Cooperatives are subject to the same taxes as regular corporations-including social security, real estate, sales, personal property, excise and franchise taxes. The issue is cooperatives and federal income taxes. The cooperative principles, operating at cost, limited returns on equity capital and member ownership suggest a different tax treatment.

Federal income taxes were enabled by the 16th amendment (1913) – The Revenue Act of 1913. During the time frame of 1913-1951, all revenue acts asserted that “cooperatives were not required to pay income taxes on net margins that they distributed as patronage refund allocations (PRA’s).

The Revenue Act of 1951 had provisions intended to insure that all net margins of cooperatives would be subject to a single income tax, either at the cooperative level or patron level.

Finally, the Revenue Act of 1962 with its sub-chapter “T” authority was put in place. The Internal Revenue Title (Title 26 of the U.S. Code) Title 26-IR; Sub-Title “A” – Income Taxes (8 sub-titles); Chapter 1 –Normal Taxes and Sur-Taxes (6 chapters); Sub-Chapter “T”- Cooperatives and their Patrons. There are 21 Sub-Chapters, A-U. We are most familiar with Corporations Sub-Chapter C and Sub-Chapter S in addition to Sub-Chapter “T” which addresses cooperatives and their patrons.

Internal Revenue Service Code: Sub-Chapter “T”.

The current authority for cooperative taxation is Sub-Chapter “T”- applies to any corporation operating on a cooperative basis.

Under “T”, all income of the cooperative must be included in gross income in determining taxable income. (Member, non-member, non-patronage). The only net income of cooperatives not subject to income tax at the cooperative level is patronage refund allocations (PRA’s).

Qualified Allocations- i.e., allocations that qualify for not being reported by the cooperative, but must be reported by the patron if she/he agrees.

Patronage refunds can be distributed in 3 ways: 1) Pay patrons in cash (at least 20% of PRA’s issued each year must be in cash); 2) Pay patrons in equity certificates such as stock (not to exceed 80%) and 3) Pay patrons in property (not usually done) – not over 80%.

NOTE: Patrons must agree to report the total PRA’s as current income. When the equity certificates are redeemed at a later date, no additional income taxes are due. Usually the cooperative will pay more than 20% cash to cover the tax bill on the total PRA.

Member consent can be given in three ways: 1) Members agree in writing; 2) The cooperative’s by-laws state that membership constitutes consent; 3) Member endorses and cashes a patronage refund check.
that includes a written statement granting consent. NOTE: Unallocated profits are taxed at the cooperative level at the corporate tax rate. Profits paid as dividends on equity are double taxed (at the cooperative level and the stockholder level).

Section 521 (exempt cooperatives).

Section 521 Code is part of the 1954 Revenue Act which allows certain additional deductions from taxable income. Section 521 should not be confused with Section 501Code which regulates non-profits (including some utilities and credit unions). The two major additional deductions are: 1) non-patronage income (e.g., rent and interest earned on bank deposits) and income from non-member business distributed to members on a patronage basis; and 2) dividends paid on capital stock.

Currently, most cooperatives are non-exempt (“T” cooperatives) rather than 521 (exempt cooperatives) because the rules are very strict for qualifying as an “exempt” cooperative. There are several qualifications but three are fundamental: 1) Must be an agricultural marketing or supply cooperative; 2) Non-members must be treated the SAME as members in ALL ways, including the allocation of patronage refunds; and 3) the 50-50-15 rule: Non-member business activities: a) marketing cooperatives – at least 50% of the business must be done with members; supply cooperatives – at least 50% of the business must be done with members and not more than 15% of the business with non-members who are also non farmers.

Some factors to consider in choosing the “T” or 521 status:

1) Proportion of member vs. non-member business; 2) Type of financial organization (stock vs. non-stock); 3) Non patronage income (exempt cooperative does not pay taxes on allocated non-patronage income); 4) Size of net income – with the progressive tax schedule, exempt favors the higher income cooperative; 5) Additional non-member business activities (50-50-15 rule can be restrictive); 6) Effect on other cooperatives – primary application on a federation, all member cooperatives must be exempt for the federation to be exempt.

Per Unit Capital Retains (PUCR’s). Marketing cooperatives may assess a fee (cents per bushel or cwt.) for operating or growing the cooperative. These fees are usually deducted from the proceeds that the member receives. These retains then can be allocated or unallocated. If unallocated, the cooperative pays corporate income tax in the year earned. If allocated and there is member consent, the member pays tax on the retained allocation in the year earned. Unlike patronage refunds, the IRS does not require 20% of the PUCR to be paid in cash.

Consumer Cooperatives - Income tax is due on patronage refunds if they relate to a business activity such as feed or fertilizer purchases which are tax deductible farm business expenses. The refund is viewed by the IRS as a savings in these expenses and must be included as taxable income. However, household expenditures such as food purchases are not tax deductible. Therefore, any patronage refunds from consumer cooperatives (e.g., food cooperatives) are not considered taxable income for members.