THE TAX TREATMENT OF COOPERATIVES IN KOREA: A LACK OF CONSIDERATION OF COOPERATIVES' STRUCTURAL CHARACTERISTICS AND SUGGESTIONS FOR IMPROVEMENT

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Abstract

This Article comprehensively analyzes the history of cooperative legislation and tax policies for cooperatives in Korea, including the current legal situation caused by legislators' misconceptions. Korean tax law divides cooperatives into two categories: non-profit corporations which are entitled to tax benefits and for-profit corporations which are not. Due to this dichotomy, general cooperatives, which account for the largest number of Korean cooperatives, fall into the latter category and are not entitled to any related tax benefits. This problem results in the double taxation on the surplus of general cooperatives. The Article regards this double taxation as a core problem for cooperative legislation and suggests legal measures to solve this problem systematically. The tax laws applied to cooperatives are complexly connected to cooperative laws, which is why they constantly affect one another. Therefore, this Article presents not only a proposal for a tax law amendment but also a reform of the legal framework of cooperatives, based on the analysis of the interconnection between them. To overcome double taxation of the cooperative's surplus, this Article proposes a series of possible changes to the tax law, based on the recognition that the cooperative's income ultimately belongs to its members. As a prerequisite for this revision, the Article demonstrates that it is essential to systematize the legal rules governing patronage dividends and to clarify the legal concept of "use" of cooperatives.

KEY WORDS: Cooperative Law, Tax Treatment of Cooperatives, Cooperative Surplus, Patronage Dividends, Cooperative Identity, South Korea

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I. Introduction

The importance of the role of legal framework in stable growth of cooperatives has been increasingly emphasized internationally. In 2001, the United Nations established the "Guidelines Aimed at Creating a Supportive Environment for the Development of Cooperatives", accentuating the need for a cooperative legislation that reflects the characteristics of cooperatives.[1] In addition, the International Labour Organization (ILO) adopted the "Promotion of Cooperatives Recommendation" in 2002, which advised that "governments should provide a supportive policy and legal framework consistent with the nature and function of cooperatives and guided by the cooperative values and principles" so that cooperatives can fulfill their social roles.[2] How to determine the tax incentives for cooperatives was one of the most important issues in the cooperative policies of each country. The implementation of "cooperative-friendly taxation," which reduces several types of taxes on cooperatives, is already prevalent in many countries, especially in Western Europe and North America.[3]

The United Nations declared 2012 as the "International Year of Cooperatives," highlighting the contribution of cooperatives to socio-economic development.[4] In line with this action, South Korea enacted the Framework Act on Cooperatives[5] the same year. The enactment was the first meaningful national response to the ILO's request, and it is considered to have contributed significantly to the growth of cooperatives. Since the enactment of this Act, more than 20,000 cooperatives have been established in South Korea.[6] Despite this monumental legislation and the rapid growth of cooperatives, there has been no serious debate among legislators about tax benefits for cooperatives until now. This is because a tax system reform for cooperatives requires the correction of a long-standing misconception from the root. The Korean tax support systems that apply to business organizations, such as the income deduction and the dividend income tax exemption, are designed solely to promote investment in small stock companies and venture companies.[7] Even a social enterprise established in the form of a stock company receives more tax benefits than cooperatives in South Korea.

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[1] United Nations, G.A. Res. A/56/114, (Dec. 19, 2001), https://digitallibrary.un.org/record/454944 (last visited Mar. 26, 2021).
[2] International Labour Organization [ILO], Res. 193, *Promotion of Cooperatives Recommendation* (Jun, 20. 2002), http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:R193 (last visited Mar. 26, 2021).
[3] Nina Aguiar, *Taxation of Cooperatives: General Guideline and Problems*, iCoop Haeoeyeongudonghyang, 2 (2019).
[4] United Nations, *2012 International Year of Cooperatives*, https://www.un.org/en/events/coopsyear/. (last visited Mar. 26, 2021).
[5] Hyeopdongjohap gibonbeob [Framework Act on Cooperatives] art. 2 (S. Kor.) [hereinafter Framework Act on Cooperatives]. English translation of current Korean laws in this Article adopts the translation by the Korea Legislation Research Institute, *see* Statutes of Korea in English, http://elaw.klri.re.kr/eng_service/main.do (last visited Mar. 26, 2021).
[6] Korea Social Enterprise Promotion Agency, *Status of Cooperative Establishment* [hereinafter *Status of Cooperative Establishment*], *available at* https://www.coop.go.kr/COOP/2 (last visited Mar. 26, 2021).
[7] Park Sung Ook & Shin Chung Hyu, *A Study on Tax Support for Social Economic Activation*, 19 Journal of Taxation and Accounting, no.5, 81, 94-95 (2018).

This study examines the problems of the current tax laws concerning cooperatives and proposes a suggestion for legal reforms to be in accordance with cooperative identity. Chapter II of this Article discusses the history and the current status of legislation concerning cooperatives and their current tax treatment. Cooperative legislation in South Korea was formed after the military regime took over the country, and this historical background explains the effects and problems associated with the legal framework for cooperatives. Chapter III analyzes how the tax treatment of cooperatives in Korea can be improved, focusing on dividend income, which is one of the most controversial issues related to cooperative policy. The analysis demonstrates that it is not the cooperative itself but the members to which the cooperative's income should ultimately be attributed. To systematically reorganize dividend regulations, the current legal system, which determines a cooperative as a profit or a non-profit corporation only according to its legal basis, needs to be redesigned. This Article presents a legal method for this reform. Chapter IV explains that the reform should focus on understanding the cooperative's principle of mutuality as a premise in order to improve the regulations on patronage dividends. The essential rules for strengthening mutuality, such as membership qualification criteria and restrictions of non-members' use, cannot function well under the Korean cooperative legislation. In the long-term, fundamental legislative reform is necessary, including the creation of legal categories for various types of cooperatives and the revision of rules about the relationship between the Framework Acton Cooperatives and other cooperative laws.

II. Cooperative Legislation and Taxation Policy in Korea

A. Overview of the History of Cooperative Laws in Korea

After World War II, Korea was in the middle of the Cold War, and the Korean Peninsula was divided into South Korea and North Korea. The period of military dictatorship began in South Korea in the 1960s. Under the fierce competition between South and North Korea, the military dictatorship designed South Korea's cooperative legal system in a way that could contribute to the nation's industrial policy.[8] Since the government was only interested in creating cooperative legislation that could meet the country's industrial needs,[9] it was difficult to conduct a serious discussion about cooperative's core characteristics and identities in the legislative process.

The state-enacted cooperative laws hindered independent cooperative movements, and the government's intention continued to strongly influence cooperative operators.[10] In particular, the "Act on the Temporary Measures for the Appointment of Agricultural Cooperative Executives" stipulated that the approval of the secretary of the Ministry of Agriculture was

[8] *See* Kim Hyung Mi, *1919, The 1st year of the Korean Cooperative Movement*, *in* 100 YEARS OF THE KOREAN COOPERATIVE MOVEMENT I 20, 20-27 (2019).
[9] *See* KIM YONG JIN, KIM HYUNG MI, CHOI EUN JU, SHIN CHANG SUB, LEE TAE YOUNG & KIM JAE WON, SYSTEMIZATION OF KOREAN COOPERATIVE LEGISLATION FOR REALIZATION OF SOCIAL VALUES 17 (2020).
[10] *See* Kim Ki Tae, *Movement of Reformation of the Agricultural Cooperative*, *in* 100 YEARS OF THE KOREAN COOPERATIVE MOVEMENT II 15, 16 (2019).

required to appoint the representative of the agricultural cooperative.[11] This Act was enacted by the military regime in February 1962, right after their successful coup d'état had occurred in May 1961. Park Chung Hee, the military regime leader, became the president of South Korea in 1963, and the Agricultural Cooperatives Act was revised in the same year. Article 149 of the revised act clearly stipulated that the President of the National Agricultural Cooperative Federation should be appointed by the President of South Korea.[12] As the designated federation president could appoint local cooperative presidents, all cooperatives across the country came under the influence of the military regime, and the identity of agricultural cooperatives was decisively damaged.[13] The situation was similar in the Fisheries Cooperative Act,[14] the Forestry Cooperative Act, [15] and the Livestock Industry Cooperative Act,[16] all enacted under the military regime.[17] These kinds of government interventions in the cooperative operation, which should be democratic in its own construction, is unjustifiable.

Since then, the government has shifted to a system in which the state operates cooperatives as a policy body supporting the country's economic growth. The agricultural cooperative was a prime example of this.[18] The agricultural cooperatives, which were dominated by the military regime, received huge support from the government, established a nationwide network very quickly, and took charge of national policy projects such as agricultural financing and producing public grain, etc.[19] Independent cooperative activists, who could not agree with the government's cooperative policy, were forced to start from the bottom because they had a lack of local and human resources.[20] The government's goal was to turn cooperatives into government agencies that serve the public interest, and the government also aimed at preventing the emergence of independent cooperative movements.[21] After South Korea's 1987 democratization, much of the President and the government's authority over cooperatives were handed over to cooperatives. However, it was not easy to change the long-lasting practice of cooperatives acting as a sort of sub-governmental institution.

Because of this historical background, the National Assembly, under the government's influence during the military dictatorship period, could not deeply consider cooperative identity until democratization. Cooperatives were just a subordinate state institution to them. Agricultural

[11] Nonguphyeopdongjohapimoneimmyeongehgwanhanimsijochibeop [Act on the Temporary Measures for the Appointment of Agricultural Cooperative Executives], Act. No. 1025, February. 12, 1962, art. 2 (S. Kor.).
[12] Nonguphyeopdongjohapbeob [Agricultural Cooperatives Act], Act. No. 1584, December. 16, 1963, art. 149 (S. Kor.).
[13] Kim Ki Tae, *supra* note 10, at 16.
[14] *See* Susanuphyeopdongjohapbeob [Fishery Cooperatives Act], Act. No. 1013, January. 20, 1962, art. 128 para. 1, 2 (S. Kor.).
[15] *See* Sanlimjohapbeob [Forestry Cooperatives Act], Act. No. 3231, January. 4, 1980, art. 61, para. 2 (S. Kor.).
[16] *See* Chucksanuphyeopdongjohapbeob [Livestock Cooperatives Act], Act. No. 3276, December. 15, 1980, art. 119 (S. Kor.).
[17] The military regime continued until the Constitution was amended by the democratization movement in 1987.
[18] Lee Kyung Ran, *Origin of the Korean Modern Cooperative Movement and Living Cooperative Association*, Critical Review of History, The Institute for Korean Historical Studies 40, 54 (2013).
[19] Ko Hyun Seok, *the Beginning of Comprehensive Agricultural Cooperative and Transformation to a Government's Suborganization*, 52 Cooperative Network, Korean Society for Cooperative Studies, 53, 57 (2010).
[20] Lee Kyung Ran, *supra* note 18, at 40, 54.
[21] Ko Hyun Seok, *supra* note 19, at 53, 59.

cooperatives functioned as tools for implementing agricultural policies, and fishery cooperatives functioned as tools for implementing fishery policies, under the anachronistic legal framework. That was the role of cooperatives during this period. As cooperatives developed in close alignment with government policies, they received various institutional benefits, including tax benefits.[22] This was not intended to support cooperatives but rather to facilitate national policy. Since cooperatives were under the government's influence anyway, it was not difficult for the government to consider them as a kind of non-profit corporation and give them the same tax benefits. The government's policy of treating cooperatives as non-profit corporations and giving them many benefits has made them reluctant to create new forms of cooperatives that the government cannot predict.

Currently, nine Korean laws deal with cooperatives: the Framework Act of Cooperatives, the Agricultural Cooperatives Act,[23] the Consumer Cooperatives Act,[24] the Fishery Cooperatives Act,[25] the Forestry Cooperatives Act,[26] the Tobacco Producer Cooperatives Act,[27] the Small and Medium Enterprise Cooperatives Act,[28] the Credit Union Act,[29] and the Community Credit Cooperatives Act.[30] all the acts except for the Framework Act on Cooperatives is referred to as a "special cooperative law" because the Framework Act on Cooperatives was enacted to function as a general law. All the special cooperative laws except for the Consumer Cooperatives Act were enacted before the military regime lost its power in 1987. After democratization, The Consumer Cooperatives Act was enacted in 1999, and the Framework Act on Cooperatives was enacted in 2012 after all eight special cooperative laws were established.[31] The new act was expected to be a norm for stipulating the basic principles for the establishment and operation of cooperatives and reform of the state of legislative inadequacies that had continued for more than a half century.[32]

[22] Kim Ki Tae, *supra* note 10, at 15, 19.

[23] Nonguphyeopdongjohapbeob [Agricultural Cooperatives Act] (S. Kor.) [hereinafter Agricultural Cooperatives Act]

[24] Sobijasanghwalhyeopdongjohapbeob [Consumer Cooperatives Act] (S. Kor.) [hereinafter Consumer Cooperatives Act]

[25] Susanuphyeopdongjohapbeob [Fishery Cooperatives Act] (S. Kor.) [hereinafter Fishery Cooperatives Act]

[26] Sanlimjohapbeob [Forestry Cooperatives Act] (S. Kor.) [hereinafter Forestry Cooperatives Act]

[27] Yeopyeonchohyeopdongjohapbeob [Tobacco Producers Cooperatives Act] (S. Kor.) [hereinafter Tobacco Producers Cooperatives Act]

[28] Jungsogiuphyeopdongjohapbeob [Small and Medium Enterprise Cooperatives Act] (S. Kor.) [hereinafter Small and Medium Enterprise Cooperatives Act]

[29] Sinyonghyeopdongjohapbeob [Credit Unions Act] (S. Kor.) [hereinafter Credit Unions Act]

[30] Saemaeulgeumgobeob [Community Credit Cooperatives Act] (S. Kor.) [hereinafter Community Credit Cooperatives Act]

[31] the Bill of the Framework Act on Cooperatives, Bill. No. 1814332, December. 12, 2011, 3-4.

[32] *Id*. However, there is an obvious limitation to playing this role because the Framework Act on Cooperatives does not apply to the cooperatives established under the special cooperative laws. *See* Framework Act on Cooperatives, art. 13 para. 1.

B. Dichotomous Approach to Cooperatives in Korean Tax Law

The Korean tax system has a strict dichotomy that divides all legal organizations into two types, "for-profit" and "non-profit" corporations.[33] The majority opinion among civil law scholars in Korea on this division is that it should be based on whether the corporation distributes its profits[34] to its members or not.[35] Korean tax laws also apply this standard for classifying for-profit and non-profit corporations, with some exceptions. Under this simple classification, cooperatives that pay dividends to their members must all be treated as for-profit corporations. However, the tax law divides cooperatives into for-profit and non-profit corporations according to the base laws by which the cooperatives were established. Cooperatives established under special cooperative laws, such as agricultural cooperatives, fishery cooperatives, and consumer cooperatives, are classified as non-profit corporations by the Enforcement Decree of the Corporate Tax Act.[36] Cooperatives established based on the Framework Act on Cooperatives enacted in 2012 are divided into "social cooperatives" and "general cooperatives,"[37] and only social cooperatives are considered non-profit corporations by tax law,[38] while general cooperatives established under the Act are considered for-profit organizations. However, since this dichotomous approach does not properly reflect the organizational characteristics of cooperatives, it has received much criticism in South Korea.[39]

Korea's tax policy based on this classification will be a critical issue for corporations belonging to "for-profit," and the general cooperative is the representative example. All general cooperatives' transactions, regardless of whether they are transactions with members, are regulated the same as commercial corporations' transactions by Korean tax laws.[40] These

[33] *See* Beobinsebeob [Corporate Tax Act] art. 2, para. 1, 2 (S. Kor.) [hereinafter Corporate Tax Act].

[34] As will be mentioned below, since the cooperative is established for the promotion of interests of its members, the surplus should ultimately belong to the members. Therefore, it is not proper to refer to the surplus as 'profits.' On the other hand, because there is no difference between the profits of cooperatives from transactions with non-members and the profits of stock companies, this Article will distinguish these 'profits' from 'surpluses.' Similarly, distributing the cooperative's surplus to its members is technically a kind of 'refund,' which is distinctly different from a 'dividend' in a stock company. However, Korea's current cooperative laws and tax laws already use the term 'dividend,' and the term 'refund' is used only when a withdrawing member takes back her/his shares from the cooperative. As this Article is based on the analysis of the current laws, the term 'dividend' will be used to minimize confusion about terminology.

[35] *See* SONG HO YOUNG, BEOBINLON [THE THEORY OF LEGAL ENTITY] (ed. 2) 64 (2015).

[36] Cooperatives established under the Agricultural Cooperatives Act, Fishery Cooperatives Act, Forestry Cooperatives Act, Tobacco Producers Cooperatives Act, Small and Medium Enterprise Cooperatives Act, Consumer Cooperatives Act, Credit Unions Act, Community Credit Cooperatives Act are regarded as non-profit corporations by Beobinsebeob Sihaengryeong [Enforcement Decree of the Corporate Tax Act] art. 1 para. 2 (S. Kor.) [hereinafter Enforcement Decree of the Corporate Tax Act], and these cooperatives are subject to reduction in the corporate tax rate. *See* Josetukryejehanbeob [Restriction of Special Taxation Act] art. 72 (S. Kor.) [hereinafter Restriction of Special Taxation Act].

[37] The term "cooperative" in the Act means a business organization that intends to enhance its partners' rights and interests, thereby contributing to local communities by being engaged in the cooperative purchasing, production, sales, and provision of goods or services, and the term "social cooperative" means a cooperative that carries out business activities related to the enhancement of rights, interests, and welfare of local residents or provides social services or jobs to disadvantaged people, that is not run for profit, *see* Framework Act on Cooperatives, art. 2.

[38] *See* Framework Act on Cooperatives, art. 4 para. 2 (S. Kor.).

[39] *See* NATIONAL ASSEMBLY SOCIAL ECONOMIC SOLIDARITY FORUM & THE ICOOP COOPERATIVE RESEARCH INSTITUTE, THE WAY OF TAX REFORM TO STRENGTHEN COOPERATIVES' IDENTITY (2020).

[40] General cooperatives are called "general" cooperatives only because they do not mainly carry out public service, thus simply classifying them as for-profit companies does not meet the legislative purpose of the Framework Act of Cooperatives.

regulations on cooperatives do not conform to the trend of international cooperative law, which strictly distinguishes between transactions with members and non-members, patronage dividends and other dividends.[41] Currently, even if dividends are paid to members according to the usage ratio, Korean tax laws do not recognize them as deductible expenses. Also, the surplus earned by cooperative transactions with members are taxed unexceptionally.

While only 923 local cooperatives were established under the Agricultural Cooperative Act,[42] which are based on the oldest cooperative law in South Korea, the number of cooperatives established under the Framework Act of Cooperatives, enacted in 2012, has already exceeded 20,000 as of March 2021.[43] Among these cooperatives based on the Framework Act on Cooperatives, "general cooperatives" accounted for the majority with approximately 85 percent.[44] Considering the explosive increase of general cooperatives, it is a very serious problem that general cooperatives are simply classified as for-profit companies by the tax laws.

The problems arising from Korean legislators' lack of understanding of the cooperative's characteristics cannot be easily solved because the biggest cooperatives in Korea, such as agricultural cooperatives, are already benefiting as "non-profit" organizations, and they are not dissatisfied with the treatment they receive. That's why the remnants of the military dictatorship in Korea still remain in the cooperative legislation to this day. This dichotomous tax policy also has a negative impact on cooperatives that are treated as non-profit corporations. The tax benefits for "non-profit" cooperatives are already determined at the time they are established according to the underlying laws, so it does not matter how the cooperative operates after it is established. Even if it loses its character as a cooperative, there are almost no changes in tax benefits. For this reason, the Korean tax policy cannot function as an appropriate guideline for the operation of cooperatives. This can be a major obstacle for cooperatives seeking to grow on the basis of their cooperative identity.

C. Tax Benefits for Cooperatives under Current Tax Laws

As explained below, in the case of "general partnerships" or "limited partnerships," dividend income for members is not taxed at the corporate level due to special taxation for partnerships under Korean tax law,[45] but no type of cooperative is subject to this benefit. Instead, Cooperatives are simply divided into non-profit or for-profit cooperatives, and their

[41] *See* GEMMA FAJARDO, ANTONIO FICI, HAGEN HENRŸ, DAVID HIEZ, DEOLINDA MEIRA, HANS-H. MUENKER & IAN SNAITH, THE PRINCIPLES OF EUROPEAN COOPERATIVE LAWS: PRINCIPLES, COMMENTARIES AND NATIONAL REPORTS 43 (2017). The Principles of European Cooperative Law was drafted by a team of European legal scholars to regulate the common core of European cooperative law. Their study is based on both existing cooperative laws in Europe and the EU regulation on the *societas cooperativa europaea*.

[42] *See* Nonghyup [The National Agricultural Cooperative Federation], *Organization Detail*, https://www.nonghyup.com/introduce/organization/organization.do (last visited Mar. 26, 2021).

[43] *See Status of Cooperative Establishment*, *supra* note 6.

[44] *Id.*

[45] *See* Restriction of Special Taxation Act, art. 100-5.

tax treatment is also divided into two parts. Since general cooperatives are treated as for-profit companies such as stock companies and are not specially treated under the tax law, most of their incomes are taxable regardless of their source. On the other hand, various tax incentives are stipulated in tax laws for cooperatives considered non-profit corporations.

In principle, a non-profit corporation is not obligated to pay corporate tax under the Corporate Tax Act if it does not engage in the profitable businesses enumerated in this act. If a non-profit corporation has accumulated some money for expenditures on its own "proper purpose business," it shall be included in the deductible expenses for calculating the amount of income for the relevant business year within the range permitted by the Act.[46] The term "proper purpose business" in the Act means the business directly operated by the non-profit corporation to achieve its purpose as provided by the corporation's statutes or regulations, other than the "profit-making business" prescribed by this Act.[47] The specific scope of the "profit-making business"[48] is determined according to whether it is enumerated in the Enforcement Decree of the Corporate Tax Act regardless of the contents of the bylaws. To receive tax benefits for expenses incurred in proper purpose business, the accounting of the non-profit corporations' "profit-making business" should be demarcated from those of the "proper purpose business."

However, the Restriction of Special Taxation Act does not require cooperatives to separate accounting for profitable business and non-profit business. Instead, some kinds of cooperatives are subject to lower tax rates than commercial companies. Corporate tax in South Korea is levied from 10 to 25 percent in general,[49] whereas a relatively low tax rate of 9 to 12 percent is applied to cooperatives established under the special cooperative laws, and tax adjustment also can be simplified for them.[50] Cooperatives subject to the above special exceptions are allowed to give up these tax benefits on their own.[51] In the case of waiver, general rules for non-profit corporations apply.

There are more tax regulations only beneficial to cooperatives established under the special cooperative laws: a low tax rate on the interest income of money deposited by members,[52] exemption from the acquisition tax on real estate acquired for direct use in the cooperative's business,[53] exemption from the property tax on real estate currently used for its

[46] Corporate Tax Act, art. 29.
[47] Enforcement Decree of the Corporate Tax Act, art. 56, para. 5.
[48] Sixteen businesses are regulated as the profit-making businesses subject to the corporate income tax, such as social welfare services. *See id*. art. 3, para. 1.
[49] *See* Corporate Tax Act, art. 29.
[50] *See* Restriction of Special Taxation Act, art. 72. Because of this benefit, some studies see this preferential treatment as a compromise measure that properly takes into account both the profit and non-profit elements of cooperatives. *See* Lee Jong Je, *the Contents of Special Taxation concerning Corporate Tax on Incorporated Associations and its Reform*, *in* THE WAY OF TAX REFORM TO STRENGTHEN COOPERATIVES' IDENTITY, *supra* note 39, at 91-92. But considering that the Corporate Tax Act already acknowledged these cooperatives as non-profit corporations, it is explicit that there is a contradiction in this Act.
[51] *See* Restriction of Special Taxation Act, art. 72 para. 1 proviso.
[52] *See id.* art. 89-3
[53] *See* Jibangsetukryejehanbeob [the Restriction of Special Local Taxation Act] art. 14, 14-2, 87 (S. Kor.).

own business,[54] and exemption from the acquisition tax on the merger of cooperatives.[55] Nevertheless, all the benefits prescribed by the tax law cannot be applied to general cooperatives.

According to the Restriction of Special Taxation Act, no income tax shall be levied on dividend income distributed by a financial institution whose members comprise farmers, fishermen, or other individuals with a mutual tie to its members based on the records of its business use.[56] But this is only for members who have invested in "financial institutions" operated by the cooperatives designated in this article,[57] and this special rule does not apply to general cooperatives at all because it is strictly prohibited for general cooperatives to operate financial businesses.[58]

III. Proposals for Tax Reform for Cooperatives in Korea

A. Establishing the Legal Meaning of the Cooperative's Surplus

1. Considering Substance over Form

The most fundamental problem with Korean cooperative taxation policy is that of double taxation. As corporate tax is levied on a cooperative's income, it is necessary to discuss whether income tax or corporate tax should again be imposed when the cooperative distributes its surplus to its members. Finding out whether the surplus belongs to a cooperative or a member is essential for the realization of "the substance over form principle." This principle is a doctrine that when the form and substance of the taxation object do not coincide when applying the tax law provisions, taxation should be based on the substance, not the form,[59] explicitly reflected in Korean tax law.[60] In the case of a trustor who transfers real estate to another person according to his intention and is in a position to be able to control and dispose of the real estate in the trust, the Supreme Court ruled that the "trustor" should pay the tax rather than the trustee.[61] In another case, the Supreme Court also decided that the transfer income tax on land acquired by a housing association with money collected from its members should be paid by the members who benefit

[54] *Id.*
[55] *See id.* art. 57-2.
[56] *See id.* art. 88-5.
[57] The designated cooperatives are agricultural cooperatives, fisheries cooperatives, forestry cooperatives, credit cooperatives, and the community credit cooperatives. General cooperatives and social cooperatives under the Framework Act of Cooperatives are not included. *See* Josetukryejehanbeob Sihaengryeong [the Enforcement Decree of the Restrictionof Special Taxation Act] art. 82-5 (S. Kor.) [hereinafter Enforcement Decree of the Restriction of Special Taxation Act].
[58] *See* Framework Act on Cooperatives, art. 45 para. 3. This clause has also been criticized for unreasonably limiting the scope of the cooperative's business.
[59] Choi Seong Keun, *A Proposal to Establish the Theories and the Provisions on Substance over Form Taxation Principle*, 19 Seoul Tax Law Review, no.2, 119, 122 (2013).
[60] *See* Kuksegibonbeob [Framework Act on National Taxes] art. 14-1 (S. Kor.). This article provides that "if any ownership of an income, profit, property, act or transaction which is subject to taxation, is just nominal, and there is other person to whom such income, etc., belongs, the other person shall be liable to pay taxes and tax-related Acts shall apply, accordingly."
[61] Daebeobwon [S. Ct.], Oct. 10, 1997, 96Nu6387 (S. Kor.). In this case, since housing association had no legal entity, it was different from cooperatives established under cooperative laws.

from the transaction, not the association.[62] These are the representative precedents to which the substance over form principle applied.

Historically, the substance over form principle was judicially developed to make it easier for the government to impose taxes on a transaction's substance, regardless of its form.[63] However, simultaneously, the principle also functions as a weapon for taxpayers to reject taxation inconsistent with a transaction's substance.[64] From the latter point of view, the principle should be a norm that restricts the government's taxation powers within a reasonable range fitting with reality. The doctrine in this sense differs in function from the principle used as the standard for the interpretation of tax laws,[65] which means that the substance over form principle also should be a guidance for better regulation.[66]

The Constitutional Court of Korea has cited the doctrine from this perspective in its decisions on unconstitutional tax regulations. The court ruled that it was a violation of the substance over form principle for the government to uniformly impose a gift tax on title trusts if there were no tax avoidance purposes involved.[67] In another case, a tax office did not refund the tobacco consumption tax to a tobacco seller, who had returned the products to the supplier, which was legitimate according to the Local Tax Act at the time. The Constitutional Court decided that no actual consumption had taken place by retrieving cigarettes from sellers in the market, thus the provisions that allow the refund of tobacco taxes only with extremely few exceptions[68] did not accord with the substance of the transaction, which is why the provisions were unconstitutional.[69] The court also declared that imposing both the land excess profit tax and the transfer income tax on the same income source was unconstitutional because the provision violated the substance over form principle.[70] Given the above precedents, we can see that the Constitutional Court used the substance over form principle as a constitutional standard. According to this view of the Constitutional Court, this doctrine should be taken not only as a rule for interpreting tax laws, but also as a legislative guideline for national tax policy.

This legal reasoning of the Constitutional Court is based on "tax egalitarianism," which is implied in the principle of equality stipulated in Article 11 of Korea's

[62] Daebeobwon [S. Ct.], May. 29, 1999, 97Nu13863 (S. Kor.)
[63] *See* Victor D. Rosen, *Substance over Form – A Taxpayer's Weapon*, 22 Major Tax Plan, 689, 690 (1970).
[64] *Id.* at 689.
[65] *See* Cho Young Sik, *Constitutional Review of Substance over Form Principle*, 21 Constitutional Law Review, Constitutional Court of Korea, 525, 535 (2010).
[66] HARRY BREMMERS, SUBSTANCE OVER FORM: A PRINCIPLE FOR EUROPEAN FOOD INFORMATION REGULATION?: REGULATING AND MANAGING FOOD SAFETY IN THE EU, 195, 213 (2018).
[67] Hunbeobjaepanso [Const. Ct.] July. 21, 1989, 89Heonma38 (S. Kor.).
[68] At the time, the local tax law stipulated that the tobacco consumption tax was refunded only when cigarettes were retrieved due to the problem with packaging or poor quality.
[69] Hunbeobjaepanso [Const. Ct.], Apr. 26, 2001, 2000Heonba59 (S. Kor.)
[70] Hunbeobjaepanso [Const. Ct.], July. 29, 1994, 92Heonba49 (S. Kor.)

Constitution.[71] Tax egalitarianism, along with tax legalism (the principle of no taxation without law), is a fundamental principle of tax law based on the Constitution, and is applied not only to the imposition of taxes but also to the reduction of them.[72] In the opinion of the Constitutional Court, all taxation must be fair and equal depending on the individual's ability to pay a tax and it does not allow any discrimination against or preferential treatment of a specific taxpayer without a reasonable reason.[73] As long as the substance over form principle is understood as a derivative principle of tax egalitarianism based on the Constitution, the doctrine has constitutional effect. Thus, it naturally functions as the guiding principle of legislation.[74] If tax is levied beyond this individual capacity, it violates tax egalitarianism, a constitutional norm.[75] Therefore, when tax offices and legislators look at a cooperative's income, they need to pay attention to its "substance." If a cooperative's income is subject to corporate tax even though it has no substance as "income" from the cooperative's point of view, these tax laws are likely to be determined unconstitutional and in violation of the substance over form principle. For fair taxation, legislators must analyze the substance of cooperatives' income, and this analysis will be the first step in realizing tax egalitarianism.

2. Partnership Taxation in Korea

In addition to cooperatives, there are various partnership types in South Korea. The Commercial Act regulates five company categories which all allocate their profits to members: a partnership company, limited partnership company, limited liability company, stock company, and limited company. [76] In particular, human-based companies, such as a partnership company, limited partnership company, and limited liability company, have many structural similarities to cooperatives. These companies are organizationally the same as cooperatives in that they make decisions according to the one-person, one-vote rule,[77] the transfer of shares is strictly limited,[78] and their members can claim a share refund when they leave the company.[79] Thus, it is required to first look at the tax policy regarding these companies' income in order to accurately grasp the "substance" of the cooperative's income.

The Korean tax law already has special provisions for partnerships. According to the Restriction of Special Taxation Act, corporations established by two or more persons to share profits or losses from joint business operations are considered "partnerships," and they are

[71] Article 11 of the Constitution stipulates that "all citizens shall be equal before the law, and there shall be no discrimination in political, economic, social or cultural life on account of sex, religion or social status." *See* DAEHANMINKUK HUNBEOB [HUNBEOB] [CONSTITUTION] art. 11 (S. Kor.).
[72] SUNG NAK IN, HEONBUBHAK [CONSTITUTIONAL LAW] 485 (ED.20) (2020).
[73] Hunbeobjaepanso [Const. Ct.], June. 26, 1996, 93Heonba2 (S. Kor.)
[74] Cho Young Sik, *supra* note 65, at 525, 533.
[75] *Id.*
[76] *See* Sangbeob [Commercial Act] art. 178~267(partnership company), art. 268~287(limited partnership company), art. 287-2~287-45(limited liability company), art. 288~542(stock company), art. 543~613(limited company) (S. Kor.) [hereinafter Commercial Act].
[77] *See id.* art. 200, 201, 204, 269, 287-12, 287-16, 287-19.
[78] *See id.* art. 197, 276, 287-8.
[79] *See id.* art. 222, 269, 287-24.

not subject to corporate tax.[80] This regulation solved the double taxation problem by taxing only at the member level, not at the partnership level.[81] The introduction of this regulation in 2009 broke the formula that "corporate tax must be levied on organizations with a legal entity."[82] A "partnership company" and a "limited partnership company" established under the Commercial Act, an "association" established under the Civil Act, a "partnership firm" and an "undisclosed association" established under the Commercial Act are included in the scope of this "partnership."[83] This special provision reflects the public opinion at the time that Korean legislators should improve tax policy on partnerships by referring to the foreign partnership taxation system such as that of the United States, Germany, etc.[84] The legal form of partnership company and limited partnership company in Korea was designed with reference to German corporate law (Gesellschaftsrecht). Moreover, both general partnership (*offene Handelsgesellschaft*) and limited partnership (*Kommanditgesellschaft*) in Germany are only taxed when they attribute their profits to each partner.[85] These regulations became the basis of the Korean partnership taxation system.

Even when the above tax provision was introduced, there was no room for cooperatives since cooperatives established under special cooperative laws were already considered non-profit corporations by tax laws. Likewise, under the Framework Act on Cooperatives, social cooperatives are also regarded as non-profit corporations, and distribution to members is prohibited, so the provision of the partnership could not be applied. On the other hand, since general cooperatives under the same act can allocate dividends to their members, it is theoretically possible to apply this special provision for partnerships to general cooperatives. Nonetheless, they were not considered in the provision as well because the Framework Act on Cooperatives was enacted after the provision's introduction in 2009.

The Framework Act on Cooperatives considers that the characteristics of "limited liability company" under the Commercial Act is the closest to the nature of general cooperative; hence, it stipulates that the Commercial Act provisions regarding limited liability companies shall apply *mutatis mutandis* to general cooperatives and federations of general cooperatives.[86] However, unfortunately, the articles for a limited liability company in the Commercial Act were also enacted in 2011, after the introduction of the tax provision for

[80] *See* Restriction of Special Taxation Act, art. 100-14, 100-15.
[81] Chang Hyeon Jeen, *A Review of Taxation System of Partnership on the Human-based Company*, Tax and Law, Law Research Institute in University of Seoul 121, 131 (2019).
[82] *Id.*
[83] *See* Restriction of Special Taxation Act, art. 100-15. However, unlike the partnership company or limited partnership company, the association, partnership firm and undisclosed association are organizations without a legal personality. *See* Minbeob [Civil Act] art. 703~724 (S. Kor.) [hereinafter Civil Act], Commercial Act, art. 78~86, 86-2~86-9.
[84] At that time, there was a regulation requiring the amount of dividends to be deducted from income for a partnership company and a limited partnership company operated in knowledge-based industries, but the target industries were extremely limited to "knowledge-based industries". *See* Josetukryejehanbeob [the Restriction of Special Taxation Act], Act. No. 17759, August. 3, 2007, art. 104-11 (S. Kor.).
[85] Kim Yu Chan, *Taxation of Partnerships in Germany with an Emphasis on the Tax Treatment of Transactions between Partner and Partnership*, 8 Tax Research, Korea Tax Research Forum, no.2, 166, 173 (2008).
[86] Framework Act on Cooperatives, art. 14 para. 1.

partnerships, and that is why the limited liability company is also excluded from the tax benefit. Although it is necessary to rediscuss whether to apply the provision to general cooperatives and limited liability companies, the special article for partnerships has not been revised since 2010.

Both general cooperatives and limited liability companies are rather human-based than capital-based corporations. They are managed by the one-person, one-vote rule,[87] limiting the transfer of shares,[88] and their members have the right to claim a refund of shares when they withdraw from the corporation.[89] In this respect, they are not fundamentally different from a partnership company or a limited partnership company. Therefore, it cannot be considered fair taxation to exclude a general cooperative or a limited liability company from applying the special provisions for the partnership.[90]

3. Attribution of Cooperative Surplus

Compared to a "partnership company" or a "limited partnership company," a cooperative has a stronger reason that its income must be attributed to members. When allocating surpluses to its members, a cooperative must pay dividends according to the usage ratio, not the capital ratio. This is called "patronage dividend," which originated from the nineteenth-century Rochdale Cooperative rules[91] and now forms a portion of the seven cooperative principles established by the International Cooperative Association (ICA).[92] In contrast, for ordinary human-based companies such as partnership companies and limited partnership companies, there is no legal obligation to pay dividends according to the usage ratio; that is the key difference. The third ICA principle emphasizes that members must democratically control cooperatives'

[87] *See* Commercial Act, art. 287-12, 287-16, 287-19, Framework Act on Cooperatives, art. 23 para. 1.
[88] *See* Commercial Act, art. 287-8, Framework Act on Cooperatives, art. 24 para. 3.
[89] *See* Commercial Act, art. 287-24, Framework Act on Cooperatives, art. 26 para. 1.
[90] There is an opinion against the application of special rules to cooperatives or limited liability companies because their members have "limited" liability, unlike other partnerships. *See* SHIM TAE SUP & KIM WAN SOUK, METHODS FOR REVISION OF TAX SUPPORT SYSTEM RELATED TO COOPERATIVES, MINISTRY OF STRATEGY AND FINANCE 71-72 (2012). However, in the case of law firms or accounting firms, the members can benefit from this special provision even if they have limited liability. *See* Enforcement Decree of the Restriction of Special Taxation Act, art. 100-15 para. 1. The opinion claims that law firms and accounting firms are different from cooperatives because they provide "human-based services," but there is no comment on what is the "human-based service" and why the tax incentives for "human-based service" should be different. Furthermore, considering the existence of a "limited liability member" in a limited partnership company, the fact that members of cooperatives or limited liability companies have "limited" liability cannot justify that cooperatives and limited liability companies are not subject to the benefit. It is the same in Germany that a limited partnership (KG: Kommanditgesellschaft) is composed of members with limited liability (Komplementaere) and members with unlimited liability (Kommanditisten). *See* Handelsgesetzbuch [the Commercial Code], December. 22, 2020, art. 161 para. 1 (Germany).
[91] The pioneers of the Rochdale opposed the accumulation of surplus from transactions with members as the cooperative's capital and designed a method of distributing them proportionately to those who made them. Their first agreement was to distribute the surplus remaining after paying expenses of management and interest on capital investment to members in proportion to their transactions on a quarterly basis. *See* GEORGE JACOB HOLYOAKE, SELF-HELP BY THE PEOPLE: THE HISTORY OF THE ROCHDALE PIONEERS 47 (10th ed., 1893).
[92] The 3rd principle of ICA's Cooperative Principles is "member economic participation", which stipulates that "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." International Cooperative Alliance, *Cooperative Identity, Values & Principles*, https://www.ica.coop/en/cooperatives/cooperative-identity (last visited Mar. 26, 2021).

capital and stipulates that the dividends provided by cooperatives to members should be proportional to the amount of their transactions.[93] Like any other principle, this can be found in the "Regulations for Cooperative Societies Unanimously Adopted at the 3rd Cooperative Congress Held in London in 1832 and Chaired by Robert Owen,"[94] which was the predecessor of modern cooperative principles. The regulation explains that a trading organization, established to accumulate revenue simply to receive future dividends, should not be recognized as a cooperative.[95]

Unlike the stockholders of a stock company, members of a cooperative are both owners and users of the cooperative's business, creating surpluses through their dealing or use of the cooperative's business. For example, a consumer cooperative's members directly contribute to sales by purchasing goods or services sold by the cooperative. Members of a worker cooperative promote their own interests by working for production of goods or services of the cooperative. A producer cooperative's members make surpluses by participating in their joint business for the goods they produce. Members of cooperatives, who are consumers, workers, or producers, promote the collective interest of them depending on how much they "use" the cooperative's business regardless of their investment size. A cooperative's surplus occurs when the price of the goods or services sold to members is higher than the expected cost. These surpluses can be viewed as a kind of an error because they are caused by incorrect estimates of the costs or reflect conservatively set prices to cover market risks that would be identified at the end of the fiscal year.[96] The rule for correcting these errors is the patronage dividends.

Patronage dividend system is not only a criterion for determining the amount to be allocated to members but also the core rule that enables the establishment of cooperatives' fundamental characteristics. In order for a cooperative to function properly, it shall organize its members according to the cooperative's purpose and implement projects that meet the needs of its members. Voting rights should be given to cooperative members, so they can control its composition and business scope. However, from a legal perspective, this rule is not sufficient. If members receive the cooperative's dividend proportional to the size of the invested capital, the surplus gained through the cooperative's business will be distributed to members who have invested large amounts of capital. This will expose those who have invested little capital to a prolonged risk. As those who have dividend rights also have voting rights, there is always a possibility that the cooperative's overall decision-making will be transformed into the pursuit of

[93] *Id*.

[94] *See* International Cooperative Alliance, Guidance Notes to the Cooperative Principles 29 (2017), https://www.ica.coop/sites/default/files/publication-files/ica-guidance-notes-en-310629900.pdf (last visited Mar. 26, 2021).

[95] The regulation declared that "in order to ensure without any possibility of failure the successful consummation of these desirable objectives, it is the unanimous decision of the delegates here assembled that the capital accumulated by such associations should be rendered indivisible, and any trading societies formed for the accumulation of profits, with a view to them merely making a dividend thereof at some future period, cannot be recognised by this Congress as identified with the cooperative world, nor admitted into this great social family which is now rapidly advancing to a state of independent and equalised community". *See id.*

[96] Nina Aguiar, *supra* note 3, at 5.

high profits. Consequentially, persons who cannot contribute significant capital will lose the incentive to join the cooperative, threatening the cooperative's very existence. This tendency would undermine the long tradition of cooperative movements to control the influence of capital. Therefore, the systematization of patronage dividends should be the basis of the legal protection of cooperative identity. Korean legislators need to pay attention to the fact that major European countries, such as France, Italy, and Spain all deduct patronage dividends.[97]

Currently, the Korean tax laws and the Framework Act on Cooperatives do not conform to the nature of the patronage dividends and the characteristic of cooperatives. The Framework Act on Cooperatives stipulates that cooperatives "may" distribute surpluses to their members as prescribed by the bylaws after making up for losses and accumulating legal reserves and voluntary reserves,[98] which means that the Act does not mandate surplus distribution to members. Under the current law, when a cooperative distributes surpluses, the dividends of earnings from the use of the cooperative's business shall not be less than fifty percent of the total amount of dividends,[99] but if the cooperative decides not to allocate itself to its members, the principle of patronage dividends will not work at all. Furthermore, the Framework Act on Cooperatives entrusts important decisions that are closely related to the cooperative identity to the cooperatives' discretion and there is no legal method to assess what kind of dividends can be qualified as patronage dividends, thus, it is difficult for the tax office to set the criteria for the patronage dividends. To accurately reflect the nature of cooperatives in tax laws, cooperative legislation, including the Framework Act on Cooperatives, must be fundamentally revised.

B. Systematizing the Cooperative's Patronage Dividends

1. Removing Double Taxation on Patronage Dividends

The tax law and the cooperative law must be equipped to treat patronage dividends in order to protect the identity of cooperatives. No matter how hard cooperatives try to stabilize their own patronage dividend system, Korean tax law does not consider such efforts at all. Even if the ratio of patronage dividends reaches 100 percent of their surplus, it is counted

[97] Numerous Korean studies on the cooperative tax system criticized Korean tax deduction system through comparative legal analysis. *See,* for example, SON WON IK, SONG EUN JOO & HONG SUNG YOUL, A STUDY ON THE COOPERATIVES TAXATION, CENTER FOR TAX LAW AND ADMINISTRATION, KOREA INSTITUE OF PUBLIC FINANCE 58-89 (2013), Kim Wan Souk & Shim Tae Sup, *Suggestions for Tax Reform of Cooperatives in Korea*, 12 Tax Research, no.2, 7, 21-29 (2012), Jung Soon Moon, *A Study on the Improvement of the Cooperative System*, 19 Seoul National University Public Interest and Human Rights L. Rev., 233, 279-280 (2020), Park Kyeong Hwan & Jung Rae Yong, *A Study of Cooperative Taxation*, 21 Hongik L. Rev., no.2, 513, 526-531 (2020), SHIM TAE SUP & KIM WAN SOUK, *supra* note 90, at 29-62, Lee Byeong Dae, Kim Wan Seok & Suh Hi Youl, *A Study on Income Taxation System of Cooperatives and Copartners*, 15 Tax Research, no.2, 39, 52, 57-58 (2015), Lee Han Woo, *Suggestions for the Taxation Issues of the Transactions Between a Cooperative and Its Members*, 27 Ehwa Law Journal, no.2, 369, 387-389 (2014), Moon Sung Hwan & Im Young Je, *The Research on Characteristics of Accounting Standard and the Problems of Profit and Loss Taxation System of Community Credit Cooperatives*, 76 Korea International Accounting Review, 83, 98-99 (2017). Countries mentioned in these studies are France, Italy, Spain, United Kingdom, Germany, the Netherlands, United States, Japan, Canada, Finland. Norway. The studies underline that all of these countries recognize cooperative's patronage dividends as deductible expenses.

[98] Framework Act on Cooperatives, art. 50 para. 1, 2.

[99] *Id.* art. 51 para. 3.

just as the cooperative's income. When a cooperative's income is distributed to its members, taxes are levied on both the cooperative and the members. This legislation has come under criticism for distorting not only the principle of patronage dividends, but also the identity of cooperatives.[100] As seen above, the tax laws provide some reductions for cooperatives, but this is rigidly limited to cooperatives established under special cooperative laws such as agricultural cooperatives and fishery cooperatives. Even when these reductions are possible, only the tax rate is partially reduced without careful consideration of the doctrine of the patronage dividend.[101] This is not a reflection of the cooperative identity but just a reward for cooperatives that had cooperated with government-led industries.

In order to normalize the patronage dividend system in Korean cooperative legislation, the tax law must first be amended so that no tax is imposed on the amount that cooperatives distribute to members according to the usage ratio. Specifically, to solve this double taxation problem, a cooperative established under the Framework Act on Cooperatives should be added to the special taxation provision for partnerships under the Restriction of Special Taxation Act to prevent corporate tax at the cooperative level,[102] or a method to treat the amount of patronage dividends as deductible expenses should be considered.[103] The former method will be more advantageous for cooperatives in that no tax is imposed at the corporate level regardless of the standard of allocation. However, the latter method is more suitable for cooperatives as they need to sort out the patronage dividends and equity dividends to promote their operations following cooperative principles.

Surely, it is not appropriate that all of the cooperatives' dividends are subject to tax benefits. There is no reason for treating profits obtained from operations for non-members differently from those of general commercial companies, nor should this be the case for profits obtained from transactions outside the cooperative's proper business scope.[104] Expenses paid as interest on members' contributions should also not be included as deductible accounts because dividends based on share investment are not returns to the surplus creator.

[100] *See*, for example, Park Kyeong Hwan & Jung Rae Yong, *supra* note 97, at 534-535, Kim Wan Souk & Shim Tae Sup, *supra* note 97, at 31-36, SHIM TAE SUP & KIM WAN SOUK, *supra* note 90, at 66-69, Lee Byeong Dae et al., *supra* note 97, at 59-61, Jung Soon Moon, *supra* note 97, at 279-280, Lee Han Woo, *supra* note 97, at 387-389. Yu Jong Oh, *The nature of cooperative member transactions and the direction of tax reform*, *in* THE WAY OF TAX REFORM TO STRENGTHEN COOPERATIVES' IDENTITY, *supra* note 39, 31, at 41-42, Lee Jong Je, *supra* note 50, at 95.

[101] *See* Restriction of Special Taxation Act, art. 72, 88-5.

[102] Although this method is the easiest way to get rid of the current unfair treatment of cooperatives under the tax law in Korea, no studies have been found to suggest this view. Instead, most of the research focuses on treating dividends as deductible expenses. *See infra* note 103.

[103] *See* Kim Wan Souk & Shim Tae Sup, supra note 97, at 33, Jung Soon Moon, *supra* note 97, at 279-280, Park Kyeong Hwan & Jung Rae Yong, *supra* note 97, at 534-535, SHIM TAE SUP & KIM WAN SOUK, *supra* note 90, at 66.

[104] Even for these transactions, it would be possible to cut taxes for policy reasons. *See* Nina Aguiar, *supra* note 3, at 6-8.

2. Distinguishing between Member Transaction and Non-member Transaction

Since the patronage dividend system is designed for cooperatives' surplus to be attributed to their source, the surplus from member transactions must be differentiated from those of non-members. If the cooperative distributes surplus made from transactions with non-members to members, who are not directly related to the surplus, the patronage dividend system loses its original purpose. To differentiate the treatment of surpluses from member transactions and profits from non-member transactions, it is essential to record them separately. For proper operation of a patronage dividend, an accounting system that can accurately demarcate between transactions with members and non-members has to be established. The Principles of European Cooperative Law also ruled that cooperatives shall record transactions with non-members in a separate account.[105]

In Korea, the Framework Act on Cooperatives and most special cooperative laws do not stipulate that non-member transactions shall be recorded apart from member transactions. Although some cooperative laws have provisions that non-member transactions are not permitted if members' use is impeded,[106] there is no provision to reflect this distinction in accounting. Accounting rules in Korean cooperative legislation only require a demarcation between credit and non-credit businesses.[107] The large cooperatives in Korea, usually established under special cooperative laws, were criticized for gradually neglecting their original purpose as their credit business had been over-expanded.[108] To prevent this tendency, regulations have emerged that require a distinction between accounting for credit business and all other businesses. However, what matters is not whether it is a credit business but whether it is a non-member transaction.

It is hard to establish the separate accounting system for member and non-member transactions. For example, although it is possible for consumer cooperatives to distinguish between sales to members and non-members, demarcating the extent of expenses incurred on each transaction would be a quite difficult task. If departments of the cooperative are not completely divided, it is laborious to separate these transactional expenses accurately. But, in non-profit corporation accounting procedures in Korea, the expenditures on the "purpose business" and the "profitable business" have been classified. Moreover, there is already a separate accounting obligation for a "credit business" and the "other business" in cooperative legislation, and several foreign cooperative legislations also distinguish between member and

[105] "When cooperatives carry out non-member cooperative transactions they shall keep a separate account of such transaction", *see* GEMMA FAJARDO ET AL., *supra* note 41, at 48.

[106] *See*, for example, the Agricultural Cooperatives Act, art. 58 para. 1, Fishery Cooperatives Act, art. 61 para. 1, Forestry Cooperatives Act, art. 51 para. 1, Small and Medium Enterprise Cooperatives Act, art. 35 para. 3, Consumer Cooperatives Act, art. 4 para. 1, Credit Unions Act, art. 40 para. 1, and the Community Credit Cooperatives Act, art. 30. However, these regulations only declare the principle to prohibit the use of non-members, and do not effectively control the use of non-members due to the lack of specific regulations.

[107] *See*, for example, the Agricultural Cooperatives Act, art. 63 para. 2, Fishery Cooperatives Act, art. 66 para. 2.

[108] Cooperatives established under special laws have been criticized for not concentrating on the original business and overly focusing on profitable credit businesses. And this criticism has led to a reorganization of the governance structure that divides the business organization of agricultural cooperatives and fisheries cooperatives into financial and economic business sectors since the 2010s.

non-member transactions in accounting, such as Spanish cooperative law[109] and French cooperative law,[110] etc. Hence, it would not be legally impossible to stipulate a separate accounting obligation for member and non-member transactions in cooperative laws.

Among the cooperative laws in Korea, only the Consumer Cooperative Act includes a provision regulating that member and non-member transactions shall be separately recorded in accounting. Despite the fact that this provision also has limitations in that it applies only to health and medical services, it can be a great legislative example that stipulates classified accounting duties. Following the Consumer Cooperative Act, other cooperative-related laws, including the Framework Act on Cooperatives, should fix their legislative flaws in the demarcation of both transactions so that the cooperatives' mutuality and contributions to the community are clearly visible in their financial statements.

3. The Necessity of Stipulating Dividend Obligations

If cooperative laws or bylaws stipulate the obligation to return surpluses periodically, surpluses must be recorded as "liabilities," which is not taxable.[111] Examples of this approach have been found in countries with a common-law tradition, such as the United States[112] and Canada.[113] On the other hand, in Europe, where cooperative laws are generally more influenced by ideological principles than practical considerations, there are no legislative examples of such obligation.[114]

The cooperative can use the surplus in its own way if the obligation is not specified in law, which makes it difficult to assess it as a liability to its members. In this case, the surplus will be legally valued as the cooperative's income, not its liability. If the cooperative's surplus is deemed as its income, it is logically impossible to exclude it from taxation. Here, there may be objections that even if the surplus is not immediately distributed to members and is reserved internally, this eventually constitutes a share portion that must be returned to a member when she or he withdraws, so it consequentially becomes the member's asset. The problem, however, is that the current cooperative laws stipulate that when a member withdraws from membership, the member share should be refunded and calculated in proportion to her or his capital, not patronage.[115] Even for a stock company, the residual

[109] *See* Ley 27/1999, de 16 de julio, de Cooperativas [Cooperatives Law], art. 57(3) (Spain) [hereinafter Law 27/1999] https://www.boe.es/buscar/doc.php?id=BOE-A-1999-15681 (last visited Mar. 26, 2021).
[110] *See* Loi n° 47-1775 du 10 septembre 1947 portant statut de la cooperation [Law 47-1775 of September 10, 1947 on the statute of cooperation, hereinafter the 1947 Law], art. 19b (France), https://www.legifrance.gouv.fr/loda/id/JORFTEXT000000684004/ (last visited Mar. 26, 2021).
[111] *See* Nina Aguiar, *supra* note 3, at 5.
[112] The special rules for patronage dividend apply "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid." 26 U.S.C. §1388(a)(2).
[113] Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), sec. 136(2) (Canada). This section requires that "the statute by or under which it was incorporated, its charter, articles of association or by-laws or its contracts with its members or its members and customers held out the prospect that payments would be made to them in proportion to patronage."
[114] *See* Nina Aguiar, *supra* note 3, at 5.
[115] Framework Act on Cooperatives, art. 4 para. 2.

property is ultimately distributed to the shareholders upon dissolution after it pays off its debt, which is why this objection is not valid.

Therefore, a cooperative's bylaws or cooperative laws are required to specify the obligation to return its surplus periodically or authorize cooperatives to accumulate the surplus according to the patronage proportion of each member. Current Korean laws already have rules regarding patronage dividends,[116] like other European and North American countries, but the provisions are not mandatory, and there is no other provision that legally requires dividends to be returned to members. In order for the cooperative's surplus to be evaluated as a liability to its members, the relevant regulations in Korean cooperative laws should be amended to be mandatory.

4. Revision of the Articles for Repudiation of Wrongful Calculation

Where the tax office deems that a corporate tax burden has been unjustly reduced through the "wrongful calculation" of the amount of corporate income from transactions with "a specially related party," taxpayers shall calculate their income regardless of the "wrongful calculation."[117] This is a rule to prevent corporate tax evasion. The term "specially related party" means a person who has an economic relationship with a corporation, or a relationship prescribed by presidential decree. The decree includes the persons exercising actual influence over the management of the relevant corporation, for example, exercising the right to appoint or dismiss executive officers or determining the course of business and investors in the corporation.[118] In addition, the decree enumerates examples of wrongful calculations, such as a case in which money, other assets, or services are lent or provided gratuitously or at an interest rate, tariff, or rent lower than the market price, or received at an interest rate, tariff, or rental rate higher than the market price.[119]

Maximizing the members' interests by minimizing the cooperative's surplus is the ultimate goal of a cooperative's business. Consumer cooperatives achieve this purpose by providing their members with products at the lowest price, producer cooperatives by purchasing their goods or services at the highest price, and workers' cooperatives by providing the highest wages to their members. However, in Korea, transactions between cooperatives and members are deemed "wrongful calculation" by the Corporate Tax Act. When he members of consumer cooperatives receive goods or services from the cooperative at a price lower than the market price, or when producer cooperatives receive goods or services from their members at a price higher than the market price, that price must be

[116] When a general cooperative distributes a surplus, the dividends of earnings from the use of the cooperative's business shall not be less than 50 percent of the total amount of dividends. *See* Framework Act on Cooperatives, art. 51 para. 3.
[117] Corporate Tax Act, art. 52 para. 1.
[118] *Id.*
[119] *Id.* art. 88 para. 1, para. 6, para. 7.

adjusted to the market price through the denial of the wrongful calculation, making business for members practically impossible.[120]

The Basic General Rules of the Restriction of Special Taxation Act enacted by the National Tax Service stipulate that wrongful calculation provisions do not apply to cooperatives established under the special cooperative laws designated by the Act. However, this rule is only an internal guideline of the administrative agency without legal effect.[121] Even if the Basic General Rules are applied, cooperatives established by the Framework Act on Cooperatives, which is the most common type of cooperative in Korea, are still subject to rules of the "wrongful calculation."[122] Although the tax office is not actively applying the rule of wrongful calculation because these cooperatives' business in Korea is not large yet, this rule is a potentially dangerous regulation that can lead to threats to the whole Korean cooperative system.[123] Therefore, it is necessary to establish exceptional provisions for cooperatives as soon as possible, reflecting their business structures and characteristics.[124]

C. Abrogation of the Dichotomous Division of Cooperatives

1. Repeal of the Regulation that Regards Cooperatives as Non-profit Corporations

Although there is no strict standard for the distinction between for-profit and non-profit corporations in any articles in Civil Act or related legislative data, it is the dominant opinion of Korean civil law and commercial law academia to classify corporations into for-profit and non-profit corporations depending on whether a corporation pays dividends to its members.[125] This trend is considered to be due to the influence of German and Swiss civil law.[126] From this perspective, a for-profit corporation can pay dividends, whereas a non-profit corporation should not. This view deeply influenced the cooperative legal framework as well. Social cooperatives established under the Framework Act on Cooperatives are not permitted to distribute surpluses to their members[127] since they are considered to be non-profit corporations. On the contrary, general cooperatives based on the same act, deemed as for-profit corporations, are allowed to pay dividends to members.

Korean tax laws adopt this dichotomous classification in principle but makes some exceptions for cooperatives operated under government influence.[128] According to the

[120] *See* Lee Han Woo, *supra* note 97, *at* 385.
[121] *See* Daebeobwon [S. Ct.], Sept. 8, 1992, 91Nu13670 (S. Kor.). The Judgment of this case ruled that The Basic General Rules of the Restriction of Special Taxation Act enacted by the National Tax Service has no legal effect because it is just an internal guideline of the administrative agency.
[122] *See* Lee Byeong Dae et al., *supra* note 97, at 52, 62-63.
[123] *See id.* at 62.
[124] *See* Lee Han Woo, *supra* note 97, *at* 392-393. This study argued that cooperatives should be excluded from the application of the article of "wrongful calculation" if over 90 percent of users are their members and over 90 percent of dividends are patronage dividends.
[125] Kim Chin Woo, *The Demarcation between For-profit and Non-profit Corporation*, 36 The Journal of Property Law, no. 3, The Korean Society of Property Law, 1, 2 (2019).
[126] *See* SONG HO YOUNG, *supra* note 35, at 63.
[127] Framework Act on Cooperatives, art. 64 para. 2.
[128] Corporate Tax Act, art. 2, para. 2.

Corporate Tax Act, cooperatives formed under special cooperative laws are regarded as non-profit corporations, even though they can distribute dividends to their members, unlike social cooperatives based on the Framework Act on Cooperatives. It is contradictory legislation in that it considers cooperatives established under the special laws, which can distribute their surpluses to the members, as non-profit corporations, and grants various tax incentives to them. Besides, it excludes general cooperatives established under the Framework Cooperative Act from the category of non-profit corporations.

Korean legislators must provide an appropriate answer to "why cooperatives formed under the special laws should be treated as non-profit corporations even though they are paying dividends," and "why general cooperatives are not included in non-profit corporations even though they are not different from cooperatives established under the special cooperative laws." For the answer, legislation from an entirely new perspective, different from the existing legal system, is essential, and the current simple dichotomy-based legal system must be abrogated first for such improvement.

Since a cooperative is an organization oriented toward members' interests, it is inherently aimed at zero-cost management, so the purpose of establishing a cooperative cannot be regarded the same as that for establishing a for-profit company.[129] In particular, as mentioned above, dividends to members must be calculated according to the usage ratio, and allocating dividends to investors is strictly limited, so cooperatives' distribution of dividends should not be the reason for treating a cooperative as a for-profit corporation.[130] Moreover, it is fundamentally different from a for-profit company in that anyone who meets the requirements of the cooperative's bylaws can join the cooperative and use its business. Because the cooperative's surplus comes from users, and anyone in the community can become its user, the cooperative also has the character of a public interest corporation existing for the community.

Still, it is not reasonable to regard a cooperative strictly as a non-profit corporation. One of the most important reasons for dividing a for-profit corporation and a non-profit corporation in Korea is to regulate the process of obtaining legal entity status differently.[131] While the establishment of a for-profit corporation is completed with registration, a non-profit corporation must go through a much stricter procedure, such as obtaining permission from the competent authority in addition to the registration. When the competent authority grants permission for the establishment, essential factors for evaluation include non-distribution of profits to members, the corporation's purpose specified in the bylaws, and the business scope to achieve such purpose.[132] The distinction between for-profit and non-profit is also related to the dissolution procedure as

[129] *See* KIM YONG JIN ET AL., *supra* note 9, at 24-29.
[130] *See* Shim In Sook, *Introducing Cooperatives as a Type of Enterprise: Focusing on the Governance Structure of General Cooperatives under the Framework Act on Cooperatives of Korea*, 68 Advanced Commercial Law Review, Ministry of Justice of Korea 33, 35-36 (2014), Jung Soon Moon, *supra* note 97, at 258 (2020).
[131] *See* SONG HO YOUNG, *supra* note 35, at 63.
[132] See For example, SEOUL METROPOLITAN GOVERNMENT, STANDARDS FOR APPLICATION DOCUMENTS AND PERMITS OF NON-PROFIT CORPORATIONS IN SEOUL, https://news.seoul.go.kr/gov/archives/78472 (last visited Mar. 26, 2021).

well.[133] If a non-profit corporation conducts business other than its intended purpose, the competent authority may revoke its permission without a court's judgment,[134] whereas the judgment is essential in the case of a for-profit corporation's dissolution.[135] Since cooperatives can be established by various groups such as consumers, workers, and business operators, their business types are very diverse, and it is almost impossible for the competent authority to form a consistent standard to judge its establishment and dissolution. The autonomy of cooperatives should be guaranteed as much as possible, which is also requested by the Framework Act on Cooperatives[136] and the ICA's principles.[137] Therefore, the procedures for "non-profit" corporation's establishment and dissolution is not suitable for cooperatives.

The tax laws and the cooperative laws should reform dichotomous rules and redesign the legal system to recognize cooperatives as another type of corporation based on "mutuality," not as for-profit or non-profit corporations.[138] And the methodology of simply dividing tax-paying corporations into two categories and then treating them as completely equal within the same group should now be repealed. The operation of a member business and a non-member business must be treated separately, and procedures governing the patronage dividends and the capital dividend must also be different. Besides, it is necessary to distinguish between transactions for cooperatives' operation and all other transactions.[139] Specific regulations based on each tax law category need to be redesigned to suit the cooperative's identity. First, the provisions of the Corporate Tax Act and the Enforcement Decree, which simply designates some cooperatives as non-profit corporations, should be abrogated for this reform. It should be considered to thoroughly review the legal methodology that justifies the dichotomy between for-profit and non-profit corporations in the long-term perspective.

2. Establishment of Rules for Indivisible Reserves

Due to Korean cooperatives' history, in which cooperatives have acted like government-affiliated organizations, Korean society has a problem with understanding that the cooperative identity lies in contributing to their communities. This lack of understanding leads to the argument that there is no reason to treat cooperatives, especially those established under the Framework Act on Cooperatives, differently from other commercial enterprises. The legal basis of this argument can be summarized in two ways. The first is that

[133] Kim Chin Woo, *supra* note 125, at 2.
[134] *See* Civil Act, art. 38.
[135] *See* Commercial Act, art. 176.
[136] The Act stipulates that "The central government or a public organization shall not encroach the autonomy of a cooperative, federation of cooperatives, social cooperative, or federation of social cooperatives." *See* Framework Act on Cooperatives, art. 10 para. 1.
[137] The 4th principle of ICA is "autonomy and independence", which declares that "Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy." *See Cooperative Identity, Values & Principles*, *supra* note 92.
[138] KIM YONG JIN ET AL., *supra* note 9, at 29-30.
[139] For example, investment in other corporations, trading of fixed assets, etc. *See* Nina Aguiar, *supra* note 3, at 2.

the cooperative pays dividends to its members, and the second is that when the cooperative is disbanded, the remaining assets are returned to the members. The argument that a for-profit corporation and a cooperative are the same because the surplus of the cooperative is distributed to members, can be refuted by the principle of patronage dividend as described above. However, it is indeed difficult to rebut the fact that when a cooperative disbands, in Korea, all residual property is ultimately distributed to its members. This means that the final destination of the cooperative's excess profit beyond the surplus incurred from the cooperative's use is the members. It can be a serious obstacle to the growth of cooperatives in that it nullifies the cooperative's efforts that have paid surpluses in proportion to patronage, and it causes inappropriate profits to be returned to members such as profits from transactions with non-members.

Therefore, it is necessary to consider improving the legal system so that profits from non-member transactions can be allocated as indivisible reserves in order to settle disputes on the "for-profit" characteristics of cooperatives and infuse their true identity in cooperative laws.[140] Indivisible reserves function as a device to handle the cooperative's excess profits, which exceed the surpluses obtained from transactions with members, in accordance with the cooperative's core value. Member and non-member transactions should be systematically classified, and profits generated from non-member transactions are required to be accumulated as indivisible reserves so that they will not be leaked outside the cooperative, and members will not be able to enjoy profits other than the transaction they participate in. In addition, as indivisible reserves are not distributed to the cooperative's members, they become permanent assets that can be used for long-term business operations, thus benefiting future cooperative members.[141] Since cooperatives are in principle open to all persons who wish to have rights and obligations as members, assets for future members are ultimately resources for the community. This is another reason to show that indivisible reserves can be a powerful legal mechanism to prevent cooperatives from being mistakenly recognized as commercial enterprises.[142]

The Principle of Cooperative declares that a certain part of the surplus be deposited as an indivisible reserve.[143] Also, the Principles of the European Cooperative Laws, which divide the reserves into "mandatory reserves" and "voluntary reserves," stipulate that "mandatory reserves" shall not be divided even when the cooperative is dissolved,[144] and profits arising from transactions with non-members must be accumulated in indivisible

[140] Several studies in Korea claim that the introduction of indivisible reserve system is essential for the growth of cooperatives. *See*, for example, Yang Dong Su, *Issues on the Revision of the Framework Act on Cooperatives*, Yonsei Global Law Review, 39, 52-54 (2013), Jung Soon Moon, *supra* note 97, at 258-260, KIM YONG JIN ET AL., *supra* note 9, at 364-371.

[141] *See* KIM YONG JIN ET AL., *supra* note 9, at 364. Given the "open membership" principle, one of the seven cooperative principles, it is particularly important to have a financial foundation for future members. *See Cooperative Identity, Values & Principles*, *supra* note 92.

[142] *See* Jung Soon Moon, *supra* note 97, at 258.

[143] *See* GUIDANCE NOTES TO THE COOPERATIVE PRINCIPLES, *supra* note 94, at 29.

[144] Section 3.4.(3) of Principles of European Cooperative Law. *See* GEMMA FAJARDO ET AL., *supra* note 4041, at 83.

reserves.[145] Many European countries already have provisions on indivisible reserves in their cooperative laws. For example, the Portuguese cooperative law stipulates that all mandatory reserves and surpluses from third-party operations are not susceptible of any distribution.[146] In France, cooperatives' remaining assets should be vested to other cooperatives, unions of cooperatives, or another enterprise in social and solidarity economy, not to their members.[147]

In Korea, every cooperative law has its own provision regarding "legal reserves" and "voluntary reserves," but most require that reserves be distributed to members when they are dissolved. "Social cooperatives" formed under the Framework Act on Cooperatives[148] and "health and medical cooperatives" established under the Consumer Cooperatives Act[149] are the only cooperatives with legal regulations stipulating that their residual assets shall not be returned to their members when they are dissolved. Local agricultural cooperatives must distribute residual assets to other local agricultural cooperatives designated by a resolution of general meeting upon cooperatives' dissolution,[150] however, this is regulated by model bylaws, not by law.[151] Likewise, in the case of cooperatives under special cooperative laws other than the Agricultural Cooperatives Act, their model bylaws also said that the cooperative's residual assets shall be distributed to members.

The indivisible reserve system should be introduced, especially for general cooperatives based on the Framework Act on Cooperatives, being the subject of controversy over whether they are for-profit corporations or not. As there are already legislative models of indivisible reserve for social cooperatives and health and medical cooperatives, it would not be difficult to regulate residual asset distribution in the law. The Framework Act on Cooperatives has to be amended to prohibit the distribution of residual assets to members upon dissolution of a general cooperative. Instead, cooperatives may distribute their assets to other cooperatives, higher associations, or government. There can be some criticisms claiming that the cooperatives should be able to decide themselves whether to make the residual assets indivisible or not, on the ground of the principle of contract freedom. However, if this is determined by the bylaws and not the law, unpredictable dissolution of cooperatives could happen because the cooperative's decision to distribute residual assets to the members can be easily made when the cooperative has a large amount of accumulated

[145] *Id.* Section 1.5(5), at. 43, Section 3.7.(1), at 92.
[146] *See* Codigo Cooperativo [Cooperative Code], art. 99 (Portugal), https://dre.pt/home/-/dre/70139955/details/maximized (last visited Mar. 26, 2021).
[147] *See* The 1947 Law, art. 19 (France)
[148] Like France, when a "social cooperative" is dissolved in Korea, the ownership of residual property shall be vested in the higher federation of social cooperatives, a social cooperative for similar purposes, a non-profit corporation, or the Government. *See* Framework Act on Cooperatives, art. 104.
[149] *See* Consumer Cooperatives Act, art. 56.
[150] *See* Art. 153 para. 3 of Jiyeokhyeopdongjohapjeonggwanrye [the Model Bylaws of Local Agricultural Cooperatives], Ministry of Agriculture, Food and Rural Affairs of Korea, Notification. No. 2018-44, June. 11, 2018 [hereinafter the Model Bylaws of Local Agricultural Cooperatives]
[151] Since most of the local agricultural cooperatives adopt the model bylaws, the indivisible reserve system would be effective for them.

assets.[152] Hence, it is reasonable to regulate the distribution of residual assets by law, as in social cooperatives and health and medical cooperatives.

The indivisible reserve system is expected to help the cooperatives fulfill their unique role. The original purpose of the patronage dividend also can be realized only when the indivisible reserves system is working. After the system is introduced in cooperative laws, it is possible to discuss tax benefits for the reserves.[153] Considering the function of such indivisible reserves, it would be desirable to induce cooperatives to accumulate more indivisible reserves by reducing corporate tax on indivisible reserves.

IV. Legal Prerequisites for the Realization of the Patronage Dividend

A. Consistency Between Owners and Users

The core identity of cooperatives is in the form of patronage dividends, and their systematization is the basis for designing appropriate tax policies. Legislative efforts to systematize the patronage dividends become meaningful on the condition that legal regulations are in place for cooperatives to become user-owned corporations. To establish this condition, two stages of regulation must be premised. One is to limit qualification of cooperative members to those who wish to jointly use the cooperative's business. The other is to limit users of the cooperative business to its members.[154] If either of these two levels of regulation is loosened, not only patronage dividends but also various tax benefits for cooperatives lose their function. Therefore, the Korean cooperative legal system has to be improved from this point of view.

The first condition for consistency between owners and users is that those who join a cooperative must be limited to those who wish to use the cooperative's business. Cooperatives should be owned, controlled, and run by and for their members to realize their common economic, social, and cultural needs and aspirations.[155] In other words, the membership of a cooperative should be set appropriately to fulfill the "common needs and aspirations" of those who wish to gather within the fence of the cooperative, and those who do not share the "common needs and aspirations" should not enter the fence in principle.[156] For example, non-farmers cannot join agricultural cooperatives, and non-workers should not join workers cooperatives. If the participation of those who do not have "common needs and aspirations" is allowed, the "common needs and aspirations" of existing members are likely to be broken down. The democratic governance structure of the cooperative will be distorted as well.[157] Hence, properly setting the qualifications of members in line with the purpose of the cooperative is essential to solidify the legal foundation of the cooperative's core principle.

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[152] KIM YONG JIN ET AL., *supra* note 9, at 30.
[153] *See* SON WON IK ET AL., *supra* note 97, at 88-89.
[154] *See* Jang Jong Ick, *A Study on the Identity of Cooperatives' Business*, 37 The Korean Journal of Cooperative Studies, Korean Society for Cooperative Studies, no. 3, 67, 70-71 (2019).
[155] *See Cooperative Identity, Values & Principles*, *supra* note 92.
[156] KIM YONG JIN ET AL., *supra* note 9, at 371.
[157] *Id.* at 42.

The special cooperative laws in Korea stipulate members' qualifications very strictly under this consideration,[158] whereas the Framework Act on Cooperatives entrusts the restriction on unqualified members to the bylaws,[159] so there are virtually no legal regulations on members' qualifications. This is an inevitable side effect of legislation that does not explicitly define types of cooperatives and allows cooperatives to carry out any business, even those irrelevant to their purposes. Korean government has yet to come up with an appropriate solution to this problem.

In addition to proper restrictions on members' qualifications, cooperatives should constantly monitor whether member management is being carried out according to their regulations. Even if laws or bylaws adequately limit members' qualifications, there may be cases in which cooperatives accept unqualified members or unfairly remove qualified members by a resolution of the general meeting or the board of directors, which also leads to fatal damages to democracy and mutuality of cooperatives.[160] For example, in South Korea, despite the fact that the Agricultural Cooperatives Act has rigorous standards of member qualification, local agricultural cooperatives under this act severely suffer from the problem of unqualified members whenever there is an election for the president of the cooperatives.[161] Local agricultural cooperatives conduct thorough investigations at least once a year to confirm members' qualifications.[162] Nonetheless, they are not completely free from disputes about unqualified members in cooperatives. Most cooperatives established under the Framework Act on Cooperatives do not even make efforts similar to the agricultural cooperatives, so the problem is much worse.

The second condition for consistency between owners and users of a cooperative is to restrict the use of non-members to ensure that the cooperative's business can be controlled according to the original purpose of their members. Since there is always a possibility that a cooperative regards non-members as a business target to generate more monetary profits, if control of transactions with non-members is left exclusively to the cooperative, the original purpose is likely to be distorted and undermined quickly. Even if the cooperative law strictly controls member qualifications, the law cannot effectively protect the cooperative's identity if it permits excessive non-member use of the business.[163] For these reasons, many countries'

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[158] For example, The Enforcement Decree of the Agricultural Cooperatives Act has detailed provisions on membership qualifications, such as that the person who wants to join an agricultural cooperative shall have farmland over a certain area and engage in agriculture for a certain period of time. *See* Nonguphyeopdongjohapbeob sihaengryeong [Enforcement Decree of the Agricultural Cooperatives Act] art. 4.

[159] *See* Framework Act on Cooperatives, art. 20, 21.

[160] KIM YONG JIN ET AL., *supra* note 9, at 42.

[161] According to the National Agricultural Cooperative Federation, the membership investigation was conducted on 1,948,481 members in 2018, and 74,872 members of them were found to be unqualified. *See* Lee Tae Su, *Agricultural Cooperatives, tens of thousands of unqualified members who do not farm: Concerns about election dispute*, Yonhap News, October. 18, 2018. As seen above, it is not easy to constitute a cooperative only with qualified members. If an ineligible member of the cooperative enters the cooperative and exercises voting rights, the election of directors or other resolutions of the general assembly may be legally invalidated.

[162] Johaponeui Jagyoekyogeonin nongupinui hwakin bangbeob mit gijun [Methods and Standards for Identification of Farmers, the Qualification Requirements for Members], Ministry of Agriculture, Food and Rural Affairs of Korea, Notification. No. 2018-7, January. 24, 2018, art 2, the Model Bylaws of Local Agricultural Cooperatives, art. 11(5).

[163] Hans-H. Munkner, *Chapter 8. Germany*, *in* GEMMA FAJARDO ET AL., *supra* note 41, 253, 270 (2017).

cooperative laws restrict non-member use of business to protect cooperatives' mutuality.[164] In Korea, the Framework Act on Cooperatives and most special cooperative laws restrict non-member use as well,[165] which shows that the Korean cooperative laws also recognize the importance of consistency between owners and users of cooperatives.[166]

However, as described above, unlike other special cooperative laws, the Framework Act on Cooperatives in Korea do not restrict member qualifications. If a cooperative has already accepted an unqualified person as a member, the provisions of the Framework Act on Cooperatives, which prohibit non-members from using the business, completely lose their meaning. As such, the Framework Act on Cooperatives, which restricts non-members' use of business but does not specifically regulate member qualifications, cannot protect cooperative identity.[167] Thus, Korean legislators must revise the Framework Act on Cooperatives to create a new legal system that controls the non-user member and non-member use. The tax policy for cooperatives without such efforts would be a house of cards.

B. The Criteria for Interpreting the "Use" of Cooperatives

To limit non-user membership, the cooperative should be systematically defined for whom the cooperative exists and what the cooperative is intended to do. Under this systematic definition, the owners and users of cooperatives will be legally consistent, and the principle of patronage dividends can be realized as well. Determining for whom the cooperative exists and what the cooperative does is the same as identifying the "use" of cooperatives. That's why cooperative legislation should establish core criteria for interpreting the concept of "use" of cooperatives. Establishing this concept is a prerequisite to organizing the cooperative tax policies. Although the cooperative law strictly stipulates the obligation to distribute patronage dividends to its members, it cannot be said that the obligations are properly regulated if the standard for the "use" is not provided. If the principle of patronage dividends is unfulfilled, the claim that the cooperative's surplus should be distributed to the members no longer become persuasive.

The concept of "use" of cooperative depends on who founded the cooperative. In the case of a stock company, it is only necessary to distribute dividends in proportion to the number of shares held by each shareholder in accordance with the principle of shareholder equality, but cooperatives that pay dividends based on the performance of members are not easy to set the standard for dividends.[168] For example, the use of producer cooperatives is based on carrying out production activities through the cooperative, such as supplying goods

[164] For example, the Spanish cooperative law places a limit on the total volume of transactions with non-members and requires that profits from transactions with non-members must be accumulated as indivisible reserves. *See* Gemma Fajardo, *Chapter 11. Spain*, *in* GEMMA FAJARDO ET AL., *supra* note 41, 517, at 538.

[165] *See*, For example, Agricultural Cooperatives Act, art. 58, Fishery Cooperatives Act, art. 61, Forestry Cooperatives Act, art. 51, Consumer Cooperatives Act, art. 46, Credit Unions Act, art. 40, Community Credit Cooperatives Act, art. 30.

[166] KIM YONG JIN ET AL., *supra* note 9, at 44-45.

[167] *Id*. at 6.

[168] *Id*. at 52.

to it. The use of consumer cooperatives is the purchase of certain goods or use of services through the cooperative, and the use of worker cooperatives would be to provide labor to the cooperative. Considering these concepts of use, the standard of patronage dividends also has to be different for each type of cooperative.[169]

Special laws for cooperatives in Korea, such as the Agricultural Cooperatives Act and the Fishery Cooperatives Act, have specific regulations regarding types of use, membership qualification, and business types; hence the criteria for evaluating the use of cooperatives have been established over the years. However, under the Framework Act on Cooperatives, general cooperatives are permitted to conduct every kind of business except that of the financial business.[170] Also, compliance with cooperative principles is not subject to audit or supervision; thus, there is no suitable way to control it after their establishment.[171] This has made it possible for cooperative members to receive patronage dividends even for capital gains through a distortion of the standard of cooperatives' use, placing cooperatives in a legally vulnerable situation.[172] Even membership requirements not suitable for the character of the cooperative or conducting other business that does not meet the purpose of the cooperative cannot be effectively restricted under the Framework Act on Cooperatives.

The Framework Act on Cooperatives stipulates that the important issues related to cooperative operation, such as types of use, membership qualifications, and business types, shall be determined by the bylaws. However, these must be stipulated in the law, not in the bylaws, since the bylaws can be changed at any time with a resolution of the general meeting,[173] and a majority of members of a cooperative can freely set the standard for dividends without legal restriction. Besides, a cooperative is a very vulnerable legal entity from the standpoint of creditors because its members have "limited" liability for the cooperative's debts[174] and may claim for refund of their share when they quit.[175] Therefore, it should always be taken into account that the legal personality of a cooperative can be easily abused. Under this situation in South Korea, it seems an empty claim to request tax benefits for cooperatives based on the reason that cooperatives pay patronage dividends to their members and that cooperatives' owners and users coincide. Since the key conceptual element of the "use" of a cooperative, which is the basis for calculating the patronage dividends, should not be easily influenced by majority members, it is reasonable to stipulate it by law rather than in the bylaws.

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[169] *Id.*
[170] *See* Framework Act on Cooperatives, art. 46.
[171] The local governments in Korea, which are the competent authorities, may issue a corrective order to the cooperative only in the following cases: When two or more years have elapsed during which the number of members of the cooperative was less than the minimum number of members, when the general meeting has not been held for two or more consecutive years, or when the essential business of the cooperative has not been carried out continuously for two or more years. *See* Framework Act on Cooperatives, art. 70-2.
[172] KIM YONG JIN ET AL., *supra* note 9, at 52.
[173] *See* Framework Act on Cooperatives, art. 29 para. 2
[174] *See* Framework Act on Cooperatives, art. 22 para. 5.
[175] *See id.* art. 26.

There are two ways to regulate the concept of "use" in the cooperative legislation: the classification of the core types of cooperative use based on member interests such as in Spanish cooperative law[176] or Quebec's cooperative law,[177] and establishing a legal system for periodical audit or supervision of compliance with the Cooperative Principles, such as in German cooperative law.[178] Certainly, it would be ideal if the two methods were concurrently adopted as they are complementary.

In particular, it's worth referring to Quebec's cooperative law in that it attempts to categorize cooperatives more systematically based on the stakeholders who comprise the cooperative's main body, rather than simply categorizing them by "industry" types. As evidenced in the cooperative laws in Spain, Portugal, and France, the method of classification of cooperatives by "industry" serves just to enumerate the predictable industry types of cooperatives in the law. For this reason, regulations become more complex over time, making it increasingly difficult to control cooperatives through consistent standards. Under Quebec-type legislation, on the contrary, the membership entry of those with opposite interests will be fundamentally blocked without any regulations regarding the "industry."

Furthermore, classification centered on the type of member interests, as in Quebec's cooperative law, is reasonable from a legal point of view in that it is easy to assess whether the laws governing the market, such as the fair-trade laws, labor laws, or consumer protection laws, apply to the cooperative, its members, or its counterparts.[179] This is because the existing legal system is also designed to be centered on the interests of economic actors. According to Henry Hansmann's theory, a corporation's "owner" has the right to control the firm and the right to appropriate the firm's profits, and based on who "owns" the corporation, the corporation is classified as a stock company, producer cooperative, consumer cooperative, worker cooperative, etc.[180] Other groups that do not own the corporation are put into contractual relationships with the corporation.[181] When the cost of ownership is less than the cost of the contract, he or she owns the corporation, which means that it is reasonable for other groups to be in a constant contract relationship.[182] This is because they are in a

[176] In Spain, the basic cooperative types are listed directly in a single cooperative act. There are 12 types of cooperatives listed in the Act, each consisting of a single section, including workers' cooperatives, consumer cooperatives, housing cooperatives, agricultural cooperatives, land use cooperatives, service cooperatives, fishery cooperatives, transportation cooperatives, and insurance cooperatives. *See* Law 27/1999 (Spain), https://www.boe.es/buscar/doc.php?id=BOE-A-1999-15681 (last visited Mar. 26, 2021).

[177] The Cooperatives Act of Quebec, Canada also includes five types of cooperatives: producers cooperatives, consumer cooperatives, work cooperatives, shareholding workers cooperatives, and solidarity cooperatives. The chapter on producer cooperatives includes provisions on agricultural cooperatives, and the chapter on consumer cooperatives includes provisions on housing cooperatives and school cooperatives. *See* the Cooperatives Act (Quebec, Canada), http://legisquebec.gouv.qc.ca/en/showdoc/cs/C-67.2?langCont=en#ga:l_i-h1 (last visited Mar. 26, 2021).

[178] German cooperative law establishes an independent organization called the "Confederation of Auditors" to oversee the operation of cooperatives. *See* Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften, art. 54, 55. (Germany), https://www.gesetze-im-internet.de/geng/ (last visited Mar. 26, 2021).

[179] *See* KIM YONG JIN ET AL., *supra* note 9, at 56-58.

[180] *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 11-16 (1ST HARVARD UNIVERSITY PRESS PAPERBACK ED. 2000) (1996)

[181] *Id.* at 18-20.

[182] *Id.* at 20-22.

confrontational relationship in general. Hence, it is proper to establish regulations for each type of group by reflecting these confrontational relations in the cooperative legal system. Most of the research, discussing the typology of cooperatives, also analyzes producers, consumers, and worker cooperatives separately.[183] It is inefficient to design a more specific type by law, because within the same group, diverse relationships can be created, which can be rather reciprocal instead of confrontational. Thus, the cooperative itself should regulate a more detailed structure for member management in its bylaws.

Consequently, it is required to reflect the core concept of "use" of each type of cooperative in the Framework Act on Cooperatives. Supervision by a higher association or competent authority is also essential. Legal reforms in this direction will enable and justify the systematic discussion of cooperative tax policies, including tax benefits for cooperatives. South Korea has not corrected its tax policy on cooperatives since the 1960s. It was not possible because there were no serious attempts for such systematization. Now, the legal framework of cooperatives in Korea, which has no consideration of the concept of "use" of cooperatives, must be reorganized to correctly reflect the nature of cooperatives. Establishing all of the tax incentives for cooperatives should be based on this reform.

V. Conclusions

In South Korea, cooperatives are strictly divided into non-profit and for-profit corporations, just like other legal entities. Historically, under this dichotomous legislation, cooperatives considered to be non-profit corporations have been established and operated to support the country's industrial policy, almost playing the role of sub-governmental organizations. With the enactment of the Framework Act on Cooperatives in 2012, it was expected that legal reform centered on cooperatives' identities would be carried out, but those expectations have not yet been fully realized. Under the influence of previous legislation, the new Act also divides the cooperative's legal entity into two categories: general cooperatives and social cooperatives, and stipulates that general cooperatives are regarded as for-profit corporations while social cooperatives are regarded as non-profit corporations. Due to this dichotomy, the general cooperatives, which account for most cooperatives in Korea, cannot receive any tax benefits at all, even though other similar partnerships established under the Corporate Act may receive such benefits. This unfair situation is created by the legislature's lack of understanding of the cooperative's true nature.

[183] *See* JOHNSTON BIRCHALL, PEOPLE-CENTERED BUSINESSES: CO-OPERATIVES, MUTUALS AND THE IDEA OF MEMBERSHIP 3-5 (2011), Vera N. Zamagni, *Interpreting the Roles and Economic Importance of Cooperative Enterprises in a Historical Perspective*, 1 Journal of Entrepreneurial and Organizational Diversity, no. 1, 21 (2012), KIM KI TAE, KIM YEON MIN, PARK BEOM YONG AND PARK JU HEE, A STUDY ON THE OPERATIONAL MODEL OF NEW COOPERATIVES' TYPES, MINISTRY OF ECONOMY AND FINANCE (2012), Jang Jong Ick, *A Typology of Cooperatives: Focusing on the Cooperatives Newly Established in the Science and Technology Sector*, 33 The Korean Journal of Cooperative Studies, Korean Society for Cooperave Studies, no. 2, 79 (2015), However, these studies are not directly related to the "legalization" of the cooperative type, only focusing on an economic analysis. Regarding the legal typology, *see* KIM YONG JIN ET AL., *supra* note 9, 35-215.

Korean legislators must now abrogate this anachronistic dichotomy that hinders the growth of cooperatives.

The cooperative distributes its surplus to its members in the form of patronage dividends, which justifies the fact that the cooperative's income belongs to its members, not the cooperative. Nevertheless, the Korean tax laws impose taxes on cooperative surpluses both at the corporate level and at the member level. Fixing this double taxation is one of the most important issues for cooperatives. To improve the current tax policy, the principle of patronage dividends, the ideological basis of cooperative finance, must be thoroughly implemented. This requires patronage dividends to be included in deductible payments and the cooperative legislation surrounding the dividends to be revised systematically.

For systematizing cooperative's patronage dividends, member transactions and non-member transactions must be distinguished clearly, and patronage dividends to members must be defined as the cooperative's obligation. In addition, tax regulations that view transactions between a cooperative and its members as a "wrongful transaction" should be revised as well. As these reforms are difficult to implement under the current tax system, which divides all corporations only into for-profit and non-profit corporations, the Corporate Tax Act's regulations that underlie this dichotomy will need to be revised first. The introduction of an indivisible reserve system for general cooperatives could be an opportunity to break new ground to overcome the dichotomy that separates for-profit and non-profit corporations.

There are legal prerequisites to realizing the principle of patronage dividends. Members should be users, and users should be members because a cooperative is an organization of its users. This has to be the starting point of all discussions about the tax treatment of cooperatives. A legal device to control these conditions is strongly required, which Korean cooperative laws currently lack. For consistency between a cooperative's members and users, there must be a constructive answer to what "use" of a cooperative means. Ultimately, it is essential to reflect the interpretative standard for the "use" of cooperatives in the legislation, which will create a solid logical basis for reforming the cooperative taxation policy.

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