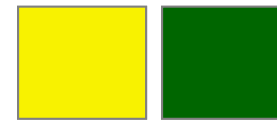
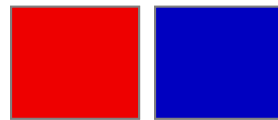




Basic Cooperative Taxation



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Corporate Income Tax

■ Tenets

- The corporation is a taxable entity
- Not all income is taxable
- Contributions to capital are treated differently than operating income

$$\text{Tax} = (\textit{income} - \textit{deductible expenses}) \times \textit{rate(s)}$$

Tax Treatment by Business Type

Business Type	Times Earnings Subject to Tax	Level
Proprietorship	1	Owner
Partnership	1	Owners
LLC	1	Owners
Limited Co-op Association	1	Owners
Corporations		
Investor-General	2	Corporation / Owners
Subchapter S	1	Owners
Cooperative	1	Owners

Benefit Of Single Tax Treatment

	General Business Corporation	Single Tax Entity (Co-op)
Taxable Income	\$40,000	\$40,000
Corporate Income Tax (15%)	<u>6,000</u>	<u>0</u>
Passthrough	\$34,000	\$40,000
Personal Income Tax (25%)	<u>8,500</u>	<u>10,000</u>
Value to Owners	\$25,500	\$30,000

Tax Savings \$4,500

Subchapter T

Internal Revenue Code

Sections 1381-1388

- Home to the basic rules establishing single tax treatment for co-ops
- Applies to any corporation “*operating on a cooperative basis,*” **except...**

Utility Cooperatives

- **Electric and Telecommunications Co-ops** are tax exempt if at least 85 percent of their income is from providing service to members, Code sec. 501(c)(12)
- If a Utility cooperative doesn't meet the 85 percent test, then, under common law, it is taxed *similarly* to a Subchapter T cooperative

Other Exempt Cooperatives

- **Credit Unions** without capital stock organized and operated for mutual purposes and without profit, Code sec. 501(c)(14)(A)
- **Cooperative Hospital Service Organizations** organized and operated solely to purchase supplies and provide administrative services to members, Code sec. 501(e)

Sales of Consumer Goods

- Allocations of patronage-sourced earnings from the sale of “*personal, living, or family items*” are free of taxation at both the co-op and the patron levels, Code sec. 1385(b)(2)

Subchapter T

- Applies to any corporation “*operating on a cooperative basis.*” What does that mean?
- Not defined in the Code
- Essentially, it means returns earnings to users (*patrons*) on the basis of use (*patronage*) by issuing them patronage refunds

Basic Cooperative Tax Rule

- **Net margins (*earnings*) on business conducted with or for patrons**

Basic Cooperative Tax Rule

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- **Are taxable income to only the co-op or the patron**

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Basic Cooperative Tax Rule

- Net margins (*earnings*) on business conducted with or for patrons
- Are taxable income to only the co-op or the patron
- If distributed or allocated to patrons
- **On the basis of business done with the cooperative**

Patronage Refund

- The Internal Revenue Code definition of a Patronage Dividend (*Refund*) is
 - An amount paid by a cooperative to a patron
 - Based on the quantity or value of business done with the co-op
 - Under a **pre-existing legal obligation**
 - Determined by net margins on business with all patrons

Patronage Refund

- If ABC Cooperative earned **\$1,000** last year, and
- ABC Co-op did **6 percent** of its business with Ms. Jones, then
- **Ms. Jones is entitled to a Patronage Refund of \$60** ($\$1,000 \times .06$)



“Patron” vs. “Member”

■ Patron

- A person with or for whom a co-op does business “*on a cooperative basis;*” that is, a person who is eligible to receive a **patronage refund**

■ Member

- A person allowed to **vote** on issues decided by the membership

Payment Period

- The time period during which a cooperative can make a patronage refund eligible for single tax treatment. It starts at the beginning of the tax year and ends:
 - **Subchapter T Co-ops**
8½ months after close of tax year
 - **Exempt Co-ops**
4½ months after close of tax year
 - **Taxable Utility Co-ops**
2½ months after close of tax year

Payment Options – Patronage Refund

- Cash Distribution
- Retain the money, credit it to patron equity accounts, issue written notices of allocation
 - Qualified
 - Nonqualified

Taxes: *Cash Patronage Refund*

- A Patronage Refund made as a cash distribution to patrons is
 - Deductible by the co-op in year earned
 - Taxable to the patron in year received

Taxes: *Qualified Allocation*

- A qualified allocation of a retained patronage refund is taxed just like cash. It is
 - **Deductible by the co-op in year earned**
 - **Taxable to the patron in year received**

Taxes: *Qualified Allocation*

- A qualified allocation of a retained patronage refund is taxed just like cash. It is
 - Deductible by the co-op in year earned
 - Taxable to the patron in year received
 - **Redemption is a nontaxable event**

Tax Treatment of Cooperative & Patron Cash & Qualified Allocation

COOPERATIVE		PATRON	
Expenses		Income	
Crop	\$600	Crop	\$600
Other	<u>\$300</u>		
Total	\$900		
Income	<u>\$1,000</u>		
Margin	<u>\$100</u>	Refund	<u>\$100</u>
Taxable Income \$0		Taxable Income \$700	



Qualifying a Patronage Refund

- At least **20 percent** payout in cash

Qualifying a Patronage Refund

- If ABC Cooperative earned **\$1,000** last year, and
- ABC Co-op did **6 percent** of its business with Ms. Jones, then
- Ms. Jones is entitled to a patronage refund of **\$60** ($\$1,000 \times .06$)
- **At least 20 percent of the patronage refund (\$12) must be paid in cash**



Qualifying a Patronage Refund

- At least 20 percent payout in cash
- Patron consents to include entire allocation in taxable income

Obtaining Patron Consent

- **Bylaw**

Obtaining Patron Consent

- Bylaw
- **Written Consent Form**

Obtaining Patron Consent

- Bylaw
- Written Consent Form
- **Endorsing and Cashing Qualified Patronage Refund Check**

Taxes - Nonqualified Allocation

■ Year of Issuance

- Taxable to co-op in year earned
- Not taxable to patron in year received

Taxes - Nonqualified Allocation

■ Year of Issuance

- Taxable to co-op in year earned
- Not taxable to patron in year received

■ Year of Redemption

- **Deductible by co-op in year redeemed**
- **Taxable to patron in year redeemed**

Tax Treatment of Cooperative & Patron Non-Qualified Allocation

COOPERATIVE		PATRON	
Expenses		Income	
Crop	\$600	Crop	\$600
Other	<u>\$300</u>		
Total	\$900		
Income	<u>\$1,000</u>		
Margin	<u>\$100</u>	Refund	<u>\$100</u>
Taxable Income \$100		Taxable Income \$600	



Tax Treatment of Cooperative & Patron – Nonqualified Allocation, When Redeemed

- The cooperative is entitled to a refund of the tax it paid on the \$100 of taxable income it reported in the year the nonqualified were issued (*special rules cover intervening changes in tax rates*)
- The patron includes the \$100 received in redemption of the nonqualified in taxable income for the tax year in which the cash is received

Per-Unit Retains

- Portion of sales proceeds
- Retained by a marketing cooperative
- Based on dollar value or volume of products marketed for each patron

Per-Unit Retains

- If Mr. Jones was due **\$10,000** for product delivered last year, and
- ABC Co-op collected a per-unit retain of **3 percent** of the sales proceeds, then
- Mr. Jones receives **\$9,700 cash** and a **per-unit retain allocation of \$300** ($\$10,000 \times .03$)
- **Tax treatment is similar to patronage refunds, except no 20% cash payout is needed to “qualify” the retain, only consent**



Non-Exempt Utility Co-ops

- Taxed under rules in effect when Subchapter T was enacted into law, in 1962
- Patronage refunds deductible by co-op under Revenue Act of 1951
- Courts had held that redemption of retained patronage refunds was uncertain, so the value of the retains wasn't income to patrons until they were actually redeemed for cash
- So, non-exempt utility co-ops can claim a deduction for patronage refunds when issued and patrons don't have to include the value of the retain in income until it is redeemed for cash

Exempt Utility Co-ops

- All income is exempt from tax at the co-op level under I.R. Code section 501(c)(12)
- Patrons of exempt utility co-ops are also able to delay reporting the value of retained patronage refunds as income until they are redeemed for cash

Section 521

- Farmer cooperatives
- Meeting several organizational tests
- Can deduct dividends on stock
- Can deduct nonpatronage income distributed to patrons on a patronage basis

Section 521

- Farmer cooperatives
- Meeting several organizational tests
- Can deduct dividends on stock
- Can deduct Nonpatronage income distributed to patrons on a patronage basis
- **Often incorrectly called “*tax exempt*” co-ops**

Forms

- Subchapter T Cooperatives
 - IRS has released a new Form 1120-C to be filed for tax years ending on or after December 31, 2007
- Tax exempt Cooperatives file Form 990
- Non-exempt Utility Cooperatives file Form 1120
- Distributions to patrons are reported on Form 1099-PATR

Worksheets - Vegepacker Cooperative

- Net Margin - \$50,000
- Corporate tax rate is 15% on that income
- Half of the total net margin is allocated to patrons in the 15% bracket, half to patrons in the 25% bracket
- Two representative patrons each provide 8% of Vegepacker's product - Patron A who is in the 15% bracket and Patron B in the 25% bracket

Vegepacker Cooperative

Worksheets

- A. The \$50,000 margin is placed into a tax paid reserve
- B. The \$50,000 margin is distributed as qualified patronage refunds (20% in cash)
- C. The \$50,000 margin is distributed as non-qualified patronage refunds

Vegepacker Cooperative

Example A: Total Tax Obligations (*Tax Paid Reserve*)

Cooperative tax ($\$50,000 \times .15$)	\$7,500.00
Addition to equity	\$42,500
Patron tax, when equity is redeemed for cash	
($\$21,250 \times .15$)	\$3,187.50
($\$21,250 \times .25$)	<u>\$5,312.50</u>
TOTAL TAXES PAID	\$16,000.00

Vegepacker Cooperative

Example B:

Tax treatment, all \$50,000 distributed as **qualified patronage refunds (20% in cash, 80% as an allocation of retained equity)**

Vegepacker Cooperative

Example B: Total Tax Obligations (*Qualified Allocations*)

Cooperative tax (\$_____ x .15)	\$ _____
Addition to equity \$ _____	
Patron tax in total	
(\$_____ x .15)	\$ _____
(\$_____ x .25)	\$ _____
TOTAL TAXES PAID	\$ _____

Vegepacker Cooperative

Example B: Total Tax Obligations (*Qualified Allocations*)

ANSWERS

Cooperative tax (\$ <u>0</u> x .15)	\$	0
Addition to equity <u>\$ 40,000</u>		
Patron tax in total		
(\$ 25,000 x .15)	\$	3,750
(\$ 25,000 x .25)	\$	<u>6,250</u>
TOTAL TAXES PAID	\$	10,000

Vegepacker Cooperative

Example B: Individual Patron Analysis

Patron A:	Individual refund allocation	\$	4,000
	Cash received ($\$4,000 \times .20$)		800
	Tax owed ($\$4,000 \times .15$)		<u>600</u>
	Cash Flow	\$	200

Vegepacker Cooperative

Example B: Individual Patron Analysis

Patron B:	Individual refund allocation	\$	4,000
	Cash received	(\$ _____ x _____)	_____
	Tax owed	(\$ _____ x . 25)	_____
	Cash Flow	\$	_____

Vegepacker Cooperative

Example B: Total Tax Obligations (*Qualified Allocations*)

ANSWERS

Patron B:	Individual refund allocation	\$	4,000
	Cash received	$(\$4,000 \times .20)$	800
	Tax owed	$(\$4,000 \times .25)$	1,000
	Cash Flow	\$	(200)

How do you think Patron B feels about receiving a patronage refund?
What can be done about it?

Vegepacker Cooperative

Example C:

Tax treatment, all \$50,000 distributed as **nonqualified** patronage refunds (*100% as an allocation of retained equity*)

Vegepacker Cooperative

Example B: Total Tax Obligations *(Non-Qualified Allocations)*

YEAR OF ISSUANCE

Cooperative tax (\$_____ x .15)	\$ _____
Addition to equity \$ _____	
Patron tax in total	
(\$_____ x .15)	\$ _____
(\$_____ x .25)	\$ _____
TOTAL TAXES PAID	\$ _____

Vegepacker Cooperative

Example B: Total Tax Obligations (*Non-Qualified Allocations*)

ANSWERS

YEAR OF ISSUANCE

Cooperative tax (<u>\$ 50,000</u> x .15)	\$	<u>7,500</u>
Addition to equity <u>\$ 42,500</u>		
Patron tax in total		
(\$ <u>0</u> x .15)	\$	<u>0</u>
(\$ <u>0</u> x .25)	\$	<u>0</u>
TOTAL TAXES PAID	\$	<u>7,500</u>

Vegepacker Cooperative

Example C: Total Tax Obligations *(Non-Qualified Allocations)*

YEAR OF REDEMPTION

Cooperative tax (\$ _____ x .15) \$ _____

Patron taxes in total

(\$ _____ x .15) \$ _____

(\$ _____ x .25) \$ _____

TOTAL TAXES PAID \$ _____

Vegepacker Cooperative

Example C: Total Tax Obligations (*Non-Qualified Allocations*)

ANSWERS

YEAR OF REDEMPTION

Cooperative tax (\$ - 50,000 x .15)	\$	<u>-7,500</u>
Patron taxes in total		
(<u>\$25,000</u> x .15)	\$	3,750
(<u>\$25,000</u> x .25)	\$	<u>6,250</u>
TOTAL TAXES PAID	\$	10,000

Vegepacker Cooperative

Example C: Individual Patron Analysis (*Non-Qualified Allocations*)

Year of Issuance

Patrons receive no cash and have no tax liability,
so there is nothing to analyze

Vegepacker Cooperative

Example C: Individual Patron Analysis *(Non-Qualified Allocations)*

YEAR OF REDEMPTION

Patron A:	Individual refund allocation	\$	4,000
	Cash received	\$	<u>4,000</u>
	Tax owed (\$_____ x .15)	\$	_____
	Cash Flow	\$	_____
Patron B:	Individual redemption payment	\$	4,000
	Cash received	\$	_____
	Tax owed (\$_____ x .25)	\$	_____
	Cash Flow	\$	_____

Vegepacker Cooperative

Example C: Individual Patron Analysis *(Non-Qualified Allocations)*

ANSWERS

YEAR OF REDEMPTION

Patron A:	Individual refund allocation	\$	4,000
	Cash received	\$	<u>4,000</u>
	Tax owed (<u>\$4,000</u> x .15)	\$	<u>600</u>
	Cash Flow	\$	<u>3,400</u>
Patron B:	Individual redemption payment	\$	4,000
	Cash received	\$	<u>4,000</u>
	Tax owed (<u>\$4,000</u> x .25)	\$	<u>1,000</u>
	Cash Flow	\$	<u>3,000</u>



Tax Summary

	Reserve	Qualified	Non-Qualified
Co-op (<i>Earned</i>)	\$ 7,500	0	\$7,500
Co-op (<i>Redeemed</i>)	0	0	-\$7,500
Patrons (<i>Allocated</i>)	0	\$10,000	0
Patrons (<i>Redeemed</i>)	<u>\$ 8,500</u>	<u>0</u>	<u>\$10,000</u>
TOTAL	\$ 16,000	\$10,000	\$10,000

Cooperative Taxation

QUESTIONS