MEMORANDUM REGARDING COOPERATIVE ASSOCIATION ACT

Date: January 26, 2006
Re: Issue Discussion: Status of a Cooperative Association under various other statutes

BACKGROUND

In numerous discussions of the Committee, it has been observed that it is important to maintain the qualification or exemption status available to traditional cooperative organizations for Cooperative Associations that would be created under the Uniform Cooperative Associations Act (the "Act"). This Memorandum is intended to focus those issues without being an in depth research report regarding any of them. It will identify some of the relevant federal statutes and pose an issue under each of them and will provide, as an example, a bit more discussion of the application of Subchapter T of the Internal Revenue Code that is probably reflective of an approach to analysis that would be undertaken under other statutes.

A THOUGHT FOR CONSIDERATION

Despite a desire on the part of some people to try to preserve qualification or exemption requirements for Cooperative Associations under the Act, some Commissioners, advisors and observers have said that is not likely to happen with organizations organized under the Act. A bit of research suggests there are reasons to believe this may not be correct.

EXAMPLE RELEVANT STATUTES

This Memorandum focuses, for illustration, on the question of whether an entity will qualify for a qualification or exemption under statutes based on the quantity of business done by the entity with members and patrons. It does not look at other requirements for qualification or exemption, such as whether the entity is required to allocate and distribute patronage refunds, whether the entity has one member-one vote, whether the entity must be involved in agriculture and its members be agricultural producers, whether patron members are the only ones allowed to vote, whether an entity must be a corporation. Each of these items could make a difference as to how an entity would be treated for purposes of a particular statute.

The following five (5) statutes have a quantitative requirement:

(1) 7 U.S.C. § 291 (quantitative requirement in definition of cooperative in Capper-Volstead federal antitrust exemption);
(2) 12 U.S.C. § 1141j(a) (quantitative requirement in definition of cooperative for farm credit purposes);
(3) 12 U.S.C. § 2129 (quantitative requirement in definition of cooperative for borrowing from bank for cooperatives);

(4) 49 U.S.C. § 303(b) (quantitative requirement in definition of cooperative for ICC exemption); and
(5) 12 U.S.C. § 3015 (§ 105(a), Pub.L. 95-351, 92 Stat. 499, 506 (August 20, 1978)) (quantitative requirement in definition of cooperative in National Consumer Cooperative Bank Act).

Taken from *Conway County Farmers Association v. U.S.*, 588 F.2d 592, 1978 U.S. App. LEXIS 7273, 78-2 U.S. Tax Cas. (CCH) P9840, 42 A.F.T.R. 2d (RIA) 6323.

Generally, in each of the statutes noted, for an entity to be a "cooperative" for purposes of the statute, it must conduct a specified quantity of business (usually more than 50%) with members and/or patrons than with non-members.

Thus, if a Cooperative Association were structured and operated to conduct the required quantitative amount of business with members/patrons than non-members, it would meet the required qualification on this test. *For this purpose only*, outside investment in the entity is not relevant although it may be for voting requirements and other requirements.

SUBCHAPTER T

From a federal income tax standpoint, the Internal Revenue Service took the position that to be "a corporation operating on a cooperative basis" under Subchapter T (§1381(a)(2)) required the corporation to conduct more business with members and patrons than with non-members. Rev. Rul. 72-602, 1972-2 Cum.Bull. 511. The Service did not prevail on this requirement in three cases:

Conway County Farmers Ass'n v. U.S., 588 F.2d 592 (8th Cir. 1978)
Columbus Food & Veg. Coop v. U.S., 7 Claims Ct. 561 (1985)
Geauga Landmark, Inc. v. U.S., #81-942 (Nor. Dist. Ohio 1985)

As a result, the Service dropped this requirement and has said the "member/patron" portion of a cooperative corporation's business and patronage refunds resulting from it could receive patronage refund treatment under Subchapter T but the net profits/losses from the non-member/patron business would be taxable in the same manner as a non-cooperative corporation.

"Whether a nonexempt cooperative is entitled to the benefits of Subchapter T depends upon the finding that it is 'operating on a cooperative basis' under 26 U.S.C. §1381(a)(2)." Geauga Landmark, Inc., *supra*, p. 7. This determination obviously needs to be made on a case by case factual basis.

It should also be noted that while doing less than 50% of its business with members/patrons might not disqualify a Cooperative Association from "operating on a cooperative basis" for Subchapter T, it would not permit it to use the 9-1/2 month period following its taxable year to file its income tax return under IRC §6072(d). *Conway County Farmers Association*, *supra*, 588 P.2d at 600.

THE POINT

The point of this is the Cooperative Associations Act could hardwire a result but in doing so it could eliminate the flexibility of the statute. It is likely the ultimate results will need to be left to practitioners and users of the Act to craft structures that will obtain the benefits of various other statutes if they desire to do so. This may require knowledge and skill and leave a trap for the unwary, but to accomplish the goal of creating the Act, this may be something that will need to be. It may ultimately require administrative determinations and rulings for final guidance to be provided.

Tom Geu and Jim Dean