Welcome to an NSAC Auditing and Accounting Seminar Presentation:

Advanced Cooperative Taxation

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Discussion Topics

- Review of the Basics
- Patronage and Nonpatronage Income
- Section 521
- Handling of Losses
- Equity Redemptions at Less than Face
- Domestic Production Deduction

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Basic Concept

Internal Revenue Code Subchapter T

(Secs. 1381-1388)

Provides for single tax treatment of patronage refunds and per-unit retains allocated or distributed by any "corporation operating on a cooperative basis"

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Patronage Dividend (Refund)

- Distribution of earnings on business conducted with or for patrons from a cooperative to a patron
- Paid pursuant to a pre-existing obligation to make the distribution, and
- Based on the patron's pro rata share of all business conducted with patrons during the year

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Patronage Refund

- If ABC Cooperative earned $500 last year, and
- ABC Co-op did 8 percent of its business with Ms. Smith, then
- Ms Smith is entitled to a patronage refund of $40 ($500 x .08)

If ABC Co-op retains 60 percent of its patronage refunds, Ms. Smith receives $16 cash and $24 in equity in the co-op

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Qualified Patronage Refund

- Many cooperatives pay at least 20% of a patronage refund in cash to "qualify" the refund
- The tax obligation for the entire refund (cash returned and portion retained) passes through to the patrons
- Deductible by the co-op in year earned, taxable to patrons in year received

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Qualified Patronage Refund

COOPERATIVE		PATRON	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin (refund)	$100	Refund	$100
Taxable Income	$ 0	Taxable Income	$700

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Non-Qualified Patronage Refund

- **In the year of issuance, the tax on the retained portion is paid at the cooperative level**
- **If the retained refund is redeemed for cash in a subsequent year, the co-op gets a credit for the tax paid in the year of issuance**
- **The amount paid to the patron at the time of redemption is reported as income by the patron in the tax year the cash is received**

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Non-Qualified Patronage Refund

COOPERATIVE		PATRON	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin (refund)	$100	Refund	$100
Taxable Income	$100	Taxable Income	$600

Per-Unit Retain

- **Portion of sales proceeds due a patron for products marketed for that patron, retained to capitalize the cooperative**
- **Favorable tax treatment only available for marketing activities**

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Per-Unit Retain

- If Mr. Jones was due $10,000 for product delivered to ABC Cooperative last year, and
- ABC Co-op collected a per-unit retain of 3% of the sales proceeds, then
- Mr. Jones receives $9,700 cash and a per-unit retain allocation of $300 ($10,000 x .03)

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Per-Unit Retain Taxation

- **Same as for patronage refunds:**
  - The tax obligation for qualified per-unit retains passes through to the patrons
  - The tax on non-qualified per-unit retains is paid by the cooperative in the year collected, and the obligation transfers to the patrons in the year the per-unit retains are redeemed for cash

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Subchapter T Compliance Issues

- Pre-existing written, legally enforceable obligation to make patronage allocations
- 8½ month payment period
- Patron consent (qualified allocations)
- Written notice explaining the allocation

Patronage / Nonpatronage Income

- Subchapter T provides single tax treatment for patronage refunds and per-unit retains, which are based on business conducted with or for those patrons (Patronage-sourced income)

- Other income is taxed twice, when earned and when distributed, just like general business corporations (Non-patronage sourced income)

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Patronage / Nonpatronage Income

- **The nature of the customer:** **If the person with or for whom the cooperative conducts business is not a patron, any earnings are non-patronage income. Usually clear cut.**
- **The nature of the transaction:** **Non-operating income, such as interest on the investment of surplus cash, may not be clearly from business with or for patrons. Controversial for decades.**

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

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Patronage / Nonpatronage Income

- **Rev. Rul. 69-576**:
  - "Patronage sourced income (and expenses)" are those directly related to transactions that actually facilitate the primary cooperative function(s)
  - Income that merely enhances the overall profitability of the cooperative is nonpatronage sourced
  - Patronage refund from Bank for Cooperatives is patronage-sourced income

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Patronage / Nonpatronage Income

- IRS: Income from the three examples in the Regulation (rent, interest, gains on the sales of assets) is always nonpatronage
- 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

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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

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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 non-patronage income

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Section 521 – Business Activity

- **Primary activity must be:**
  - Marketing products of members and other producers, and/or
  - Providing supplies to members and other persons
- **Limited marketing of non-producer goods is permitted in special situations:**
  - Emergency purchases
  - Ingredient purchases
  - Incidental purchases

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Section 521 – Business Activity

- **The value of products marketed for members and the value of supplies provided members must both exceed the value of such transactions with nonmembers each year**
- **The value of purchases for persons who are neither members nor producers can't exceed 15 percent of total purchasing activity each year**
- **Business done with the United States or any of its agencies is disregarded in making these computations**

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Section 521 – Capitol Stock

- **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**
- **If the association has voting stock, substantially all (85 percent) must be owned by producers who use the cooperative's services**

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Section 521 – Margin Allocations

- 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

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Section 521 and 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

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Securing Section 521Status

- 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

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Handling of Losses

- Since 1971, IRS has taken the position that, as to its patronage business, a cooperative operates “at cost” and therefore simply can’t have a loss on its patronage operations
- If expenses exceed income, the cooperative should recoup the shortage on a pro rata basis from the patrons who were paid too much for product they delivered or charged too little for the supplies they purchased

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Handling of Losses

- **IRS has suggested several approaches a co-op may use to recoup a loss from the patrons whose business generated the loss:**
  - **Send them a bill and ask for direct reimbursement**

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  - Send them a bill and ask for direct reimbursement
  - **Cancel retained patronage refunds and per-unit retains**

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Handling of Losses

- **IRS has suggested several approaches a co-op may use to recoup a loss from the patrons whose business generated the loss:**
  - Send them a bill and ask for direct reimbursement
  - Cancel retained patronage refunds and per-unit retains
  - **Establish an account receivable due from each patron that can be satisfied with patronage allocations in later years, direct payment, or cancellation of equities**

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Handling of Losses | Sec. 172

- Cooperatives have consistently argued for greater flexibility in handling losses
- Another option advanced by cooperatives is to carry the loss back up to 2 tax years and forward for up to 20 tax years, at the cooperative level, under Code Section 172
- The loss is applied to reduce taxable earnings generated by the same allocation unit, so the outcome is to assign the loss to patrons of the same service(s) but who used the service(s) in different years

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Handling of Losses | Sec. 172

- The Service initially resisted efforts of cooperatives to carry losses back and forward under Section 172
- However, several court cases held this was an acceptable option for cooperatives
- Now the IRS begrudgingly allows cooperatives to use the net operating loss deduction provided by Section 172 and to carry the loss of one allocation unit back and forward to offset income of that same unit without tracing the loss to any particular patrons

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Handling of Losses | Netting

- **Another option advanced by cooperatives in two or more lines of business is to net the gains and losses of different allocation units**
- **Co-ops argued that the members, not IRS, should decide how much risk sharing the members engaged in**
- **In 1985, IRS issued a letter ruling flatly rejecting a major cooperative's plan to "net" the results of different allocation units**

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Handling of Losses | Netting

- Cooperatives secured passage of legislation amending Subchapter T to make it clear cooperatives can “net” patronage gains and losses, provided patrons are given proper written notice of how the netting will take place (IRC sec. 1388(j))
- Netting of patronage gains and losses is allowed among allocation units in the same or different functions, divisions, departments, geographic areas, or however else the cooperative determines its allocation units

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Handling of Losses | Netting

- Cooperatives with patronage and nonpatronage operations would also like the option to net the gains and losses between the two
- Again, IRS has resisted both netting nonpatronage losses with patronage earnings and netting patronage losses with nonpatronage earnings

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

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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 co-ops may not net patronage losses with nonpatronage earnings and thereby reduce the tax due on the nonpatronage income

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Equity Redemptions

- **Most cooperative redemptions of patronage-sourced equity are for the face value of the investment**
- **Qualified equity – As the cooperative takes a deduction when the equity is issued and the patron includes it in taxable income in the year received, the redemption of qualified equity is a non-taxable event for both the cooperative and its patrons**

Equity Redemptions

- Nonqualified equity – The cooperative includes the value of the equity in its taxable income for the year the equity is issued
- In the year of redemption, the cooperative recovers the tax paid in the year of issuance and the patron includes the cash received in its taxable income for the year it is received

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Redemptions at Less Than Face

- **Cooperatives occasionally redeem equity at less than face value (or simply cancel it), usually for one of two reasons:**
  - To transfer a loss to patrons whose business created the loss
  - As part of its equity management program
    - Terminate inactive members
    - Get old equity off the books
    - Provide some cash to members as quickly as possible

Redemptions at Less Than Face

- **Tax consequences, redemption of nonqualified equity at less than face value:**
  - At the **cooperative level – **The cooperative can deduct whatever, if any, amount it pays to patrons
  - At the **patron level –** The patrons include any funds received in taxable income in the year received
  - This is the same as if the equity were redeemed at face value

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Redemptions at Less Than Face

- **Tax consequences, redemption of qualified equity at less than face value - IRS position and conventional wisdom:**
  - At the cooperative level - The tax benefit rule applies. As the cooperative took a deduction when the equity was created, it must now include the amount of equity cancelled in taxable income
  - At the patron level - As the patron included the face value of the equity in ordinary income when issued; the patron has suffered a loss and can take a deduction for the amount of the loss under Section 165(a)

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Redemptions at Less Than Face

- **Tax consequences, redemption of qualified equity at less than face value – 11th Circuit Court of Appeals (*Gold Kist*, 1997):**
  - The issuance of qualified equity and its later redemption are two separate, unrelated transactions. Therefore, the tax benefit rule does not apply.
  - The cooperative does not have to include the value of the cancelled patronage equity in taxable income.

Redemptions at Less Than Face

- **Tax consequences, redemption of qualified equity at less than face value – 11th Circuit Court of Appeals (*Gold Kist*, 1997):**
  - The patrons included the value of the equity in taxable income when the equity allocation was made, but are still entitled to a deduction for their loss when the equity is cancelled, so no tax is paid at the patron level either
  - So, under this decision, no tax is paid on income retained by the cooperative as qualified equity allocations and later converted to unallocated equity through cancellation of the allocated equity account

Domestic Production Activities Deduction

- Enacted by Congress in 2004 for tax years beginning in 2005 and beyond, to compensate U.S. companies for tax benefits lost when various export promotion programs (DISC, FSC, ETI) were found to violate international trade agreements (Code Sec. 199)
- Actually goes much further, providing a general tax break for any company involved in manufacturing, regardless of whether it exports any of its products

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Domestic Production Activities Deduction

- **Provides a deduction equal to a percentage of the lesser of:**
  - Qualified production activities income (QPAI) for the tax year, or
  - Taxable income for the tax year
- **The percentage of QPAI or taxable income that can be deducted is:**
  - 6% for tax years beginning in 2007 through 2009
  - 9% for tax years beginning in 2010 and later

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Domestic Production Activities Deduction

- **To compute your QPAI:**
  - Total gross receipts from the sale, lease, or other disposition of tangible personal property, electricity, and natural gas manufactured, produced, grown, or extracted in the United States
  - Subtract the cost of goods sold and other expenses allocable to those receipts
- **To compute your deduction, multiply the lesser of the result above or your taxable income by the applicable percentage for the tax year**

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Domestic Production Activities Deduction

- **The Co-op Dilemma:**
  - If a cooperative allocates most or all of its income as cash patronage refunds, retained qualified patronage refunds, and qualified per-unit retains, it has little or no taxable income. Therefore, without a special rule, this deduction is of little or no value to many co-ops.

Domestic Production Activities Deduction

- **The deduction is further limited in that it can not exceed 50% of W-2 wages paid by the taxpayer for the year. This is designed to deny the deduction to firms that do most of their manufacturing overseas.**
- **This limitation impacts many cooperatives' QPAI deduction, even if they have no overseas operations.**

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Domestic Production Activities Deduction

- **The law and legislative history are especially favorable to agricultural and horticultural cooperatives:**
  - The deduction is available for most activities of agricultural and horticultural cooperatives, including income from marketing, processing, storage and handling (but not transporting) agricultural products
  - The deduction is also specifically available for manufacturing activities of supply cooperatives

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Domestic Production Activities Deduction

- **The law and legislative history are especially favorable to agricultural and horticultural cooperatives:**
  - Attribution rule for marketing co-ops: The qualifying activity of patrons who market agricultural or horticultural products through a cooperative is considered activity of the cooperative when it computes its "gross receipts" for purposes of the QPAI deduction. This attribution rule also applies to the determination of qualifying wages for the wage limitation.
  - Pass through: An ag co-op has the option to keep or pass-through all, some or none of the QPAI deduction to its patrons within the co-op's "payment period"

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Domestic Production Activities Deduction: Add-Back Rule

- **Agricultural cooperatives can compute their taxable income without regard to deductions allowed for:**
  – Qualified patronage refunds and redemptions of non-qualifieds
  – Qualified per-unit retains and redemptions of non-qualifieds
  – For Sec. 521 co-ops, special deductions for dividends on stock and patronage-based allocations of non-patronage income
- **So when computing it "taxable income" for purposes of the limitation on its Sec. 199 deduction, the co-op can add back all of these amounts to its actual taxable income**

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Domestic Production Activities Deduction: Add-Back Rule

- When computing per-unit retains to be added back when determining "taxable income" for purposes of the section 199 limitation, payments by agricultural marketing co-ops to producers for product delivered can be treated as "per-unit retains paid in money" (PURPIMs). [Numerous IRS Rulings]
- In the past, these were treated as a cost of goods sold, a deduction when computing taxable income. Now, like other qualified refunds and retains, they can be added back, increasing the amount of the taxable income limitation.

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Domestic Production Activities Deduction: Add-Back Rule

- PURPIMs must be reported properly as per-unit retains to be added back, including reporting them to patrons in Box 3 on the 1099-PATR
- This has no impact on taxable income at the patron level, as patrons have always had to include payments for products delivered to the co-op in taxable income

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Qualified Patronage Refund

COOPERATIVE		PATRON	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin (refund)	$100	Refund	$100
Taxable Income	$ 0	Taxable Income	$700

Domestic Production Activities Deduction: Computations

- **Let's look first at the $600 payment by the co-op to the patron for the crop produced by the patron. Under normal Sec. 199 rules, this is a "cost of goods sold" and subtracted from gross receipts when computing QPAI. And it is not includable in taxable income for purposes of computing the limitation. But for ag co-ops**:
  - Under the rule that allows marketing co-ops to attribute producer production to the co-op it becomes gross receipts at the co-op level
  - To prevent double counting, the patrons may not include this $600 payment in their QPAI
  - Under the regulations and IRS rulings, this $600 payment can also be added back as a PURPIM when computing taxable income at the co-op level

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Domestic Production Activities Deduction: Computations

- The $300 spent to process and market the patron product must be subtracted from gross receipts when computing QPAI.
- Assume that the co-op’s marketing, processing, storage and handling wages are included in this $300 and total $90.
- The $100 qualified patronage refund (both the cash distribution and any retained portion) can be added back when determining the co-op's taxable income for purposes of the limitation on the Sec. 199 deduction.

Domestic Production Activities Deduction: Computations

QPAI Computation

- The co-op's initial gross receipts are $1,000, the amount realized when it sells the goods made from patron product. This includes the $600 attributable to the co-op for the value of goods produced by the patron.
- To compute QPAI, subtract the cost of goods sold (the $600 for product delivered) and the $300 in expenses handling the product, to arrive at an initial QPAI of $100. Then add back the $600 attributable to product delivered by patrons, arriving at a QPAI of $700.

Domestic Production Activities Deduction: Computations

- **Taxable Income Computation**
  - The co-op has income of $1,000. It can deduct the $600 paid to the patron for product delivered, the additional $300 in expenses handling the product, and the $100 qualified patronage refund, so it has taxable income of $0.
  - But for sec. 199 purposes, it can add back the $600 paid for product delivered (as a PURPIM) and its $100 patronage refund, producing a taxable income amount for sec. 199 purposes only of $700, the same as its QPAI.

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Domestic Production Activities Deduction: Computations

- **Sec. 199 Deduction Computation**
  - The co-op multiplies the lesser of QPAI or taxable income ($700) by the applicable rate (6% of 2009, 9% for 2010 and beyond) to determine its deduction:
    - 2009 -- $700 x .06 = $42.00
    - 2010 -- $700 x .09 = $63.00
  - The wage limitation of $45 (50% of $90) will limit the co-op's QPAI deduction in 2010 to $45.
  - But the co-op still has no real taxable income, so what can it do with the deduction? Use the pass-through option to make the deduction available to the patron.

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Domestic Production Activities Deduction: Computations

Patron Taxation

- The patron must include in its taxable income:
  - The $600 received for product delivered to the co-op (reported as a PURPIM in box 3 of the 1099-PATR).
  - The $100 qualified patronage refund (reported in box 1 of the 1099-PATR).
- The patron is allowed to deduct the amount of the co-op's sec. 199 deduction passed through (with proper documentation and within the co-op's payment period, reported in box 6 of the 1099-PATR). But the patron can't include any of the $700 received from the co-op in its "gross receipts" when computing its own QPAI.

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Domestic Production Activities Income: Planning Issues

- **This presentation gives you the basics of the rules. In actual practice, there are many other issues to deal with, including:**
  - Allocations between patronage and non-patronage activities
  - Determining wages related to patronage v. non-patronage activities
  - Explaining the rules to patrons

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QUESTIONS ?

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