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FOREWORD

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The Agricultural Economics/Law Research Program, a cooperative venture between the School of Law at the University of North Dakota and the Department of Agricultural Economics at North Dakota State University has been in operation since 1960. The effort is funded by the North Dakota Agricultural Experiment Station Research Project No. ND 3319. Designed to research various aspects of North Dakota law and to report the findings in published form readily available to all North Dakotans, the program has been successful in producing numerous reports. Among those published as Department of Agricultural Economics Miscellaneous Reports are;

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6 Condemnation of Farmland for Highways

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HOW FARMERS/RANCHERS CAN USE THE COOPERATIVE-CORPORATION FORM OF BUSINESS ORGANIZATION

by JEROME E. JOHNSON and RANDALL K. HANSON*

Most North Dakota farms and ranches are organized as sole proprietorships. Under this form of organization, the farmer or rancher is the sole owner of the land and personal properties and he usually operates the farm himself. Some farms and ranches are organized as partnerships where two or more contribute capital or labor to the organization with all partners having control over the partnership. Limited partnerships also are allowed where limited partners can join one or more general partners. The limited partner is bound only to the extent of his investment and has no control over the partnership operation.

One common form of business organization not allowed to North Dakota farmers and ranchers is the corporation. The Anti-Corporation Farming Law, an initiated measure which took effect in 1932, prohibits farms from being organized as corporations in North Dakota. But the law specifically allows cooperative-corporations. The result is a cross between a cooperative and a corporation which has characteristics of both, and some unique characteristics of its own. The cooperative-corporation has many features of the prohibited corporate form. The table shows some characteristics of the forms of business organizations available for organizing farms and ranches in North Dakota. A comparison will show the advantages and disadvantages of each type.

What Is a Cooperative-Corporation?

A cooperative-corporation is an association of members who contribute either capital, or labor, or both and receive either stock or membership. The cooperative-corporation distributes its profits as stock dividends (limited to 6 percent of par value) and patronage dividends to members in proportion of which their patronage bears to total patronage of the association. If distribution based on patronage is not appropriate, the association can set up other methods to distribute their income. Cooperative-corporations in North Dakota can be formed for any lawful purpose, except banking, insurance, or building or operating a railroad.

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How Is a Cooperative-Corporation Formed?

At least five adults, one of whom must be a resident of North Dakota, are needed to form a cooperative-corporation. In addition, seventy-five (75) percent of the members must be actual farmers residing on the farm or depending principally on farming for their livelihood. The cooperative-corporation is formed when the five adults sign, acknowledge, and file articles of association with the Secretary of State.

Articles of association generally include:

1. Name of the cooperative-corporation.
2. Period of existence.
3. Purposes for which it is organized.
4. Whether it is organized with or without capital stock.
5. Designation of the classes of members, if more than one.
6. Number and par value of shares of each authorized class of stock.
7. Which classes of stock are membership stock.
8. Rate of dividends to be paid to each class of stock.
9. City in North Dakota in which its principal office is to be located.
10. Names and addresses of each incorporator.
11. Names and addresses of at least five incorporators who will act as the initial temporary board.

The requirement that seventy-five (75) percent of the members must be actual farmers residing on the farm or depending principally on farming for their livelihood could have serious effects on a small family farm operating as a cooperative-corporation as the following hypothetical situation suggests:

Suppose that a five-member family (father, mother, and their three adult children) form a cooperative-corporation. This cooperative-corporation will lose protection from the Anti-Corporation Farming Law when any two members no longer reside on the farm or no longer rely on the farm as their principal source of livelihood. It is possible that two of the children could move from the farm and derive their livelihood elsewhere, thereby, dropping the

TABLE 1. CHARACTERISTICS OF FARM AND RANCH FORMS OF BUSINESS ORGANIZATION

Characteristics	Forms of Business Organization			
	Sole Proprietor	Partnership	Cooperative	Cooperative-Corporation
Perpetual Existence	No	No	Yes	Yes
Number of Members Needed to Form This Organization	One	Two or More - One or More General Partners and One or More Limited Partners	Three or More	Five or More
Classes of Stock	None	No Stock	Stock is Optional, Can Have One or More Classes	Stock is Optional, Can Have One or More Classes
Voting Format	None	Limited Partners Have No Vote or Control	One Vote Per Member	One Vote Per Member
Easy Transfer of Interest	No	No	Yes	Yes
Must Maintain 75 Percent Ratio of Farmers Residing on the Farm or Relying on Farm as Principal Source of Income	No	No	No	Yes
Must Follow Strict Procedural Rules, Such as Complete Bookkeeping Records and Report, Formal Meeting, Elect Directors, Etc.	No	No	Yes	Yes

farm dependency below the required seventy-five (75) percent. The land could then be subject to a forced sale because of the law prohibiting the holding of farming land by corporations.

North Dakota law is unique and confusing in that while farmers are prohibited from organizing their farms as corporations, other corporations are allowed to acquire farming land. The North Dakota Century Code provides that corporations which acquire farmland by judicial process or operation of law can hold land, but not longer than ten years. The corporation may farm and use the land for agricultural purposes, during the ten-year period. If a corporation attempts to hold agricultural land for more than ten years, the title to the property will escheat (pass) to the county where the property is located upon an action instituted by the local state's attorney. The county then must put the land up for public auction within one year. The proceeds, less expenses, are then paid to the corporation which held the land.

Operating Rules for a Cooperative-Corporation

North Dakota cooperative-corporations must follow strict operating or procedural rules. It must adopt bylaws showing how the cooperative-corporation will be operated. An annual meeting of all members is required and must be held within six months after the close of its fiscal year.

Members of the cooperative-corporation must elect directors to manage its affairs. Cooperative-corporations with less than 50 members must have at least three directors and those with 50 or more members are required to have five or more directors. If the membership of the association is less than three, then the number of directors need not be greater than the number of its members.

The cooperative-corporation must keep complete and correct books and records of accounts and minutes of all meetings. It must file an annual report with the Secretary of State.

The required operating rules for cooperative-corporations may be expensive and time consuming for a small family farm group to comply with. However, the operating rules may also benefit the association by forcing it to keep accurate records. Organizers of cooperative-corporations should discuss the costs of the procedures with an attorney when determining if the cooperative-corporation is the form of business organization that will most benefit them.

Powers of a Cooperative-Corporation

The powers of a cooperative-corporation are broad and are similar to those of both a corporation and an individual. The cooperative-corporation may:

1. Exist perpetually.
2. Sue and be sued.
3. Create contracts, incur liabilities, and borrow money all in its own name.
4. Acquire and dispose of property and may mortgage, pledge, lease, or otherwise use property in any manner.
5. Invest its funds, lend money for its purposes, and hold property as security for repayment of loans.
6. Elect officers and appoint agents, define their duties, and fix their compensations.
7. Create and alter bylaws.
8. Exercise all powers necessary or convenient to effect its purposes.

Advantages of the Cooperative-Corporation Form of Business Organization

The cooperative-corporation form of business organization offers several advantages to its members:

1. The cooperative-corporation offers limited liability which means that the risk of loss to a member is limited to the amount of his investment in the association. The member does not risk losing his personal property for obligations or responsibilities of the association, such as may occur with a sole proprietorship or a partnership. This can be particularly helpful in risky businesses like farming where market fluctuations and weather can destroy a good farm business. However, this advantage may be eliminated when lenders require the head of the family (or association members) to personally sign for the money borrowed or things purchased on credit and thus, bind himself and the association. The advantage of limited liability can thus be nullified and the creditor remains the protected person because he can go against both the association's assets and assets of the family head (or association members).

2. The cooperative-corporation form of business organization simplifies property transfer before or at death. Most North Dakota farms are sole proprietorships and owner-operated. Upon the owner's death, the property may be split into acreages too small to farm economically when it is distributed to the children or relatives. These units may then have to be sold to other farmers rather than kept in the family. The continuity of the farming operation is not affected when a member of a cooperative-corporation dies, assuming that the 75 percent ratio of farm members is not violated as a result of the death. The farm business continues intact and the deceased membership's

shares are merely transferred to another. This perpetual existence is an attractive feature of the cooperative-corporation form of business organization.

3. A member of a cooperative-corporation may before his death transfer some or all of his shares or membership by gift or sale without necessarily affecting the farming operation. This flexibility is a distinct advantage over the sole proprietorship.

4. The cooperative-corporation format also may attract more capital into the farming operation than a single owner-operator could obtain. More members may mean that more capital is available to the farming unit. Farming requires a large investment in land and modern operating equipment. A small family farm may not generate an adequate flow of income to permit growth or permit borrowing more capital to achieve an optimum size. Some family farmers may not appreciate this advantage because they may not be interested in working with outsiders.

5. Large farming units, including cooperative-corporations, may be able to purchase fertilizers, pesticides, machinery, and other modern farming necessities from manufacturers or distributors at a reduced cost by by-passing the local firm or other middlemen. Substantial economies of size exist in large scale buying and selling which may increase farm returns. The cooperative-corporation may find it feasible to assign members with specific managerial skills to manage certain enterprises or to hire personnel with specific skills to increase further the efficiency of the farm.

6. The formal operating rules required by the cooperative-corporation form of organization may be an advantage in that more formal record keeping will result.

Possible Disadvantages of a Cooperative-Corporation

1. The cooperative-corporation must follow formal operating rules which can be both time consuming and expensive. It must maintain the 75 percent membership ratio of farmers who either reside on the land or rely on the farm as their principal source of income.

2. Decision making may become complicated and time consuming because of the voting format within the cooperative-corporation. Each member has one vote regardless of the amount of capital invested or stock owned. Disagreements may arise between members and directors or officers over the use or disbursements of funds within and outside of the association. The day-to-day decision making, however, can be delegated to one business manager to avoid many confrontations.

3. The voting requirement may hinder the formation of a cooperative-corporation. The major investor may not want to risk letting minority members control his investment. For example, the head of a family farm may want to retain absolute control over its operation and not want others to control it. The principal contributors in a nonfamily cooperative-corporation may fear loss of control by members who have invested relatively little in the association. It is possible that a group of minority stockholders or members could unite to control operations of the association.

Managing a Cooperative-Corporation

At least five adult members are needed to form a cooperative-corporation. They are the incorporators and usually form its temporary board. The temporary board holds an organizational meeting after the articles of association have been filed with the Secretary of State. The temporary board adopts bylaws, elects temporary officers, and transacts other business matters at the organizational meeting.

Next the first membership meeting must be held. It should be held as soon as is reasonably possible after an organizational meeting of the temporary board but not later than six months after filing the articles. The initial bylaws of the association may be adopted by the temporary board, but members can adopt other bylaws or amend those adopted by the temporary board. The board of directors is elected at the first member meeting. The board of directors then elects (board members must also be members of the association) the officers of the association. The board of directors is bound by the bylaws and cannot exceed the authority granted it by those bylaws. The board of directors manages the business and affairs of a cooperative-corporation. The board makes the day-to-day business decisions and directs the organization, or selects (elects, appoints, or hires) that person who becomes the principal manager, who thus, makes the day-to-day decisions and operates their business.

Members who are not satisfied with the actions of a director or the board of directors have at least two alternatives. The director may be removed upon the majority of vote of all members or the members can elect another director when the term of that director ends. Directors, who in bad faith vote for any distribution of assets contrary to the articles of association, may be liable to the association for the value of the assets wrongfully distributed. In contrast, members, shareholders,

and patrons of a cooperative-corporation are not personally obligated to pay, nor liable for, any association obligation. The most they can lose is the amount contributed to the association.

A member or stockholder who wishes to force the association to do something or to refrain from doing something, may bring a derivative action against the association. If he is successful in court, he can force the desired action and recover attorney's fees for bringing the action. The right to sue the cooperative-corporation is allowed to insure that it is held accountable to its members and that it will be responsible to the needs of its members and stockholders. Thus, members and shareholders have some control over the action of the association in that they can elect different directors, remove incompetent directors, and initiate a derivative action to force a desired action. The member also has some control in that he has a vote in adopting or amending the bylaws which govern the association.

Distribution of Net Proceeds

Directors of the cooperative-corporation, at least once annually, determine and distribute net proceeds. They have some discretion in how the proceeds are distributed. The following may be deducted from the total proceeds or income:

1. All operating expenses and costs.
2. Costs of supplies, equipment, and other property or services performed for patrons.
3. Costs of services performed for patrons.
4. All taxes and other expenses.
5. Reasonable allowances for depreciation.
6. The directors may declare dividends on the capital stock, which cannot exceed 6 percent of par value.
7. Reasonable reserves can be created for necessary purposes, but these reserves shall be credited to patrons in accordance with the ratio which their patronage bears to total patronage.

The type of the cooperative-corporation determines the distribution of the remainder of net proceeds. There are basically two types of organizations and each distributes profits differently.

The first type is a marketing organization whose main purpose is to sell goods and services to its members. An example is a farmer's cooperative which sells gas, fertilizers and other farm supplies. The members are called patrons and net proceeds are distributed to the patrons in the proportion of each member's patronage to total patronage.

The second type is production orientated. A good example is a family farm which becomes a cooperative-corporation. The organization strives to produce as much grain or livestock as possible. There really are no patrons in this organization because all members are making inputs into the organization rather than taking anything out. Profits are distributed in this organization on the basis of each member's contribution of capital and labor rather than on patronage. A value is assigned to the contributions of each member at the time the cooperative-corporation is formed. Members share in proportion of their contribution of capital and labor to the annual value of all inputs.

Taxation of Cooperative-Corporations

Taxation of cooperative-corporations will vary somewhat depending on the functions of the association. If the cooperative-corporation performs primarily marketing or purchasing functions, it is considered an exempt association and is entitled to several deductions which will reduce tax liabilities. Generally, family farm organizations will not qualify as an exempt association and will in effect be taxed as an ordinary business corporation. The first $25,000 of income is taxed at twenty (20) percent, the next $25,000 at twenty-two (22) percent, and any income over $50,000 is taxed at forty-eight (48) percent.

This may be advantageous to the farmer and may result in tax savings as the following example indicates. The example compares the taxation of a farm organized as a sole proprietorship with one organized as a cooperative-corporation. The tax savings results from splitting income between the cooperative-corporation and the individual rather than taxing all income to the farmer individually. The same figures are assumed under both organizational formats except that the figure for salary and land rent is varied under the cooperative-corporation format. This is done to show the effect of differing salaries to the individual. Forming a cooperative-corporation will not always result in tax savings. Taxes paid will depend on many different factors which vary from one association to another. Generally, there will be no tax advantage unless net income is over $30,000 to $40,000.

Members of a cooperative-corporation normally must report any patronage dividends received or credited to them as personal income, subject to personal income taxes. However, there are exceptions to this rule. One exception is when a patron acquires a capital asset which is subject to depreciation. Here the patronage refund serves to reduce the basis of the asset instead of being personal income. For example, a farmer who acquires

TAXATION OF A NONEXEMPT ASSOCIATION

Sole Proprietorship		Cooperative-Corporation	Situation 1	Situation 2
Gross Income	$150,000	Gross Income for Coop-Corp	$150,000	$150,000
Less: Personal Exemptions and Itemized Deductions	4,000	Less: Salary & Land Rent	100,000	60,000
			50,000	90,000
	$146,000	Less: Deductible Operating Expenses	40,000	40,000
Less: Deductible Operating Expenses	40,000	Taxable Income (Tax Rate: 20% on first $25,000 and 22% on next $25,000)	$ 10,000	$ 50,000
Taxable Income	$106,000			
Tax Payable for Individual	$ 48,900	Tax Payable By Coop-Corp	$ 2,000	$ 10,500
		Individual Income		
		Gross Income (Salary & Land Rent)	$100,000	$ 60,000
		Less: Personal Exemptions and Standard Deduction	6,550	6,550
		Taxable Income for Individual	$ 93,450	$ 53,450
		Tax Payable on Individual Return	$ 41,250	$ 18,828
Total Taxes Payable by the Sole Proprietorship	$ 48,900	Total Taxes Payable by Association and Individual	$ 43,250	$ 29,328
		Tax Savings by Forming Coop-Corp (this money will remain in Association to provide working capital)	$ 5,650	$ 19,572

farm machinery from an association at the cost of $1,000 and later receives a patronage dividend rebate of $50 will adjust his basis as of the first day of the year the patronage dividend is received with the new basis for its depreciation being $950.

Potential organizers of a cooperative-corporation are urged to discuss the possible tax consequences of this form of business organization with an attorney or an income tax accountant who is acquainted with the laws affecting cooperative-corporations.

North Dakota Cooperative-Corporations

Even though available to family farms, most agricultural cooperatives in North Dakota are formed for performing purchasing and marketing functions related to farming, such as grain elevators, creameries, and farm supply stores. Farmers acting together in these associations usually hire skilled management to better perform these specialized functions for them. They combine their purchases or sales to obtain some economies of size, which come from buying and selling in larger quantities.

Some states like South Dakota and Minnesota permit farmers to incorporate their farms. Farmers in these states could use the cooperative form of organization for organizing and operating their farms, but they prefer to use the corporate form. North Dakota does not permit corporation farming. The most comparable form of organization is the cooperative-corporation, which permits the organizers to obtain most benefits of the corporate form of business organization.

The cooperative-corporation form of business organization permitted in North Dakota is a unique form of business organization. However, the specific rules and regulations and laws which apply to this form of business organization are not clearly stated in the North Dakota statutes. At best, one could argue that that which is not prohibited is permitted to the cooperative-corporation in North Dakota. It requires a degree of expertise in writing the articles of association and the bylaws of a cooperative-corporation in North Dakota to avoid having it challenged in the courts as being some prohibited form of corporate farming. Potential organizers of cooperative-corporations are advised to select an attorney who understands the intricacies of this form of business organization and also carefully examine its possible tax consequences.