

THE TAXATION OF CO-OPERATIVES' INCOME: ANALYSIS OF ITS RATIONALE

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Abstract

In this paper we address the issue of taxation of cooperatives' income. Cooperatives traditionally receive a specific tax treatment distinct from that given to companies. In general terms, that specific cooperative tax regime is apparently more favorable when compared to the one applied to companies. A tradition of granting cooperatives a favorable tax relief-based tax regime is widely extended, being noticeable in all Western European Countries and in the Northern American countries (USA and Canada). This paper seeks to lay down some conceptual basis on which the issue ought to be analyzed, with a special emphasis on the definition of what is to be treated as cooperative income for tax purposes and the rationale for a favorable cooperative tax regime.

I. Purpose and scope of the study

We must warn from the very beginning that the subject that we propose to discuss in this paper is not new or original and most probably we will not be able to bring any new insight about it.

In fact, since the very emergence of cooperative societies, modern tax systems have created and developed special rules for the taxation of these entities. These special tax regimes have persisted to this day, regardless of the ideological and social fluctuations occurred in the different countries and in the large regional legal and political families. And since the very beginning, the issue of taxation of cooperatives has been debated, in the perspective of equal tax treatment with other forms of business. The debate has always been ideological more than technical and it remains so.

From the perspective of a tax lawyer or of a tax legislator, the principle of equality in taxation is cardinal in the topic of taxation of cooperatives. It's not sustainable, in our humble opinion, that cooperatives should be granted any favorable tax regime on the simple and unelaborated statement of their especially relevant social function. Not because cooperatives do not have an especially relevant social function, but because companies have a very relevant function as well, particularly in developed economies. It may be true that gigantic companies' power must be brought under control; but it is also true that the company model of enterprise

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organization has become popularized and that an enormous part of GDP in developed countries is generated by small and medium for-profit enterprises, most of them companies, largely based on the work of their owners (is the assumption that companies are capital centered still valid?). If we fail to guarantee equality in taxation we risk creating malfunctions in our societies, which would result in a decrease in our general well-being.

But guaranteeing equality in taxation entails treating differently what is different and equally what is equal.² And there is no doubt that there are differences between cooperatives and companies. The most important basis to guarantee an equal treatment between cooperatives and companies as well as other forms of business is to carefully distinguish differences between them.

Differences that matter for the taxation issue begin with the nature or status of net proceeds (income) of transactions carried on by cooperatives. There is a possibility that not all net proceeds accruing to cooperatives have a tax substance, with the consequence that not taxing those proceeds should not even be seen as favorable tax treatment (a tax incentive) at all.³

So, in this study we propose to explore the concepts mentioned above – income, differences and similarities with companies and tax incentives – in their relationship with the special structure of cooperatives, a structure that is related to the very nature of cooperatives and to the cooperative principles.

We intend to address the subject from a strict legal perspective, which means that we will purposely refrain from referring to any issue related to the development of the cooperative sector. Also, we will try to treat the topic in terms of its general theory, which means that we'll be searching for concepts that are applicable to any cooperatives in any given legal system, although occasionally some examples can be taken from particular jurisdictions to help clarifying the analysis.

But, going back to our first declaration at the beginning of this introduction, it's unlikely that we will be able to bring any truly innovative insight into this subject, since it was already been brilliantly treated by Arthur Pigou in his 1920 study "Co-operative societies and income tax".⁴ We can only, and that's our true purpose, modestly review the contribution of that honored Author and bring it to the current discussion.

² MUSGRAVE, Richard (1990). *Horizontal equity, once more*. National Tax Journal, Vol. 43, 2 (June, 1990), p. 113.

³ In this regard, PEPE, Francesco (2009). *La fiscalità delle cooperative, Riparto dei carichi pubblici e scopo mutualistico*, Mian: Giuffrè Editore, p. 74.

⁴ PIGOU, Arthur C. (1920). *Co-operative societies and income tax*. The Economic Journal, Vol. 30, 118 (Jun 1920), pp. 156-162.

II. Types of cooperative earnings

In order to classify the different types of earnings accruing to cooperatives, it will be helpful to review some specific structural features of the cooperative enterprise. The cooperative is an associative organization, like companies, but in which, unlike in companies, the members join the cooperative with the purpose of carrying out an economic activity with it, whether as producers of goods and services or workers, or as consumers of goods and services.⁵

It's important to note, for those who may not be so acquainted with the cooperatives' topic, and for the purpose of the analysis of the taxation issue, that economic transactions carried on between members and the cooperative are not something that occurs incidentally in a cooperative, or just as a side effect of the normal functioning of the cooperative, but stands rather as the very specific and core objective of the cooperative institution itself.⁶ This means that members join the cooperative with the aim of conducting economic operations with it, rather than doing so with any other organization, and do it in order to maximize their economic advantage.⁷

The clearest example might be given by agri-food cooperatives. In agri-food cooperatives, members are agricultural producers who, in most cases, sell their crops to the cooperative for marketing or processing.⁸ Producers may also use services provided by the cooperative and that they need to incorporate into their individual production process, such as technical advice, supply of inputs or equipment, etc. When a farmer joins an agricultural cooperative, they seek to sell their crops at the highest price possible, and buy inputs from the cooperative at the lowest price possible.

The same reasoning applies to any other type of cooperative. In housing cooperatives, cooperative members enter into transactions with the cooperative with the purpose of acquiring a house in more favorable conditions than those they would be able to be granted if they simply bought the house or acquired the construction service from any other type of commercial organization. And so on.

The economic transactions that cooperative members perform with the cooperative ("cooperative transactions") vary in their nature. In some cases, cooperative members join the cooperative to carry out a professional activity (labor cooperatives, teaching cooperatives) or a productive activity (agricultural cooperatives); In other cases, members join the cooperative to be able to purchase goods (consumer cooperatives) or services (housing cooperatives,

⁵ FICI, Antonio (2013). "An Introduction to cooperative law", in D. CRACOGNA, A. FICI & H. HENRY (eds.). *International Handbook of Cooperative Law*, Berlin: Springer, p. 22-23; HENRY, Hagen (2012). *Guidelines for cooperation legislation*. 3. ed. Geneva: ILO – International Labour Organization, p. 38.

⁶ FICI, Antonio (2013), cit., p. 23; MEIRA, Deolinda (2012a). *Revisitando o problema da distinção entre excedente cooperativo e lucro societário*. Proceedings of the 2nd Congress of Corporate Law. Coimbra: Almedina, p. 355.

⁷ FICI, Antonio (2015). *La Función social de las cooperativas: Notas de derecho comparado*. REVESCO 117, p. 84.

⁸ Some Authors sustain that members do not sell "to the cooperative" but to third parties through the cooperative. In our view, the answer to this question depends on whether the cooperative assumes the risk associated with property of the goods that it acquires from members. In Portugal, cooperatives fully assume the risk associated to goods bought from members.

financial cooperatives) that they use in their personal life domain. Even in the case of solidarity cooperatives, members acquire a service that is provided by the cooperative (e.g. special education for handicapped people), which can still be seen as an economic need of members.⁹

It should not be objected to our basic assumption – “cooperative members join cooperatives with the purpose of conducting economic transactions with them, rather than doing so with any other organization, in order to maximize their economic advantage” – that this is an economical approach incompatible with cooperative values, not reflecting the essence of cooperatives. In fact, some cooperative scholars might oppose to our premise that cooperatives are mainly focused on non-economic values, like cooperation in itself, etc. We think we can reply, for the purpose of our analysis, that “economic transactions” and “economic advantages” should be interpreted in a very broad sense, covering any type of human necessities. It is worth noting that the cooperative movement was born to solve the problem of hunger and the lack of work – two essentially economic problems – of large sections of the population in European industrialized countries.¹⁰

Besides, as several Authors point out,¹¹ the above characteristic – the main focus on transactions with members – is what differentiates cooperatives from other forms of enterprise organization from a legal point of view. It can be found in the ICA's Statement on the Co-operative Identity, specifically in reference to the definition of a cooperative: “A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.”

The above-mentioned distinctive trait of cooperatives becomes critical for the definition of what cooperative's income is. For it is of the essence of cooperative organizations that while trading with members the cooperative must seek to maximize the member's economic advantage instead of its own advantage or earnings.¹²

This economic process, which is exclusive to cooperative organizations, is what defines their very nature. When an investor acquires a share in a joint stock company, that investor just trusts their capital to the company's administrators, hoping that their money will be invested by the company's administrators in the most efficient way possible (from the point of view of obtaining profit) in order to receive dividends in the future. The investor no longer has a role in the life of the company, apart from the control role that, in a very limited way, is given to him to be exerted through the company's general assembly. The company's shareholders have a legitimate expectation that their money will be used in the most profitable way possible, which is the aspect that defines the nature of companies and frame all their activity.

⁹FICI, Antonio (2013) ... *cit.*, p. 23.

¹⁰ COLE, George (1944). *A century of co-operation*. Manchester, George Allen And Unwin Ltd, p. 1.

¹¹ FICI, Antonio (2013) ..., *cit.* p. 23.

¹² FICI, Antonio (2013) ..., *cit.* p. 39.

This structural characteristic of companies implies that the company buys all its inputs at the lowest possible price and sells all its products or services at the highest possible price.

It is not so with cooperatives, because cooperatives must seek “not making profit”, since in the case of a cooperative, profit is made at the expense of the members, thus being averse to its very purpose and essence. Let’s consider, for instance, a lawyers’ cooperative that provides services to its members. The cooperative is supposed to pay the lowest possible price for inputs (leasing, electricity, communications, etc.), that it uses to provide services to its members, but it is also supposed to provide its services to members at the lowest possible price, in order to maximize the members' economic benefit. If the cooperative should sell its services to its members at the lowest possible price, it should desirably not obtain any income from the transaction with the member.¹³ The price at which the cooperative sells the service to its member must tend to equal the value of the inputs incorporated into that service. The concept of “cost”, of course, must include not just the specific costs incorporated in the service provided to any single member, but also general costs and, moreover, the estimated costs of replacing and renewing the productive capacity. Of course, “estimated costs of replacing and renewing the productive capacity” is a very comprehensive concept, that may offer a broad basis to justify retaining surpluses. From the point of view of taxation, that would not hamper its treatment in the same way as any other cooperative surplus, as long as full and transparent accountability is granted concerning the application of those reserves.

The concept of cooperative surplus must be understood in the light of the explained context of transactions between the cooperative and its members.¹⁴ If the cooperative sells the service to the member at a price that exceeds the costs incorporated in the service, a cooperative surplus is generated.¹⁵ Such surplus is not something that the cooperative should pursue in order to fulfil its constitutional object but rather an “error”, arising from an imperfect estimation of the value of the costs embodied in the service provided¹⁶ or rather from the prudent inclusion in the price charged of a margin intended to cover a market-related risk that does not prove materialized at the end of the year.¹⁷

¹³ HENRY, Hagen (2012) ..., *cit.*, p. 105.

¹⁴ Legal statutes do not always embody a definition of cooperative surpluses as distinctive and clear as the one given here. For instance, in the Portuguese Cooperative Code, article 100 says that “[T]he annual net surpluses, with the exception of those arising from operations carried out with third parties, which remain after the payment of interest on the capital securities and the building of the various reserves, may be returned to the cooperators.” And “[T]he distribution of surpluses among the cooperators may not be carried out, nor the creation of free reserves, before the losses of previous years have been offset or, having used the legal reserve to offset these losses, before having rebuilt the reserve to the level prior to its use.” The first error in this provision is that cooperative surpluses cannot arise from operations carried out with third parties. A second error is that there are not any surpluses before the “payment of interest on the capital securities”, because interest is a cost that must be offset to receipts when computing surpluses, not after surpluses are already computed. And finally, losses of previous years are the result of errors in setting the price in cooperative transactions, so of course losses must also be offset to receipts when computing surpluses, not after surpluses are already computed.

¹⁵ MEIRA, Deolinda (2012a), ... *cit.*, p. 105.

¹⁶ CABALEIRO, Maria (2000). *El excedente de la sociedad cooperativa, especial referencia a la Ley 5/1998 de Cooperativas de Galicia*. REVESCO- Revista de estudios cooperativos, 72, p. 37.

¹⁷ HENRY, Hagen (2012) ... *cit.* p. 94.

But not all financial surplus obtained by cooperatives come from “cooperative transactions”, i.e. transactions with members. Although these should form the nuclear part of the cooperative’s activity, cooperatives can carry out transactions with third parties,¹⁸ albeit limitedly.¹⁹ These transactions with third parties may be of the same type or nature of “cooperative transactions”²⁰, except that are carried on with non-members. The case of an agricultural cooperative that purchases products from non-member farmers, or of a housebuilding cooperative that sales a house to a non-member party, or the sale of goods to non-members in the case of consumer cooperatives are examples of transactions of the same nature of cooperative transactions carried on with third parties.²¹ Along with Munkner, we designate these transactions as “purpose transactions with third parties”.²² Earnings arising from this type of transactions form the so called “extra-cooperative income”.²³

On the other hand, cooperatives can carry out non-purpose activities, i.e. operations not comprised in its regular activity, such as the acquisition of financial assets, the sale of fixed assets, the leasing of facilities or equipment that are not being used by the cooperative, etc. These transactions are instrumental in relation to the cooperative’s purpose activity.²⁴ Earnings arising from this type of operations form “non-operational income”.²⁵

Both “extra-cooperative income” and “non-operational income” have a radically different nature from “cooperative surplus”. Any discussion on cooperative income taxation must consider these three different sources of income, as will be better explained in the following sections.

III. Taxation of “cooperative surpluses”

As Pigou says in his above-mentioned famous writing,²⁶ “much the most important part of this question concerns the status of the net proceeds of transactions of sale between co-operative societies and their own members. Representatives of private traders maintain that the whole of these net proceeds constitute a (money) profit: the majority of the Royal Commission on the Income Tax maintain that part of them which is retained by the societies

¹⁸ VARGAS, Carlos. (2006) *La actividad cooperativizada y las relaciones de la cooperativa con sus socios y con terceros* Navarra: Editorial Aranzadi; MEIRA, Deolinda & RAMOS, Elisabete (2014). *Governança e regime económico das cooperativas -Estado da arte e linhas de reforma*. Porto: Vida Económica.

¹⁹ HENRY, Hagen (2012) ... *cit.* p 93; TORRES, Carlos (2013). “Peru”, in D. CRACOGNA, A. FICI & H. HENRY (eds.). *International Handbook of Cooperative Law*, Berlin: Springer, p. 594.

²⁰ MUNKNER, Hans-H. (2018). *Legal Framework analysis*. National Report: Germany. ICA-EU Partnership, Cooperatives Europe, p. 5, referring to German cooperative law, distinguishes between “purpose transactions”, i.e. transactions to serve the purpose for which the cooperative society was formed, with non-members, and “counter-transactions, transactions to make purpose transactions possible. Purpose transactions with non-members match our concept of “operations with third parties”.

²¹ FICI, Antonio (2013) ..., *cit.* p. 31.

²² MUNKNER, Hans-H. (2018), *op. cit.*, p. 5.

²³ BANDEIRA, Ana, MEIRA, Deolinda & ALVES, Vera (2017). *Los diferentes tipos de resultados en las cooperativas portuguesas*. Un estudio de caso múltiple. REVESCO- Revista de estudios cooperativos, 123, p. 40.

²⁴ FICI, Antonio (2013) ..., *cit.* p. 31.

²⁵ FAJARDO, Isabel-Gemma (1992). *La gestión económica de la cooperativa: Responsabilidad de los socios*. Valencia: Universidad de Valencia, p. 229.

²⁶ PIGOU, Arthur C., *op. cit.*, p. 156.

and not distributed in the form of dividends on purchases constitutes a profit; and the representative of the co-operative societies maintain that no part of them constitutes profit”.

It became clear in the end of the previous section that “cooperative surplus” is not to be seen as any positive difference between receipts and costs at the end of any fiscal year, but is only the surplus generated in “cooperative transactions” which are the “purpose transactions” carried on with members, ie transaction with members that fulfil directly the object of the cooperative (“purpose operations with members”).

Since “cooperative surpluses” as previously explained are originated by an “error” in estimating the price to be paid or charged to the member, or by incorporating in the price payed or charged a margin aiming to cover a market-related risk that did not materialize at the end of the year, “cooperative surpluses” should, in principle, be returned to members, through a “patronage refund”²⁷, so the cooperative fully fulfils its constitutional purpose of maximizing the member’s economic advantage.²⁸ Therefore, refunding cooperative surpluses is not to be seen as an extra benefit that members can receive as a result of a good performance of the cooperative, but rather as a mere adjustment in financial flows that is required in order to fulfil the purpose of the cooperative.

Therefore, in principle, if cooperative surplus is to be seen as an amount accruing to the cooperative due to an imperfect estimation of the price to be paid or charged to the member and which must be returned to them, then cooperative surplus should not, in idealistic terms, be considered income of the cooperative.²⁹ Consequently, it should not, in principle, denote a cooperative’s ability to pay tax and therefore should not trigger any taxation. Also, since surplus is not to be seen as income, the non-taxation of cooperative surplus is not technically a tax exemption, i.e. a tax incentive. It must rather be seen as the exclusion from taxation of an accrual that has no taxable substance.

However, the issue is not as linear as described above. Since cooperative bylaws and cooperative legislation allow cooperative bodies a wide margin of discretion regarding the decision as to whether or not refunding surpluses to members, cooperative surpluses are not always necessarily paid to members in the form of patronage refunds.³⁰

Regarding this topic, it is worth recalling the Third Cooperative Principle, as stated by the International Cooperative Alliance, that states on the application of cooperative surpluses:

²⁷ FREDERICK, Donald (2005). *Income tax treatment of cooperatives: Patronage Refunds and other Income Issues*, Cooperative Information Report 44, Part 2, Washigton: USDA Rural Development.

²⁸ LLOBREGAT, Maria (1989). *El principio de mutualidade y su incidència sobre el régimen jurídico-económico de las sociedades cooperativas*. Alicante, Universidad de Alicante, p. 470; MEIRA, Deolinda (2015). “O regime da distribuição de resultados nas cooperativas de crédito em Portugal. Uma análise crítica”. *Boletín de la Asociación Internacional de Derecho Cooperativo*, p. 100.

²⁹ HENRY, Hagen (2012) ... *cit.* p. 94.

³⁰ Referring again to Portuguese law, article 100 previously cited (footnote 13) says only that “surpluses may be returned to members”. With the aggravation of the fact that the term “surplus” used there is too broad and inaccurate, this leaves the cooperative assembly a very wide margin to decide on the distribution of surpluses, such that, in most cases, the cooperator will not be able to perceive any connection between returns and the transactions carried out by them.

"Members allocate surpluses for any or all of the following purposes: developing their cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership." This principle provides cooperatives with a legal basis for holding surpluses, being thus crucial to assess the legal nature of retained surpluses.

The first important notion arising from the Principle is that there is no legal obligation for cooperatives to return cooperative surpluses to members, and therefore there is no general basis for cooperatives to consider cooperative surplus as a liability instead of income in their accounts. Thus, the above assumption, that cooperative surpluses should not, in idealistic terms, be considered income of the cooperative need, in practical terms, to be evaluated in light of the actual rules governing the cooperative in question.

It is true that the Third Principle, among various possibilities concerning the application of cooperative surpluses, refers to one consisting in "benefiting members in proportion to their transactions with the cooperative," which means the refunding of surpluses to the members who originated them through the transactions they entered in with the cooperative.

In view of the economic nature of the surplus – a net margin generated by an operation with the member – taking into account the fact that the occurrence of a surplus means that the cooperative failed in its essential purpose of maximizing the member's economic gain, considering also that the holding of surpluses means an accumulation of financial assets in the cooperative at the expense of the member, and finally taking into account the possibility provided for in the Third Principle of refunding surpluses to cooperators, it can be sustained that there is no impediment for the cooperative internal bylaws or even national law to lay down a legal obligation for the cooperative to refund surpluses on a periodical basis. Whenever such an obligation is laid down in law or in the cooperative internal bylaws there is no doubt that the surpluses which the cooperative refunds to members must be classified and disclosed in accounts as liabilities and not as income and are therefore not to be treated as taxable income. We find this approach put into practice in some legal systems of the Anglo-Saxon legal systems family, like the USA.³¹ Even in the cases where the members, following a deliberation of the general assembly will decide to renounce receiving refunds for specific reasons, this could very clearly be seen as a capital contribution, which would not change its nature for tax purposes.

But even when patronage refunds are not based on any legal or regulatory obligation but on a deliberation of the membership, the fact cannot be ignored that the surplus always represents an imperfect accomplishment of the main obligation of the cooperative towards its members, of maximizing their economic gain in any transaction, and therefore was unduly obtained at their expense. Thus, by refunding surpluses, the cooperative is only returning to members a sum that already belonged to them. To that extent, surpluses returned to cooperators should

³¹ BAARDA, James (2007). *Cooperatives and Income Tax Principles*. Little Rock: University of Arkansas, p. 2.

not be considered as income of the cooperative for tax purposes. Or as Pigou says, refunded surpluses “are, in essence, not a profit in any sense, but a refund made from an overcharge”.³²

Obviously, surpluses refunded to members can be subject to tax as income of those who receive them, depending on the nature of the transaction that gave rise to the surplus. In this regard, the key point is whether the transaction between the cooperative and the member was intended to generate income for the latter in the first place, or just a personal saving. Taking the example of an agricultural cooperative, who bought the production of the member A at a price X, and later paid them an additional sum Y for patronage refund, the refund Y is an income accruing to A, as well as the price X initially paid to them, both coming from their agricultural activity. Considering now a consumer cooperative, if the member A initially was first charged the price X and subsequently received an amount Y as a patronage refund, the sum Y is not income, but only a deduction of a price paid by them for personal consumption,³³ so that there will be nothing to tax.

But again, there is more to this question than just that. Traditionally, cooperative surplus is returned to members in proportion to the volume of transactions of each member, which equals distributing surpluses to the members who originated it in the amount generated by each member. This is the practice, in our view, that is more in line with the Third Principle, mentioned above.

However, some legislations allow refunding of surpluses not in proportion to the volume of transactions carried on by each member, but rather in proportion to the capital subscribed by each member.³⁴ When this possibility is available, and when it applies to “cooperative surpluses”, this necessarily means the enrichment of some members on the basis of capital invested, just like any company shareholder, at the expense of other members who will not be able to maximize their economic advantage from their transactions with the cooperative. Aside from the difficulty of making this mechanism compatible with the essence of cooperatives and with the Third Principle in particular, the fact is that these gains have nothing to distinguish them from the profit of a company, since the cooperative is remunerating a capital contribution that is not mutualistic in its essence. We can say that the capital contribution is not mutualistic in its essence because the investor is seeking a capital gain, as in any for profit organization; besides they are not, concerning the capital contribution, in the same position as the other cooperative members. The capital investor is in the position of providing a capital sum for the cooperative activity, while the other members are in a position where they need that capital.

³² PIGOU, Arthur, *op. cit.*, p. 56.

³³ HANDSCHIN, Hans (1950). *Die Besteuerung der Genossenschaften*. Wöhen, 25, p. 236.

³⁴ MUNKNER, H.-H., *op. cit.*, p. 10, describes the possibility of distributing surpluses in proportion to the capital subscribed in the German cooperative law. Apparently, the same possibility also exists in Portuguese cooperative law, since the 2015 cooperative code provides for the existence of investing members, while, on the other hand, it regulates the possibility of distributing surpluses in a generic way among the “members”, without fix any criteria for that distribution.

In fact, by establishing the possibility of paying dividends out of cooperative surpluses, the cooperative and its members recognize that non-investor members are not entitled a right to receive the correspondent surpluses on the basis of transactions, which somehow means that such surpluses no longer have the nature of “cooperative surpluses” but the nature of a cost to non-investor members,³⁵ a sum that all members have agreed to pay to investors as a remuneration for the contributed capital. Thus, not taxing the investor-member for those dividends payed out of surpluses cannot be justified by any essential characteristic of cooperatives.

Aside from distributing it to members, the Third Principle provides for two other possibilities for the application of surpluses: using it for “developing the cooperative”, usually through the prior formation of reserves, and using it to support “other activities” approved by the membership.

The principle means in practical terms that the cooperative bodies may decide to withhold surpluses to build reserves that will be used either in activities that will help developing the cooperative in view of supporting its core activity in the future (e.g. the acquisition of new facilities, equipment, etc.) or in activities that are not fundamental to the core business of the cooperative, although seen as beneficial to members.

It’s important to stress in this regard, once again, that the concept of surplus must be very carefully delimited, in order to exclude from any costs that the cooperative bears in the development of its activity. For this purpose, the concept of “cost” must also be strictly defined, including all costs of future replacement of productive capacity. Such a delimitation of the concepts of surpluses and costs would probably lead to “thinning” the amount of surplus.

Examining the problem on the basis of a strict concept of surplus, when looking at retained surpluses for purposes of taxation, there’s a clear similarity between retained surpluses in cooperatives and retained profit in companies, which are, as a general rule, taxed at the company’s level.

Let’s look again at what Pigou said about this:³⁶ “[cooperatives] are not, as companies and corporations, liable to tax; they are merely channels through which, with as much accuracy as practical conditions allow, the taxation due from their members is collected. Hence, if the money put to reserve by co-operative societies is taxable profit at all, it must be taxable profit of the members. But to decide that the proceeds of mutual trade are not profits from the income tax point of view when they are distributed, is to make the nature of these proceeds

³⁵ The question raised in this point has nothing to do with another question, debated in literature, about the compatibility of “investor members” with the Cooperative Principles. All we bring to discussion here is the possibility of paying dividends to “investor members” out of cooperative surpluses without eliminating, at the same time, the its nature of “profit surpluses”.

³⁶ PIGOU, Arthur, *op. cit.*, p. 57.

depend, not on their origin – which is clearly the proper test – but on their destination, which is no test at all.”

It is a fact that retained “cooperative surpluses” are still accruals (from the cooperative’s perspective) generated in transactions with members, due to a “mistake” in estimating the price to be paid or to be charged to the members, and thus realized at the expense of members. Unlike capital contributions to companies, which are an investment of available assets, surpluses that the members decide to waive are either extra costs they supported in purchasing goods or services or gains that members were never able to dispose of. As extra costs supported, that income has been taxed before the expenditure; as waived gains, as with dividends, surplus has never been real income to members. Thus, considering the way in which surpluses are generated, the conclusion must be that they should not be taxed even when retained in the form of reserves.

However, considering the great flexibility that the cooperative principles allow with regard to the treatment of surpluses, the nature of the surplus as something that belongs to the member should be perfectly clear in the applicable rules, either through cooperative law or through the cooperative by laws, as a condition to not consider withheld surpluses as income. Otherwise, in our opinion, withheld surpluses must be seen as taxable cooperative income. Whether that income is to be taxed or exempt from tax on the basis of its application by the cooperative is a question to be considered in terms of tax incentives.

IV. “Extra-cooperative” and “non-operational” income

Recalling the previously mentioned notion, “extra-cooperative” earnings are earnings realized in operational transactions (“purpose transactions”) carried on with third parties. Operational transactions with third parties are transactions with non-members that directly fulfil the specific purpose of the cooperative, like e.g. an agriculture cooperative that buys a crop from a non-member farmer. In the terminology we use in this paper, if the selling farmer is a member the operation is a “cooperative transaction” and the surplus generated will be a “cooperative surplus”; If, on the contrary, the selling farmer is a non-member, the operation will be termed a “transaction with a third party” and the surplus generated in that transaction will be designated as “extra-cooperative surplus”. In these transactions, capital originally owned by members and invested in the cooperative – either through initial capital contribution or through waiving of surpluses – is used to produce economic utilities (goods, services) that are provided to non-members who pay a remuneration for them. In terms of the economic nature of the whole operation, from the capital contribution to the final transaction, there is nothing that can distinguish it from operations carried on by companies. It is a commercial transaction that is not a mutualist transaction and have nothing to do with the mutualist scope.

On the other hand, “non-operational earnings” are those earnings obtained in transactions that are not related with the core objective of the cooperative: rental of equipment or facilities not

used by the cooperative, earnings from financial investments, sale of fixed assets, etc. The income generated in these transactions is of the same nature as income from purpose transactions with non-members (“extra-cooperative transactions”). When, e.g., a cooperative sells land, the land sold is capital that members invested in the cooperative and is used in commercial transactions that are not mutualist transactions and have nothing to do with the mutualist scope.

In any of these cases, we are faced with effective accruals generated in the cooperative’s sphere and by means of the application of the capital invested by members for non-mutualistic purposes.

None of the considerations that we have made regarding cooperative surpluses, which led us to consider that these belong to the members and not to the cooperative, apply to these two types of earnings, which are definitely income of the cooperative.

In terms of taxation, it is important to set the idea that the arguments on which we concluded that “cooperative surpluses” should not be seen as showing any ability to pay do not apply to “extra-cooperative” and “non-operational” income. Citing Pigou again:³⁷ “There is no dispute that the net proceeds of a co-operative society’s trade with non-members is a money profit and properly taxable. The income they receive from securities held by them is no less clearly a money profit”.

By saying this, we are not suggesting that this income must always necessarily be taxed. But as we consider the taxation of “extra-cooperative” and “non-operational” income of cooperatives, we must inevitably address the problem in the perspective of justifying a “favorable” tax treatment of cooperatives. A “favorable tax regime” means a tax regime that incorporates tax reliefs that are not granted, under the same conditions, to companies.

In some tax systems - such as the Portuguese, the Spanish, the Italian and the German - tax reliefs for cooperatives have deep historical roots.³⁸ The situation may not be very different in the United States and Canada (MAGILL 1960). In the Portuguese legal system, the “principle of favorable tax treatment for cooperatives” is even laid down in the Constitution, since 1976. This principle is designated by cooperative law scholars as the principle of “positive discrimination of cooperatives.”³⁹

³⁷ PIGOU, Arthur, *op. cit.*, p. 58.

³⁸ For the Portuguese case, AGUIAR, N. (2016). *O Problema da Tributação do Rendimento das Cooperativas – reflexão a partir do direito português*. Revista Cooperativismo e Economia Social, 38; regarding the case of USA, PACKEL, Israel (1941). *Cooperatives and the Income Tax*. University of Pennsylvania Law Review, 137, pp. 137-155.

³⁹ HENRY, Hagen (2005). *Guidelines for cooperatives legislation*, 2. ed., Geneva, ILO - International Labour Organization, p. 4.

The rationale for these tax reliefs granted to cooperatives is found by cooperative law academics in the particularly relevant social function of the cooperatives⁴⁰ or in the legal limitations that cooperatives face regarding the distribution of dividends and the formation of capital.⁴¹

Again, when considering tax issues we need to rely on neutral and very objective assumptions, and we certainly lack objective analysis concerning the limitations that cooperatives effectively face. Just by looking at the structure of cooperatives, one can safely conclude that cooperatives face structural constraints, that can put them at a competitive disadvantage position towards non-cooperative enterprises, regarding capital formation.⁴² These constraints result from the fact that, in general, cooperatives will not be targeted to remunerate capital investments. To the extent that in cooperatives, as a rule, there is no remuneration for capital investment or this remuneration is strictly limited, some cooperatives may face a problem as to the formation of capital. In order to form capital, cooperatives must retain cooperative surpluses most of the time. The withholding of surpluses, on the other hand, may work as a disincentive for joining the cooperative. Thus, naturally, “extra-cooperative” transactions and non-operational transactions can be an important instrument for cooperatives to form capital. But by not taxing income arising from these types of operations the legislator will be granting cooperatives a tax incentive.

As for the aforementioned particularly relevant social role of cooperatives, and as to whether it represents a sound rationale for a favorable tax regime for cooperatives, as we started saying at the beginning of this paper, it is not its purpose to discuss the social role of cooperatives. Which, however, does not seem to be an impediment to point out one or two ideas.

The first one is that in less developed countries, with incipient private business sectors, cooperatives seem to be an important legal instrument that allows the formation of small enterprises with little capital in situations where other types of enterprises are not viable, thus allowing the emergence of business activities where a large number of people can participate directly⁴³. The second is that in developed market economies, like in all OECD countries, cooperatives appear to be a solution for the specific needs of particular sectors, where they are better suited than non-cooperative enterprises. Agriculture is the most resilient traditional cooperative sector in developed market economies, proving that the cooperative form is particularly well fitting for the agricultural sector. But there might be some emerging cooperative sectors, such as labour intensive services and work cooperatives.

⁴⁰ ALGUACIL, Maria (2010). *Condicionantes del régimen de ayudas de estado en la fiscalidad de las cooperativas*. Revista de Economía Pública, Social y Cooperativa, 69, p. 31. About the social function of the cooperative enterprise, the important study, unique as far as we know, from FICI, Antonio (2015), *cit.*

⁴¹ HINOJOSA, Juan (2010). *Fiscalidad y financiación de las cooperativas: ¿A qué juega la Unión Europea?*, Revista de Economía Pública, Social y Cooperativa, 69,p. 77.

⁴² HENRY, Hagen (2012) ... *cit.* p. 92.

⁴³ BELLO, Dogarawa (2005). *The Role of Cooperative Societies in Economic Development*. MPRA - Munich Personal RePEc Archive, Paper nr. 23161.

In any case, both the particularly relevant social role of cooperatives and the legal constraints they face in their economic regime are closely linked to the "cooperative identity" which is based on the Cooperative Principles as defined by the International Cooperative Alliance. If cooperatives are not effectively forced to strictly follow the Cooperative Principles, if they do not have a totally transparent and democratic governance, if they do not observe strict rules on the use of reserves, etc., both their social function and their structural constraints will cease to exist, and cannot serve as a rationale for any favorable tax regime. For this reason, the tax laws that establish tax reliefs for cooperatives should impose as a condition for them to enjoy such tax reliefs, to operate in strict compliance with the Cooperative Principles.⁴⁴

However, even if the requirements referred to in the two previous paragraphs are safeguarded, it is still important to bear in mind that the tax reliefs granted by law to cooperatives can collide with both the principle of equal taxation and the principle of free competition.⁴⁵ And since these two principles are also fundamental values of the legal order of democratic countries, a tension between these apparently contradictory values will arise. In other words, any tax scheme favoring cooperatives must ensure that, because of them, cooperatives are not placed in a situation of competitive advantage in relation to non-cooperative enterprises. To this end, tight control is required to ensure that cooperatives act strictly in accordance with Cooperative Principles.

V. Conclusion

Three types of earnings must be distinguished in cooperatives: "cooperative surpluses", "extra-cooperative earnings" and "non-operating earnings".

"Cooperative surpluses" are exclusive to cooperatives. They are generated by "cooperative transactions", which are those transactions carried on with members and that fulfil the specific purpose of the cooperative (buying farmers' crops in agricultural cooperatives; selling houses to members in housebuilding cooperatives; selling goods to the members in the case of consumer cooperatives; etc.). Since the normal objective of "cooperative transactions" is to maximize the economic advantage of the member, the surplus arising from it ought to be seen as belonging to the member. Therefore, the surplus only becomes an accrual for the cooperative at the moment the member waives its reimbursement.

Withheld surpluses, on the other hand, even when they must be seen as accruals for the cooperative, should only be taxed at the cooperative level if they were to be seen as profit for the members in the first place. Since surpluses are never profit for the members, retained surpluses should not be seen as taxable income. However, it must be safeguarded that retained surpluses are placed in non-distributable reserves, according to the Third Cooperative Principle.

⁴⁴ AGUIAR, Nina (2015), *op. cit.*, p. 438.

⁴⁵ GIORGI, Maurizio, & VACIAGO, Giuseppe (2011). *Le società cooperative. Tipi di cooperative. Strumenti di tutela. Aspetti civili, concorsuali, tributari e penali*. Padua: CEDAM, p. 28.

Extra-cooperative earnings are originated in operational transactions exceptionally carried on with third parties.

Non-operational earnings are originated in non-operational transactions that are instrumental to the realization of the cooperative's main objective.

Extra-cooperative earnings and non-operational earnings both are earnings that accrue to the cooperative in a way totally similar to what happens with profits in companies. They represent therefore income of the cooperative, as opposed to surpluses which means that its non-taxation qualifies as a tax relief.

The granting of tax reliefs to extra-cooperative and non-operational income is a matter of political positioning of the community in relation to the cooperative sector. A "favorable", tax relief-based tax regime for cooperatives can be justified by the need to put cooperatives on a level playing field with non-cooperative enterprises, given their structural difficulties in terms of capital formation.

However, a tax benefit scheme for cooperatives should always be balanced against the principles of fiscal equality and free competition which are also constitutional principles of market economies and democratic countries. The tax system of cooperatives cannot be so advantageous that, because of it, cooperatives grow to a position of competitive advantage with non-cooperative enterprises, where the freedom of economic agents would be jeopardized.

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