US WORKER COOPERATIVES: A DIRE NEED FOR A PROFOUND REVISION OF THEIR TAX REGULATION AT A FEDERAL LEVEL

Sofia Arana-Landin[1][2]

Abstract

Cooperatives in the USA (US) contribute in important ways to many sectors of society not only from a financial point of view but also, above all, from a non-financial one.

Because cooperatives do not act like normal corporations, in many countries they are subject to different tax laws, which should not be considered a handout but an understanding of their differences and fair compensation for their contribution to society.

In the US, the taxation of cooperatives constitutes a very peculiar regime with great differences from that of many other countries. The system, however, is not that different compared to other US entities, as in many instances the fact that an entity is a cooperative makes no difference for taxation.

Therefore, the US system can be considered peculiar in the sense that both its taxation and, above all, its substantive regime are very different from the pattern followed by the vast majority of systems adopted for cooperatives around the world.

Thus, the tax treatment of cooperatives in the US can be regarded as an unusual one with certain peculiarities that originate from the tax clauses in the Internal Revenue Code and judicial doctrine. This happens because how a business is taxed at the federal level in the United States is partly dependent on how it is organized. This is not an easy topic to study but a worthwhile one.

First, because unlike in most legislations where the cooperative form is legally recognized, in the US it is not. What counts when considering an entity a cooperative is not the fact that it has been constituted or registered as such, but that the entity acts on a cooperative basis. Thus, depending on the possible forms that the entity acting on a cooperative basis takes, there are different choices of taxation. This means that there is no single special regime for all cooperatives but several ones, as different tax provisions may apply depending on the legal and tax form chosen. These include both general provisions for those entities and, sometimes, particular ones for acting on a cooperative basis.

Second, the regime is complex because different legal provisions apply to cooperatives, which derive from the type of cooperative they are (as regards their social object). For example, tax measures for agricultural cooperatives do not apply to worker cooperatives or electricity ones. Some of the measures in this system date back to the first half of the twentieth century, so the protection of certain activities that appeared reasonable back then may no longer be so today;

Third, because there are different levels of taxation due to the fact that the US is a multi-level system. There is a federal regime for each of the different legal forms a cooperative may take.

[1] University of the Basque Country, Spain, sofia.arana@ehu.eus

[2] MINECO PID2020-115834RB-C32 and GIU18/147.

Furthermore, there are 47 States and the District of Columbia with their state tax regimes. There are also many more local ones, as several municipalities impose corporate income tax.
Fourth, certain provisions are only applicable depending on each cooperative's bylaws, so these need to be acknowledged in advance.
Fifth, the regime is made more complex because the different tax measures passed in the Tax Cuts and Jobs Act of 2017 and other measures recently adopted as COVID-19 relief may also apply to cooperatives.
Fifth, because there is no comprehensive and substantive regulatory framework that deals with cooperatives, some of these entities are also regulated by the judicial interpretation of sections 1381–1388 in Subchapter T of the Internal Revenue Code.
In summary, the US has different tax measures both in general and specifically concerning cooperatives that make understanding taxation hard not only for scholars but also especially for cooperatives.
This paper has two aims: on one hand, to provide an overview of this very peculiar system from a tax law perspective, concentrating only on cooperatives' Income Tax. It should be added that many other types of taxes apply to cooperatives that are not taken into account here, such as Property tax (real estate and personal), Payroll tax or Sales tax (States and local), and License and Excise taxes. There may also be employment taxes such as Social Security and Medicare taxes and Income Tax Withholding and Federal unemployment tax not taken into account for this paper with the purpose of simplification. On the other hand, the paper seeks to delve into the regulation of cooperatives, analyzing their low resilience due to lack of proper regulations and the frequent inadequacy of their measures, and suggest a different approach.

Introduction

At the federal level, the most common forms of business in the US are sole proprietorships, partnerships, corporations, and S corporations. Legal and tax considerations enter into the selection of the business structure for all these forms. The same applies to cooperatives, i.e. there is a great choice of forms for an entity that plans to act on a cooperative basis; there is no cooperative legal form as such.
The legal forms that a cooperative may take in the US are: Corporations, 501(c) cooperatives, "Exempt" or 521 Entities and Partnerships. Limited Liability Company (LLC) is a business structure that is also very often used for entities acting on a cooperative basis.
The complexity lies in the fact that there is a different choice of tax regime for each of these legal forms. Thus, it can be said that cooperatives do not register and take a particular legal form but adapt themselves to the chosen one by working on a cooperative basis and maintaining whatever legal form they have chosen, then paying taxes accordingly.

Income tax for corporations: overview and most recent changes

To understand US Income tax for cooperatives we need to have a grasp of Income tax for corporations. The Tax Cuts and Jobs Act (TCJA) and certain post-COVID 19 provisions have

made very significant changes to Income tax. Moreover, further important changes are to be expected as President Biden has already announced new legislation to address the long-term effects of the TCJA[3].

A distinction needs to be made depending on the form the entity takes (C corporation, sole proprietorship, partnership, Subchapter S, and limited liability company).

Even though double taxation occurs for certain entities, different forms of taxation coexist for otherwise identical businesses without an obvious reason except that of taxing them differently. Several studies have already demonstrated that differences in taxation result in an inefficient allocation of resources, which occurs at the expense of stronger economic performance and standards of living[4].

Corporations in the US are usual C corporations, regulated under Subchapter C of the Internal Revenue Code (IRC). The income of these corporations is taxed once at the corporate level, according to the corporate tax system, and then a second time at the individual shareholder level, according to individual tax rates when the corporate dividend payments are made or whenever capital gains are recognized. As in most systems around the world, this leads to the so-called "double taxation" of corporate income. There may be ways to diminish or avoid this double taxation of dividends or capital gains both domestically or internationally through double taxation conventions whenever there is this international component.

However, this double taxation is not always avoided. As we will see, in corporations acting on a cooperative basis the main difference with other entities lies precisely in the possible avoidance of this double taxation due to the "Single Tax Principle" that applies to them. However, this is not always the case; also, it has some unwanted consequences in the long run.

Businesses that choose any other form of organization (i.e. not corporations) are generally not subject to corporate income tax. Instead, the income of these businesses passes through to their owners and is taxed according to individual income tax rates, which are higher than corporate tax at the moment. Examples of these alternative "pass-through" forms of organization include sole proprietorships, partnerships, Subchapter S corporations, and limited liability companies (LLCs).

[3] There are very different opinions on the long-term effects of this Act. See GALE, W. G., and others (2018), *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis*, Washington DC: The Tax Policy Center. On its short-term effects, a different opinion is that of YORK, E. and MURESIANU, A. "The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households", available at https://taxfoundation.org/the-tax-cuts-and-jobs-act-simplified-the-tax-filing-process-for-millions-of-americans/.

[4] See Congressional Research Service, *A Brief Overview of Business Types and their Tax Treatment*, R43104. See also Department of the Treasury (1992), *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf. For a summary of the Treasury report, see also R. Glenn HUBBARD, "Corporate Tax Integration: A View from the Treasury Department", *Journal of Economic Perspectives*, vol. 7, no. 1 (Winter 1993), pp. 115-132. See also IRS at https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations.

Corporate income tax is imposed on all domestic corporations and foreign corporations that carry out activities within the US. For federal purposes, an entity treated as a corporation and organized under the laws of any State is considered to be a domestic corporation. For State purposes, entities organized in that State are treated as domestic ones and entities organized outside that State are now considered as foreign.

However, there have been recent changes in US Income tax that need to be mentioned for their consequences on the system, which could probably influence other systems in the future. The US has a very long tradition of exporting its tax measures to the OECD through their tax technicians. More often than not, US measures are adopted as frameworks and end up becoming "soft law". On too many occasions, these soft law measures end up having the form of regulations (as happened, for instance, with transfer pricing methods).

In the US, a very important reform was passed on 22 December 2017, the TCJA that made significant amendments to the connecting points and the reduction of tax rates for Income tax. Even though this Act is "the largest tax overhaul since 1986" according to GALE and others[5], we consider the TCJA to be significant not only because of these tax cuts but also, most importantly, because it implemented a much-needed change in the concept of nexus of resident entities. This change applies not only to corporations but also to pass-through entities. It is not the purpose of this paper to analyze the international implications of this act. However, it should be noted that up until the approval of this act, corporations resident in the US had to pay for their "worldwide" income, as still happens in the vast majority of jurisdictions in the world due to the prevalence of the residence principle. The act completely redesigned this consensus and the old international system, changing it to one based on "territorial" taxation in the US (only on income derived within its borders and irrespective of the taxpayer's residence). The purpose of the act was to simplify controlled foreign corporation (CFC or Subpart F) rules and passive foreign investment company (PFIC) rules that subject foreign earnings to US taxation in certain situations. However, the act went much further[6].

The TCJA is also known for reducing the Corporation Income Tax rate from a graduated rate that reached 35% to a flat one of 21% for tax years beginning January 1st, 2018. The alternative corporate minimum tax was repealed, which is what interests us in this paper.

Moreover, this act allows businesses to deduct the full cost of qualified new investments in the year they are made (referred to as 100% bonus depreciation or "full expensing") for five years. After five years, in 2023, the bonus depreciation diminishes by 20% each year and is fully eliminated by 2027. Before the TCJA came into effect, the law admitted only a 50%

[5] See GALE, W. G., and others, *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis* (2018), Washington DC, The Tax Policy Center, p. 2.

[6] As stated by GALE, William and others in op. cit, p.2: "The new law will reduce federal revenues by significant amounts, even after allowing for the modest impact on economic growth. It will make the distribution of after-tax income more unequal, raise federal debt, and impose burdens on future generations. When it is ultimately financed with spending cuts or other tax increases, as it must be in the long run, TCJA will, under the most plausible scenarios, end up making most households worse off than if TCJA had not been enacted".

bonus depreciation in 2017, decreasing it in subsequent years and fully eliminating it after 2020.

However, in terms of interest deductibility, this act imposes a limit of 30% of business income before interest, depreciation, and amortization. Starting in 2022, the adjustment for amortization and depreciation will be removed from this limitation. Small businesses with gross receipts below US$25 million are exempt from the limitation. Previously, interest paid was fully deductible for all businesses when calculating taxable income.

The TCJA doubles the expensing limit for the investments made by small businesses (C corporations acting on a cooperative basis mostly belong to this category) from US$500,000 to US$1,000,000 for qualified property. This is called "small business expensing" and we consider it a measure that could have an impact on cooperatives' taxation. In a way, it also simplifies accounting rules for smaller firms. However, what is being promoted by all these measures is spending, to make the economy grow. Businesses, though, also need to save for "a rainy day" and, as we will see, doing so is penalized. This leads us to the conclusion that the measures in question are good for the economy but can have undesired effects should the outlook worsen.

In general, taxable income for a corporation takes the same deductions as those of a sole proprietorship to calculate its taxable income. A corporation can also take special deductions. The TCJA made fundamental changes to the treatment of multinational corporations and their income from foreign sources. Before the TCJA, dividends distributed by foreign subsidiaries to their US parent corporations were subject to US tax with a credit for any foreign income taxes paid (this system still applies in the vast majority of states worldwide). Now, a 10% return on certain qualified business asset investments is exempt from further US tax, moving toward what could be described as a more "territorial" system.

Moreover, the TCJA introduces the reduced-rate Global Intangible Low-Taxed Income and applies a minimum tax to returns above that amount regardless of whether they are repatriated as dividends or not.

The TCJA also creates a new minimum tax for domestic cases, the Base Erosion and Anti-abuse Tax, which is designed to prevent cross-border base erosion and profit shifting. A deduction for certain foreign-derived intangible income serves as an incentive for corporations to locate intellectual property inside the US.

These changes in nexus after BEPS can be considered of the utmost importance as in the EU's jurisdictions there is a tendency toward extraterritorial taxation, such as the Digital taxes and the Financial Services one, without considering that the new US model is headed in another direction and needs to be acknowledged.

For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes, and distributes

profits to shareholders. The Income tax comes from gross income (business and possibly non-business receipts minus the cost of goods sold) minus allowable tax deductions. Certain incomes, and some corporations, are subject to a tax exemption. Furthermore, tax deductions for interest and certain other expenses paid to related parties are subject to limitations. With regard to the concept of the tax year, in the US corporations may choose when it begins and ends as long as it lasts 12 months or between 52 and 53 weeks. The tax year need not coincide with the financial reporting year or the calendar year, provided books are kept for the selected tax year. It can even be changed with the IRS's prior consent.

As regards state income taxes, most US States determine that they need to be paid on the same tax year as the federal one[7].

Finally, some COVID-19 relief measures need to be discussed because they affect corporations. For example, there is a new tax act that is popularly known as the "Three Martini lunch" tax break, which increases the deductibility of restaurant expenses from 50% to 100%. We believe that this measure is intended for big corporations as a way to revive the restaurant industry battered by the pandemic. It benefits the most exclusive hotels and restaurants, not the smaller ones, which are those that could be working on a cooperative basis. Taking clients out for lunch and lavishing them is a practice suited to bigger corporations, not cooperatives, which in the US usually belong to the small-business sector. Moreover, too many firms and individuals have devised means of deducting personal living expenses as business expenses thereby charging a large part of their cost to the Federal Government. This is a highly inefficient measure for small businesses and equity[8].

C corporations for federal tax purposes

For federal purposes, there are two different kinds of corporations: C corporations and S corporations.

A C corporation must file an income tax return at the end of the tax year in which it reports its income, gains, losses, deductions, and credits to the IRS (generally it needs to do this using Form 1120, US Corporation Income Tax Return). Unless an extension is asked and granted, a corporation must fully pay its taxes no later than the 15th day of the third month after the end of its tax year.

[7] See Congressional Research Service, *A Brief Overview of Business Types and their Tax Treatment*, R43104.
See also JOHANSSON Å., and others, in OECD, *Tax and Economic Growth*, Economics Department Working Paper 620. In this study, the authors delve into the design of tax structures aimed at promoting economic growth. "It suggests a "tax and growth" ranking of taxes, confirming results from earlier literature but providing a more detailed disaggregation of taxes. Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption. The paper breaks new ground by using data on industrial sectors and individual firms to show how re-designing taxation within each of the broad tax categories could in some cases ensure sizeable efficiency gains".

[8] Tax Policy Center, "Restoring the Three Martini Lunch Tax Deduction Won't Feed the COVID-19 Economy." Available at https://www.taxpolicycenter.org/taxvox/restoring-three-martini-lunch-tax-deduction-wont-feed-covid-19-economy, accessed January 29, 2021.

Depending on its taxable income, a corporation may be taxed at a rate of 21%. This is the rate since January 1, 2018, thanks to the TCJA that reduced it from a graduated one that could reach 35%. As already mentioned, the fact that this system has moved from a graduated tax to a flat rate does not benefit small businesses in the same way as it does big ones. The vast majority of cooperatives belong to the small-business category and have thus not benefited from the TCJA in the same way big corporations have.

At a federal level, therefore, a C corporation is taxed at 21%; the same is true of shareholders receiving dividends. Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends and capital gains from the sale of shares. Dividends need to be separated into two different categories: qualifying dividends, comprising most ordinary dividends of US corporations, and other dividends. As regards capital gains, they can also be differentiated into two groups: long-term ones, for assets held at least one year, and short-term ones for the rest.

Non-qualifying dividends and short-term capital gains are taxed as ordinary income at current rates of up to 40.8% (the top marginal individual income tax rate of 37% plus the 3.8% tax on net investment income).

Qualifying dividends and long-term capital gains have an applicable maximum tax rate of 23.8%. However, depending on the type of corporation, being taxed at the shareholders' level can be avoided, though this is not the case for entities acting on a cooperative basis.

They must pay quarterly installments that are either 25% of the previous year’s income tax or 25% of the estimated income tax.

S corporations, partnerships, and LLCs for federal tax purposes

Many US businesses are not subject to Corporate Income Tax but are taxed as “pass-through” entities. Pass-through businesses do not have an entity-level tax, which means their owners must include their allocated share of the business’s profits in their taxable income under individual income tax.

Pass-through entities include sole proprietorships, partnerships, LLCs, and S-corporations. Cooperatives can take these forms, so they can also be pass-through entities.
Thus, an S corporation is a corporation that elects to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. S corporations are only responsible for tax on certain built-in gains and passive income at the entity level. Therefore, for the remaining entities, income tax is taxed only to the shareholders. Thus, shareholders of S corporations report incomes and losses on their tax returns and are assessed at their individual income tax rates. This allows S corporations to avoid double taxation on corporate income.

Only certain corporations can qualify for S corporation status. To be an S corporation, the corporation must meet the following requirements:

- be a domestic corporation;
- have only allowable shareholders (individuals, certain trusts and estates but not partnerships, corporations, or non-resident alien shareholders);
- have no more than 100 shareholders;
- have only one class of stock;
- not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations)[9].

If every one of these requirements is met, to become an S corporation the corporation must submit its choice of form as a Small Business Corporation, signed by all the shareholders. This S corporation legal form is one of the preferred forms for cooperatives, particularly worker and retail cooperatives.

All these forms have also a taxation aspect, not as corporate income tax but as personal income tax, which the TCJA has modified because it includes changes specific to pass-through businesses with provisions scheduled to expire after 2025.

In this sense, the TCJA introduces a new deduction that is only applicable to joint tax filers with a personal taxable income below US$315,000 (US$157,500 for other filers). If this is the case, filers can now deduct 20% of their qualified business income (this can come from a pass-through entity acting on a cooperative basis because they are usually small businesses). Thanks to this new deduction, the effective top personal income tax rate on business income goes down to 29.6%.

To summarize, this means that in the US only C corporations have to pay Income Tax at entity level and are thus taxed twice at entity and shareholders' level. Therefore, double taxation cannot be said to be the general rule for entities in the US and single taxation cannot be considered an advantage devised only for cooperatives. It is a very widespread one.

Corporations acting "on a cooperative basis" in judicial doctrine

Corporations may act on a cooperative basis when they are incorporated as such, to provide mutual benefit to their members. There is a separate legal form in this instance, which differentiates this regime from others, whereas there is no legal form, for example, in the case of partnerships. Since 1951, whenever this is the case, corporations acting on a cooperative basis can apply Subchapter T of the Internal Revenue Code (IRC).

[9] See Department of the Treasury (1992), *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf. For a summary of the Treasury report, see HUBBARD, R. G. (1993), "Corporate Tax Integration: A View from the Treasury Department", *Journal of Economic Perspectives*, vol. 7, n. 1, pp. 115-132. See also IRS at https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations.

Although there are several sources that contribute to cooperative law, we have to extract the meaning of what a cooperative is from taxation, because at a federal level there is no other regulation that can help us. Moreover, the IRC has to be complemented by the rulings of the Internal Revenue Service (IRS) and above all, by judicial doctrine, which in many cases dates back to the previous century.

However, as we will see, most of the regulations are old and they were usually intended for agricultural cooperatives and not for other types of cooperatives, such as retail, supply, or worker ones, so they may be ill-suited for these cases[10].

Also, there are special provisions designed for other types of cooperatives such as irrigation or electricity ones with a particular regime regulated in section 501 of the IRC.

The IRC provides the basic regulation for cooperatives, so in a sense, the concept of cooperative has to be interpreted through the IRC. The Code contains two sorts of provisions: those applicable to all businesses and those specifically referring to cooperatives.

Through a variety of administrative determinations, the IRS interprets the IRC and applies it to the situation of each taxpayer. We can find IRS rulings that give their opinion on the interpretation of different aspects of the Code and provide very useful guidance for cooperatives.

However, it should be noted that these rulings have no legal value. Thus, even though they might help us understand the interpretation of the IRS concerning certain IRC provisions, we cannot consider them as true sources of law. While rulings can guide us in understanding the IRS's interpretation of a provision, it is really for the courts to interpret the Code and act as final arbiters of any unsettled disputes between the IRS and taxpayers. IRS rulings have sometimes been proved wrong by judicial doctrine[11].

[10] From NESS, M. and NESS I. (2013), *Worker Cooperatives in the United States: A Historical Perspective and Contemporary Assessment*, available at http://www.workerscontrol.net/authors/worker-cooperatives-united-states-historical-perspective-and-contemporary-assessment. In 1890, the Sherman Act, while containing no specific part on cooperatives, was used by government officials to ban them. As agricultural cooperatives could set a common price, they were accused of stifling competition. The Clayton Act of 1914 sanctioned cooperatives by exempting all "agricultural, or horticultural organizations, instituted for the purposes of mutual help, and not having capital stock or conducted for a profit", from the Sherman Act. While the Clayton Act legalized non-profit cooperatives that issued no stock, the legal status of other cooperatives remained ambiguous until the 1920s. In 1922, the US Congress passed the Capper-Volstead Act, commonly referred to as the "Cooperative Bill of Rights", allowing farmers to market products without violating antitrust laws. "However, under the new law cooperative members were required to engage in agricultural production and all cooperatives had to follow a one-member-one-vote rule and annual dividends on stock or capital could not exceed eight percent. In addition, non-member business could not exceed 50% of the cooperatives total business. A decade later, in 1933, the US Congress extended the rights of cooperatives through passage of the Farm Credit Act that created a network of cooperative lending institutions to provide loans for agriculture and farmers' cooperatives".

[11] As was the case of Revenue Ruling 61-47, 1961-1 C.B. 193, according to which the amounts distributed by a worker cooperative to its members on the basis of man-hours worked were not true patronage dividends eligible for deduction at the cooperative level. Another example is the case of the so called "50% rule" in Revenue Ruling 93-21, 1993-1 C.B. 188.

The historical background of cooperative regulations in the US

In the War Revenue Act (1898), Congress recognized the contribution and importance of cooperatives. It provided exemption from federal excise taxes to cooperative companies, not-for-profit mutual benefit associations, agricultural or horticultural cooperatives, among others.

At a federal level, different acts were passed to regulate cooperatives; however, they were restricted to agricultural and farmer cooperatives.

The Revenue Act of 1916 (IRC 1916) made a clear distinction in the cooperative regime between farmer cooperatives in section 521 (what is wrongly called "exempt regime"), mutual or cooperative insurance companies, ditch or irrigation companies, telephone companies, and "like organizations" in section 501(c)(12), and all other cooperatives in Subchapter T. Cooperatives that do not apply Subchapter T have no special provision in the IRC.

In 1936, during the Great Depression, the administration started regulating electricity and irrigation cooperatives.

This long history, which dates back to the nineteenth century, reveals that cooperatives can be regulated at a federal level not only by what is inferred from the IRC but also as entities to be promoted. There have been different attempts to do so for agricultural, farmers, electricity, and other sorts of cooperatives. However, this has not been done for all cooperatives. Therefore, there is a need for the proper regulation of all cooperatives, and the principle of mutuality could sustain this operation.

In 1951, Congress passed legislation that was thought to ensure that, when complemented by Treasury rulings, cooperative earnings would be taxable either to the cooperatives or to their patrons, depending on their legal form, to the extent that they reflected business activity.

However, certain court decisions (Long Poultry Farms v. Commissioner, 249 F. 2d 726 [4th Cir. 1957]; Commissioner v. B. A. Carpenter, 219 F. 2d 635 [5th Cir. 1955]) held that non-cash allocations of patronage dividends generally were not taxable to the patron, although the allocations were deductible by the cooperatives. Congress determined that further clarification was necessary.

In 1961, Revenue Ruling 61-47, 1961-1 C.B. 193, was issued according to which the amounts distributed by a worker cooperative to its members based on man-hours worked were not true patronage dividends eligible for deduction at the cooperative level. In this case, the IRS maintained that this holds even when State law provides that labor performed as a member of a worker cooperative is a form of patronage of the cooperative. It concluded that to be deductible as a true patronage dividend, the return had to be "either an additional consideration due to the patron for goods sold through the association or a reduction in the

purchase price of supplies and equipment purchased by the patron through the association." However, Senator Kerr disagreed with this view, arguing that worker cooperatives were the true cooperative form and should exclude patronage refunds, thus designing Subchapter T as it lasts to this day.

Hence, in 1962 Congress added Subchapter T to the Code (consisting of IRC sections 1381–1388) to address the shortcomings of the existing law. The Subchapter clarifies that:

a) A cooperative may exclude, as patronage refunds, amounts allocated in cash or scrip;

b) Its patrons are to be taxed on such refunds.

Despite this clarification, the IRS pursued its objective in litigation as it did not want worker cooperatives to benefit from Subchapter T. However, in Linnton Plywood Ass'n v. United States, 236 F. Supp. 227 (D.C. Ore. 1964), the judge ruled against the IRS.

Still, because the Code does not define what a cooperative is, the only way to decide on the meaning of "acting on a cooperative basis" is through judicial doctrine. Some court cases have dealt with this issue, referring to cooperative principles when addressing the matter. As we will see, cooperatives follow the one-member-one-vote principle, give a limited return on equity, and allocate profits based on business done with the cooperative. However, there is a certain flexibility as regards these principles compared to other systems. Therefore, the US system is more flexible and, certainly, more uncertain.
The Tax Court in Puget Sound Plywood v. Commissioner, 44 T.C. 305, 307-308 (1965), acq.1966-1 C.B. 3 issued a more thorough opinion on the phrase "operating on a cooperative basis" in Code sec.1381(a)(2) and reached the same conclusion, i.e. that worker cooperatives could exclude their patronage refund allocations. Because this case has not been overruled, the exclusion of patronage refunds from the calculation of a worker cooperative income lasts to this day. This rule is known as the Single Tax Principle.
Therefore, the Code says that "any corporation operating on a cooperative basis" may receive the tax benefits of Subchapter T. The Code does not include any specific definition of "operating on a cooperative basis". The regulations repeat the Code's phrasing and add "and allocating amounts to patrons on the basis of the business done with or for such patrons."
As we can see, this lack of regulatory definition does not mean that any entity, corporation or otherwise, can be defined as acting on a cooperative basis and use the provisions stated in the IRC without further proof. Even though there is no univocal regulation, judicial doctrine offers some light on the matter. History and judicial doctrine provide guidelines for what "acting on a cooperative basis" means[12].
There are three basic requirements:
(1) democratic control by the members;

[12] SETO, M. and CHASIN, C. (2002), "General Survey of I.R.C. 501(c)(12) Cooperatives and Examination of Current Issues", CPE.

(2) vesting in, and allocating among, the members all excess operating revenues over the expenses incurred to generate the revenues (i.e. operating at cost);
(3) subordination of capital.
These basic requirements apply to cooperatives described in section 501(c)(12) as well as those described in Subchapter T and IRC section 521.

The substance-over-form principle

As we have seen, Subchapter T cooperatives are governed by IRC sections 1381–1388, which are devoted to cooperatives conducting any kind of business, nonexempt from federal income tax. Depending on their actual legal form, their earnings are taxed at either the cooperative or the member-patron level.

Thus, if it adopts the form of a C corp, the cooperative itself is going to be the taxpayer, while if the form is that of an S corp, it can be a pass-through entity, with the members being the taxpayers. If it is an LLC, it can choose to be taxed either as a corporation or as a pass-through.

The Mississippi Valley Portland Cement v. US case is a clear precedent for the use of the substance-over-form doctrine and the true test for unmasking entities that pretend to be "working on a cooperative basis"[13].

In this case, the taxpayer was an allegedly nonexempt cooperative incorporated in Mississippi that sought to deduct distributions to shareholders from its corporate income tax as "patronage dividends". These payments were made from the corporation's net profits during the tax years in question. After excluding patronage dividends, the taxpayer reported no taxable income for several years.

The District Court ruled as follows: "There is nothing in the method of doing business by the taxpayer in this case that distinguishes it from the average or normal corporation doing business for profit, no matter that the taxpayer is called a cooperative, or that the dividends to stockholders are referred to as patronage rebates. Other characteristics of this taxpayer, akin to that of a corporation for profit is that the dividends were payable only to stockholders of record at the end of each fiscal year, leaving stockholders, who might have sold their shares prior thereto, with no entitlement to a rebate on the basis of earnings during the fiscal year; and the fact that, as stipulated, actually no stockholder used the cement produced. All allocations were assigned to a sales agency or sold by that agency. As further stipulated, any allocations and delivery of cement to a patron were discouraged."

"It is the opinion of this Court, after carefully scrutinizing the structure of this taxpayer and its method of doing business, that it was not doing business with its consumer patrons or assigns in the historical sense of a consumer cooperative, but that its stockholders are in no

[13] 408 F.2d 827 (1969), n. 2561 US Court of Appeals Fifth Circuit. March 14, 1969.

different category from that of any corporation interested in profits, no matter whether the source of that profit be from the production of cement or any other product, and that accordingly the sums paid here are not excludable from taxable income."

The Court decided that the taxpayer's distribution of its net profits could not be categorized as patronage dividends in the sense of Section 1388(a), as added by the Revenue Act of 1962, which provides as follows:

"(a) Patronage Dividend. — For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies — (1) on the basis of quantity or value of business done with or for such patron. (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."

Of particular importance to the disposition of this case is the language requiring that the distribution be made out of earnings from "business done with or for patrons".

On one hand, the Commissioner argued that "with or for" means that the patrons must physically handle the products of the cooperative. On the other hand, the taxpayer argued that neither the statute nor the cases have imposed such a physical contact requirement. In previous cases, evidence that the patron used the product pointed logically to the conclusion that the business was conducted "with or for" such patron. Conversely, the absence of such evidence would support, but not compel, a conclusion to the contrary.

However, agreeing with the Commissioner, the District Court, 280 F. Supp. 393 ruled that notwithstanding the "cooperative camouflage", these payments were in reality no more than dividends paid to the corporation's shareholders, as the taxpayer's method of conducting its business was not distinguishable from normal corporations doing business for profit. Moreover, the so-called "patrons" were just "paper patrons" as they had no actual use of the cement. Thus, the economic reality was uncovered and patronage dividends were ruled not deductible.

As we have said before, though, the language is imprecise and there seem to be two errors:

- first, we cannot speak of a deduction but of an exemption, which is easier to prove than deductions, belonging to legislative grace. The so-called "patronage dividends" should be excluded at the time of calculating income not taken into account and later deducted;
- second, it is also imprecise to refer to "patronage dividends" as we are dealing with

"patronage refunds". The legal nature of dividends from capitalistic entities and refunds from cooperatives is not the same.

Earnings on non-cooperative operations, such as those of investor-general corporations, are subject to taxation at both the firm and ownership levels. Hence, the exclusion of the patronage refund is valid only for cooperative operations. The general regime applies to all other operations.

A possible tax proposal for entities applying Subchapter T

Any corporation or LLC "operating on a cooperative basis" can be taxed under Subchapter T of the IRC.

Subchapter T does not apply to mutual savings banks, mutual insurance companies, or rural electric or telephone cooperatives, as they have their own provisions. All of these organizations are taxed under separate special sections of the IRC (section 501(c)). Consumer and retail cooperatives can be taxed under Subchapter T.

The taxation classification of a cooperative business is separate from its incorporation status. For that reason, an LLC or a corporation operating on a cooperative basis can be taxed under Subchapter T while an entity incorporated as a cooperative would not qualify if it did not distribute patronage based on use and follow the other principles of operating on a cooperative basis.

The basic rationale of Subchapter T and cooperative taxation is that the cooperative is an extension of the patrons who own it. In addition to making deductions for expenses allowed to other businesses (including the new "Three Martini lunch" tax break), Subchapter T allows a cooperative corporation to also deduct certain distributions of net income to its members—known as the Single Tax Principle.

However, a distinction needs to be made between qualified and non-qualified patronage distribution.

For a cooperative to make a patronage distribution either in cash or in stock that can be considered to be "qualified", the distribution must be made within 8 months from the end of the tax year in which the income occurred. The member must receive written notice of the allocation. At least 20% of the total distribution must be in the form of cash. Finally, the member must consent to include the patronage on their tax return as ordinary income.

The rationale for the 20% cash rule is that the member should have enough cash to pay the taxes on the stock patronage received. Many producers have effective tax rates above 20% and would still be in a negative cash flow position if they received a 20% cash and 80% qualified stock patronage refund. For that reason, most agricultural cooperatives try to pay more than 20% cash. The 20% cash requirement applies to qualified stock

distributions. There is no cash requirement associated with a non-qualified stock patronage refund. The patron consent requirement is typically satisfied by having the patron sign an agreement as part of the membership application or is specified as part of endorsing and cashing a qualified check.

When the patronage distribution is tax-deductible to the cooperative in the current year, it is called “qualified”. Cash patronage refunds are always qualified.

Cash patronage is therefore tax-deductible to the cooperative and taxable income to the patron in the year it is distributed. Retained patronage refunds (stock patronage refunds) can be either qualified or non-qualified.

A qualified stock patronage refund is taxable to the cooperative and tax-deductible to the member in the year it is distributed.

Cooperatives also have the option of retaining a portion of member profits as unallocated retained earnings. Because that income is not distributed as qualified retained patronage it is not deductible and the cooperative retains the after-tax portion. The availability of the Section 199A tax deduction has allowed cooperatives to offset that tax effect and has led some cooperatives to retain more member profits as unallocated retained earnings.
If the cooperative does not meet any of the requirements for a qualified distribution or chooses not to classify the distribution as qualified, we are in the presence of a non-qualified distribution. Because cash patronage is always qualified, only the stock portion of the patronage refund can be structured as non-qualified.
Non-qualified patronage distributions cannot be deducted in the year they are issued but the cooperative can deduct the redemption of non-qualified stock. That non-qualified redemption becomes taxable income for the patron in the redemption year.
Historically, personal income tax had lower tax rates than the corporate tax, which was graduated and higher. That made it logical to shift the tax to the patron’s lower tax rate immediately rather than “park the tax payment” with the cooperative until the time of equity retirement.
However, the TCJA of 2017 substantially reduced the corporate income tax from a graduated scale with a maximum rate of 37% to a flat rate of 21%. That resulted in cooperatives having lower tax rates relative to most of their patrons. From that moment onward, more cooperatives are shifting to non-qualified distributions. This may involve tax-motivated shifts from LLCs and partnerships to C corporations working on a cooperative basis. Still, we should take the long view and keep in mind that there is a new tax proposal in the air that might change things once more.

When issuing non-qualified retained patronage, the cooperative pays taxes on that income in the year of distribution and then gets a tax deduction in a later year when the equity is redeemed. The taxation is ultimately transferred to the patron but the timing is shifted to match the cash payment rather than the stock distribution.

Those distributions become taxable income to the member. Consequently, the net income is only taxed once. In some cases, the taxation is immediately passed on to the patron; in others, the income is taxed at the cooperative level and then the cooperative receives a tax deduction while the member accepts the taxation for that income in the future.

Profits from non-member business cannot be distributed as patronage under the general provisions of Subchapter T. Cooperatives pay taxes on non-member profits and any undistributed member profits at the general corporate rate (a flat rate of 21%).

Like other corporations, cooperatives calculate taxable income when they are incorporated but with one main difference due to the distinct way of distributing net margins to its patrons, based on use, rather than to investors, based on investment. What cooperatives get is not profits but income or margins, which allows speaking of net income, net margins, or a net surplus. This difference is the basis for the Single Tax Principle that applies when business income sources and distribution methods can be considered to be "cooperative" in nature. Earnings from sources other than patronage and margins not distributed in the manner specified by the IRC are generally not eligible for single tax treatment.

If the cooperative is a corporation, some types of cooperatives can apply Subchapter T to exclude the patronage-sourced earnings they distribute to member-patrons from their gross income. Profits from non-member business cannot be distributed as patronage under the general provisions of Subchapter T. Cooperatives pay taxes on non-member profits and any undistributed member profits at the general corporate rate. Cooperatives are taxed on any remaining income, including non-member income, non-patronage income, and member income not distributed as patronage, at the general corporate rate.

Only patronage-sourced earnings are eligible for exclusion by the cooperative and the conditions for this tax treatment include an agreement by the patron to recognize the full patronage refund for tax purposes even though it is not received in cash or negotiable form (as allocated income).

Under all other circumstances, cooperatives are taxed at the ordinary corporate rate on their taxable income calculated after cash patronage, qualified retained patronage, and qualified per-unit retained payments.

All cooperatives (except Section 521 ones) must include non-member income in their taxable income. All cooperatives (including Section 521 ones) should also include income from rents, investment revenues, gain on sale of capital assets, and income from sales to the federal government as taxable income. For that reason, even Section 521 cooperatives often have some taxable income.

Income distribution in corporations acting as a cooperative consists of two elements: the distribution based on the utility or work accomplished by each patron and the creation of reserves which contribute to the consolidation of the firm's financial standing. This profit-

sharing model explicitly recognizes the value of employee labor and the importance of making the firm sustainable so that it may be handed over to future generations. However, contrary to what occurs in most parts of the world where substantial norms regulate the allocation of an important part of the net margins to reserves, this provision cannot be found in the US.

Therefore, one of the main differences cooperatives have compared to other entities is precisely the possible exclusion from income tax, at the corporate level, of patronage-sourced income when this is distributed under certain conditions (in cash or as qualified payment). This income is only taxed at the taxpayer level.

However, a Subchapter T cooperative must usually pay tax on the patronage-sourced earnings it retains, which creates a difficulty. When cooperatives have income they want to keep to strengthen their funds, no consideration is given to reserves and they have to pay just as any other traditional corporation would. Hence, the single tax treatment is lost, even though the entity is acting on a cooperative basis. If the funds are later distributed, the recipients must pay a second income tax at the recipient level.

I believe that what was designed as an incentive can become an important disincentive for cooperative resiliency, as it is the money allocated to reserves that makes a cooperative strong in the long run. If cooperatives are to be different from other types of corporations, they have to look after their financial health, avoiding decapitalization.

The patronage refund clause looks at enhancing the distribution of refunds back to patrons, penalizing their non-distribution. Moreover, this incentive for patronage refunds can be said to be contrary to the ones we find in most countries where cooperatives are well developed, where the allocation of margins to reserves is usually compulsory and promoted by law, partly or totally excluding them from taxable income.

For the US legislator, margins have to pay income once, so if they are refunded to patrons, they are excluded from taxation at the cooperative level. However, if they stay in the cooperative, patrons do not receive their share but the cooperative has to pay for them as they can no longer be considered distributed patronage refunds. If later, part of those reserves goes back to patrons, they will pay income tax again. This may not have been the original purpose of the incentive but it clearly promotes decapitalization.

As an example, in Cooperative Oil Ass'n v. Commissioner, 115 F.2d 666 (9th Cir. 1941), the exclusion of patronage refunds was not permitted where some net margins were not allocated or distributed to patrons but were placed instead in a working capital reserve.

This means that there are two different possibilities: first, cases in which taxation is immediately passed on to the patron through patronage refunds and those refunds are not taxed at a corporate level but at a patron's one; second, those cases in which not all income is passed to patrons or it is not passed as patronage refunds. In these cases, these profits become

taxed at the cooperative level and the members accept the taxation for that income in the future. All this needs to be notified to members to avoid shifting the responsibility from members to the cooperative to build in more equity or doing the opposite.

We wish to make a proposal: the exclusion (or reduced inclusion) from taxable income of the margins devoted to reserves might be a better way of promoting cooperatives by enhancing their capitalization. Even if, in the end, these reserves were not used for the cooperative and were instead distributed to its members, the latter would pay income tax on them. If this were to happen, it would just be a deferral of taxes that could greatly help the allocation of resources to these funds and make cooperatives undeniably more resilient. If the cooperative ended up not distributing the reserves, this would be for the long-term benefit of the organization. The cooperative would thus become stronger. A partial exclusion of the percentage that is compulsorily devoted to reserves would be in accordance with what is done in other countries with strong cooperative sectors. Choosing the corporate form for a cooperative has important advantages.

First, flexibility, as being taxed as a cooperative corporation allows using patronage dividends to allocate profits. Thus, these cooperatives can either choose to pay income tax at the corporation level or allocate some or all of the profit to the patrons, having them pay personal income tax;

Second, the possibility of a tax deferral, given that the tax paid by patrons for the refunds is paid in the year that cash or a qualified notice of allocation is received. This can result in the deferral of the tax paid on the patronage dividend for a year.

However, it should be noted that of the five types of businesses recognized in the US, only investor-general corporations pay income tax at both the business and owner levels (these organizations amount to only around 12% of businesses). This means that the proposed advantage is not specific to cooperatives but is a widespread one.

For those benefits that are taxed, the federal tax rate is 21% and State rates vary from 0% to 10%. Keeping those benefits may result in paying around 30% for them in corporate tax, which is very high.
The IRS establishes a benefits minimum of 20% for patronage dividends, which foreign observers find hard to understand because in many other countries it is the other way round. That is to say, most countries oblige their cooperatives to keep a percentage of net income as reserves. This percentage may vary from country to country but it is not unusual to find provisions that mandate cooperatives to keep around 50% of their net income for reserve. In these other countries, the tax provisions are precisely meant to promote reserves by making a percentage of them deductible from the tax base, as happens in Spain, Portugal, and Italy.
The IRC takes the opposite point of view. In the US case, patrons are to be protected, with a compulsory minimum refund of 20% of net income. In other contexts, cooperatives are encouraged to make a minimum retention of net income for their reserves obligatory. This

different approach results in different models and, above all, in very different levels of resiliency.
Thus, it is not surprising that cooperatives in the US are not as resilient as in other countries where reserves are compulsory, but also promoted by different tax measures.

A proposal for other entities that may or may not apply Subchapter T

Subchapter T does not apply to all corporations acting on a cooperative basis, because mutual savings banks, mutual insurance companies, or rural electric or telephone cooperatives cannot apply this regime. These organizations are taxed under separate sections of the IRC, in particular sections 501 and 521.
Not all corporations acting on a cooperative basis apply Subchapter T. Consumer and retail cooperatives may be taxed under Subchapter T and worker cooperatives are usually incorporated as consumer ones. They can take the form of incorporated cooperatives, LLCs, or Limited Cooperative Associations that have elected to be taxed as corporations.
An LLC is a business structure allowed by state statute that may or may not apply Subchapter T. Each state may use different regulations. Depending on the choice of the LLC and the number of its members, the IRS will treat the LLC as a corporation, a partnership, or as part of the LLC's owner's tax return (a "pass-through entity").
Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it specifically chooses to be treated as a corporation (in which case it may apply Subchapter T).
For income tax purposes, an LLC with only one member is treated as an entity regarded as separate from its owner, unless it files Form 8832 and elects to be treated as a corporation. However, for purposes of employment tax and certain excise taxes, an LLC with only one member is still considered a separate entity.
Owners of an LLC are called members and this can either be physical or legal persons in most States (corporations, other LLCs, and even foreign entities). As we are dealing with State law, regulations may vary but there is usually no minimum or maximum number of members.
LLC is probably the most frequent form for cooperatives. As there is no legal person involved, everything is allocated to individuals and nothing to the partnership as such. Cooperatives taking this form follow the same rules as all other partnerships. All taxes are paid by members, with some unusual exceptions, such as California. However, bearing in mind the changes in taxation made by the TCJA, changing to a form that pays taxes as a corporation may be useful. However, as Watson and McBride have noted, congressional policymakers have proposed to revert the changes made by the TCJA in corporate income tax, including raising the 21% rate to 28% and creating a minimum rate for large corporations[14]. The purpose of the proposal is to raise revenue; however, other side effects need to be taken into account. In the case of cooperative taxation, this proposal could make

[14] See WATSON, G. and MCBRIDE, W. (2021), "Evaluating Proposals to Increase the Corporate Tax Rate and Levy a Minimum Tax on Corporate Book Income", available at https://files.taxfoundation.org/20210224151522/Evaluating-Proposals-to-Increase-the-Corporate-Tax-Rate-and-Levy-a-Minimum-Tax-on-Corporate-Book-Income1.pdf

having the form of a corporation superfluous. While changing from a pass-through entity to a corporation is easy, though, doing the opposite is not. There is a certain amount of flexibility in moving from partnership to corporation but not in doing the opposite. This is why taxation effects need to be considered in the long run.
The reserves of the cooperative do not belong to the partnership; they belong to the partners. Each member reports under his/her personal income tax. Everything gets allocated down to the members. Accrual of cash is in the same year. In this case, there is no deferral as there was for C corporations.
This accrual of cash can be interpreted in different ways depending on the bylaws. Traditionally, it is based on ownership but it can also be based on hours worked. If it was set up in advance, the IRS sets no limit on how to do it. Non-members cannot get allocations, so usually they are just employees.
Special attention needs to be paid to filing the first year because there is a large fine (US$205 per member per month for up to a year). For this reason, some cooperatives that do not file the first year dissolve and start again. The rules depend on the State.
However, because the TCJA has substantially reduced corporate income tax from 37% to 21%, interest in being a pass-through entity has diminished. Nowadays, cooperatives have lower tax rates than most of their patrons, so the choice of having income tax paid at the entity level has increased rebus sic stantibus. This may change if the new proposal referred to above is enacted. As BUNN noted, we should also bear in mind the combined effect of federal and state taxes and the new proposal[15].
Also, although the corporate income tax rate is important, the marginal effective tax rate may be even more so.

Judicial doctrine helps us understand what Subchapter T, sections 1381–1388 of the tax code offers for certain types of cooperatives. Puget Sound Plywood v. Commissioner (44 T.C. 305, 307-308 [1965], acq. 1966-1 C.B. 3) is probably the most important case in this sense because it clarifies the Single Tax Principle: in general, such a cooperative may exclude, as patronage refunds, amounts allocated in cash or scrip whenever its patrons are taxed on such refunds. Therefore, any corporation "operating on a cooperative basis" may receive the tax benefits of Subchapter T.

Thus, a Subchapter T cooperative must usually pay tax on the patronage-sourced earnings it retains. When cooperatives have income that they want to keep to fortify the cooperative funds, no consideration is given to reserves and they have to pay tax just as any other traditional corporation. This way, the single tax treatment is lost. If the funds are later distributed, the recipients must pay a second income tax at the recipient level.

One of the key features in other successful systems, such as the Spanish and Basque ones (well-known because of Mondragón), is precisely constrained property rights. Property rights in cooperatives are different from those in private entities because they are constrained both

[15] BUNN, D. (2020), "How Would Biden's Tax Plan Change the Competitiveness of the US Tax Code?" Tax Foundation, https://www.taxfoundation.org/biden-tax-plan-us-competitiveness

in terms of alienation and accumulation. Alienation constraints limit the capacity to sell or transfer the property while accumulation ones limit the degree of inequality within the group associated with the property.

As regards alienation constraints, the residual value of cooperatives upon sale, closure, or liquidation cannot be appropriated and shared by worker-members. The purpose of this measure is to eliminate any financial incentive to sell the organization, or otherwise liquidate it and cash its economic value, i.e. demutualize and appropriate the market value of the enterprise, or appropriate its residual value upon liquidation. In the Basque system, there are true alienation constraints, as 30% of the annual net surplus must stay within the cooperative for education and environmental projects or difficult future periods. This allows there to be always an important fund for the cooperative. At the same time, these funds are nontransferable and indistributable. Even if the cooperative were to dissolve, the funds would not return to the worker-owners but would have to be transferred to the public administration or other cooperatives. The cooperative, then, does not act as a capitalist corporation and remains an asset for the locality and future generations. Financing problems are also reduced, as financial institutions regard cooperatives as strong entities because of these funds.

The fact that in the US patronage refunds are excluded from the taxable income according to the IRC is a measure that calls for revision. The real spirit of any tax is to obtain resources for the community and the general interest, and that is what cooperatives do. A different taxation system that bears this point in mind is therefore necessary for cooperatives.

Section 501 cooperatives

As we have seen, not all cooperatives can apply Subchapter T. Mutual savings banks, mutual insurance companies, or rural electric or telephone cooperatives have to apply another regime, Section 501 of the IRC. This section is devoted to not-for-profit corporations: religious, charitable, and civic institutions owned and operated for the benefit of their members, some credit unions, mutual insurance agencies, and rural electric and telephone cooperatives.

A major difference between IRC 501 cooperatives and the other types we have been discussing is that 501 cooperatives' earnings are not subject to federal income tax. Thus, they do not need to take deductions if they continue to meet the requirements for exemption under section 501. These requirements, which have their corresponding tests, are as follows.

First, the entity must be organized and operated as a cooperative (the cooperative organizational and operational test). This requirement assures that there is democratic control by members. A cooperative satisfies this criterion by periodically holding democratically conducted meetings with members, each of whom has one vote, and electing officers to operate the organization. It must also operate at cost, in the sense that excess net operating revenues are returned to the member-patrons.

Rev. Rul. 72-36, 1972-1 C.B. 151 sets out organizational and operational requirements an IRC 501(c)(12) cooperative must satisfy to ensure democratic control, operation at cost, and subordination of capital.

- The organization must keep adequate records of each member's rights and interests in the assets of the organization;
- It must distribute any savings to members in proportion to the amount of business done with them (based on the operation-at-cost principle);
- The cooperative must not retain more funds than it needs to meet current losses and expenses (also based on the operation-at-cost principle that we do not share);
- The cooperative cannot forfeit a member's rights and interests in the organization upon termination of membership;
- Upon dissolution, the cooperative must distribute any gains from the sale of any appreciated asset to all who were members while the cooperative owned the asset in proportion to the amount of business done with each.

Second, the organization must conduct activities described in IRC 501(c)(12) and its regulations (the activities test)[16].

Third, it must derive 85% or more of its income from members (the income source test).

Failing these requirements means losing exemption from federal income tax and no longer being regarded as a cooperative for such purposes.

The purpose of an IRC 501(c)(12) organization is to provide certain services to its members at the lowest possible cost. The income must be collected solely to meet the cooperative's losses and expenses.

The Flexible Financing for Rural America Act, which is intended for post-pandemic economic recovery and infrastructure development, appears to be good news for this sort of cooperatives. Even though it is still only a proposal for 2021, should it be passed, the act would allow cooperatives, such as electric or broadband ones, to reprice loans from the US Department of Agriculture's Rural Utilities Service at current low interest rates without prepayment penalties.

"Exempt" or Section 521 cooperatives (farmers' cooperatives)

Subchapter T also includes Section 521 of the IRC, which describes the requirements for a more restrictive form of cooperative termed a Section 521 cooperative, also known as "exempt cooperative", even though it is not so.

Section 521 provides that cooperatives must distribute profits to non-members but they are also allowed to deduct non-member profit distributions, which is the reason behind the term "exempt cooperatives".

However, as we have already said, we consider the term "exempt" to be misleading because these organizations are only exempt from *some* forms of taxation.

To qualify for Section 521, the following criteria must apply:

[16] See SETO, M., op. cit., p. 5.

- The organization must be a farmer's or fruit grower's cooperative operated on a cooperative basis and involved in marketing farm products and/or providing farm supplies and equipment;
- 85% of the capital stock must be owned by producers who market or purchase from the cooperative in the current year;
- Dividends on capital stock are limited to 8%;
- At least 50% of its marketing and 50% of its supplying must be done to members, and the total amount of marketing and supplying to non-members cannot exceed 15% (the so-called "50% rule" that applies only to this sort of cooperatives);
- Members and non-members must be treated equally in terms of patronage, pricing, and pool payments (pay patronage to non-members).

A Section 521 cooperative must also maintain records of patronage and equity and not have excessive levels of financial reserves (unallocated equity). Again, as we have commented in reference to patronage refunds, this requirement seems odd to a foreign eye as in most countries precisely the opposite is promoted. Although many of the requirements in Section 521 make sense in terms of cooperative principles, this one does not.

The advantage of Section 521 cooperatives is that while they have to pay patronage on non-member business, they can deduct those payments along with all qualified patronage and per-unit retain payments to members. In essence, a Section 521 cooperative operates and is taxed as if all of its business were business with members. Additionally, a Section 521 cooperative can deduct dividends paid on capital stock but they are limited to 8%. Therefore, the major tax advantage of Section 521 cooperatives is not a total exemption but the fact that they can deduct patronage paid to non-members and can deduct a certain amount of dividends paid on capital stock.

Conclusions

The latest approved measures exhibit some shared features that can be applied to entities acting on a cooperative basis. The common philosophy behind these features can be summarized as follows:

On one hand, both the TCJA and the COVID-19 relief package have been devised as a way to help the economy through spending, not saving. Even though this is understandable at a time of crisis, it may turn out to be a risky approach. This is particularly clear with the "Three Martini Lunch" measure that allows 100% deducibility of expenses in restaurants, bars, and hotels. Spending is promoted while saving is penalized. The same philosophy is shared in Subchapter T of the IRC concerning cooperatives. Probably the main measure in this sense is the exclusion of patronage refunds from Corporate Income Tax. Sharing benefits is promoted but not accumulating reserves for future difficulties. Moreover, if the reserves are later distributed, both Corporate and Personal Income taxes have to be paid. We believe that these measures should be revised to make cooperative entities more resilient.

On the other hand, the entities that benefit the most from this sort of measure are not those acting on a cooperative basis, i.e. small businesses, but big enterprises. Moving from a graduated tax rate to a flat one means that the savings are meant for big corporations, the bigger the better, as the difference is going to be greater. Therefore, the difference in taxation between big entities and small ones has been diminished without specific measures to promote smaller ones, contrary to the ability-to-pay principle.

As entities acting on a cooperative basis do not usually belong to the big corporation category, the latest tax measures have not benefited them in the way they should. Further measures should be taken to compensate them. Among these, the exclusion from taxation of the benefits destined for reserves could make cooperatives more resilient and at the same time make them save taxes, as the exclusion of these reserves would diminish their tax base.

The money that stays in these funds should be promoted, not penalized, as is the case with US IRC Subchapter T, sections 1351–1358, and other provisions.

Therefore, the existing policy of the exclusion of patronage refunds can be considered harmful to cooperative resilience and should be revised, as it discourages the allocation of benefits to reserves. The exclusion from taxable income of the benefits devoted to reserves could be a way of promoting their resilience.

Furthermore, for 501 cooperatives the requirement not to retain more funds than needed to meet current losses and expenses based on operation at cost shares the same philosophy. Not retaining more funds than needed to meet current losses and expenses can mean not being resilient enough in the long run. We strongly recommend a careful reconsideration of this requirement.

Another important shortcoming is investment in education, training, and innovation. We cannot find the promotion of this aim in the IRC. Should this goal be promoted, US cooperatives could become more flexible on the market and fulfill their mission. Again, the creation of measures to promote this aim would be of great interest and could be helped by the exclusion from taxable income of the benefits devoted to it, as happens in other legislations.

Another important feature for the US cooperative regime would be the creation of a framework by which cooperatives need to be registered as such and comply with certain cooperative principles, giving them their special regime.

BIBLIOGRAPHY

ALPEROVITZ, G. (2017), *Principles of a Pluralistic Commonwealth*, Washington, DC: The Democracy Collaborative.

ARANA LANDIN, S. (2020), "Social Economy as the Means to Help Achieve the Targets of Sustainable Development Goal 14", *Sustainability*, 12.
BARTHOLD, T. A. (2016), "Letter to Kevin Brady and Richard Neal", Joint Committee on Taxation, Washington, DC. Available at https://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf.

BORZAGA, C. and TORTIA, E. C. (2017), "Cooperation as Coordination Mechanism: A New Approach to the Economics of Cooperative Enterprises". In J. Michie, J. R. Blasi and C. Borzaga (eds.), *The Oxford Handbook of Mutual, Cooperative, and Co-owned Business* (pp. 55-75). Oxford: Oxford University Press.

BORZAGA, C. and DEFOURNY, J. (eds.) (2001), *The Emergence of Social Enterprise*, London: Routledge.

CECOP (2012), *Social Cooperatives and Social and Participative Enterprises*, Brussels: CECOP-CICOPA.

CHAVES, R. (2008), "Public Policies and Social Economy in Spain and Europe", *CIRIEC-España, Revista de Economía Pública, Social y Cooperativa*, 62, Special Issue, pp. 35-60.

CONGRESSIONAL RESEARCH SERVICE, *A brief overview of business types and their tax treatment*, R43104.

DEPARTMENT OF THE TREASURY (1992), *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf.
DELLER, S., and others (2009)," Research on the Economic Impact of Cooperatives", University of Wisconsin Center for Cooperatives, vol. 231, pp. 232-3.
GALE, W. G., and others (2018), "Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis." Washington, DC: Urban-Brookings Tax Policy Center.

GUTNECHT, D. (2011), "More on New Co-op Laws", Encap articles.

HANSMANN, H. (1996), *The Ownership of Enterprise*, Cambridge, MA: The Belknap Press of Harvard University Press.
HANSMANN, H. (1999), "Cooperative Firms in Theory and Practice", *The Finnish Journal of Business Economics*, 4, pp. 387-403.
HANSMANN, H., (2013), "All Firms Are Cooperatives – and so Are Governments", *JEOD*, 2 (2), pp. 1-10, DOI: http://dx.doi.org/10.5947/jeod.2013.007.

HOFFMANN, E., (2006), "The Ironic Value of Loyalty: Dispute Resolution Strategies in Worker Cooperatives and Conventional Organizations", *Nonprofit Management and Leadership*, 17, pp. 163-177.

HUBBARD, R. G. (1993), "Corporate Tax Integration: A View from the Treasury Department", *Journal of Economic Perspectives*, vol. 7, n. 1, pp. 115-132.
ILO and ICA, (2016), "Cooperatives and the Sustainable Development Goals: A Contribution to the Post-2015 Development Debate". Available at https://sustainabledevelopment.un.org/content/documents/1247ilo.pdf, accessed 04/05/19.
JOHANSSON Å., and others (2008), in OECD, *Tax and Economic Growth*, Economics Department Working Paper 620.
KASMIR, S. (2016), "The Mondragon Cooperatives and Global Capitalism: A Critical Analysis", *New Labor Forum*, 25 (1), pp. 52-59. DOI: https:doi.org/10.1177/1095796015620424.
KRUSE, D., FREEMAN, R., and BLASI, J., (2010), *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options*, Chicago: University of Chicago Press.

MALLESON, T. (2014), "Rawls, Property-Owning Democracy and Democratic Socialism", *Journal of Social Philosophy*, vol. 45, n. 2, pp. 228-251.

MURRAY, C. (2011), "Co-op Survival Rates in British Columbia", in *Summary of Reports by the Ministry of Economic Development, Innovation and Export in Quebec: Survival Rate of Co-operatives in Quebec*.

NATIONAL COOPERATIVE BUSINESS ASSOCIATION, (2005), *Annual Report*, available at http://ncba.coop/about-us/annual-reports2005.

NATIONAL LIAISON COMMITTEE FOR MUTUAL COOPERATIVE AND ASSOCIATION ACTIVITIES, (2005), *Social Economy Charter*, CIRIEC, available at https://www.eesc.europa.eu/resources/docs/qe-30-12-790-en-c.pdf.

NESS, I. (2011), *Ours to Master and to Own: Workers Control from the Commune to the Present*, New York: ed. Azzelini.

NESS I. (2013), *Worker Cooperatives in the United States: A Historical Perspective and Contemporary Assessment*, available at http://www.workerscontrol.net/authors/worker-cooperatives-united-states-historical-perspective-and-contemporary-assessment.

NYSSENS, M. (ed.) (2006), *Social Enterprise: At the Crossroads of Market, Public Policies and Civil Society*, London: Routledge.

OLSEN, E. K. (2013), "The Relative Survival of Worker Cooperatives and Barriers to Their Creation", in Douglas, K. (ed.) *Sharing Ownership, Profits, and Decision-Making in the 21st Century, Advances in the Economic Analysis of Participatory & Labor-Managed Firms*, 14, pp. 83-107, Bingley: Emerald.

OSTROM, E. (1990). *Governing the Commons. The Evolution of Institutions for Collective Action*, Cambridge, UK: Cambridge University Press.
SALAMON, L. M. and HADDOCK, M. A. (2015), "SDGs and NPIs in Private Institutions, the Foot Soldiers for the UN Sustainable Development Goals", *John Hopkins Center for Civil Society Studies Working Paper* n. 25, Baltimore.

SETO, M. and CHASIN, C. (2002), "General Survey of I.R.C. 501(c)(12) Cooperatives and Examination of Current Issues", CPE.
TAX POLICY CENTER. "Restoring The Three Martini Lunch Tax Deduction Won't Feed The COVID-19 Economy", available at https://www.taxpolicycenter.org/taxvox/restoring-three-martini-lunch-tax-deduction-wont-feed-covid-19-economy, accessed January 29, 2021.
TORTIA, E. C., (2018), "The Firm as a Common. Non-Divided Ownership, Patrimonial Stability and Longevity of Co-Operative Enterprises", *Sustainability* 10 (4), 1023. DOI: https://doi.org/10.3390/su10041023.
United Nations General Assembly (2015), "Transforming Our World: The 2030 Agenda for Sustainable Development", A/RES/70/1, United Nations General Assembly: Geneva, Switzerland.

YORK, E. and MURESIANU, A. "The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households", available at https://taxfoundation.org/the-tax-cuts-and-jobs-act-simplified-the-tax-filing-process-for-millions-of-americans/