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DISTRIBUTION OF SAVINGS
BY
COOPERATIVE LIVESTOCK ASSOCIATIONS

By
H. H. HULBERT

COOPERATIVE RESEARCH AND SERVICE DIVISION

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DISTRIBUTION OF SAVINGS BY COOPERATIVE LIVESTOCK ASSOCIATIONS

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Until recently many livestock associations were inclined to regard savings as strictly an association affair. They felt that each was free to distribute its own savings or to retain them in the business. In general, they were right, but if an association is to operate as a cooperative and take advantage of the income tax exemptions provided by law, it must follow certain well defined procedures in the distribution of savings.

Income taxes are assuming a much more important role in all businesses than they have in the past and associations do well to examine their status critically. In doing so they usually find that the method followed in distributing savings is significant. This report is designed to answer some of the questions that have proved troublesome to the cooperatives.

Exemption Letters Not Final

Many associations possess letters from the Commissioner of Internal Revenue which apparently grant them exemption from the payment of Federal income taxes. As a rule, these letters are obtained on the basis of representations made by the associations themselves. Unless these representations check in all respects with the legal and operating procedures, such letters may be void and the associations possessing them may be enjoying a false sense of security. For example, if later investigation discloses that an association was not eligible for exemption from the payment of income taxes, the Bureau may hold the cooperative liable therefor throughout the entire period covered by the letter of exemption.

That is, as cooperative associations that have letters of exemption ordinarily

NOTE.-Credit is due George T. Waas and L. S. Hulbert for assistance in preparing this material.

file no income tax returns, the statute of limitations does not run against their liability for such taxes. Therefore, if it is found that a letter of exemption has been erroneously granted, income taxes may be recovered for the entire period.

Numerous associations have turned over their income-tax problems to auditors or attorneys. Later receipt of a letter of exemption has been generally accepted as an indication of successful handling. Frequently, neither the directors nor the management verified the basis upon which exemption was obtained. The directors and officers of a cooperative association "have a continuing responsibility of not only knowing the status of the association with respect to Federal income tax exemption" but notifying the Commissioner of Internal Revenue of any changes in legal and operating procedures which affect income tax exemption.

"Exemption is based on the theory that a farmers' cooperative association is a nonprofit business and that all of its savings and earnings are distributed ratably one way or another to its patrons, who are required to take such distribution into consideration in determining their net income subject to tax."¹

Policies Varied

Livestock associations appear to have gone to extremes in their treatment of savings. On the one hand, some associations pay out all their earnings, fearing that if they retain any part of the savings they lose their tax-exempt status and their classification as cooperatives. Opposed to this group are associations that have paid out no part of their savings in the last 10 years or longer. The majority of the livestock cooperatives fall somewhere between these two extremes. Many associations have

adopted a center-of-the-road policy, paying patronage dividends each year and carrying part of their savings to reserves.

Tax Exemption Optional

It is not necessary, of course, for an association to operate, or even attempt to operate, as a tax-exempt cooperative. Many cooperative associations pay income taxes just as commercial corporations do. No stigma is attached to a cooperative simply because it pays income taxes.

Nor is it necessary for an association to distribute its savings every year to maintain a tax-exempt status. Indeed, it is possible for an association to pay out all its earnings and still be subject to income tax. From a tax exemption standpoint, therefore, the test of a cooperative is not whether it pays or does not pay out its savings as patronage refunds.

Appraising Your Tax Status

Two tests can be applied by any association to its own particular situation in appraising its income tax status:

1. Does the association maintain unreasonable reserves as measured by working capital and other asset requirements, financial risks, or business hazards?
2. Does the method employed in allocating savings treat all patrons alike?

Every association is permitted to accumulate reasonable reserves before its exemption status will be questioned from the standpoint of income taxes. This means that an association may retain an entire year's savings, or several years' savings, if it can show that they are needed as reserves to provide working capital and for other necessary purposes.

¹*News for Farmer Cooperatives*, February 1941, p. 17.

From the standpoint of cooperative associations in general, all reserves should be allocated annually to members and nonmembers on the association's records. In addition, the association's legal papers must provide for such allocation in a manner which gives the patrons a legal right thereto, subject only to reduction by future losses of the association. Should reserves become unreasonable, an association would be required either to pay income taxes or to distribute a part of its reserve as a patronage refund. To date there is no exact definition of what constitutes unreasonable reserves. It seems safe to conclude, however, that the burden of proof lies with the association.

Cooperative livestock marketing associations, unlike many other cooperatives, do not require large amounts of invested capital. Ordinarily, they own little real estate and have but small amounts invested in fixed assets. This does not mean, however, that they do not require or cannot justify the need for reserves. For example, the stocker and feeder business calls for large amounts of working capital at certain seasons of the year. As agents of the producer in the sale of livestock, cooperatives handle millions of dollars every year. In acting as intermediaries between the farmer and the packer, they guarantee payment to the producer for all livestock sold. Frequently the producer receives his money before the association is paid by the buyer.

Treat Patrons Alike

Granting an association can qualify for income tax exemption in all other respects there are two provisions affecting distribution of savings which will cause trouble if they are not observed. First, dividends on capital stock or other types of capital shares must be limited to 8 percent or the legal interest rate of the State in which the association is incorporated, whichever is

greater. Second, when savings are distributed an association must pay patronage refunds to all patrons, including nonmembers.

Not many livestock associations are affected by the 8 percent limitation on capital stock, because most of them are organized as nonstock cooperatives. Every association making any distribution of patronage refunds, however, is touched by the requirement that members and nonmembers must be treated alike. The association's organization papers should provide for allocation of savings and payment of refunds to all patrons. This means that nonmembers must share in all patronage refunds on exactly the same basis as members if exemption from income tax is to be maintained. On the other hand, an association may choose to ignore nonmembers in the payment of patronage refunds and restrict its distribution of savings to members only. If an association adopts this principle, however, it becomes ineligible for exemption from the payment of income taxes.

Establish Liability

Associations operating as nonexempt cooperatives and restricting patronage refunds to members only have been permitted under certain conditions to deduct patronage refunds paid in determining the amount of taxable income. However, in the absence of a bylaw provision which establishes a definite legal liability for the distribution of cooperative savings, it would seem to be safer for the board of directors to adopt a resolution before the close of the tax year declaring the patronage refund and setting it up as a liability or debt of the association. Further, it is believed that the bylaws of the association should at least show that the payment of patronage refunds is contemplated.

Patrons May Become Members

Exempt associations organized with capital stock may retain the nonmembers'

share of patronage refunds until such time as the amount equals the value of a share of stock, without jeopardizing their income tax status. When accumulated patronage dividends have paid for a share of stock, patrons who become members in this way must share along with other members in the distribution of savings.

Statutes Conflict

Some livestock cooperatives rely on an apparent conflict between the Packers and Stockyards Act and the Internal Revenue Act to help them out of their income tax difficulties. They point out that section 306 (f) of the Packers and Stockyards Act forbids a livestock cooperative from making refunds to anyone but members, while the Internal Revenue Act says that a cooperative association must treat members and nonmembers alike if the association is to be tax exempt. They conclude, "Now, if we obey one law, we violate the other."

Playing the provisions of one law against another is not a sound defense. The Packers and Stockyards Act does forbid cooperative livestock associations to pay patronage refunds to nonmembers, but associations have it in their power to discourage nonmember business² if they choose. As a practical matter, all associations probably could restrict their business to members only. Many associations do. If an association encourages nonmember business, it does so because it wishes to do so, not because it is required to do so. Viewed in this light, there is no conflict between the two laws.

To be on the safe side, however, and avoid any complications arising from the distribution of savings, many livestock associations have adopted the practice of making all patrons members. This is accomplished by providing a form of

membership application on the back of each shipper's proceeds check, which the producer signs by endorsing his check. While the Packers and Stockyards Administration has never formally ruled on the legality of this method of obtaining members, it apparently feels that shippers may become members in this way.

Practical Problems in Distribution

Aside from the income tax features, the treatment of cooperative savings presents many troublesome questions. For example, what disposition should be made of the large number of patronage refund checks that are too small to be sent out? Individually, the amounts are insignificant, yet collectively they run into sizable sums. One medium-sized livestock cooperative reported doing business with 20,000 shippers in 1941, of whom 8,400 paid the association no more than \$2.50 in commissions. Many paid only a dollar or less. The maximum patronage refund to the largest shipper of this group was less than 40 cents. On many of these accounts the cost of paying the refund exceeded the amount due, so the refund wasn't paid. This same condition recurs year after year.

Some associations draw an arbitrary line and send out no patronage refund checks for less than a dollar. Then what becomes of unpaid patronage refunds? How should they be carried on the records? Does failure to distribute the full patronage refund declared by the directors destroy the tax exemption status of an association?

Unpaid patronage refunds are liabilities of the association declaring them. Equal liability attaches to all unpaid patronage refunds irrespective of size. Cooperative associations, therefore, should bend every effort to make as full and complete a distribution of patronage

²The writer is informed that the right of a cooperative livestock association to refuse to do business with nonmembers has never been raised under the Packers and Stockyards Act.

refunds as possible. Where this is impracticable because of the costs involved, associations may be justified in not paying the smaller shippers by check but in requesting them to call at the association office and receive their patronage refunds in cash. No association should deny any patron his patronage refund, however, simply because it happens to be small.

As an alternative procedure, small patronage refunds may be accumulated from year to year and paid by check when they amount to a dollar or more. This is apt to be cumbersome, however, and to require a great deal of bookkeeping, because the turnover in livestock patrons is high, especially among the smaller producers. Some livestock cooperatives report doing business with as many as 100,000 producers a year. To accurately accumulate the savings and keep the records for a group of this size is a tremendous job.

Conceivably some farmers might never ship enough livestock to accumulate a dollar in patronage refunds. Thus, under the accumulation plan, this group of patrons might never receive refunds even though they had been declared by the directors. To avoid the accusation of confiscating the savings of small shippers, an association should publicly offer and be prepared to pay such refunds in cash at any time.

The same problems arise in connection with associations using the certificate-of-interest method for distribution of savings. The larger patrons receive their certificates, while the smaller ones receive none. When the certificates are redeemed the larger shippers are paid, but the refunds due small producers are not paid because no certificates have been issued to them. Here again an association needs to set up some definite procedure by which the smaller shipper may be assured of his share of any patronage refunds distributed. Payment

in cash is a logical method. Or, an association may choose to add the refund to the next shipper's proceeds check, drawing attention thereto, but avoiding the cost of a separate refund check for small shippers.

Suggested Procedure

In the light of the above discussion, it seems clear that cooperative associations should carry all unpaid patronage dividends on the books as current liabilities for at least a year. Balances remaining after 1 year should be closed to an "Unclaimed Patronage Refund" account. Subsidiary records should reflect the detailed amounts placed in this account each year and should provide a method whereby unpaid refunds could be distributed as claimed.

The Bureau of Internal Revenue has never issued a ruling on incomplete distribution of patronage refunds declared by the board of directors of a cooperative livestock marketing association. It is doubtful, however, if failure to make complete distribution of each year's patronage refund would destroy an association's income tax status provided the association acted in good faith, employed sound accounting procedure, and made an honest attempt to secure full distribution.

An illustration may serve to clarify some of the points discussed. For example, an association doing business with members and nonmembers and claiming exemption from Federal income taxes shows savings of \$50,000 at the end of its fiscal year. Its board of directors votes a patronage refund amounting to \$40,000 on the year's business and carries \$10,000 to reserves. The entry recording the transaction would appear on the records as follows:

Savings.....	\$50,000.00
Patronage refunds declared..	\$40,000.00
Reserves.....	10,000.00

At least three possibilities are to be considered:

1. In paying the \$40,000 refund, the association finds that \$35,000 is due members and \$5,000 is due nonmembers. In harmony with the Internal Revenue Act the association pays refunds to every member and every nonmember on a like basis. In so doing the association avoids any conflict over income taxes insofar as payment of patronage dividends is concerned. Yet, if the association follows this procedure, it violates the prohibition of the Packers and Stockyards Act against the payment of patronage dividends to nonmembers.
2. On the other hand, had the association decided to pay out the \$35,000 due members and withhold the \$5,000 due nonmembers, it would have forfeited its right to exemption from payment of Federal income taxes because it failed to treat members and nonmembers alike. It would, however, have complied with the provisions of the Packers and Stockyards Act.
3. As another alternative, the association might have added the \$5,000 due nonmembers to the \$35,000 due members and paid it all to members. In this case the association would not only have lost its right to income tax exemption but it would have violated the provisions of the Packers and Stockyards Act as well.

There are two ways of avoiding the dilemmas discussed above. An association may qualify as a tax exempt cooperative and comply with the Packers and Stockyards Act at the same time if it restricts its business to members only. Or, if an association chooses to operate as a nonexempt cooperative it may meet the requirements of the Packers and Stockyards Act merely by confining patronage refunds to members only.

In writing the refund checks the association finds 6,700 patrons, part of whom are members and part of whom are nonmembers, whose patronage refunds amount to less than a dollar each. These refunds are not paid by check because of an association rule against sending out checks for less than a dollar. In addition to these small checks there are numerous larger checks for which the association can find no home. The sum total of these small and unclaimed checks amounts to \$5,800.

Probably an association is within its right in refusing to send out checks to patrons for amounts less than a dollar. It seems reasonable to assume that an association can establish any check minimum it sees fit. An association, however, cannot employ an arbitrary check limitation as a means of avoiding payment of its obligations. Refunds not paid by check should be paid in currency.

Unclaimed Refunds

Associations following this procedure should be prepared to show that they made an honest attempt to reach all patrons to whom cash dividends are due. After exhausting reasonable means of securing full distribution of patronage dividends, amounts still remaining after 1 year should be carried to "Unclaimed Patronage Refunds." The closing entry would appear as follows:

Patronage refunds	
declared.....	\$40,000.00
Cash.....	\$34,200.00
Unclaimed patronage refunds.	5,800.00

Any refunds subsequently paid out should be charged to "Unclaimed Patronage Refunds" so that the account will always reflect the amount of refunds unpaid at any given date.

It is believed that patronage refunds which an association has been unable to distribute within the period of the

statute of limitations may be treated in either of two ways:

1. They may be included as miscellaneous revenue on the operating statement, or
2. They may be transferred to the permanent capital of the association and allocated to the then existing reserve holders.

In either event they lose their identity. If included as miscellaneous revenue the records would carry the following entry:

Unclaimed patronage	
refunds.....	\$5,800.00
Cash.....	\$3,400.00
Miscellaneous revenue.....	2,400.00

If transferred to permanent capital, the entry would appear as follows:

Unclaimed patronage	
refunds.....	\$5,800.00
Cash.....	\$3,400.00
Reserves.....	2,400.00

The above entry assumes that the association distributed \$3,400 in small refunds within the period of the statute of limitations when the funds were carried as "Unclaimed Patronage Refunds."

The procedure outlined for associations in handling their patronage refunds should be followed in revolving reserves. In the case of reserves, however, it may be even more difficult to locate the patrons to whom refunds are due. Reserves ordinarily are not revolved for 5 or perhaps 10 years, and in that period many deaths and changes of addresses occur. The same principles, however, hold for the distribution of reserves as for the distribution of annual patronage refunds. A reserve distribution is in reality a further patronage refund on the business of an earlier year. Reserves which have been declared payable and which the association is unable to distribute may be included as other miscellaneous revenue or transferred to permanent capital, in the same manner as that described for unclaimed patronage refunds.



