the member-patrons are not taxed under subchapter T. The value generated at each co-op stage is reflected in patrons' taxable income either through improved prices or as patronage refunds.

It is also appropriate from the vertical integration perspective that patronage refunds are deductible when made to both member and nonmember patrons. Patrons are those whom the co-op was established to benefit, or, analogously, those for whom it provides vertical integration. In contrast, when co-ops do business with nonpatrons, (for example, when an agricultural co-op deals with nonfarmers) the income generated is usually taxable to the co-op. This treatment is appropriate because these transactions do not represent the vertical integration which the co-op was established to provide.

Thus, with the switch of analogies from the corporation-shareholder rela-

tionship to that of the vertically integrated firm, the present tax treatment of cooperatives becomes strikingly consistent with the rest of the tax code. To assert that cooperative-patron transactions should be treated differently from those between vertical subsidiaries of a corporation is equivalent to arguing that cooperating firms should be punished because they are too small to undertake integration by themselves, a position at odds with most anyone's sense of fairness.

As it turns out then, Caplin's arguments hinge on the inappropriate comparison of a cooperative and its patrons to a corporation and its shareholders. His illustration of "pricing-out" illustrates why the comparison is inappropriate:

A cooperative that markets wheat for a farmer is entitled to a profit for processing and marketing his products. In essence, the farmer has elected to split his business into two controlled entities: his trade or business of producing crops and a separate association which performs functions of processing [and] marketing[.] Both entities would be required to report a fair profit on dealings between them under Section 482 [p. 39].

The logical extension of Caplin's argument is to urge taxation of "income" created from transactions between an oil refiner and its pipeline, an automaker and its body-stamping facility, or the internal stages of any such vertically integrated operation. To demonstrate that a co-op's patrons are also its owners does not give a logical basis for thinking patronage refunds are equivalent to shareholder dividends. Rather, it merely illustrates the obvious: a vertical subsidiary (cooperative) is owned by its parents (the farmers) who are also its patrons and who must ultimately receive and be responsible for its income.

Then there is the oft-made appeal to the Lucas vs. Earl ruling against antipa-

tory assignment between separate taxing parties. It is similarly futile because transactions between vertically integrated entities are not normally assignments between separate taxing parties.

We conclude, therefore, that cooperatives' subchapter T tax treatment is fair and consistent with the rest of the tax code. However, resolving the fairness controversy does not address the argument that cooperatives' tax advantage has stimulated their growth which, in turn, has been harmful to the economy. We focus on that part of the debate in a coming issue of CHOICES. **C**

### Acknowledgement

*The authors acknowledge comments received from Tom Hazlett, Dan Petree, and Steve Sosnick. However, errors and opinions are the authors alone.*

### For Further Reading

For a succinct summary of some traditional defenses of the co-op tax treatment, see *Tax Treatment of Cooperatives* by Donald A. Frederick. It is CIR 23 and was published by and is available from The Agricultural Cooperative Service, U.S. Department of Agriculture, Washington, D.C. 20250, without cost.

Definitive statement of the co-op opponent's position is given in Mortimer M. Caplin's article "Taxing the Net Margins of Cooperatives," *Georgetown Law Journal*, Vol. 58, No. 6, 1969, pp. 6-45.

For an authoritative analysis of co-op tax rules and excellent historical background, obtain a copy of the information bulletin written by Morrison Neely and James Baarda. It's title is *Legal Phases of Farmer Cooperatives: Federal Income Taxes*. It is "Information 100" and printed in May 1976 and is also available free from the Agricultural Cooperative Service, U.S. Department of Agriculture.

Lee F. Schrader and Ray A. Goldberg address co-op tax rules and the tax controversy and they report on a computer simulation analysis of co-op taxation in their book *Farmer Cooperatives and Federal Income Taxes*. It was published in 1975 by Ballinger Publishing Company. The company reports that it is out of print. If you would like to see a copy, we suggest that you contact the agricultural library at the land grant university in your state.