Choosing the Best Income Tax Status for Your Cooperative

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Farmer cooperatives should periodically review their business activities, income sources, and patronage distribution practices to determine if their current federal income tax status is best for them. In the constantly changing business environment of recent years, many cooperatives have found it advantageous to change their tax status.

The federal taxation of farmer cooperatives, as well as other corporations operating on a cooperative basis, is defined in subchapter T of the Internal Revenue Code. Subchapter T, which consists of sections 1381–1388 of the code, provides that in determining its taxable income, a cooperative may exclude certain patronage refunds. Patronage refunds are amounts paid patrons from the net income of a cooperative on the basis of quantity or value of business done with or for the patrons under a preexisting legal obligation. Subchapter T specifies the conditions patronage refunds must meet to be excluded from income.¹

Subchapter T also provides that certain cooperatives, commonly called “exempt” or “section 521” cooperatives, may deduct additional distributions from their taxable income as specified under section 521 of the code. Specifically, only cooperatives with section 521 tax status can deduct nonpatronage income

distributed to patrons on a patronage basis and dividends on capital stock from taxable income.\(^2\)

To qualify for section 521 tax status, a cooperative must meet the following requirements:

1. It must be a farmer, fruit grower, or similar association organized and operated on a cooperative basis to market farm products or provide farm supplies and equipment.

2. If organized on a capital stock basis, substantially all the cooperative’s voting stock must be owned by agricultural producers who market farm products or purchase farm supplies from it.

3. Dividends on capital stock are limited to eight percent per annum or the legal rate in the state in which the cooperative is incorporated, if greater.

4. The cooperative’s financial reserves must not exceed those that are necessary or required by state law.

5. The cooperative must conduct no more than 50 percent of either its marketing or farm supply business with nonmembers and no more than 15 percent of its farm supply business with nonproducers.

6. Nonmembers must be treated in the same manner as members with respect to business transactions such as pricing and the allocation of patronage refunds.

In choosing its tax status, a cooperative should consider these factors:

**Dividends on capital stock.** Section 521 tax status may be beneficial to cooperatives that pay substantial dividends on capital stock because it permits them to deduct dividends in determining taxable income.

**Nonmember and nonproducer business.** Cooperatives without section 521 status are not required to pay patronage refunds to nonmembers. Thus, cooperatives with substantial nonmember income may choose to increase permanent capital by retaining the after-tax earnings from nonmember business as unallocated equity. Cooperatives operating convenience stores or selling lawn and garden supplies to suburban homeowners may have difficulty complying with the limits on nonmember and nonproducer business imposed by section 521.

**Nonpatronage income.** In determining taxable income, cooperatives with section 521 status are allowed to deduct nonpatronage income distributed to patrons on a patronage basis whereas cooperatives without section 521 status must include it.

**Business activities.** Cooperatives with section 521 status are prohibited from engaging in nonfarm business activities. A cooperative might consider the benefits of engaging in other business activities as an advantage of not holding section 521 status.

**Effects on other cooperatives.** The tax status of a federated cooperative that pays dividends on capital stock can affect how its members are taxed on those dividends. On the other hand, it may be difficult for a federated cooperative to satisfy the section 521 restrictions on nonmember and nonproducer business if it has members that do not operate under section 521.

**Securities laws.** Cooperatives with section 521 tax status are exempt from the registration and prospectus requirements of federal securities laws.

**Record keeping costs.** Because cooperatives with section 521 status must maintain permanent records of the patronage and equity interests of both members and nonmembers, the costs of record keeping may be greater under section 521.

**Tax bracket.** The deductions under section 521 are more valuable the higher the cooperative’s tax rate.

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\(^2\) The term “exempt” is misleading because tax treatment under section 521 is not the same as under section 501, which exempts some organizations from paying federal income tax. Section 521 cooperatives often have taxable income.