Taxation of Cooperatives in South Dakota: An Evaluation of Selected Tax Proposals

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TAXATION OF COOPERATIVES IN SOUTH DAKOTA:
AN EVALUATION OF SELECTED TAX PROPOSALS

BY
MARC R. WIITALA

A thesis submitted
in partial fulfillment of the requirements for the
degree Master of Science, Major in
Economics, South Dakota
State University
1972
TAXATION OF COOPERATIVES IN SOUTH DAKOTA:
AN EVALUATION OF SELECTED TAX PROPOSALS

This thesis is approved as a creditable and independent investigation by a candidate for the degree, Master of Science, and is acceptable for meeting the thesis requirements for this degree. Acceptance of this thesis does not imply that the conclusions reached by the candidate are necessarily the conclusions of the major department.

[Signatures and dates]
ACKNOWLEDGEMENTS

The author wishes to extend his sincere appreciation to Mr. Leonard Benning, thesis adviser, for his suggestions and guidance while writing this thesis. Thanks are also extended to Dr. Gordon Rose and Mr. Robert Antonides for their review of the thesis manuscript.

The author is grateful to Mr. J. D. Lynd, Executive Secretary of the South Dakota Association of Cooperatives, for his assistance in obtaining the data for this study. Gratitude is also extended to the cooperative enterprises of South Dakota which supplied the data for this study.

Special appreciation is extended to the typist, Linda Beemer, for bearing with the tedious assignment of typing this manuscript.

MRW
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CHAPTER 1

THE STUDY

INTRODUCTION

The cooperative corporation, more commonly referred to as the cooperative, has been of special interest in the area of taxation. Much research has been conducted on Federal taxation of farmer cooperatives. As a rule, the issue of cooperative taxation has been limited to legal interpretations of the taxability of cooperative net savings. At the state and local levels of taxation evaluation of the economic impact of tax systems on cooperatives has been sparse. It is this lack of information on cooperative taxation at the state and local levels that prompts the need for research to provide policy-makers with the information necessary to formulate tax policy. This study will be a step in fulfilling the need for research in the areas of state and local taxation of cooperatives.

STATEMENT OF PROBLEM

Attempts to reform South Dakota's tax system will undoubtedly affect cooperatives. The economic viability of cooperatives depends in part on the economic impact of the tax system. Since cooperatives play a significant role in the South Dakota economy, it is necessary for policy-makers to understand both how cooperatives will be affected by different aspects of the tax system and what consequence this will have for communities.
The cooperative form of enterprise is dissimilar in many respects from other forms of economic enterprise (i.e., corporations, single proprietorships and partnerships). The economic philosophy of cooperative enterprise which forms the basis for developing its legal and economic nature poses a great source of misunderstanding in the area of taxation. There is a need to more fully understand what significance the relationship between cooperative and community has for the formulation of tax policy. Furthermore, since the economic nature of the cooperative differs from other forms of enterprise, it is necessary to determine how and why cooperatives are affected in a manner different from other economic enterprises. When these factors have been taken into consideration, policy-makers will be in a better position to evaluate the impact of various tax proposals on cooperatives and formulate a tax system which is equitable and minimizes undesirable economic effects.

OBJECTIVES

The objectives of this study are:

1. to outline some general considerations in determining the importance of cooperatives to tax policy and tax policy to cooperatives

2. to ascertain why the difference in the economic nature of cooperatives and corporations requires differentiated taxation of net savings and net income

3. to determine how selected tax proposals affect cooperatives and evaluate each proposal as a method of taxing cooperatives
4. to recommend on the basis of the information presented in this study which of the tax proposals evaluated is the most desirable method of taxing cooperatives.

SCAPE OF INVESTIGATION

This study has been limited to farmer cooperatives. Included are farm marketing and supply cooperatives. However, it should be recognized that many of the general observations on tax policy and cooperatives are equally applicable to other types of cooperative enterprise. But the empirical analysis considers only farmer cooperatives.

METHODOLOGY

The method used to evaluate the selected tax proposals is the case study. Twelve farmer cooperatives were selected from survey data supplied by the South Dakota Association of Cooperatives. This data consisted of 114 responses from petroleum and grain marketing cooperatives.

The twelve selected firms represent four cooperative categories—farm supply, grain marketing, petroleum and conglomerate. The three firms of each category represent low, medium and high volume of sales and approximate the average net margin of all the firms for each category.

After selecting the twelve firms for case study, operating statements were obtained to secure additional information. All data necessary for this study was ascertainable from the preliminary survey and the operating statements with the exception of taxable net income.
This figure was computed indirectly from data on Federal income tax liability and the disbursement of net savings to dividends and unallocated reserves.

To preserve the anonymity of the firms selected for the case study, all figures have been adjusted. Aggregate figures have been rounded. Those figures which comprise the aggregate figures have been so adjusted to equal the aggregates while simulating the relationships existing in the empirical data.

The twelve simulated cooperative firms will be used to evaluate three tax proposals--a gross receipts tax and two variations of an income tax. The rates of tax selected in each instance are arbitrary and do not suggest an appropriate rate of taxation in South Dakota.

**Data Collected**

The data collected for the empirical study includes total sales representing sales to and for patrons. Member equity refers to semi-permanent and permanent capital contributed by members--net worth--while net margin is determined by net savings as a percentage of total sales.

Net savings is the excess of total revenues over total costs. In the case of cooperatives which derive corporate income, net savings includes net corporate income (i.e., income after corporate income taxes have been deducted). Net savings may be distributed in the form of cash, revolving certificates or dividends or retained by the cooperative as unallocated reserves. Revolving certificates are paper allocations to patrons informing the patron of the amount of patronage refunds due but
retained for the capital structure or operating and contingency reserves. Dividends may be paid on the member capital or equity structure. Unallocated reserves are net savings (or net income) which have not been allocated to patrons. Federally computed taxable income is the amount of taxable income determined under Federal income tax laws.

REVIEW OF LITERATURE

Joseph Knapp's *Farmers in Business* contributed significantly to the determination of necessary considerations for the formulation of tax policy affecting cooperatives.\(^1\) Knapp's contribution was primarily related to the importance of cooperatives to communities. John F. Due's *Public Finance* provided a number of tax objectives which were then evaluated within a cooperative perspective.\(^2\)

In considering the issue of taxing cooperative net savings as corporate income, Robert T. Patterson's *The Exemption of Farmer Cooperatives* provided useful insight into the comparative nature of cooperative net savings and corporate net income.\(^3\) George L. Griffin's "The Taxation of Farmer Cooperatives" contributed to a comparative analysis of the economic nature of corporations and cooperatives.\(^4\)

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\(^2\)John F. Due, *Government Finance* (Homewood: Richard D. Irwin, Inc., 1963), p. 120.


Empirical analysis of the impact of various taxes on cooperatives is sparse. Most of the information in this area is limited to defining the applicability of taxes to cooperatives. Legal Phases of Farmer Cooperatives: Federal Income Taxes was the major source of information in outlining how the Federal corporate income tax affected farmer cooperatives when used as a base for state corporate taxation. C. David Hollis and Charles Ingraham in their research bulletin—Farmer Cooperatives and Federal Income Taxes: Is Exempt Status More Beneficial—outlined further Federal taxation of cooperatives. A study conducted by Calvin A. Kent, State Taxation of Cooperatives, reviewed the variety of state tax systems affecting cooperatives. This study also considered some specific issues involved in corporate income taxation of cooperatives.


CHAPTER 2

COOPERATIVES AND TAX POLICY

INTRODUCTION

Tax reform will center around the changing financial needs of government and an evolving philosophy on what is considered desirable features of a tax system. The significant economic role cooperatives play in South Dakota requires that this role be placed in perspective before attempting tax reform. Achieving this perspective necessitates recognition of the importance of cooperatives to the formulation of tax policy. Moreover, a broader perspective also requires an awareness of the importance of tax policy to cooperatives. The purpose of this chapter is to provide a framework of reference to tax policy decision-making in the area of cooperatives.

THE IMPORTANCE OF COOPERATIVES TO TAX POLICY

The considerations presented on the importance of cooperatives to the formulation of tax policy are not all exclusively associated with cooperative enterprise. However, since this study is concerned with cooperative taxation, only the consequence of taxing cooperatives is taken into perspective.

Cooperatives and Communities

The taxation of cooperatives may or may not significantly affect the economic welfare of communities. However, since there exists a
possibility that cooperatives may be adversely affected by tax policy, it is necessary to determine what form the impact on the community might take. This requires noting the importance of cooperatives to communities.

**Economic activity.** The loss of a cooperative, assuming no enterprise to take its place, could alter trade patterns. Cooperative services which were once purchased in a community may be secured outside the community shifting trade to another center of economic activity. This has the effect of reducing the prosperity of remaining businesses. In addition to this erosion of community economic activity, there is also a loss of services and employment opportunities. The consequence of losing a cooperative enterprise (and other enterprises as well) is of special concern for small urban communities who are already victims of a declining rural population and improved transportation. Therefore, the impact of tax policy on cooperatives is of relevant concern to these communities.

**Tax revenues.** An important objective of tax policy is to ensure that while a particular tax program adds to current tax revenue the long-run capacity to generate tax revenues is not reduced. In the case of cooperative taxation, if a specific tax is so harsh as to cause economic failure, the consequent liquidation of assets would reduce the personal property tax base. Hence, while short-run revenues may be

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8Knapp, op. cit., pp. 44-46.
increased, long-run economic effects may reduce the ability of the cooperative to generate greater taxable capacity in the future. The consequent effect on the community is to either impair provision and improvement in governmental services or increase the burden of taxation for other tax sources.

Form of enterprise. The cooperative may have several traits which merit special consideration in developing tax policy. First, the cooperative is locally owned. Consequently, the economic gain derived from the cooperative remains in the community. Cooperative net savings are either absorbed in expanded operations or returned to member-patrons of the community. This contrasts foreign-owned enterprises which, while possibly expanding operations, permit the flow of excess earnings out of the community. This loss of community wealth reduces economic activity.

Second, the disbursal of economic earnings by the cooperative has a unique impact on the community not observed in enterprises seeking a profit. The cooperative imparts a greater degree of equity in distributing the economic benefits derived from its existence. A cooperative distributes its net savings to member-patrons on the basis of patronage while the economic earnings of other enterprises accrue to one or a few individuals. The cooperative then enhances the economic success of all member-patrons' operations, contributing to a more general success of the community.

It might be concluded that certain economic aspects of the cooperative make it a desirable form of enterprise for enhancing community welfare. Both characteristics, being home-owned and distributing the wealth throughout the community, should be prime considerations in the formulation of tax policy.

**Competition.** Cooperatives may also improve community welfare by fostering competitive market conditions. While cooperatives do not generally engage in price cutting, they serve to check movements toward monopolistic market conditions through the policies of returning patronage refunds to patrons and not following profit maximizing pricing actions.\(^\text{10}\)

Since the cooperative is not concerned with maximizing profits, it serves as a countervailing force to firms which adopt monopolistic profit maximizing policies. If this contribution of the cooperative to communities is recognized as a public objective, the formulators of tax policy must incorporate this objective into their evaluation of cooperative taxation.

**THE IMPORTANCE OF TAX POLICY TO COOPERATIVES**

**Cooperative and Member-patrons**

To have a greater perspective of the importance of cooperatives to tax policy, it is also necessary to determine how cooperatives view their role in the tax system. The cooperative's concern with taxation is the concern of any business enterprise. The economic viability of the

\(^{10}\)Ibid., p. 293.
cooperative is of great importance to the welfare of members and patrons.\(^{11}\) A specific tax on the cooperative ultimately affects those who participate in that enterprise. Regardless of the type of tax instituted, it must be passed on to the patron as lower prices paid or higher prices charged and/or indirectly through reduced patronage refunds.\(^ {12}\) Of course, it is possible for the cooperative to absorb the tax internally. This could be done by reducing investment.

To maintain the cooperative under adverse economic circumstances requires a sacrifice on the part of the patrons. The cooperative's economic success depends on the willingness of participants to grant that success, for it is the pooling of member resources that establishes the cooperative. Thus, while the return to member equity may be the criterion for determining economic efficiency, the real return is to the investment of the patron's personal business. The investment in the cooperative is only an extension of the patron's personal operation, since the cooperative is an integrated part of his enterprise. Consequently, taxing a cooperative reduces indirectly the return to investment in the patron's business.

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\(^{11}\) For this chapter it is assumed that cooperatives return their net savings to both member and non-member patrons.

\(^{12}\) Patronage refunds or distributions refer to the distribution of cooperative savings on the basis of patronage. Patronage refunds may take the form of cash refunds or paper refunds. Paper refunds are certificates that notify the patron of a patronage allocation that has been retained.
**Tax Paying Entity**

The cooperative is an integral part of the tax system. It acknowledges its role as a tax paying entity. While the cooperative's willingness to pay taxes is related to its concern with improving state and community welfare, it is equally aware that the tax system can greatly affect its economic viability. There is recognition that in the long-run the social benefits received via cooperative tax revenue may not outweigh the social costs to state and community if the cooperative failed as a result of a particular tax program.\(^{13}\) The loss of the cooperative enterprise and potential tax revenue could seriously affect the social and economic welfare of a community in the future.

**Cooperative Perspective on Taxation**

The cooperative perspective on taxation includes a number of views related to the objectives of taxation and the possible effect of these objectives on cooperative enterprise. It is necessary to consider several of the general objectives of tax policy and ascertain how cooperatives see their role in the tax system in relation to these objectives.

**Equity: ability to pay.** If achieving equity is an objective of tax policy, the cooperative must know how it will be affected by the equity concept. The equity tax objective may incorporate the "ability to pay" principle which presupposes some criterion for measuring the

\(^{13}\) *Due*, op. cit., p. 120.
ability to pay taxes. The cooperative may be grouped into a special tax classification to achieve this tax objective. This type of selective taxation of cooperatives can be used to circumvent restraints imposed on certain tax programs by the legal nature of cooperatives. The rationale that underlies the selective taxation of cooperatives should be stated explicitly in order that this special classification can be evaluated as a part of the tax system under the equity consideration.

Another problem of equity may arise if cooperatives are taxed as a singular classification. Cooperatives take the form of many business enterprises and, thus, exhibit a wide variation in economic nature. In developing a tax for the cooperative classification there may not be recognition of these economic variations. Consequently, numerous inequities may result within the cooperative tax classification.

Equity: benefits received. The equity tax objective is sometimes based on the "benefits received" principle. This requires establishing a criterion to measure benefits received from governmental services. Readily separating the benefits of governmental services into those received by the individual and those by the whole of society presents the most difficult problem of this approach. The "ability to pay" principle is associated with payment for benefits received by society. Thus, it becomes necessary to clearly identify in which cases

and to what degree a tax should be developed on the "benefits received" principle.¹⁵

The cooperative's concern with taxes developed on the "benefits received" principle is primarily over the criterion used to determine benefits received, and ultimately, the tax liability. Hence, if the tax is an excise tax, it is necessary to know if the tax incidence correctly identifies the benefits received.¹⁶ For the cooperative the question is whether the tax effectively and indiscriminately determines who receives the benefits throughout the community subjected to the tax. Tax differentiation is justified only to the extent necessary to make tax incidence correspond with benefits received.

Economic development and tax policy. The cooperative may be affected by certain public policies which influence the flow of resources between areas of economic development. Tax policy can play an important role in promoting economic development. Hence, it is not a coincidence to find a cooperative enterprise established in areas of economic development which also receive special tax consideration. For example, rural electrification where cooperatives play a significant role has received special tax consideration.

Cooperatives are found in areas of development receiving developmental tax consideration for primarily the same reasons that

¹⁵ Ibid.

¹⁶ The gasoline excise tax is a good example of a tax which may not correctly identify those who receive the benefits from governmental services. For instance, the farmer who uses gasoline in his operation is not taxed to provide revenue for maintenance of highways.
prompted special tax legislation. The economic nature of the cooperative makes it more conducive to developing certain economic areas than other forms of enterprise. Hence, both cooperatives and tax policy are consonant in facilitating the public goal of development. In many instances development could not occur without one or the other.

The concern of cooperatives with special tax legislation promoting development is a projection of those factors which brought about the cooperative form of development (e.g., improvement in economic and social well-being). It is important for cooperatives to impress upon tax policy-makers that the issue of granting cooperatives favorable tax consideration should not obscure more basic public objectives in the area of taxation (e.g., developmental objectives).

SUMMARY COMMENT

To develop an adequate system of taxation, policy-makers must be aware of the role various enterprises play in the economy. Only then is it possible to achieve the necessary insight into evaluating the consequence of taxation on the economy. This chapter has attempted to provide a very general overview of a number of considerations which are imperative to evaluating the impact of taxation on cooperatives. As this study progresses, these considerations may again be of concern in evaluating specific tax proposals.
In the following chapter a digression is made into the economic nature of corporations and cooperatives noting what implications this has for a particular form of taxation—corporate income taxation. This chapter further elucidates a number of important aspects of cooperatives which are relevant to formulation and evaluation of cooperative tax policy.
CHAPTER 3

FACTORS CONTRIBUTING TO THE TAXABILITY
OF NET SAVINGS AND NET INCOME

INTRODUCTION

Before considering the empirical analysis of the effect of various taxes on cooperatives, it is necessary to review a topic of controversy in the area of cooperative taxation. The controversy surrounds the comparative nature of cooperative net savings and corporate net income.

It is the objective of this chapter to ascertain whether there exists a fundamental difference in the nature of cooperative net savings and corporate net income. Since this issue will enter into inferences about the taxes under empirical analysis, this lengthy issue is more appropriately explored in a separate chapter.

NET SAVINGS AND NET INCOME;
BOTH SUBJECT TO TAXATION?

The question that arises is whether cooperative net savings should be taxed in the same manner as corporate net income. This issue must be explored from both an economic and legal viewpoint. Intertwining these views is the problem of determining whether the economic philosophy or economic intent is a factor sufficient to warrant differentiating the taxation of net savings and income. It is these considerations that will be reviewed.
Economic Nature of Corporations and Cooperatives

Several general differences between cooperatives and corporations can be noted. These differences reflect the basic economic philosophy underlying the nature of these organizations.

Ownership and control. George L. Griffin notes that "Cooperatives are voluntary, self-help organizations, designed to provide a service for the member-patrons and not for third parties." The investor and consumer are synonymous in the cooperative. However, corporations are formed by investors to provide a service for the consumer—a third party.

Control of the cooperative and corporation exhibits a vivid contrast. According to Griffin,

Cooperatives are democratically controlled. Control is based on membership, and each member has an equal voice in the control of the organization. Corporations are controlled by stockholders on the basis of number of shares of common stock owned. In one instance, control is based on membership, membership being necessary to patronize the association. On the other hand, control of the corporation is based on stock ownership, stock ownership being the necessity to participate in corporate profits. Thus, a farmer becomes a cooperative member in order to do business with the cooperative which provides him with the advantages of centralized bargaining power, an owner of a share of corporate stock becomes an owner in order to realize gain as an investor.18

Market power. A crucial point of economic difference between cooperatives and corporations is found in their market actions. The economic nature of a corporation is such that it attempts to achieve


18Ibid.
the greatest return possible to its investment. The corporation's intent is to extract from the consumer as much revenue as can be attained in maximizing economic gain—profits.

The cooperative attempts to provide a service at cost in facilitating the transfer of producer's goods and retail products. To maximize the return to investment in the cooperative is not the intent of this organization. Instead, the provision of service at cost increases the use of that service. Providing an essential consumer product, the cooperative enhances the patron's well-being both from the viewpoint of lower costs and increased use or consumption of a necessary consumer product.

Economic gain. The economic gain from the cooperative and corporation as reflected in net savings and net income is sometimes asserted to be of equivalent nature. This viewpoint is expressed by Lorne D. Cook as he says,

The gains from cooperative enterprise are found to be in the nature of corporation profits, which, although they are distributed according to patronage, accrue to member-patrons in proportion to investment and entrepreneurial risks undertaken.\(^ \text{19} \)

Under ideal circumstances a consumer or farm supply cooperative would attempt a zero-savings pricing policy. All benefits would immediately be passed to the patron in the market transaction. As a result, there would be no savings accrual corresponding to Cook's

"corporate profit." The policy of zero-profit pricing would not be acceptable to the corporation because it must reward the investor. The corporation, because of its relationship to the consumer, cannot pass its accrued economic gain to the investor (who is not the consumer) through market transaction.

However, it is recognized that for the purpose of permitting a source of investment funds and maintaining a financial condition secure from adverse economic circumstance the cooperative may seldom employ the zero-savings price policy. But the cooperative does not price to maximize "corporate profits." This policy would restrict the use of the cooperative's services to the disadvantage of the member-patron and contrary to the original intent of organizing the cooperative (i.e., providing a service at cost).

Cook is incorrect in asserting that the gain from the cooperative accrues in the form of corporate profits. The net savings or economic gain held by the cooperative does not accrue to the cooperative but the patron. It is true that net savings could be maximized, but only by restricting the use of the cooperative's services. This policy would have the effect of depriving the patron, in the case of farmer cooperatives, of low cost inputs and increased consumption of inputs which could permit greater utilization of patron's enterprise. John H. Davis expresses a similar view about the nature of the gain from the
cooperative when he says,

Farmers invest their funds in cooperative facilities, not primarily to receive earnings on such invested capital, but to provide services which will enhance their earnings from farming operations. 20

Risk and return to investment. The return to capital stock in a cooperative is limited by Federal statute to eight percent, and sometimes limited further by state law. In some instances, either no return is granted to capital stock or the cooperative operates without capital stock. It appears that the nature of cooperative capital stock does not resemble a risk-bearing security. As Griffin notes "the capital stock of a cooperative resembles a debt obligation, and speculation is not a significant factor in purchasing such an investment." 21 The common stock of a corporation exhibits both the dividend return and accumulated gain, this latter feature not being present in cooperative common stock. Thus, the size of cooperative net savings does not have an effect on the value of common stock as might be the case of net profits in a corporation.

Distribution of economic gain. The distribution of economic gain characterizes the greatest difference between cooperatives and


21 Griffin, op. cit., p. 9.
corporations. In the cooperatives, the economic gain accrues to the member-patron in proportion to the business conducted with the cooperative. There must exist, however, a prior obligation on the part of the cooperative to return overcharges or underpayments after the cost of operating the cooperative has been deducted. Only under this prior obligation does the patron retain ownership of the economic gain provided by the cooperative. The economic gain (net savings) the cooperative accumulates for the member-patron is distributed to the member-patron once a year in the form of cash, merchandise or certificates in proportion to business transacted.\(^{22}\)

In the corporation the economic gain (net income) is distributed to investors proportionally per share of stockholder's capital. The economic gain is a transfer of profits to a third party—the investor. The corporation is under no preexisting legal obligation to distribute the economic gain to the patron-consumer. The patron-consumer has lost title to the underpayment or overcharge in the market transaction.

The Legal Interpretation

Many authorities do not recognize that the difference in economic philosophy of the corporation and cooperative does contribute to a fundamental dissimilarity in the nature of cooperative net savings and corporate net income. The method of distributing the economic gain of these organizations as commensurate with their economic philosophy is

\(^{22}\)Ibid., p. 10.
considered to have no bearing in differentiating the nature of these economic gains. This view is expressed by Robert T. Patterson:

The member-patrons of a cooperative are 'owner-enterprisers of a profit-seeking business.' They are attempting through the transactions of their mutual organization to save or to gain. Though their savings may be hidden or obscured by the complex relationship of owner-patron, prices, and patronage dividends, those savings or earnings are there, nevertheless, to the extent that the association operates economically.23

What Patterson implies is that the difference between total revenues and costs is the only criterion to be used in defining the nature of net savings or corporate profit (whatever the terminology might be). He is at a loss to recognize that the legal system plays an important role in defining economic concepts. As an economist, Patterson cannot see that the preexisting agreement to return net savings in a cooperative to patrons imparts a unique legal character to net savings not existing in corporate net income. Hence, the issue of the difference in net savings and income is confused by limiting the definition of these terms to the realm of "economics of the firm" while rejecting legal considerations.

FINAL PERSPECTIVE

A number of aspects have been outlined to illustrate the different economic nature of the cooperative and corporation. It is

the difference in economic philosophy of each organization which ultimately gives rise to dissimilar interpretations of the nature of their earnings. It cannot be concluded that, while net savings and net income are calculated in the same manner (i.e., total revenue minus total cost), these earnings are similar in nature.

The legal system provides the opportunity for the cooperative and corporation to express the economic nature of their organization. It is in the by-laws that the relationship of these organizations to the investor, member-patron and consumer becomes vivid. This relationship defines the basic nature of their earnings. In the case of the true cooperative, ownership of net savings remains with the patron.

The preexisting agreement to return overcharges and underpayments to the member-patron exemplifies the philosophy that the cooperative should only facilitate the movement of producer's goods and consumer products as an intermediary not seeking an economic gain for itself. In the corporation the ownership of net income is exchanged from consumer to the corporation and investor.

The above premises concerning the economic nature of corporate and cooperative enterprise form the rationale for taxing net income in a manner dissimilar to net savings. Since net savings belong to the member-patron both before and after his transaction with the cooperative, net savings are not taxable as an accrual of income to the cooperative. Furthermore, it must be noted that when the cooperative exhibits the traits of corporate enterprise (as it often does), the
cooperative's earnings are of the same nature as corporate earnings and are taxed accordingly.

It is the fundamental difference in the nature of true cooperative net savings and corporate net income that has been a major source of misunderstanding in the area of corporate income taxation. This review of the topic should set the framework for the empirical analysis of Chapter 4.
CHAPTER 4

AN EVALUATION OF HOW COOPERATIVES ARE
AFFECTED BY SELECTED TAX PROPOSALS

INTRODUCTION

The purpose of this chapter is to analyze how various tax
proposals affect cooperatives. These proposals included a gross receipts
tax and two variations of a state corporate income tax. This chapter
limits its consideration to four categories of cooperative enterprise—
farm supply, grain marketing, conglomerate and petroleum cooperatives.
The tax proposals are considered on their individual merits and not
with respect to alternatives or additions to the present tax system
in South Dakota.

More specifically an attempt is made to determine how the taxes
are applied and what effect will be imposed on cooperatives in different
types of economic enterprise. Comparisons concerning equity are made
within the community of cooperatives as well as between cooperatives and
other forms of business. Where discernible the economic consequences
of the taxes on cooperatives are noted.

Cooperative Categories Defined

Grain Cooperatives. Since there is an overlapping of business
characteristics in the area of farm supply and grain marketing, it was
necessary to arbitrarily establish a criterion for separating these areas.
From the sample data it was found that grain marketing cooperatives do not exclusively handle grain for a number of economic reasons. For analysis purposes grain cooperatives have been defined as those with grain sales and associated services in excess of 85 percent of total sales.

Farm supply cooperatives. Farm supply includes fertilizer, chemicals, feeds, light farm equipment and other farm services and products. For the purpose of contrast between the farm supply and grain marketing categories, the farm supply cooperative is defined as a firm in which grain sales are less than 30 percent of total sales.

Petroleum cooperatives. The petroleum cooperative category includes bulk fuel, liquid propane, tires, batteries, accessories, service station, services and other associated products.

Conglomerate cooperatives. The conglomerate category includes cooperatives which are so diversified as not to fall into the preceding categories. These firms as a rule include several of the following operations: grain marketing, petroleum, farm supply, lumber consumer merchandising and service departments.

Because of the low margins involved in handling grain, most grain marketing enterprises have diversified into high margin farm supply goods to improve net savings—a major source of investment funds—and improve service.
GROSS RECEIPTS TAX

The gross receipts tax (GRT) is often considered for a tax program because tax liability under this tax is easy to determine. Its computation is not as complex as the corporate income tax with its numerous deductions or adjustments. The GRT also provides a stable source of tax revenue by ensuring payment of a tax whether or not a business is receiving a net income.\(^{25}\) This feature raises the question of equity. Furthermore, because the GRT does not consider variances in the economic nature of different enterprises, another question of equity arises.

The Cooperative Classification

This section is primarily concerned with the impact of the GRT on cooperatives. How cooperatives will fare under the GRT will depend on the structure of the tax classification. If cooperatives are selected for special tax consideration, application of a GRT must be evaluated from two viewpoints. The first viewpoint considers the effect of the GRT on cooperatives of a different economic nature within the cooperative tax classification. The second viewpoint notes the impact of the GRT on the cooperative as a member of the business community.

Economic impact. The effect of the GRT is to raise the prices charged or lower the prices paid to patrons, reduce patronage.

distributions, decrease the flow of internal investment funds or any combination thereof. However, if the cooperative operates in a competitive market and other types of enterprise do not have to pay the GRT, the cooperative will be required to absorb the GRT cost to maintain its competitive position.\textsuperscript{26} In this case either patronage distributions or the flow of investment funds will be affected.

In this study the GRT will be considered an expense, decreasing the net margin of the cooperative. The price structure will remain intact, avoiding price-cutting warfare considerations.

Changes in net margins resulting from the alternative GRT rates of one-half, one and three percent as applied to total sales of the twelve cooperatives (Table I) are summarized in Table II. The GRT has been translated into an effective tax on net savings\textsuperscript{)} (i.e., the percent reduction in net savings) to illustrate the inequities existing between the cooperative categories.

\textbf{Intercooperative inequities.} It can be observed of the data in Table III that at each GRT rate the tax burden varies substantially between the cooperative categories. Grain marketing cooperatives, which are low net margin businesses, are most greatly affected by the GRT. Following the grain marketing firms from greatest to least tax burden are farm supply, conglomerate and petroleum cooperatives. At the

\textsuperscript{26}Most farmer cooperatives probably operate under oligopolistic market conditions. In this case the cooperative would not be aggressive in making drastic changes in its price structure for fear of competitive retaliation.
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This figure is the average net margin for each cooperative category.

This figure is the average GRT as a percent of net savings or net margin for each cooperative category.

This figures is obtained by applying the GRT rates to total sales.
one-half percent GRT rate, the grain marketing, farm supply, conglomerate and petroleum cooperatives have their average net margins reduced 15.5, 11.0, 9.6 and 5.2 percent, respectively (see Table II).

Reinterpreting the effect of the one-half percent GRT rate as a comparable tax on net savings (i.e., the percent reduction in net savings) shows explicitly the inequities of the GRT. Referring specifically to the firms with the highest and lowest net savings (see Table I), Table II shows that firm G pays only eight percent of its net savings, $250,000, in tax revenue—$20,000. In contrast firm F pays 17.5 percent of its net savings, $10,000, in tax revenue—$1,750.

At the one-half percent GRT rate the difference between high and low average net savings in percent of net savings taxed away is 10.3 percentage points. However, the inequities between categories are more vividly exposed at the three percent GRT rate where the difference is 62.1 percentage points.

It can be observed that the GRT will have a much greater impact on the economic operations of a low net margin firm than a high net margin firm. This results because the GRT takes a bigger bite of a smaller net margin when the GRT is levied on dollar sales and not net income or savings derived from dollar sales. Hence, the economic efficiency of the low net margin cooperative will be most greatly threatened at a specific GRT rate. In the low net margin firm this would cause more drastic changes in investment, patronage distribution and possibly pricing policy than would be the case in high net margin firms.
Ability to finance tax expenditures. It must be recognized that the cooperative's ability to pay taxes is not reflected in the size of net savings. All or part of the net savings may legally belong to the patron. Consequently, the ability to pay taxes on that portion of net savings belonging to the patron must be evaluated with respect to the patron. For now, to circumvent the determination of "ability to pay" taxes and analyze the impact of the GRT on the cooperative, it is possible to consider the cooperative's ability to "finance tax expenditures." This ability is dependent in part on the size of net savings, total sales and the profit margin.

The absolute size of net savings may not be an indication of ability to finance tax expenditures. It was seen in Table II that the GRT has greater impact on the net savings of firm F than G, even though firm G had the larger net savings (Table I). Moreover, firm J has less than half the net savings of firm G but conducts slightly less than one-fourth the size of firm G's total sales (see Table I). Consequently, firm J has a greater net margin than firm G, 12.8 and 6.25, respectively. The larger net margin may indicate a greater ability to finance tax expenditures without substantially affecting investment and patronage distribution policy than the absolute size of net savings. In the case of firms G and J, the GRT rate of one-half percent is effective at a rate of eight percent of G's and 3.9 percent of J's net savings. Translated into dollars of tax revenue, firm J pays approximately $4,500 while firm G pays $20,000. This shows that the GRT as levied on sales does not consider the ability of the cooperative to finance tax
expenditures as being indicated by the absolute size of either net savings or net margins.

Rate increases. Another observation of the impact of the GRT is noted as the GRT rate increases. Although small increases in the GRT rate may not appear as having a significant impact on a business, the contrary may be true. Assuming the cooperative absorbs the tax, the effect of a GRT rate increase will vary from firm to firm and category to category. For example, in Table II the farm supply category shows that a small absolute increase in the GRT rate from one-half to one percent causes an increase of effective tax on net savings of 55.1 percentage points (i.e., from 11 to 66.1 percent).

The impact of GRT rate increase on the net savings of the firms in each category will depend on the size of the net margin. The lower the net margin the greater is the impact of the GRT on net savings. Figure 1 shows the average percent of net savings paid in GRT by each category for alternative GRT rates. As the GRT rate increases, the inequities, as shown by the effective tax on net savings, between categories and between firms become greater. Those firms which handle low net margin goods (e.g., grain) are affected most greatly by the GRT rate increases.

Intercomparison: Business Community

Equity. Equity is the primary consideration when comparing the effect of the tax system on cooperatives and the rest of the business
Figure 1

The GRT as a Percentage of Average Net Margin
For the Four Cooperative Categories:
Effective Tax on Net Savings
In the case of the special cooperative tax classification whether more or less equity is achieved will depend on how similar businesses outside the cooperative classification are taxed. If the GRT is an addition to the present tax system, cooperatives will be at a disadvantage. They must either absorb the tax cost or reduce their competitiveness with other businesses by adjusting prices to the consumer. If the GRT is instituted in lieu of an alternative means of taxation, then it is necessary to evaluate the comparative burden imposed by the respective taxes on each business classification. If the GRT supplants the corporate income tax where cooperatives are concerned, the effect on the economic position of the cooperative will depend on the change in the absolute burden of taxes and consequent alteration of its competitive position with other enterprises. With the wide variance in effective tax on net savings resulting from the GRT, there is little doubt that in many instances great inequities in the tax structure would result.

**Net savings versus net corporate income.** Imposing the GRT on a cooperative classification raises a much broader question related to the nature of cooperative net savings as was covered in Chapter 3. If the GRT is instituted with intent to circumvent the legal restraints imposed by the cooperative on taxing net savings (sometimes suggested to be the equivalent of corporate income), a new issue arises. The GRT while in nature does not appear to tax cooperative net savings has indirectly the same economic effect.
It is often contended that the cooperative entity does not shoulder the same burden of taxes as its counterparts in the business community. This judgment is usually made where the corporate income tax is levied without recognition of one of the fundamental precepts underlying cooperative enterprise. This precept is that net savings resulting from patronage belongs to the patron not the cooperative if a precontractual obligation to return the net savings exists.\(^\text{27}\) If this precept is not supported by the majority of the public, the cooperative classification can serve to equalize the absolute burden of taxation on cooperatives and corporations per se.

STATE CORPORATE INCOME TAX: I

Federal Corporate Income Tax

How the corporate income tax will affect the cooperative will depend on how taxable income is defined. Because there exists a Federal corporate income tax, the legal tax status of cooperatives is well established by precedent. States which institute corporate income taxes generally follow in similar fashion the precedent established by the Federal government in determining the cooperative tax liability. However, while the definition of what is or is not cooperative income has been established by legal precedent, individual states are at liberty to vary the structure of corporate income tax rates.

In analyzing the impact of the corporate income tax on cooperatives, this section will briefly review the circumstances under which cooperatives have taxable income. Primary reference will be made to the current status of cooperatives under Federal income tax law. After the taxability of cooperatives has been established, corporate income tax schedules from two states will be evaluated. In addition, the corporate income tax will be examined within the perspective of the complementary personal income tax.

**Exempt and non-exempt tax status.** Under existing Federal income tax laws farmer cooperatives may be classified as either exempt or non-exempt. The exempt status allows the cooperative several deductions in computing taxable income. These deductions include (1) normal business expenses, (2) yearly dividends and interest on capital stock, (3) amounts of non-patronage income distributed to patrons (members and non-members alike) on the basis of patronage and (4) patronage refunds—cash and qualified allocations. The last deduction

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28 See Appendix A for Federal qualifications for conferring the exempt tax status.

29 The term dividend will throughout this analysis refer to the fixed interest return to capital stock (common and preferred) and semi-permanent forms of capital (e.g., revolving certificates). Unlike corporate common stock dividends on cooperative stock are not variable, but fixed as stipulated by cooperative by-laws. Hence, dividends and interest returns to cooperative capital will be considered synonymous for the purpose of this study.

30 Qualified allocations are those methods of patronage allocation in which the patron has agreed to include the face value
is allowable only if a precontractual agreement between cooperative and patron requires this action.\textsuperscript{31} This deduction is also extended to corporations under the precontractual arrangement.\textsuperscript{32}

Subject to the non-exempt tax status the cooperative can deduct in computing taxable income (1) normal business enterprise and (2) all precontractual obligations to pay refunds based on patronage to members and non-members.\textsuperscript{33} Non-exempt cooperatives have the option of not returning patronage refunds to non-members; in which case the income is taxable. This option does not exist for cooperatives who wish to maintain the exempt tax status. Non-exempt cooperatives cannot deduct dividends on capital stock in computing taxable income as is the case with corporations. Non-patronage income must be included as taxable income whether or not it is distributed to members or patrons by a non-exempt cooperative.\textsuperscript{34}

\textsuperscript{31}Neely, op. cit., pp. 7-10.

\textsuperscript{32}Ibid., p. 13, footnote 30.

\textsuperscript{33}Neely, op. cit., pp. 7-10.

\textsuperscript{34}Hollis and Ingraham, loc. cit.
State Corporation Income Tax

Two tax schedules are applied to twelve cooperative firms (Table I). The first schedule is a single tax of six percent on taxable income computed under Federal corporate income tax law. The second schedule similar to that of Wisconsin has graduated rates as follows: $0 to $1,000 at one percent, $1,001 to $2,000 at two percent, $2,001 to $3,000 at three percent, $3,001 to $4,000 at four percent, $4,001 to $5,000 at five percent, $5,001 to $6,000 at six percent, and over $6,000 at seven percent. This schedule will also be applied to the taxable income as determined under Federal income tax law. The results from applying the tax schedules to the cooperative firms are summarized in Table II. Included also in the table is the amount of income received by the patron from the cooperative which under Federal tax law becomes taxable to the patron.

The extent of tax liability under a state corporate income tax, if it were to follow the Federal tax base, will depend on whether the cooperative's tax status is exempt or non-exempt. While the cooperative may avail itself of the special tax status granted under Federal tax law, the policy of cooperative internal finance will also determine to what extent it has taxable income.

Exempt cooperatives. The exempt cooperative may not have taxable income although it has net savings. There may be no relationship between

the size of net savings and taxable income because of the deductions granted the exempt cooperative in computing taxable income. Consequently, if all net savings are allocated to patrons on the basis of patronage, the cooperative may have no taxable income (e.g., firms B, C and E in Table III). To maintain the exempt status the cooperative must operate at cost. That is, it must allocate all savings on the basis of patronage even if retained as surplus or reserves. 36

**Non-exempt cooperatives.** The tax liability of the non-exempt cooperative depends on the amount of income received from non-patronage sources and non-member business. Also, deduction of dividends from income is not granted to non-exempt cooperatives. The income obtained from non-patronage sources and non-member business and the policy of the cooperative concerning patronage distributions to non-members would determine the tax liability. 37 The corporate income tax would be levied on income derived from the above sources. The application of the two state corporate income tax rate schedules to the twelve cooperative firms is summarized in Table III.

**Graduated versus single tax rates.** Observation of the data in Table III will show that the graduated tax schedule produces more equity

36 Neely, op. cit., p. 50, "Fertile Cooperative Dairy Association v. Huston," 119 F. 2d 274 (8th Cir. 1941), affirming 33 F. Supp. 712 (N. D. Iowa 1940). For other necessary qualifications for exempt tax status see Appendix A.

37 Hollis and Ingraham define non-member income as income derived from non-member business. (Hollis and Ingraham, op. cit., pp. 8-10).
<table>
<thead>
<tr>
<th>Firms</th>
<th>Federal Tax Status</th>
<th>Federally Computed Taxable Income</th>
<th>Income Subject to Personal Income Tax</th>
<th>State Tax Liability on Federal Income Tax Base</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(3)</td>
<td>(4)</td>
<td>Graduated Rates</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$18,000</td>
<td>$37,500</td>
<td>$1,050&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Farm Supply</td>
<td>Non-exempt</td>
<td>19,000</td>
<td>35,000</td>
<td>1,120&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Exempt</td>
<td>19,000</td>
<td>35,000</td>
<td>1,120&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Exempt</td>
<td>19,000</td>
<td>35,000</td>
<td>1,120&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Grain Marketing</td>
<td>Non-exempt</td>
<td>15,000</td>
<td>25,000</td>
<td>94&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Exempt</td>
<td>15,000</td>
<td>25,000</td>
<td>94&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>Conglomerate</td>
<td>Non-exempt</td>
<td>10,000</td>
<td>10,000</td>
<td>9,900&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>Petroleum</td>
<td>Non-exempt</td>
<td>8,500</td>
<td>40,000</td>
<td>2,100&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Non-exempt</td>
<td>8,500</td>
<td>40,000</td>
<td>2,100&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Non-exempt</td>
<td>8,500</td>
<td>40,000</td>
<td>2,100&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>a</sup>Seven percent tax rate.

<sup>b</sup>Six percent tax rate.

<sup>c</sup>Four percent tax rate.

Sources:
Column 3: Column 10, Table I.
Column 4: Columns 6, 7 and 9, Table I.
(based on ability to pay) than the single tax. For example, firm G has the greatest taxable income, $165,000. Under the graduated tax schedule it would have to pay $11,340 in state income taxes. However, the single tax rate would only require $9,900 in income taxes. For firm F with the smallest positive amount of taxable income at $3,850 the tax liability is $94 and $231 under the graduated and single tax schedules, respectively. The graduated tax schedule weighs less heavily than the single tax on small income but the reverse is true of large incomes.

**Intercomparison: Cooperatives**

Within the community of cooperatives the corporate income tax does not show the discernable pattern of greater impact on specific cooperatives as was present with the gross receipts tax. However, it should be observed that the exempt and non-exempt status does produce a variance in impact of the corporate income tax. This variance is attributable to legal definition of cooperative earnings under each tax status. The weight of firms with the exempt status within each category depends upon the ease with which various types of cooperatives can qualify for the exempt status and desire this objective. However, the ease of qualification for exempt status is dependent on the economic nature of the cooperative. This probably explains why grain marketing and farm supply cooperatives are more likely to hold the exempt tax status. Consequently, the impact of the corporate income tax would be less on these categories.
**Intercomparison: Business Community**

**Corporate and personal income tax.** As was noted in Chapter 3, the earnings accruing to corporations and cooperatives may not be equally subject to the corporate income tax. The nature of corporate net income, as distinguished from cooperative net savings, is the only criterion for determining the extent of taxability. Cooperatives may, however, have taxable net income. In which case, this income is taxed as it would be in a corporation.

Income from single proprietorships or partnerships is taxable to the owner under the personal income tax. Since corporations assume a legal entity apart from the owners, its income is taxed not as personal income but as corporate income.\(^{38}\) In reviewing taxation of the business sector, it is necessary to consider what implications of equity arise from this differentiated impact of taxation on businesses.

The personal income tax has only indirect bearing on the analysis of the effect of the corporate income tax on the cooperative. But since there is always the issue of cooperative net savings not being subject to taxation, the personal income tax becomes a relevant consideration. Why the personal income tax is a necessary corollary to the corporate income tax for achieving equitable taxation of the business community will be noted in the following sections.

\(^{38}\)Dye, op. cit., p. 211.
Single taxation. If the state corporate tax is based on the Federal income tax base, all income not taxable at the cooperative level is taxable at the patron level. Thus, Federal tax law has been structured to preserve the principle of a single tax on farmer income derived from farming activities through the services of the cooperative. But this only holds true when the cooperative meets the exempt tax status criterion.39

Under the existing Federal income tax laws, the income of cooperatives, whether or not distributed to patrons in the form of cash, does not escape taxation because patrons must include qualified certificates of allocation—as personal income. Otherwise, net savings are considered corporate income. Thus, the personal income tax is a necessary condition in achieving equitable taxation where the corporate income tax is instituted.

Case Application of corporate and personal income tax. A tax program including a corporate income tax, but not a personal income tax, would produce a number of inequities between types of business (e.g., corporations, partnerships, cooperatives and single proprietorships). As can be seen from the data of Table III, the member or patron of a cooperative would have distinct tax advantage if a corporate income tax were not supplemented or complemented by a personal income tax. But the cooperative itself would not receive an advantage since it would be taxed on member income only. The reduction in net income is available only to non-member patrons. The choice of method for distributing net income will depend on each cooperative's policies of financial returns.
under the same tax rate schedule as corporations. The cooperative may, however, take advantage of deductions in computing taxable income if the state corporate income tax is levied on the Federal income tax base. The personal income tax adds a greater degree of equity to the tax system where income is derived from forms of business other than corporations and cooperatives (e.g., single proprietorships and partnerships).

To illustrate more clearly how the state corporate and personal income taxes would affect a cooperative and its patrons, cooperatives with an exempt and non-exempt tax status will be analyzed. The impact of the taxes are summarized in Table IV. Firm J, holding a non-exempt tax status, has a taxable net income of $35,000 from non-patronage income and non-member business. The Federal corporate income tax liability is $10,300. With an additional state corporate income tax of $2,100 at the six percent tax rate, the net income of firm J has been reduced to $22,600. Since net income after taxes comprises a portion of net savings, the original net savings after Federal income taxes of $115,000 is reduced by the state corporate income tax to $112,900 (Table IV).

If firm J is in need of financial capital, it is likely that all or part of net income ($22,600) will be retained in unallocated reserves.\textsuperscript{40}

\textsuperscript{40}The non-member portion of net income could be returned to non-member patrons reducing taxable income (i.e., provided a preexisting obligation to return non-member income exists). The reduction in net income would be taxable only to non-member patrons. The choice of method of distribution will depend on each cooperative's policies of finance and distribution of net savings.
Table 4

The Impact of a Corporate and Personal Income Tax on the Net Savings of an Exempt And Non-exempt Cooperative

<table>
<thead>
<tr>
<th>Computations</th>
<th>Firm J</th>
<th>Firm E</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income after Corporate Income Taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable Corporate Income&lt;sup&gt;a&lt;/sup&gt;</td>
<td>$35,000</td>
<td>$0</td>
</tr>
<tr>
<td>Less: Federal Corporate Income Tax</td>
<td>10,300</td>
<td>0</td>
</tr>
<tr>
<td>Less: State Corporate Income Tax</td>
<td>2,100</td>
<td>0</td>
</tr>
<tr>
<td>Equals: Income after Corporate Taxes</td>
<td>$22,600</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Net Savings after State Corporate Income Tax</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Savings&lt;sup&gt;b&lt;/sup&gt;</td>
<td>$115,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Less: State Corporate Income Tax</td>
<td>2,100</td>
<td>0</td>
</tr>
<tr>
<td>Equals: Net Savings after State Corporate Income Tax</td>
<td>$112,900</td>
<td>$25,000</td>
</tr>
<tr>
<td><strong>Net Savings Subject to Personal Income Tax</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Savings after State Corporate Income Tax</td>
<td>$112,900</td>
<td>$25,000</td>
</tr>
<tr>
<td>Less: Unallocated Reserves&lt;sup&gt;c&lt;/sup&gt;</td>
<td>22,600</td>
<td>0</td>
</tr>
<tr>
<td>Equals: Net Savings Subject to Personal Income Taxation&lt;sup&gt;d&lt;/sup&gt;</td>
<td>$90,300</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

<sup>a</sup>Taxable corporate income is cooperative income or earnings subject to corporate income taxation.

<sup>b</sup>Total net savings is exclusive of Federal corporate income taxes.

<sup>c</sup>Unallocated reserves would be derived from after-tax corporate income.

<sup>d</sup>The net savings subject to personal income taxation includes distributions made to member-patrons in the form of cash and qualified revolving certificates, $20,300 and $70,000, respectively.
To distribute this amount to member-patrons would result in double taxation of this corporate income.

Since net savings have been reduced from $115,000 to $112,900 by the state corporate income tax, this reduction will affect the distribution of net savings. In the case of firm J, the added tax liability will probably reduce the distribution of net savings to unallocated reserves. Cash distributions of $20,300 and qualified revolving certificates of $70,000 would remain unaffected (Table IV). The combination of these two forms of allocation in amount of $90,300 would be taxable as personal income of the member-patron. Thus, without the state personal income tax the $90,300 of net savings distributed to members would escape the income tax. However, with the personal income tax all net income produced by the cooperative and net savings accumulated from patronage is subject to taxation at least once.

Considering firm E, which is exempt from the Federal income tax, there is another indication of the need for a personal income tax to complement the corporate income tax. Firm E has no taxable income under its exempt tax status provided it distributes all net savings to both members and non-members on the basis of patronage. Thus, the net savings of $25,000 becomes taxable income only at the patron level where patronage refunds are included as current income (Table IV).
The final tax to be analyzed is a modified state corporate income tax. This tax is essentially the same as the previous version of the state corporate income tax except for one qualification. A minimum income computed from member equity becomes taxable under this qualification. In this section an analysis of the nature of this tax and the consequences it has for the cooperative are determined.

**Taxing Income Computed to Member Equity**

The underlying theme of this second form of income taxation is that all firms must have taxable income. A recent proposal in taxation has suggested that a minimum limitation to cooperative income be determined with reference to member's capital employed. The essence of this line of thought is the imputation of a minimum taxable income equivalent to a five percent return to member equity.\(^{41}\) There would be a provision for deductions from the minimum taxable income of all dividends and interest payments to equity. After these deductions have been computed, the resulting income of the cooperative would be subject to the appropriate rate of corporate income tax.\(^{42}\)

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\(^{41}\)Member equity will refer to capital that is owned by the members of a cooperative and reflects their share of ownership—net worth. There is usually no obligation on the part of the cooperative to repay member equity at a specific date. Borrowings from members which have a specific payable date are not considered equity. (Hollis and Ingraham, op. cit., pp. 15-16).

\(^{42}\)Bill C-59, Section 135-3a. This was a bill introduced before the Canadian Parliament in 1971. A photostatic copy of the bill was obtained by the author upon request from J. T. Phalen, General Secretary of the Cooperative Union of Canada.
As analyzed in this study the imputed income in excess of dividends will only serve as the minimum taxable income. If taxable income as computed under Federal tax law or some other system of taxation is greater than the minimum income, the larger figure will take precedence. Application of this tax procedure to the selected cooperative firms is summarized in Table V.

To illustrate when the cooperative firm is subject to the minimum imputed taxable income in one case and the Federally computed income in another, firms A and I are chosen. In the case of firm A the minimum taxable income as determined by five percent of member equity minus dividends ($19,000) is $1,000 greater than Federally computed income ($18,000). Hence, the imputed income is the corporate income tax base. However, firm I has a greater Federally computed income ($10,000) than minimum imputed income ($7,500) in which case the Federal tax base is relevant for corporate income taxation.

**Objections to Taxing a Minimum Imputed Income**

**Patronage distributions.** One of the basic tenets of cooperative enterprise is that earnings or net savings arising from patronage by member-patrons do not belong to the cooperative. This proposition holds under the precontractual obligation of the cooperative to return net savings from patronage to the member-patron. Under the minimum imputed income concept the only means of reducing taxable income is by returning a portion of net savings (equivalent to the imputed taxable income) to
Table V

The Effect on Twelve Cooperatives of Adding the Minimum Taxable Income Qualification to the Federal Income Tax Computation
In Determining the State Corporate Tax Liability

<table>
<thead>
<tr>
<th>Firms</th>
<th>Member Equity</th>
<th>Imputed Minimum Taxable Income</th>
<th>Taxable Net Income Federal Income Base</th>
<th>State Tax Liability Imputed Base Federal Base</th>
<th>Effective Tax on Net Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
</tr>
<tr>
<td>(7)</td>
<td>(8)</td>
<td>(9)</td>
<td>(10)</td>
<td>(11)</td>
<td>(12)</td>
</tr>
<tr>
<td><strong>Farm Supply</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$500,000</td>
<td>$19,000</td>
<td>$18,400</td>
<td>$1,140</td>
<td>$1,080</td>
</tr>
<tr>
<td>B</td>
<td>250,000</td>
<td>10,500</td>
<td>0</td>
<td>630</td>
<td>0</td>
</tr>
<tr>
<td>C</td>
<td>100,000</td>
<td>4,500</td>
<td>0</td>
<td>270</td>
<td>0</td>
</tr>
<tr>
<td><strong>Grain Marketing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>250,000</td>
<td>6,500</td>
<td>19,000</td>
<td>390</td>
<td>1,140</td>
</tr>
<tr>
<td>E</td>
<td>190,000</td>
<td>9,500</td>
<td>0</td>
<td>570</td>
<td>0</td>
</tr>
<tr>
<td>F</td>
<td>200,000</td>
<td>10,000</td>
<td>3,850</td>
<td>600</td>
<td>231</td>
</tr>
<tr>
<td><strong>Conglomerate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>1,000,000</td>
<td>40,000</td>
<td>165,000</td>
<td>2,400</td>
<td>9,900</td>
</tr>
<tr>
<td>H</td>
<td>450,000</td>
<td>17,500</td>
<td>40,000</td>
<td>1,050</td>
<td>2,400</td>
</tr>
<tr>
<td>I</td>
<td>150,000</td>
<td>7,500</td>
<td>10,000</td>
<td>450</td>
<td>600</td>
</tr>
<tr>
<td><strong>Petroleum</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>J</td>
<td>700,000</td>
<td>35,000</td>
<td>35,000</td>
<td>2,100</td>
<td>2,100</td>
</tr>
<tr>
<td>K</td>
<td>230,000</td>
<td>9,500</td>
<td>8,500</td>
<td>570</td>
<td>510</td>
</tr>
<tr>
<td>L</td>
<td>300,000</td>
<td>6,000</td>
<td>6,500</td>
<td>360</td>
<td>390</td>
</tr>
</tbody>
</table>

Sources:
Column 3: Five percent of column 2 minus dividends (column 9, Table I).
Column 4: Data from column 10, Table I.
Column 5: Six percent of column 3.
Column 6: Six percent of column 4.
Column 7: Column 5 divided by column 4, Table I.
patrons via dividends. This procedure "has the effect of severely interfering with the freedom and ability of cooperatives to distribute their earnings as patronage refunds."\textsuperscript{43}

The interference of the minimum imputed income concept of taxation with the distribution of net savings can be viewed in two circumstances. First, if all net savings are distributed on the basis of patronage, the cooperative must pay a corporate income tax on the minimum imputed income. This interferes with the cooperative precept that all net savings accruing to member-patron business belong to the member-patron and is taxable only at that level. Second, if the cooperative chooses to prevent the taxation of net savings in amount of the imputed income, it must distribute a portion of net savings as dividends to the extent of reducing the imputed income to zero. This action would interfere with the cooperative's policy of allocating all net savings on the basis of patronage.

An example of the above circumstances can be found in the case of firm B. Firm B under the imputed income concept would have a taxable income of $10,500 after $2,000 of dividends are deducted. Net savings would be reduced by a $630 tax obligation if the cooperative refused to declare an additional $10,500 in dividends.

\textsuperscript{43}The Cooperative Union of Canada, Canada, Submission to the Minister of Finance (Ottawa: The Cooperative Union of Canada, 1971), pp. 1-2.
Effect on investment flow. Patronage refunds in the form of certificates of allocation provide a major source of investment funds for retiring the equity of members no longer using the cooperative's services, revolving semi-permanent equity and expanding services. It is possible that the imputed income method of taxation will reduce the flow of internal investment funds. This may result if the minimum computed income would produce taxable income in excess of what normally would be the case. Cooperatives which are exempt under the Federal method of computing taxable income would be most greatly affected.

An example of the flow of investment funds possibly being reduced is exemplified by firm B (Table V). Firm B has no taxable income under Federal tax laws. However, the imputed income concept would introduce a taxable income of $10,500. Under a six percent state corporate tax rate firm B would be required to pay $630 (Table V). This $630 tax obligation must be absorbed either through reduced cash distributions or revolving certificates. A reduction in revolving certificates would decrease the flow of investment funds.

Reducing cooperative income. The imputed income proposal provides for the single taxation of income if the cooperative is willing to reduce

44 Ibid., pp. 2-3.

45 Revolving certificates are certificates of allocation which have been retained to meet capital requirements to operating reserves and are revolved or refunded on a cyclical basis (e.g., seven year cycle). Roy, op. cit., pp. 338-342.
taxable income to zero by declaring dividends in amount equal to the imputed income base. Since this tax proposal is being analyzed at the state level, it is necessary to note the consequence for cooperatives of taxation at the state level because of restrictions imposed on the cooperative at the Federal level of taxation.

The granting of dividends to member equity is limited by Federal tax law to eight percent if the cooperative wishes to maintain the exempt tax status.\(^{46}\) Consequently, for the exempt cooperative the extent of reducing taxable income is limited. Non-exempt cooperatives whose dividends are taxable as income at the Federal corporate and personal levels would find this method of reducing taxable income undesirable. The gain on the state level would surely be offset by the loss on the Federal level of taxation.

For example, firm F's imputed taxable income is $6,150 greater than the Federally computed tax base (Table V). Firm F would have to pay $369 more in state corporate income taxes than would be the case if the Federal income base were applicable. Under these circumstances, for the firm to reduce this $369 state income tax obligation, $6,150 in dividends would have to be distributed. Since dividends of non-exempt cooperatives are taxable as corporate income at the Federal level, the increased dividends would enlarge the Federal income tax obligation.

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\(^{46}\)Neely, op. cit., p. 7. The limit imposed by Federal tax statute on dividends on cooperatives holding the exempt status is eight percent of capital stock.
by approximately $1,353 (at the 22 percent Federal corporate tax rate). The loss to the cooperative would be $957 in reducing the state corporate tax liability. Consequently, for firm F as a non-exempt cooperative it would not be financially sound to take advantage of the reduction in the imputed minimum income via dividends.

**Dividends and cooperative principles.** The imputed income concept of taxation violates several cooperative principles. The conflict with cooperative principles stems from the procedure of reducing taxable income through dividends on member equity. This aspect of the imputed income concept forces the cooperative to violate the principle of returning net savings arising from patronage back to the patron on the basis of patronage. The use of the cooperative's services as a criterion for determining the benefit to the patron can only be achieved at the cost of an increased income tax obligation under the imputed income concept. As a result, double taxation of patronage refunds occurs unless the refunds are tax exempt at the patron level.

**Adverse Effect on Low Net Savings Operations and Development**

Another problem arising with the minimum imputed income concept of taxation is related to the ability of the cooperative to finance tax expenditures. Cooperatives which operate in the area of low margin goods and have low volume sales would be greatly affected by the imputed

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47 Only taxation at the state level is considered in the following sections.

income concept. Cooperatives operating at a loss would still be faced with the imputed income tax liability. These means of taxation would then reflect a deviation from the concept of "ability to pay" present in the Federal corporate income tax.

Development of the cooperative enterprise may also be impeded by the minimum imputed income concept of taxation. Cooperatives which require a great initial capital investment for establishing a viable enterprise would have an income tax obligation of significant size. This tax burden would be incurred before it could develop its business and increase its ability to finance tax expenditures.

Several observations can be made about the data in Table V. First, the minimum imputed income would not greatly increase the tax liability of currently non-exempt cooperatives. Most of these cooperatives have non-member and non-patronage income (Table I) already exceeding the minimum imputed to member equity. Second, the exempt cooperatives would be most affected by the imputed income concept since under the Federal tax base computation they would have no taxable income. Third, the net effective minimum tax on net savings would be generally less than three percent. The exceptions are firms F and I. Fourth, where the cooperatives have distributed dividends, the imputed income and consequent tax liability has been substantially decreased (Table V). For example, firm A has an imputed minimum taxable income of $25,000. But this cooperative pays dividends of $6,000 (Table I) which reduces the imputed minimum income to $19,000 (Table V).
This study has focused on a number of problems stemming from taxing cooperatives. Two perspectives on cooperative taxation—one from the view of policy-makers and the other from the view of cooperatives—were taken to identify these problems. It was observed that the means of taxing cooperatives could have a significant impact on community welfare. Therefore, it was concluded that the possible consequence for community welfare of cooperative taxation should play an important role in the formulation of tax policy.

The taxation of cooperative net savings and corporate net income was reviewed to ascertain why the different economic nature of the cooperative and corporation contributed to a dissimilar character of net savings and net income. It was found that the difference in taxation of net savings and net income stems from a variance in the economic philosophy of cooperatives and corporations. This variance in economic philosophy has led these enterprises to establish different legal structures and conduct unlike economic actions. However, it was primarily the legal relationship between these enterprises and the consumer (patron) and investor (member) that provided the basis for making a distinction between net savings and net income for the purpose of taxation.
The empirical analysis was limited to three tax proposals. It can be concluded that in the case of the gross receipts tax it is an inappropriate means of taxing farmer cooperatives. This tax exhibited inequities between types of cooperative enterprise. For that matter, the variance in impact of the gross receipts is related to the net margin of the cooperative. As the net margin increased, the burden of taxation decreased. Consequently, cooperatives with low net margins (e.g., cooperatives handling low margin goods) were affected significantly greater than high net margin cooperatives. This conclusion was drawn by computing the effective tax on net savings of the gross receipts tax (Table II). It is concluded that the gross receipts tax base—total sales—bears no relationship to the size of net savings or net margin which indicate, in part, the cooperatives ability to finance tax expenditures (but not necessarily pay taxes).

A state corporate income tax levied on the Federally computed income base appears to be the most equitable of the three taxes evaluated. This tax considers the ability to pay and also recognizes a cooperative proposition—the right of patrons to patronage refunds before corporate taxation.

If the objective of tax policy is to increase tax revenues from cooperative and corporate enterprise, the corporate income tax as it affects cooperatives would not be a significant tax revenue producer. Many cooperatives are either tax exempt or produce little taxable income.
However, if the state corporate income tax were supplemented by a personal income tax, the earnings of patrons derived through the cooperative would be subject to taxation. Thus, where it appears cooperatives would not be paying a substantial amount of corporate income tax, patrons would be shouldering a greater burden of taxation via the personal income tax on patronage refunds. The personal income tax is a necessary corollary to the corporate income tax in achieving greater equity within the whole tax system.

Several conclusions can be drawn about the additional qualification to the state corporate income tax—the imputed minimum income for cooperatives. This qualification has the effect of interfering with the distribution of patronage refunds only to the extent it is necessary to pay dividends to reduce taxable income. Cooperatives now holding the exempt Federal tax status would either pay corporate income taxes or pay dividends to patrons in amount of the imputed income. Either action is contrary to cooperative philosophy (i.e., provided dividends paid to reduce taxable income are in excess of the dividends normally paid). If the cooperative were to pay the corporate income tax, double taxation of net savings would occur.

The imputed income qualification has an undesirable economic effect on inefficient cooperatives (e.g., those operating at a business loss). Where the imputed minimum income is in effect, the corporate tax liability can be considered a fixed cost. This fixed cost does not reflect the equity concept of taxation, the ability to pay.
the added fixed cost associated with the imputed income qualification may impede the development of new cooperative enterprises.

If the imputed minimum taxable income qualification were adopted, it would be necessary to grant exemption from the corporate income tax liability under the adverse economic conditions mentioned above. For example, a tax credit or exemption could be granted to firms with net savings less than $5,000.

The imputed income qualification would not significantly affect the economic operations of well-established cooperatives. Generally, net savings would not be reduced by more than two percent. With the tax exemption of net savings less than $5,000, the likelihood of net savings being reduced by more than two percent is even less.

The main obstacle to implementation of such a corporate income tax is the compromising by cooperatives of their principles of distributing net savings on the basis of patronage and preserving single taxation of net savings. It appears that it would be possible for cooperatives to devise a scheme of distributing dividends which would be consonant with patronage distributions. This would reduce the imputed income qualification to the corporate income tax useless.

TOPICS FOR FURTHER RESEARCH

In the area of gross receipts taxation it may be possible to develop a means of tying the gross receipts tax to a sliding rate schedule based on net savings, net margin or some other criterion. This
could bring about more equity to this method of taxation. Further research could establish whether this modification would reduce the inequities that are characteristic of gross receipts taxes.

Further research is necessary to determine the impact of the observed taxes on the financial operations of cooperatives. This is especially needed where the imputed minimum qualification has been added to the corporate income tax. It will then be possible to evaluate more fully the consequence of various tax proposals for cooperatives and communities. Since the taxes studied have not been instituted in South Dakota, it is impossible to evaluate the economic consequences in retrospect. Empirical research in this area would require studying states which have adopted tax systems analyzed in this study.

It is possible to project the total impact on all cooperatives subjected to the evaluated taxes. This would provide the basis for selecting an appropriate tax rate schedule in accordance with the revenue needs of state and local government.
SELECTED BIBLIOGRAPHY
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B. SECONDARY SOURCES

APPENDIX A
APPENDIX A

SECTION 521. EXEMPTION OF FARMERS' COOPERATIVES FROM TAX

(a) Exemption From Tax.--A farmers' cooperative organization described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, 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 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.