



Tax Treatment for Cooperatives

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Article summarized by Travis West, Coordinator, Ohio Cooperative Development Center

Taxation

Taxes are a confusing issue for some people including members of a cooperative. Cooperatives pay taxes on real estate, personal property, sales, employment, utilities, etc. just like all other businesses. Cooperatives are single taxed like all other businesses except for C-corporations, which are double taxed at the entity and stockholder levels. The single tax treatment is not special to the cooperative structure, but the taxation of the patronage refunds is unique. The net margin (income – expenses) is NOT considered taxable income because it is returned to the patrons. The net margins are returned as patronage refunds and are taxed at the patron level in all situations.

The IRS Code Subchapter T regulates the cooperative's refund taxation policies. The patronage refunds must be returned based on patron use of the cooperative and the obligation to pay refunds must exist before the transactions take place. All returned patronage refunds must have been collected through patronage transactions with the cooperative patrons. Cooperatives can pay patronage refunds to members and/or non-members. All non-member income must be returned to non-members, but if the cooperative chooses to give patronage refunds to members only then the income from non-member business is taxed at the corporate tax level and retained in the cooperative.

Patronage Refunds

There are two ways to allocate patronage refunds: cash and cash plus written notice of allocation:

1. Cash involves returning all refunds with cash, but this method is rarely used because most cooperatives need some capital to operate with the following year.
2. Cash plus a written notice of allocation involves returning a portion of the refund in a non-cash capital investment form.

Members determine the amount of capital the cooperative needs to retain in order to meet its capital requirements for the coming year. The written notice of allocations can be qualified or nonqualified. Qualified allocations must meet one of three guidelines in order to meet the IRS Code:

- a) 20% of the refund must be in cash
- b) Patrons must be able to redeem the allocation in 90 days for its full face value
- c) Consent of the patron to include the total refund amount in their taxable income must be established. The obligation to consent can be enforced by

writing it into the bylaws of the cooperative, obtaining a written consent from the patron, or issuing a qualified check to the patron

If none of these conditions are fulfilled, the allocations are considered nonqualified and taxed at the cooperative level. Once the cooperative allocates the nonqualified refunds to the patrons, then the cooperative can deduct this amount from its taxable income in the year the allocation is returned as a rebate on the taxes it paid for the nonqualified allocation. The patron must include the nonqualified allocation in their taxable income for the year the refund was received. This proves that the cooperative structure has single taxation at the patron level all the time.

Per-unit Retains

There are many ways to finance a cooperative. Retaining a portion of the patronage refunds is a common way to maintain capital, but another common practice is to have per-unit retains. Per-unit retains are usually charged on services through the cooperative and are charged based on use. For example, some marketing cooperatives charge a certain amount for every bushel of corn that patrons sell through the cooperative. This set amount is subtracted from the seller's sales total and kept in the cooperative as a source of financing. Other cooperatives might charge a certain amount for each transaction a patron has with the cooperative. Per-unit retains can be qualified or nonqualified like patronage refunds and are taxed at the patron level if they are qualified with a certificate.

Patronage refunds and per-unit retains are often used interchangeably. They are two different ways for financing a cooperative that differ in how they are allocated. The per-unit retains are charged on a unit basis and patronage refunds are determined on the use of the cooperative by the patron as it relates to the net margin of the cooperative at the end of the year. The two structures are identical in the way they are taxed, but allocation is based on different parameters.