

TO: Peter F. Langrock, Chair  
Study Committee on a Business Cooperative Act  
CC: William H. Henning, Executive Director, NCCUSL

FROM: Tom Geu, Reporter

DATE: June 20, 2003

RE: Briefing and Discussion Memorandum Prepared for the NCCUSL  
Study Committee on a Business Cooperative Act

### COMMITTEE CHARGE & BACKGROUND

The NCCUSL Executive Committee adopted a resolution at the 2002 Annual Meeting in Tucson authorizing the formation of a Study Committee on a Business Cooperatives Act. The Executive Committee adopted a resolution recommended by the Committee on Scope and Program. The text of the Resolution charges the Study Committee "to review state cooperative law, with an initial charge to contact potentially interested groups...to evaluate the viability, need, and support for such a project." The Executive Committee's Resolution also added that "the initial scope of the study authorized by the resolution be limited to farm and related cooperatives."

Commissioner Peter F. Langrock is Chair of the Study Committee. Tom Geu, Professor of Law at the University of South Dakota School of Law was appointed Reporter of the Study Committee in Spring 2003.

### PURPOSE OF MEMORANDUM

The purpose of this memorandum is to provide basic substantive background to the Study Committee including a brief introduction to the cooperative industry, discuss the basic legal structure currently governing cooperatives; highlight selected recent legal developments in the substantive law of cooperatives; begin to identify drafting parameters and considerations concerning business cooperative statutes; and, identify possible interested parties to the project, report preliminary contacts with selected parties, and delineate the status of ongoing research on behalf of the Committee.

Some of the information in this memorandum is based on Mark Hanson, "Legal Framework of Cooperative Development," Ch. 5 *Cooperatives and Development: Theory and Application for the 21<sup>st</sup> Century* (in press); McDavid, "Evolving Cooperative Structures," *National Counsel of Farmer Cooperatives* (Speech, 2002); Cook and Iliopoulos, "Beginning to Inform the Theory of the Cooperative Firm: Emergence of the New Generation Cooperative" *Financial Business Journal* (Issue 4, 1999); McEowen and Harl, *Taxation of Cooperatives, BNA Tax Management Series* (looseleaf updated through 2/2003). These sources are cited herein only where quoted. Other sources not in this preliminary listing are footnoted. Further, Israel Packel, *The Organization and Operation of Cooperatives* (AI-ABA 1970) remains one of the classic treatments of cooperatives. Much information is also derived from multiple telephone conferences with persons identified in a later portion of the article. General information is taken from selected web sites, current news articles and press releases. Those desiring another overview of the law, taxation, and operation of cooperatives might see Donald

Fredrick, *Co-ops 101: An Introduction to Cooperatives* (USDA Cooperative Information Report 55, 1997) which was used, too, in the preparation of this memorandum.

### EXECUTIVE SUMMARY

The cooperative industry includes farmer, consumer, finance, purchaser, and producer cooperatives among many others. Moreover, the law of cooperatives is in flux. The Wyoming Processing Cooperative Law went effective in 2001; the Minnesota Cooperative Associations Act was passed this legislative session; and an Act similar to the Minnesota Act was introduced in the Wisconsin legislature. Additionally there appears to be renewed interest in cooperative businesses in the federal legislative branch of government and within the federal executive branch in part, because globalization may require larger entities; because of the change in farm subsidy programs; and, because cooperatives may still represent one of the best forms of economic development in rural (and other) areas.

In addition to the new Wyoming and Minnesota Cooperative Acts, several states have reportedly consolidated some of their various special purpose cooperative statutes into a more coherent and centralized legislative scheme in the past decade. Nonetheless, there is a marked lack of uniformity in state cooperative statutes even though a substantive trend *may* be developing toward the adoption of broader and more general state cooperative statutes that are more flexible than the traditional cooperative statute.

Undeniably, however, the "New Generation Cooperative" is the favored form for new cooperatives. New Generation Cooperatives (NGCs) include some combination of features not typical of traditional cooperatives. These nontraditional features include appreciable equity shares which may or may not be transferable; limited but real opportunity for outside equity investment; legally binding delivery contracts or uniform grower agreements which may or may not be transferable; minimum up-front equity investment by members, and closed membership. All these features reflect identified theoretical economic inefficiencies in the operation of traditionally organized cooperatives. Indeed one of the primary driving forces for NGCs is the need for equity capital to build capital intensive processing and manufacturing facilities. The adoption and use of nontraditional features by cooperatives often requires organizing under state LLC laws rather than under state cooperative laws and being taxed as a partnership rather than as a corporation under Subchapter T of the Internal Revenue Code.

Organizing cooperatives under state LLC laws, however, comes at a cost caused in part by differing definitions of cooperatives in other laws. It also raises issues about registration of nontraditionally organized LLCs doing business in states other than their state of organization. Moreover, there may be some embedded efficiencies under current statutes for selected industries. One way of categorizing the cooperative industry might be to distinguish those traditionally taxed for federal income tax purposes under Subchapter T with those taxed under § 501. There are many other ways to categorize kinds of cooperatives in addition or in lieu of, the income tax categorization. Finally, some of the defining principles of cooperatives, for example the "Rochdale Principles," are not reflected by the law of other entities though the principles may still govern an organization by their addition to the organic documents of the LLC or other organization.

### THE COOPERATIVE INDUSTRY

Cooperatives are major players in the national economy. For example: (1) the net business value of agricultural cooperatives in 2000 was \$99.7 billion; (2) there are 3,346 agricultural cooperatives marketing about thirty percent of farmers' products in the United States; (3) more than twenty cooperatives have annual sales in excess of \$1 billion; (4) retailer-owned food and hardware cooperatives make it possible for independent store owners to compete with large "chains"; (5) cooperative health maintenance organizations (HMOs) provide health care services to nearly 1.4 million people in the United States; and (6) more than 48,000 different cooperatives provide more than 120 million people with a wide range of goods and services and nearly forty percent of the U.S. population belong to a cooperative.<sup>1</sup> Moreover, a study published by the United States Department of Agriculture (USDA) reported that "new-generation and traditional co-ops have major beneficial impacts on rural communities."<sup>2</sup> An official summary of the Report states:

During the 1990s, more than 50 new cooperatives were established in the Upper Midwest, with most of them based in rural communities. This surge of interest in forming new-generation cooperatives (NGCs) is creating spin-off economic benefits to the communities where these businesses locate.<sup>3</sup>

The study focused only on the Midwest during late 1997 and early 1998.

"New generation cooperatives" (NGC) are discussed in greater detail later in this memorandum (see, *infra*, "Recent Legal and Economic Developments"); however, a case study illustrates the organizing principles of the NGC and its potential economic benefit to members and the community.

One of the most successful and well-known value-added agricultural cooperatives is Dakota Growers Pasta Company (DGPC) which is owned by approximately 1,000 farmers in North Dakota, Montana, and Minnesota. It began operation in a \$40 million pasta factory near Carrington, North Dakota in 1993. By 1995 it produced about 100 million pounds of its own branded pasta in fifty different varieties. It doubled its capacity in 1997 with a \$5 million plant expansion funded, in part, by the sale of equities. In 2001 it purchased two processing plants near Minneapolis and, again, expanded its production facility at Carrington.

The plant has provided premium prices to farmers, created almost 200 jobs in Carrington, and earned farmer-members a twenty percent annual return through 1995. In 1999 the shares, which were originally issued at \$3.85, were worth approximately \$10.<sup>4</sup> Obviously, not all NGCs (or even most of them) have achieved this kind of success. Nonetheless the DGPC cooperative is an example of the NGC model.

Cooperatives are limited neither to agriculture nor marketing and may be categorized several ways. A few of the most important are by geographical territory served, by governance system, and by the function served.<sup>5</sup> Geographical territory categorization is based on the area served and the best known categorization scheme includes local, super local, regional, national and international. For geographical categorization purposes "super local" cooperatives typically serve an area of two or more

<sup>1</sup> National Cooperative Business Association website, [www.ncba.coop/stats.cfm](http://www.ncba.coop/stats.cfm) (last visited 6/10/2003).

<sup>2</sup> "Generating Rural Progress: A Summary of USDA/RBS Research Report 177" at [www.rurdev.usda.gov/rbs/pub/aug00](http://www.rurdev.usda.gov/rbs/pub/aug00) (last visited 4/23/2003).

<sup>3</sup> *Id.*

<sup>4</sup> New Generation Cooperative Case Studies Expanded 2001, p. 27 (Illinois Institute for Rural Affairs).

<sup>5</sup> Frederick, *Co-ops 101: An Introduction to Cooperatives*, Cooperative Information Report 55, p. 20 (USDA, Rural Business-Cooperative Service, 1997) (hereinafter "*Co-ops 101*").

counties and frequently have several branches within that territory while "regional cooperatives" serve an area anywhere from a few counties to one or more states.

Cooperatives are also categorized by governance system (or membership structure). This categorization includes division between and among centralized cooperatives, federated cooperatives and mixed cooperatives. The "centralized cooperative" has individuals and other business entities as members. "Federated cooperatives," on the other hand, have other cooperatives as members:

Local cooperatives commonly form federateds to perform activities too complex and expensive for them to do individually, such as manufacturing production supplies, tapping major financial markets, and marketing on a national or worldwide scale.<sup>6</sup>

"Mixed cooperatives," unsurprisingly, have a mixture of membership which may include either individuals or other non-cooperative entities *and* other cooperatives.

The most detailed categorization system is based on function performed. The basic functional types include marketing, purchasing, and service provision but each of the basic functional types may be subdivided much further.<sup>7</sup> Most marketing cooperatives involve some portion of a broadly defined agriculture industry. Nonetheless: "New marketing ventures are developing in such diverse industries as handicrafts, professional services and information technology."<sup>8</sup>

*Marketing cooperatives* may negotiate favorable prices for members, serve as "first-handlers" by aggregating bulk produce for sale, or further process or manufacture goods from the basic product or commodity (value-added processing cooperatives). Some marketing cooperatives process and brand products and integrate all processes including delivery to grocery or other retail or consumer cooperative stores. Examples of the cooperatives engaged in processing, branding, and distribution include Land O'Lakes, Ocean Spray, Tree Top, and Welch.

In addition to providing farmers' supplies like fertilizer, fuel and feed; *purchasing cooperatives* include many well known non-farm business purchasing cooperatives like True Value, Ace Hardware, IGA, and Shurfine Foods. Restaurant purchase cooperatives have been established for franchisees in the Burger King, KFC and Popeyes organizations and Wendy's franchisees use a financing cooperative. Finally, one of the fastest growing areas is pharmaceutical purchasing for hospitals and independent pharmacies.

*Service cooperatives* apply fertilizer for farmers and provide electricity and telephone service. According to the USDA:

Nonagricultural service cooperatives are also flourishing. Credit unions and the National Cooperative Bank provide credit on a cooperative basis to nonfarm individuals and cooperatives. School systems,

<sup>6</sup> *Id.* at 21.

<sup>7</sup> A slightly different functional classification includes the following categories; Marketing Cooperatives; Business Purchasing Cooperative; Worker's Productive Cooperatives; Financial Cooperatives; Insurance Cooperatives; Labor Unions; Trade Associations; Self-Help Cooperatives; and, Consumer Cooperatives. Consumer Cooperatives, in turn, include consumer stores; housing cooperatives; condominiums; electric, telephone and other utility cooperatives; and health cooperatives. Packel, *The Organization and Operation of Cooperatives* p. xv (1970).

<sup>8</sup> *Co-ops* 101, *supra* note 5, at 21.

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health care providers, and insurance buyers are among the general public segments making use of service cooperatives.<sup>9</sup>

Insurance service cooperatives are sometimes known as cooperative health alliances and such alliances have been formed by employers in Seattle, Memphis, and Sacramento, among other cities. Direct health care is provided by HMOs.

Finally, for purposes of categorization, there is another "old" kind of co-op that is more popular in Europe than the United States. It is the "Workers' Productive Cooperative" which in some ways resembles the operation and function of an Employee Stock Ownership Plan (ESOP). "Workers' is broadly defined to include professionals

### THE BASIC (AND TRADITIONAL) LEGAL STRUCTURE OF COOPERATIVES IN THE UNITED STATES

There are many similarities between cooperatives and other forms of business. Thus, cooperatives organize under state statutes. Historically these statutes generally tracked the law governing corporations in the various states. Typically, therefore, cooperatives have articles of incorporation, bylaws, and a board of directors elected by its members. Cooperative statutes frequently expressly refer to either the state's general business corporation act or its not-for-profit corporation act to fill statutory gaps that may arise under the cooperative act. Many states have both "stock" and "nonstock" cooperative statutes.

A key distinction between cooperatives and other forms of business organizations is that a cooperative distributes its income to a particular member in accordance with the member's use (patronage) of the cooperative's services. Indeed, one source flatly states: "The primary function of a cooperative is the allocation of economic benefits, either in the form of net savings or net earnings, to the member-patron based on the quantity of business done with the member-patron."<sup>10</sup> This function, "is consistent with the goal of maximizing members' interests and the notion that the cooperative is an extension of the members' business operations."<sup>11</sup> The following illustrates this principle in the context of a commodities marketing cooperative:

To accomplish this objective, a cooperative attempts to market patrons' commodities at the highest possible price and purchase quality inputs at the lowest possible cost. The resulting savings (usually referred to as net income rather than profits) belong to the patrons and are distributed to them at least annually, usually in the form of patronage refunds, though not necessarily all in cash. Typically, at least 20% is paid out as a cash patronage refund and the balance is invested in the users name as a retained patronage refund. The retained portion is redeemed at a later time, usually when the user has stopped using the cooperative.<sup>12</sup>

The focus on patronage as a metric for the allocation of net income delimits the amount of income and other sources of distribution from other sources available to pay for the use of capital and, sometimes, state statutory law limits dividends paid on account of equity contribution (return on capital) to 8 percent (although 8 percent is important for anti-trust and not tax reasons).

<sup>9</sup> *Id.* at 23.

<sup>10</sup> McEowen and Harl, *Taxation of Cooperatives*, BNA-Tax Mgmt. Series at 3.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 3-4.

The focus on returning income and savings based on patronage is consistent with the historical values of cooperatives. The foundation of the law is the "Rochdale Principles." The "Rochdale Principles" originated with the Rochdale Equitable Pioneers Society in 1844. The Society was an English workers society and it established twelve principles; which have coalesced into four generally accepted principles. These principles are: "(1) business at cost with net returns paid to members based on patronage; (2) democratic control, one person, one vote; (3) limited dividends on invested capital; and (4) ownership (or beneficial membership) limited to patrons."<sup>13</sup> The Rochdale Society ran a store (consumer cooperative) and it might be safe to assume that the store was not capital intensive.<sup>14</sup>

State statutory provisions are generally consistent with these general principles (no matter of their exact formulation). Thus, for example, state statutes variously govern the voting rights of members. It is fair to say that most statutes provide for voting based on the one member – one vote principle. That is, each member has one vote regardless of the amount of patronage by that member in the current or preceding year and regardless of the amount of capital either contributed by that member or allocated but retained in the member's equity account. Such a voting scheme is similar to default voting in the Uniform Partnership Act (both 1914 and 1997). Some states, however, provide for outside investment by allowing the issuance of preferred stock with very limited governance and dividend rights.

Moreover most statutes allow for open use by non-members of the cooperative. Net income derived from nonmember use is sometimes called "non-member patronage." Other miscellaneous and variable provisions in state statutes strictly govern board membership (to "members" and, sometimes but rarely, to citizens or residents of specific states or municipal subdivisions); capital retention requirements (Missouri's stock cooperative, for example, requires retaining ten percent of the net income until the retained fund equals fifty percent of the paid-up capital stock); limitation on dividends (again, Missouri stock cooperatives contain such a restriction); and, limiting membership to a specific occupation (agricultural producers). Some statutes require ten or more *incorporators* and, reportedly, a few states require new agricultural cooperatives to, in effect, receive permission from individuals holding specific titular positions in the state's land grant college.

According to Mark Hanson: "The non-uniform development of agricultural cooperatives and cooperative law has resulted in significant variations in state cooperative statutes many of which were

<sup>13</sup> Hanson, "Legal Framework of Cooperative Development," Ch. 5 *Cooperatives and Development* at 1 (in press). There is some slippage as to the number of principles. For example, J. Gary McDavid listed eight principles as the Rochdale Principles in a speech in 2002: (1) Open membership; (2) Democratic control based on one vote per member; (3) Fixed low rate of interest on invested capital; (4) Patronage refunds; (5) Cash trading; (6) Goods sold at retail, not wholesale, prices; (7) Promotion of education; (8) Political and religious neutrality.

The International Co-operative Alliance defines a cooperative as, "an autonomous association of person united voluntarily to meet their common economic, social, and cultural needs and aspirations through jointly-owned and democratically-controlled enterprise." It has generated a values statement of its own as follows: "Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others." Finally the Alliance lists seven co-operative principles similar to those already set forth. Two of the principles, however, are somewhat unique in their emphasis. One of the two is that cooperatives "serve their members most effectively...by working together through local, national, regional, and international structures." The other is cooperatives "work for the sustainable development of their communities through policies approved by their members."

<sup>14</sup> Hanson, *supra*, at 1.

enacted from 1910 to 1925. In fact, few states have the same cooperative statute."<sup>15</sup> William H. Henning, NCCUSL Executive Director, briefly outlined the Conference history concerning cooperatives in a memorandum to the Joint Editorial Board on Uniform Unincorporated Organization Acts dated November 18, 2002. Therein he succinctly stated:

[I]n 1936 NCCUSL promulgated a Uniform Agricultural Cooperative Association Act...that was especially designed for producers of agricultural products (The Act was adopted, with modifications, in Utah, and declared obsolete by the Conference in 1944.). The procedures for organizing a cooperative under the uniform act were consistent with the procedures for organizing ordinary business corporations, but stock ownership was limited to members and there were restrictions on the payment of dividends.

The United States Department of Agriculture developed a model non-stock cooperative act in 1927. Approximately seven states adopted that *suggested* model. The most widely adopted national model for commodity marketing purposes, however, was known as the Bingham Act which predated the USDA model. It was adopted in Kentucky, for example, in 1922 and is sometimes referred to as the "Standard Act."<sup>16</sup>

The variety of state cooperative statutes is evidenced by an obviously stale, but still useful, book written by James Baarda and published by the United States Department of Agriculture (USDA) in 1982. It is titled *State Incorporation Statutes for Farmer Cooperatives* and, as the title indicates, it is limited to those statutes applicable to farmer cooperatives. Current secondary sources and conversations with individuals actively involved in cooperative law by this Reporter confirm that, with the exception of recent legal developments introduced in the following section, much of Baarda's analysis remains valid for the current purposes of illustrating variety in state law.

Even though Baarda analyzed 86 statutes, he cautioned that his selections do "not include all statutes that may be actually used by associations, and includes some that may not be available under most circumstances."<sup>17</sup> Thus, the analysis neither includes general corporation statutes nor nonprofit association laws even though, according to Baarda, those "statutes are occasionally used for incorporation of farmer cooperatives...."<sup>18</sup> Important for current purposes, Baarda's preface lists two pages of non-state specific comparative "Highlights" which are reproduced and attached as Appendix A to this memorandum. Indeed, the information contained therein might be some of the most relevant information presented in this memorandum. For illustrative purposes only, the "Highlight" concerning the financial structure and operation of cooperatives (circa 1982) is set forth below in its entirety:

Financial structure and operation of cooperative associations are addressed by a majority of statutes, though the detail with which financial subjects are described varies widely. Some statutes apply only to nonstock associations, but most apply to cooperatives with or without capital stock. Subscription, payment, limits on ownership, and limits on transfer of membership stock are common statutory provisions. Preferred stock is noted in a majority of statutes. Other aspects of capital structure noted in many statutes are: Number of shares and their value, limits on capital stock dividends, reserves, and stock redemption.<sup>19</sup>

<sup>15</sup> *Id.* at 8.

<sup>16</sup> Hanson, *supra* note 13, at 5.

<sup>17</sup> James R. Baarda, *State Incorporation Statutes for Farmer Cooperatives*, 30 U.S.D.A. COOPERATIVE INFORMATION REPORT at 2 (1982).

<sup>18</sup> *Id.* at 3.

<sup>19</sup> *Id.* at xiii.

Interestingly Baarda suggested that, "[i]n a few States, cooperative provisions are structured so identification of separate statutes is difficult; one, two, or three statutes may be involved in one cluster of cooperative principles."<sup>20</sup> Appendix B contains Baarda's summary list of statutes by state. The numbers in parentheses following the name of the state indicate the number of statutes selected and analyzed for that state. It cannot be overemphasized that the statutes listed in Appendix B (like the "Highlights" in Appendix A) should *not* be considered current and are set forth for the limited purpose of evidencing the variety of state cooperative law structure and approaches.

The cooperative acts upon which most cooperatives in the United States are built date from mid-twentieth century and, therefore, it is probably reasonable to assume that there has been a lock-in effect with other sources of law and regulation that effect cooperatives. Several sources of other law are briefly highlighted in a subsequent section of this memorandum. It is probably helpful, however, to briefly discuss the basic current income taxation of cooperatives here even though tax law, at best, is an indirect source of cooperative law. The reason tax law might be particularly relevant is because the daily operation of cooperatives is often coordinated and constrained by the unique interaction of state law and the tax treatment of cooperatives. Therefore tax law provides an important part of the current context in which the state law of cooperatives is evolving even though any thumbnail outline of this area of taxation probably raises more questions than it answers.

The federal income tax of many, but not all, cooperatives is found in Subchapter T of the Internal Revenue Code (§§ 1381 *et seq.*). Subchapter T governs the taxation of most farmers cooperatives including *exempt farmer cooperatives* under IRC § 521. Nonetheless, the cooperative need not be a farmer cooperative to be governed by the general provisions of Subchapter T. That is, as a general matter, "[a]ny business 'operating on a cooperative basis' uses Subchapter T when computing its tax liability."<sup>21</sup> There are, however, exceptions to the general statement. Indeed, Subchapter T expressly excludes utility cooperatives (rural electric and telephone cooperatives taxed under § 501(c)(12)). It also expressly excludes mutual savings banks, mutual insurance companies and cooperative housing corporations.

Perhaps the most efficient way of explaining the general taxing scheme of Subchapter T is simply to quote the two introductory paragraphs from the BNA Tax Management Portfolio on the subject:

In general, earnings of a cooperative flow through the cooperative to the patrons, with the cooperative not retaining any margins as profit. Thus, earnings are taxed only once. The tax is ultimately paid by the cooperative patron, although under some circumstances, the cooperative pays tax on a temporary basis, then receives a deduction when the money is finally passed on to the patron. The rule of single taxation, however, only applies if business income sources and distribution methods are "cooperative" in nature. Earnings derived from nonpatronage sources and margins not distributed in accordance with the Code are generally ineligible for single-level tax treatment.

Upon the satisfaction of certain statutory conditions, cooperatives treat retained patronage refunds and per-unit retains as if the funds retained had been paid to the patron, deducted by the cooperative, accounted for in the patron's income as ordinary income, then invested in the cooperative. Conditions for this tax treatment include agreement by the patrons to recognize full patronage refund for tax purposes even though not received in cash or negotiable form.<sup>22</sup>

<sup>20</sup> *Id.* at 3.

<sup>21</sup> *Taxation of Cooperatives*, *supra* note 10 at 7 (citing IRC § 1381(a)(2)).

<sup>22</sup> *Id.* at 5-6.



Taxation under Subchapter T, therefore, is a variant on regular corporate tax provisions and could be seen *in approach* as roughly) analogous to the way S corporation tax provisions vary the regular corporate tax scheme for electing small business corporations.

Cooperatives eligible to be taxed as *exempt* farmer cooperatives under § 521 receive a couple of tax benefits in addition to the benefits more generally afforded to cooperatives under Subchapter T. The label "exempt" is a misnomer because "exempt" farmer cooperatives are *not* exempt from income taxation but, rather, are allowed deductions for distributions on capital stock (as compared with patronage-based distributions) and for patronage-based distributions of nonpatronage dividends.

Eligibility for the § 521 exemption has several specific requirements and limitations some of which reference underlying state governing law. For that reason § 521 is attached as Appendix C to this memorandum. One of the requirements, as set forth in § 521 (b)(1), mandates that the organization must be "a farmers', fruit growers', or like association organized and operated on a cooperative basis... for the purpose of marketing the products of members or other producers... or ... for the purpose of purchasing supplies and equipment for the use of members or other persons..."

Finally, as previously mentioned, other kinds of cooperative organizations are "truly" exempt (but not necessarily charitable; charitable status allows for deductibility of donations by a contributor) under IRC § 501. These exempt organizations must pay tax on such things as unrelated business income but are taxed separate and independent from treatment under Subchapter T. Selected provisions from § 501 appear in Appendices D and E in their entirety.

#### A SELECTED LIST OF OTHER LAWS AND SERVICES RELEVANT TO COOPERATIVES

State law is not the only law that shapes cooperatives. Anti-trust, federally encouraged debt financing, and an exemption from securities regulation are important features in the cooperative law landscape.

The Capper-Volstead Act was enacted by Congress in 1922 providing an exemption from anti-trust enforcement. "Cooperatives" are defined narrowly for purposes of the exemption. The definition includes, generally, farmer cooperatives "that limit membership to agricultural producers, restrict voting to one vote per member or limit dividends on equity to 8 percent per year, and handle products for members that exceeds the value of the products handled for nonmembers."<sup>23</sup>

The Farm Credit System is important for two reasons. *First*, it is organized as a cooperative under federal law. *Second*, and more relevant for current purposes, it includes elements specifically designed to loan to cooperatives. CoBank, ACB and St. Paul Bank for Cooperatives provide about 80 percent of the lending to farmer cooperatives. In 1997 these organizations had about \$11 billion in outstanding loans to farmer and rural utility cooperatives.<sup>24</sup> Rural electric and telephone cooperatives have also had access to funds from the National Rural Utilities Cooperative Finance Corporation. Finally, the National Cooperative Bank (NCB) "has become a leader in providing development

<sup>23</sup> Hanson, *supra* note 13 at 4.

<sup>24</sup> *Co-ops 101*, *supra* note 5 at 8.

funding for new, non-agricultural cooperatives and in devising methods of attracting outside capital to leverage its investments."<sup>25</sup>

The exemption from securities registration, too, has eased the cost of capital formation for farmer cooperatives. Generally, this exemption is from the provisions of the Securities Act of 1933 and is available only to farmer cooperatives exempt from taxation under § 521 of the Internal Revenue Code. It is, however, a limited exemption. Indeed one of the most famous cases construing the definition of a security is *Reves v. Ernst & Young*, 494 U.S. 56 (1990), which involved the sale of demand promissory notes to both members and nonmembers (and that were found to be securities).

Finally the USDA's a Cooperative Services unit is part of its Rural Business-Cooperative Service within the Rural Development Mission Area. Ways in which Cooperative Services assist cooperatives include development assistance, technical assistance, education, research, and grant programs that fund cooperative research and educational efforts. The grant programs *might* be a source of funding for this NCCUSL project if it goes forward into the drafting stage.

### RECENT LEGAL AND ECONOMIC DEVELOPMENTS

In the late 1980's and 1990's, Minnesota, Colorado and Ohio redrafted their cooperative statutes.<sup>26</sup> The recodification of Minnesota's cooperative statutes is instructive: "In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute" in 1989.<sup>27</sup> Moreover, Hanson states that "many" states loosened the statutory restrictions in their commodity marketing acts to allow nonagricultural producers to form cooperatives. Again according to Hanson, "[t]he modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer cooperatives."<sup>28</sup>

A major part of this renewed interest in cooperative business organizations and cooperative organization statutes is the evolution of value-added agricultural cooperative illustrated by the case vignette, *supra*, in "The Cooperative Industry" portion of this memorandum. A book published by the Illinois Institute for Rural Affairs delineates this evolution as follows:

The development of cooperatives in the Upper Midwest from the 1970s through the 1990s provides vivid examples of several new phenomena and trends. Among the most important are the New Generation Cooperatives (NGCs). The term, used since the mid-1990s, was proposed by the Centre for the Study of Cooperatives, University of Saskatchewan, Canada [citation omitted]. These NGCs represent the newest wave of U.S. co-ops. While earlier generations had emerged in the 1900s, the 1920s, and again in the 1940s, NGCs have several features that distinguish them from traditional farmers co-ops.<sup>29</sup>

These distinguishing NGC features include: (1) a focus on value-added processing; (2) expanded use of equity as a funding source; and, (3) restricted membership with equity shares limited by the requirements to build plant, process, and/or product (thus, many NGCs are "closed-end" while

<sup>25</sup> *Id.* at 9.

<sup>26</sup> Hanson, *supra* note 13 at 6.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> Igor Kotov, "New Generation Cooperatives: A Short History of the Idea and the Enterprise", NEW GENERATION COOPERATIVES: CASE STUDIES EXPANDED 2001 at 19 (2001).

generally retaining the one member one vote concept and maintaining effective governing control in producers while at the same time providing a governance "voice" for nonproducer outside investors).<sup>30</sup>

In 1996 Iowa enacted a cooperative statute specifically designed for agricultural value-added purposes. It was a corporation-based statute and it required, among other things, that "farming entities" have at least 60 percent of the voting and financial rights.<sup>31</sup> Further, it provided "authorized persons" to have 75 percent of the voting and financial rights.<sup>32</sup> Some organizations incorporated under the 1996 Iowa Act sought "Exempt Farmer Cooperative" Certification from the IRS under § 521 and, according to Hanson, questions were raised whether they qualified for § 521 status as operating on a cooperative basis.<sup>33</sup> As a result of these questions the Iowa statute was amended to replace corporate terms like "incorporation," "stock" and "shareholders" with unincorporated entity terms like "organizers", "members" and "interests" so that the organization might qualify for partnership income tax status (like a limited liability company under state law) and, therefore, be taxed on a purer flow-through basis under Subchapter K.

This different statutory design approach which attempts to take advantage of partnership tax classification should not be underestimated because it evidences that the organizers were willing to leave the traditional protective confines of the corporate tax structure as modified by Subchapter T in order to make value-added processing financially viable based on a different capital structure. In other words, the approach evolved from perceived real-world need.

Wyoming enacted a "Wyoming Processing Cooperative Law", effective in 2001, for purposes similar to Iowa's law. The impetus for the Wyoming law was from lamb producers in Wyoming and adjoining states. Its purpose was to allow the producers to "acquire lamb, meat, wool and pelt processing and marketing businesses to make lamb production more marketable on a cooperative basis."<sup>34</sup> It was drafted to allow for partnership taxation or, at the discretion of the particular entity, to elect corporate taxation and thereby be eligible for Subchapter T and, perhaps, § 521 tax treatment. As a result, the Wyoming Act is more flexible than traditional cooperative acts and gives far more freedom to the organizers in their entity documents than typically afforded under traditional cooperative statutes.

Neither the Wyoming nor the Iowa cooperative statutes have received revenue rulings, however, an entity organized under the Wyoming Act has apparently received a private letter ruling (PLR) from the Internal Revenue Service indicating that it will be eligible for partnership income tax classification. Identifying facts are excised from published letter rulings. Nonetheless PLR 2001-125369 included the following statement of relevant fact:

Company A is a new entity that will be organized on Date 1, under the State Cooperative LLC Act (Act). The Act was enacted on Date 2, with an effective date of Date 1. The Act defines "Cooperative" as association organized under this article conducting business on a cooperative plan as provided under this Article.

It concluded:

<sup>30</sup> *Id.* at 19-20.

<sup>31</sup> Hanson, *supra* note 13, at 10.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* (citation omitted).

<sup>34</sup> *Id.*

In the present case, Company A is organized as an unincorporated association under the Act, which does not refer to an association as incorporated or as a corporation, body corporate, or body politic... Therefore, it is an "eligible entity" and not a per se corporation under section 301.7701-2(b)(1).

Minnesota enacted a new agricultural processing statute this legislative session; one was introduced in Wisconsin, and; an industry study group has been formed in Iowa. It is not known whether legislator study activity in other states has been undertaken.

The Legal, Tax & Accounting Committee of the National Council of Farmer Cooperatives (NCFC) has been following the legal and economic developments concerning cooperatives closely. At a recent committee conference, J. Gary McDavid attributed the success of cooperatives to several factors including: "1. Tax, SEC, antitrust, and other benefits provided to co-ops, 2. Special banks that provided financing for co-ops, 3. Encouragement and assistance from USDA and NCFC, and 4. the fact the concept worked."<sup>35</sup>

He also identified several current structural challenges for cooperatives (and the continued viability of the cooperative business organization) given the advent of other entity choices. Structural challenges included "lack of outside equity" and the "inability to access going concern value."<sup>36</sup> Other challenges included "competition from LLCs" and the desire of investment return on the part of member-investors and stock options in order to retain qualified management.<sup>37</sup> Specifically the speech stated, "some cooperatives have converted to LLCs and many new ventures are structured as LLCs... [because] LLCs are flexible vehicles and allow patronage and non-patronage income to pass through to the members."<sup>38</sup> McDavid's comments seem to be supported generally by agricultural economists.

A 1995 article in the *American Journal of Agricultural Economics* lists five problems inherent in operating within the traditional cooperative structure. All five relate to "vaguely defined property rights."<sup>39</sup> According to the article, a *free-rider problem* exists for open-membership cooperatives because new members receive the same patronage dividends as do members who originally invested in the cooperative; *portfolio* and *horizon* problems arise due to lack of share transferability; that is, members cannot adjust their investment over time to match their investment profiles; and, there is a disincentive for members to invest more capital because of lack of liquidity of the investment and lack of the ability for the investor to time sales (e.g. redemption fixed upon death or retirement). Finally, the *control* and *influence cost problems* (e.g. agency cost and monitoring costs) inherent in any nonpublicly traded business are present in cooperatives. According to follow-up research conducted in 1996 and 1997, "[e]mpirical work confirmed the connection between theory and practice."

The research analyzed,

[A]ll rural or agricultural-related cooperative formations in the Upper Midwest between 1988 and 1996... and made the following observations:

<sup>35</sup> J. Gary McDavid, "Evolving Cooperative Structures", *Study Subcommittee: Legal, Tax & Accounting Conference of the National Council of Farmer Cooperatives*, Jan. 21, 2002, at 1.

<sup>36</sup> *Id.* at 2.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> Michael L. Cook, *The Future of U.S. Agricultural Cooperatives: A Neo-Institutional Approach*, 77 AMER. J. AGR. ECON. 1153 at 1156 (1995).

1. More than 80 percent of cooperative formations in the Upper Midwest adopted non-traditional cooperative organization characteristics.
2. Why? According to the results of the survey - to solve for a set of problems caused by vaguely defined property rights.
3. A coordinated set of simple organizational policies to solve for vaguely defined property rights; transferable and appreciable equity shares, defined membership, uniform grower agreements, and a minimum upfront equity investment requirement were identified.
4. Ninety-six percent of the cooperatives in the survey reduced the free-rider problem by linking member investment to use.
5. Ninety-four percent allowed members the ability to adjust their asset portfolio to meet the risk preferences by allowing the transfer of equity shares.
6. In addition, 93.6 percent of the cooperatives allowed producers to realize changes in the cooperative's value upon divestment of their equity shares.
7. Defined (closed) membership policies were popular among newly organized agricultural cooperatives with 98 percent of the survey cooperatives implementing a defined membership structure.
8. Direct investment through the sale of nonvoting equity stock was the primary method employed to raise producer equity in these cooperatives. Nearly 98.7 percent of equity raised from producers took this form.<sup>40</sup>

The findings, above, are consistent with theoretical suggestions to amend the cooperative form to include some combination of such features as transferability of equity shares, appreciable equity shares, defined membership, legally binding delivery contract or uniform grower agreement, and minimum up-front equity investment.<sup>41</sup> These features, however, are not necessarily consistent with cooperative values as described by the Rochdale Principles.

There have been a plethora of developments concerning cooperatives at the federal level in addition to state law and private business innovations. For example, the National Cooperative Business Association reported in 2000: "[A] coalition of cooperative organizations is asking the Congress for \$150 million... to jump-start the equity fund. This is a small step in addressing the emerging equity crisis in cooperatives...."<sup>42</sup>

The same year USDA proposed to expand the authority of its Cooperative Services unit to include programs to all types of rural cooperatives and it is reported that new Assistant Secretary Tom Dorr has made cooperatives and rural development one of the focuses of that unit. The goal of the expanded authority of Cooperative Services would be to provide, "[t]he same bundle of services currently offered to farmer cooperatives..., with proper budget support and staffing, to rural nonfarm cooperative businesses such as those in housing, health care, child and elder care, credit, rural utility, purchasing and worker owned [cooperatives]."<sup>43</sup> Moreover, at least as of June 29, 2002, the House and Senate Appropriations Committees had increased appropriation for rural development grant programs.

In addition to the foregoing, there is other evidence of strong interest in Congress in the cooperative industry. The Chair of the Senate Finance Committee, for example, is Charles Grassley (R-Iowa) and its Ranking Member is Senator Baucus (D-Montana). Both have long histories of interest in farmers and rural economic development and, together, the two senators introduced a bill to

<sup>40</sup> Michael L. Cook, Constantine Iliopoulos, *Beginning to Inform the Theory of the Cooperative Firm: Emergence of the New Generation Cooperative* 1999 THE FINNISH JOURNAL OF BUSINESS ECONOMICS 525 at 530 (Issue 4).

<sup>41</sup> *Id.*

<sup>42</sup> The Co-op Home Page - National Cooperative Business Association - [www.ncba.coop](http://www.ncba.coop) (last visited 6/10/03).

<sup>43</sup> Speech at [www.usdaeconomists.org](http://www.usdaeconomists.org) (last visited 4/23/03).

amend a portion of the federal income tax dividend allocation rule for cooperatives this session. Other legislation is also pending.

Another possible reason for renewed interest in agricultural cooperatives within the federal government might be the changing international trade climate concerning direct farm subsidies. As the immediate past Deputy Administrator of the Rural Business-Cooperative Service (Dorr's predecessor) stated at the USDA Economists Group Meeting in late 1999:

Current trends that are leading to a renewed interest in cooperatives include industrialization and concentration, increased contracting, phase-out of farm price supports... and the "new generation" cooperative phenomena.<sup>44</sup>

He also noted that there was an increase of mergers or consolidation of cooperatives in many sectors in order for cooperatives to become global competitors.

Two other private developments merit mention, in addition to the advent of the NGC: (1) Since late 2000 cooperatives have a new top-level Internet domain that joined .com and .org. It is, of course, .coop; (2) the financial accounting rules for redeemable stock have reportedly been changed within the past several months in a way that will require this kind of capital to be reported as debt rather than equity. The accounting change will rather obviously have a material affect on the balance sheets of most cooperatives.

#### CONTINUING RESEARCH AGENDA

As with other projects, the timely success of any drafting project in this area would partially depend on the expertise provided by interested organizations. The Reporter continues to identify organizations and individuals with experience, expertise, and interest in cooperatives. It seems that state based organizations, for example from states with strong cooperative traditions like California, might contain such groups. Thus, the primary area of continuing research is to identify additional interested organizations with the expertise and currency necessary for the drafting of a successful uniform act, should the conference decide to go forward with the drafting process. Although many of the organizations listed in the following section have been contacted initially; some have not. Moreover, continued conversations with those organizations that have been contacted is necessary to help establish an informational base-line for any drafting project.

Finally, the Reporter continues to (slowly) accumulate citation to, and copies of, cooperative acts from the various states with which this, or another Committee might consider more technical policy and drafting issues.

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<sup>44</sup> *Id.*

## INTERESTED ORGANIZATIONS

Names in the following list preceded by an asterisk either have contacted, or have been contacted by, the Reporter or Chair.

### Cooperative Trade Associations

#### American Bar Association Business Law Section

Harold S. Barron, Section Chair  
McDermott, Will & Emery  
227 W. Monroe St.  
Chicago, IL 60606-5055  
Tel: (312) 984-7700

Groups and committees include Nonprofit Corporations, Partnerships and Unincorporated Business Organizations, Corporate Laws, Credit Unions, Venture Capital and Private Equity.

#### American Bar Association Real Property, Probate & Trust Law Section

Dennis Belcher, Section Chair  
McGuirewoods LLP  
1 James Ctr.  
Richmond, VA 23219-4063  
Tel: (804) 775-4304

*Probate Trust Division Committees* include Estate Planning for Farmers and Ranchers; Organizational and Operational Issues of Exempt Organizations. *Real Property Division Groups* include Special Investors and Investment Structures; Partnerships and Limited Liability Companies; Development, Operation & Management of Community Associations.

#### American Bar Association Tax Section, Agriculture Division

James Nepple, Chair  
Nepple Law Offices PLC  
216 Sycamore St., Suite 500  
Muscatine, IA 52761-3842  
Tel: (563) 264-6844

Craig Houghton, Vice Chair  
Baker, Minock & Jensen  
5260 N. Palm Ave., Suite 421  
Fresno, CA 93704-2217  
Tel: (559) 432-5400

#### Cooperative Development Foundation

National Cooperative Business Association  
1401 New York Ave. NW, Suite 1100  
Washington, D.C. 20005-2160  
Tel: (202) 638-6222  
Contact: Judy Ziewacz, Executive Director

#### Iowa Institute for Cooperatives

2515 Elwood Drive, Suite 104  
Ames, IA 50010-8263  
Tel: (515) 292-1672  
Fax: (515) 292-2667  
Email: [iacoops@netins.net](mailto:iacoops@netins.net)  
Contact: Larry Kallcm  
\* James Long, Esq.  
Tel: (515) 237-1181

#### Minnesota Association of Cooperatives

Blair Arcade West, Suite Y  
400 Selby Avenue  
St. Paul, MN 55101  
Tel: (651) 228-0213  
Fax: (651) 228-1184  
Email: [macinfo@wfcmac.org](mailto:macinfo@wfcmac.org)  
Contacts: Bill Oemichen, Maura Schwartz

#### National Cooperative Business Association

1401 New York Avenue NW, Suite 1100  
Washington, D.C. 20005-2160  
Tel: (202) 638-6222  
Contact: Leta Mach, Dir. of Communications  
\*Paul Hazen, CEO  
(202) 283-5444

#### National Council of Farmer Cooperatives

50 F St. NW, Suite 900  
Washington, D.C. 20001  
Tel: (202) 626-8700  
Fax: (202) 626-8722  
Email: [info@ncfc.org](mailto:info@ncfc.org)  
Contact: \*David Graves, President and CEO  
J. Gary McDavid, Chair  
NCFC Legal, Tax & Accounting Committee  
(Dorsey & Whitney LLP)

#### National Farmers Organization

\*Eugene Paul  
528 Billy Sunday Road  
Ames, IA 50010  
Tel: (515) 292-2000

#### National Rural Electric Cooperative Association (NRECA)

4301 Wilson Blvd.  
Arlington, VA 22203  
Tel: (703) 907-5500

**National Telecommunications Association**  
Tom Wacker, Director of Government Affairs  
Tel: (703) 351-2039  
Serves small and rural phone cooperatives and commercial companies.

**Washington State Council of Farmer Cooperatives**  
Box 97  
St. John, WA 99171  
Tel: (509) 648-3466  
Fax: (509) 648-3726  
Email: [wscfc@wscfc.org](mailto:wscfc@wscfc.org)  
Contact: Jim Kite, President

**Wisconsin Federation of Cooperatives**  
131 W. Wilson St., Suite 400  
Madison, WI 53703  
Tel: (608) 258-4400  
Email: [bill.oemichen@wfcmac.org](mailto:bill.oemichen@wfcmac.org)  
Contact: Bill Oemichen (note: this is the same contact as for Minnesota)

#### Universities

**Kansas State University**  
Arthur Capper Cooperative Center  
305 Waters Hall  
Manhattan, KS 66506  
Tel: (785) 532-1508  
Fax: (785) 532-6925  
Director: Dr. David G. Barton

**Missouri Institute for Cooperatives**  
University of Missouri-Columbia  
\*Kristi Livingston  
Education Coordinator  
Agribusiness Research Institute  
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Columbia, MO 65211-6200  
Tel: (573) 882-0140  
Fax: (573) 882-3958  
Email: [livingstonK@missouri.edu](mailto:livingstonK@missouri.edu)  
Contact: \*Professor Michael L. Cook

**North Dakota State University**  
Quentin Burdick Center for Cooperatives  
PO Box 5437  
Fargo, ND 58105-5437  
Tel: (701) 231-1016  
Contact: Bill Nelson, Director

**University of California-Davis**  
Center for Cooperatives  
One Shields Avenue  
Davis, CA 95616  
Tel: (530) 752-2408  
Fax: (530) 752-5451  
Email: [centerforcoops@ucdavis.edu](mailto:centerforcoops@ucdavis.edu)

**University of Wisconsin-Madison**  
Center for Cooperatives (UWCC)  
230 Taylor Hall  
427 Lorch Street  
Madison, WI 53706  
Tel: (608) 262-3981  
Fax: (608) 262-3251  
Contact: \*Robert Cropp, Director  
The Center for Cooperatives works in rural and urban settings to provide educational programs, technical assistance and research on the cooperative form of business.

#### Banks

**CoBank**  
PO Box 5110  
Denver, Colorado 80217  
Tel: (303) 740-4055  
Contact: Larry E. Williams, Senior Vice President, Corporate Development Division  
Legal Counsel: Richard Manner (tel: (763) 765-2700)  
New Projects: Jeff Kistner (tel: 800-34605715 ex. 205)

**National Cooperative Bank**  
1401 Eye St. NW, Suite 700  
Washington, DC 20005-2204  
Tel: (202) 336-7700  
Contact: Jane Demarnies, Public Relations  
The National Cooperative Bank provides financial and advisory services to cooperatives including commercial lending, mortgage lending, and capital markets.

#### Others

**Congress**  
\*Elizabeth Paris  
Staff Counsel, Senate Finance Committee (ag, co-op & estate tax)  
Tel: (202) 224-7388

**\*James B. Dean**  
Dean & Stern, PC  
4155 E. Jewell Ave., Suite 703  
Denver, CO 80222  
Tel: (303) 756-6744  
Member, Colorado Bar Association Cooperative Statute Revision Committee

**Land O'Lakes, Inc.**  
Contact: John T. Rebane, V.P. & Gen. Counsel  
(Contacted by Reporter)  
Tel: (651) 481-2824  
Email: [jreba@landolakes.com](mailto:jreba@landolakes.com)



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**Lindquist & Verner PLLP**  
Agribusiness and Cooperative Group  
Contact: \*Mark J. Hanson  
Tel: (612) 371-3545  
Email: [mhanson@lindquist.com](mailto:mhanson@lindquist.com)  
(Helped draft Minnesota statute, advisory member  
Agmarc - a consortium of Iowa State, Kansas State,  
California-Davis)

**The National Society of Accountants for Cooperatives**  
6320 Augusta Drive, Suite 800  
Springfield, VA 22150  
Contact: Barbara Hickey, Executive Director  
Tel: (702) 569-3088  
Email: [bhickey@NSACoop.org](mailto:bhickey@NSACoop.org)

**NCR - 194 Research on Cooperatives**

\*Roger Ginder, President  
460 Heady Hall  
Ames, IA 50011  
Tel: (515) 294-7318  
Fax: (515) 294-1700  
Email: [ginder@iastate.edu](mailto:ginder@iastate.edu)

The objectives of NCR-194 are: (1) to promote and coordinate research and educational activities focusing on cooperatively owned business organizations and their role in marketing agricultural products, supplying agricultural inputs, coordinating farm production and marketing activities, performing value-added processing, and providing rural services and (2) to provide a forum for the interaction of decision-makers and analysts from industry, government, and universities and for the distribution and discussion of research results and their implications for cooperatives, their producer-members, the food production and distribution system, the environment, and rural communities.

**USDA**

\*Assistant Secretary Tom Dorr, (202) 720-2261  
\*Keith Heferman, (515) 294-0670, Iowa State-USDA  
\*Don Frederick, Staff Attorney Cooperative Services and Rural Development, (202) 720-2261

## APPENDIX A

## STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES-HIGHLIGHTS

Most cooperative associations in the United States are incorporated. Incorporation of most businesses, whether cooperative or noncooperative corporations, is a matter of State statutory law. Statutes describe incorporation requirements and many aspects of the structure and operation of the incorporated cooperative.

Every State has at least one statute farmers may use to form a cooperative. Most have more than one. Eighty-five statutes were analyzed and compared. Also included in the analysis is the "Standard Act" drafted primarily by Aaron Sapiro and adopted by a majority of States in the early 1920's. It provides the basis for about half the statutes.

State cooperative incorporation statutes vary widely, both in what topics are covered by each statute and in specific requirements by topic. Some statutes are detailed, while others give only summary descriptions of organizational and structural requirements of cooperative associations to which the statute applies.

Many statutes apply business corporation law if not in conflict with the cooperative incorporation statute. Many statutes say the cooperative association is "deemed" nonprofit because its purpose is not to make a profit for itself nor for its members as shareholders, but only for its members as farmer producers.

About half of the 85 statutes analyzed are restricted to use by farmers only. Remaining statutes are more general, available to farmers and nonfarmers alike who wish to organize a cooperative business association.

Incorporation statutes give organizations power to conduct business. In cooperative incorporation statutes, powers may be either specific or general. Powers to market, process, handle byproducts, purchase, and manufacture are commonly specified in the statutes. More general powers, such as all powers necessary and proper to conduct business, or powers granted generally to all business corporations, are commonly granted in cooperative incorporation statutes.

Statutes usually describe the association formation process, including number of incorporators required, association name, expenses, and how long the association may exist. Articles and bylaws are described in some detail by most statutes. Most require listed contents for articles of incorporation and permit, but do not require listed contents for bylaws.

Qualification for membership is described in most statutes, the most common that members be farmers. Documents of membership such as membership or stock certificates may be described. Many statutes say what rights members have when they join the association. Statutes may restrict membership transfer.

Members' control of their cooperative is described by most statutes. Topics include: voting power of individual members (one-member, one-vote, patronage based voting, or other), and books and records available to members. Regular meetings are typically required, and many incorporation statutes give members the right to call a special membership meeting when certain conditions are met.

Incorporation statutes usually give the number of directors required, their qualifications, and the method by which they are selected. Procedures for director removal are common in statutes. Director compensation, board meetings, and board committees are often described. Offices to be filled are specified by most statutes, and officer removal may be described.

Incorporation statutes frequently describe the patronage relationship between user and cooperative. Many statutes limit business done with nonmembers to half the association's total business. Patronage refunds are also described, and detailed information on marketing contracts is common in incorporation statutes.

Financial structure and operation of cooperative associations are addressed by a majority of statutes, though the detail with which financial subjects are described varies widely. Some statutes apply only to nonstock associations, but most apply to cooperatives with or without capital stock. Subscription, payment, limits on ownership, and limits on transfer of membership stock are common statutory provisions. Preferred stock is noted in a majority of statutes. Other aspects of

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capital structure noted in many statutes are: Number of shares and their value, limits on capital stock dividends, reserves, and stock redemption.

Merger, consolidation, subsidiaries, and cooperative association dissolution are described by some statutes. Detail and procedures described vary. Disposition of all assets many require special member approval, as is the case for merger, consolidation, and dissolution.

Cooperative incorporation statutes may contain regulatory provisions, the most common being annual report filing requirements. Special State antitrust rules for farmer cooperatives are frequently found in cooperative incorporation statutes.

**APPENDIX B****1.02.02 Statutes Identified**

(State Incorporation Statutes for Farmer Cooperatives  
compiled by the USDA circa 1982)

**Alabama (3)**

## Code of Alabama

## Title 2. Chapter 10. Cooperatives and Associations

- [1] Article 2. Marketing Associations Generally  
ss 2-10-20 to 2-10-35

- [2] Article 3. Incorporated Marketing Association  
ss 2-10-50 to 2-10-74

- [3] Article 4. Mutual Farming or Trucking Associations  
ss 2-10-90 to 2-10-108

**Alaska (1)**

## Alaska Statutes

## Title 10. Corporations and Associations

- Chapter 15. Alaska Cooperative Corporation Act  
ss 10.15.005 to 10.15.600

**Arizona (1)**

## Arizona Revised Statutes Annotated

## Title 10. Corporations and Associations

- Chapter 2. Corporations and Associations Not for Profit
- Article 1. Cooperative Marketing Associations  
ss 10-701 to 10-724

**Arkansas (3)**

## Arkansas Statutes Annotated

## Title 64. Corporations and Associations

- [1] Chapter 15. Cooperative Associations  
ss 64-1501 to 64-1525

## Title 77. Agriculture and Horticulture

- [2] Chapter 9. Cooperative Marketing Associations  
ss 77-901 to 77-928

- [3] Chapter 10. Agricultural Cooperative Associations  
ss 77-1001 to 77-1027

**California (2)**

## California Food and Agricultural Code

Division 20. Processors, Storers, Dealers, and Distributors of  
Agricultural Products

- [1] Chapter 1. Nonprofit Cooperative Associations  
ss 54001 to 54294

## California-Corporations Code

## Title 1. Corporations

## Division 3. Corporations for Specific Purpose

- [2] Part 2. Cooperative Corporations  
ss 12200 to 12956

**Colorado (3)**

## Colorado Revised Statutes

## Title 7. Corporations and Associations

- [1] Article 55. Cooperatives - General  
ss 7-55-101 to 7-55-121

- [2] Article 56. Cooperative Marketing Associations  
ss 7-56-101 to 7-56-133

- [3] Article 57. Agricultural and Livestock Associations  
ss 7-57-101 to 7-57-106

**Connecticut (2)**

## Connecticut General Statutes Annotated

## Title 33. Corporations

- [1] Chapter 595. Cooperative Associations  
ss 33-183 to 33-193

- [2] Chapter 596. Cooperative Marketing Corporations  
ss 33-194 to 33-217

**Delaware (1)**

## Delaware Code Annotated

## Title 3. Agriculture

Part VII. Cooperative Agricultural Associations or  
Corporations

- Chapter 85. Corporation Law for Cooperative  
Agricultural Associations  
ss 8501 to 8562

**District of Columbia (1)**

## District of Columbia Code Encyclopedia

## Title 29. Corporations

- Chapter 8. Cooperative Associations  
ss 29-801 to 29-847

**Florida (2)**

## Florida Statutes Annotated

## Title 34. Corporations and Business Trusts

- [1] Chapter 618. Agricultural Cooperative Marketing  
Associations

ss 618.01 to 618.28

- [2] Chapter 619. Nonprofit Cooperative Associations  
ss 619.01 to 619.09

**Georgia (1)**

## Code of Georgia Annotated

## Title 65. Marketing Associations

- Chapter 65-2. Nonprofit Cooperative Associations  
ss 65-201 to 65-231

**Hawaii (1)**

## Hawaii Revised Statutes

## Title 23. Corporations and Partnerships

Chapter 421. Agricultural Cooperative  
Associations

ss 421-1 to 421-27

**Idaho (1)**

## Idaho Code

## Title 22. Agriculture and Horticulture

- Chapter 26. Cooperative Marketing Associations  
ss 22-2601 to 22-2628

**Illinois (2)**

## Smith-Hurd Illinois Annotated Statutes

## Chapter 32. Corporations

- [1] Cooperative Act  
ss 305 to 331

- [2] Agricultural Cooperative Act  
ss 440 to 472

**Indiana (1)**

## Burns Indiana Statutes Annotated

Title 15. Agriculture and Animals  
Article 7. Miscellaneous  
Chapter 1. Indiana Agricultural  
Cooperative Act  
ss 15-7-1-1 to 15-7-1-33

Iowa (3)  
Iowa Code Annotated  
Title 19. Corporations  
[1] Chapter 497. Cooperative Associations  
ss 497.1 to 497.32  
[2] Chapter 498. Nonprofit-sharing Cooperative  
Associations  
ss 498.1 to 498.34  
[3] Chapter 499. Cooperative Associations  
(Organized after July 4, 1935)  
ss 499.1 to 499.84

Kansas (2)  
Kansas Statutes  
Chapter 17. Corporations  
[1] Article 15. Cooperative Societies  
ss 17-1501 to 17-1519  
[2] Article 16. Cooperative Marketing  
ss 17-1601 to 17-1636

Kentucky (2)  
Kentucky Revised Statutes  
Title 23. Private Corporations and Associations  
Chapter 272. Cooperative Corporations and Marketing  
Associations  
[1] Cooperative Corporations Generally  
ss 272.020 to 272.050  
[2] Agricultural Cooperative Associations  
ss 272.101 to 272.345

Louisiana (2)  
West's Louisiana Revised Statutes Annotated  
Title 3. Agriculture and Animals  
Chapter 2. Cooperative Associations  
[1] Part I. Agricultural Cooperative Associations  
ss 71 to 88  
[2] Part II. Cooperative Marketing Associations  
ss 121 to 149

Maine (1)  
Maine Revised Statutes  
Title 13. Noncapital Stock Corporations  
Chapter 85. Cooperatives  
Subchapter II. Agricultural Marketing and Bargaining  
Articles 1 to 5. Uniform Agricultural Cooperative  
Association Act  
ss 1771 to 1952

Maryland (1)  
Annotated Code of Maryland  
Corporations and Associations  
Title 5. Special Types of Corporations  
Subtitle 5. Cooperatives  
ss 5-501 to 5-532

Massachusetts (3)

Annotated Laws of Massachusetts  
Chapter 157. Cooperative Corporations  
[1] Cooperative Business Corporations  
ss 1, 2  
[2] Cooperative Agricultural, Dairy or Mercantile  
Associations  
ss 3 to 9  
[3] Agricultural and Other Cooperative Corporations  
Without Capital Stock  
ss 10 to 18

Michigan (1)  
Michigan Statutes Annotated  
Title 21. Corporations  
Part 1. General Provisions  
Chapter 195. General Corporations Act  
ss 21.99 to 21.110

Minnesota (2)  
Minnesota Statutes Annotated  
Chapter 308. Cooperative Associations  
[1] ss 308.01 to 308.18  
[2] Cooperative Marketing Act  
ss 308.51 to 308.92

Mississippi (2)  
Mississippi Code Annotated  
Title 79. Corporations, Associations, and Partnerships  
[1] Chapter 17. Agricultural Associations;  
Conversion to Corporate Form  
ss 79-17-1 to 79-17-41  
[2] Chapter 19. Agricultural Cooperative Marketing  
Associations  
ss 79-19-1 to 79-19-63

Missouri (2)  
Vernon's Annotated Missouri Statutes  
Title 17. Agriculture and Animals  
[1] Chapter 274. Cooperative Marketing  
Associations  
ss 274.010 to 274.300  
Title 23. Corporations, Associations and Partnerships  
[2] Chapter 357. Cooperative Companies  
ss 357.010 to 357.190

Montana (3)  
Montana Code Annotated  
Title 35. Corporations, Partnerships, and Associations  
[1] Chapter 15. Cooperative Associations  
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Nebraska (2)  
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[1] Article 13. Cooperative Companies  
ss 21-1301 to 21-1306  
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**Nevada (3)**

## Nevada Revised Statutes

## Title 7. Corporations; Associations; Partnerships

## Chapter 81. Nonprofit and Cooperative Corporations and Associations

## [1] Nonprofit Cooperative Corporations

ss 81.010 to 81.160

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**New Hampshire (1)**

## New Hampshire Revised Statutes Annotated

## Title 27. Corporations, Associations, and Proprietors of Common Lands

## Chapter 301. Cooperative Marketing and Rural

## Electrification Associations

ss 301:1 to 301:52

**New Jersey (1)**

## New Jersey Statutes Annotated

## Title 4. Agriculture-Domestic Animals

## Chapter 13. Agricultural Cooperative Associations

ss 4:13-1 to 4:13-50

**New Mexico (2)**

## New Mexico Statutes Annotated

## Chapter 53. Corporations

## [1] Article 4. Cooperative Associations

ss 53-4-1 to 53-4-45

## Chapter 76. Agriculture

## [2] Article 12. Cooperative Marketing Associations

ss 76-12-1 to 76-12-23

**New York (1)**

## McKinney's Consolidated Laws

## Cooperative Corporations Law

## Chapter 77. Cooperative Corporations Law

ss 1 to 134

**North Carolina (2)**

## General Statutes of North Carolina

## Chapter 54. Cooperative Organizations

## [1] Subchapter IV. Cooperative Associations

ss 54-111 to 54-128

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**North Dakota (1)**

## North Dakota Century Code

## Title 10. Corporations

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## Title 2. Agriculture

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**Oregon (1)**

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## Title 7. Corporations and Partnerships

## Chapter 62. Cooperatives

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**Pennsylvania (2)**

## Purdon's Pennsylvania Statutes Annotated

## Title 15. Corporations and Unincorporated Associations

## Chapter 32. Particular Types of Cooperative Corporations

## [1] Productive and Distributive Associations

ss 12001 to 12023

## [2] Agricultural Associations

ss 12101 to 12135

**Rhode Island (1)**

## General Laws of Rhode Island

## Title 7. Corporations, Associations, and Partnerships

## Chapter 7. Producers' Cooperatives

ss 7-7-1 to 7-7-22

**South Carolina (2)**

## Code of Laws of South Carolina

## Title 33. Corporations, Partnerships, and Associations

## [1] Chapter 45. Cooperative Associations

## Generally

ss 33-45-10 to 33-45-200

## [2] Chapter 47. Marketing Cooperative Associations

ss 33-47-10 to 33-47-1150

**South Dakota (1)**

## South Dakota Compiled Laws Annotated

## Title 47. Corporations

## Chapters 47-15 to 47-20. Cooperatives—Formation and General Powers

ss 47-15-1 to 47-20-17

**Tennessee (1)**

## Tennessee Code Annotated

## Title 43. Agriculture and Horticulture

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ss 43-16-101 to 43-16-148

**Texas (3)**

## Texas Civil Code Annotated

## [1] Title 32. Corporations

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Utah (1)  
Utah Code Annotated  
Title 3. Agricultural Cooperative Associations  
Chapter 1. General Provisions Relating to  
Agricultural Cooperative Associations  
ss 3-1-1 to 3-1-41

Vermont (1)  
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Title 11. Corporations, Partnerships, and  
Associations  
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Virginia (2)  
Code of Virginia  
Title 13.1. Corporations  
Chapter 3. Cooperative Associations  
[1] Article 1. Cooperative Associations  
Generally  
ss 13.1-301 to 13.1-311.1  
[2] Article 2. Agricultural Cooperative  
Associations  
ss 13.1-312 to 13.1-345

Washington (2)  
Revised Code of Washington Annotated

Title 23. Corporations and Associations (profit)  
[1] Chapter 23.86. Cooperative Associations  
ss 23.86.010 to 23.86.230  
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[2] Chapter 24.32. Agricultural Cooperative  
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ss 24.32.010 to 24.32.900

West Virginia (1)  
West Virginia Code  
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Wisconsin (1)  
West's Wisconsin Statutes Annotated  
Title 17. Corporations  
Chapter 185. Cooperatives  
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Wyoming (1)  
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Title 17. Corporations, Partnerships and Associations  
Chapter 10. Cooperative Marketing Associations  
ss 17-10-101 to 17-10-125

#### The Standard Act

The Bingham Cooperative Marketing Act  
From Carroll's Kentucky Statutes, Baldwin's 1936 Revision  
ss 883M to 883f-41

## APPENDIX C - IRC § 521

**(a) Exemption from tax.**

A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this title except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

**(b) Applicable rules.**

**(1) Exempt farmers' cooperatives.** The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

**(2) Organizations having capital stock.** Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

**(3) Organizations maintaining reserve.** Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

**(4) Transactions with nonmembers.** Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

**(5) Business for the United States.** Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

**(6) Netting of losses.** Exemption shall not be denied any such association because such association computes its net earnings for purposes of determining any amount available for distribution to patrons in the manner described in paragraph (1) of section 1388(j).



**APPENDIX D - § 501(c)**  
**(selected subparts)**

...

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

...

(5) Labor, agricultural, or horticultural organizations.

...

(12)(A) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

(B) In the case of a mutual or cooperative telephone company, subparagraph (A) shall be applied without taking into account any income received or accrued--

- (i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company,
- (ii) from qualified pole rentals,
- (iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company, or

(iv) from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987).

(C) In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied without taking into account any income received or accrued--

- (i) from qualified pole rentals, or
- (ii) from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987).

(D) For purposes of this paragraph, the term "qualified pole rental" means any rental of a pole (or other structure used to support wires) if such pole (or other structure)--

- (i) is used by the telephone or electric company to support one or more wires which are used by such company in providing telephone or electric services to its members, and
  - (ii) is used pursuant to the rental to support one or more wires (in addition to the wires described in clause (i)) for use in connection with the transmission by wire of electricity or of telephone or other communications.
- For purposes of the preceding sentence, the term "rental" includes any sale of the right to use the pole (or other structure).

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(14)(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in--

- (i) domestic building and loan associations,
- (ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,
- (iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in section 591(b)

(C) Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

(15)(A) Insurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$350,000.

(B) For purposes of subparagraph (A), in determining whether any company or association is described in subparagraph (A), such company or association shall be treated as receiving during the taxable year amounts described in subparagraph (A) which are received during such year by all other companies or associations which are members of the same controlled group as the insurance company or association for which the determination is being made.

(C) For purposes of subparagraph (B), the term "controlled group" has the meaning given such term by section 831(b)(2)(B)(ii).

(16) Corporations organized by an association subject to part IV of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

## - APPENDIX E - § 501(e), (f), (g)

**(e) Cooperative hospital service organizations.**

For purposes of this title, an organization shall be treated as an organization organized and operated exclusively for charitable purposes, if—

(1) such organization is organized and operated solely—

(A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection (including the purchase of patron accounts receivable on a recourse basis), food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and

(B) to perform such services solely for two or more hospitals each of which is—

(i) an organization described in subsection (c)(3) which is exempt from taxation under subsection (a),  
 (ii) a constituent part of an organization described in subsection (c)(3) which is exempt from taxation under subsection (a) and which, if organized and operated as a separate entity, would constitute an organization described in subsection (c)(3), or  
 (iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8 1/2 months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

For purposes of this title, any organization which, by reason of the preceding sentence, is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), shall be treated as a hospital and as an organization referred to in section 170(b)(1)(A)(iii).

**(f) Cooperative service organizations of operating educational organizations.**

For purposes of this title, if an organization is—

(1) organized and operated solely to hold, commingle, and collectively invest and reinvest (including arranging for and supervising the performance by independent contractors of investment services related thereto) in stocks and securities, the moneys contributed thereto by each of the members of such organization, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members,

(2) organized and controlled by one or more such members, and

(3) comprised solely of members that are organizations described in clause (ii) or (iv) of section 170(b)(1)(A)—

(A) which are exempt from taxation under subsection (a), or

(B) the income of which is excluded from taxation under section 115(a),

then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.

**(g) Definition of agricultural.**

For purposes of subsection (c)(5), the term "agricultural" includes the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.

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