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Book Notes

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BOOK NOTES

THE TAX EXEMPTION OF COOPERATIVES*

This book presents a strong case against the cooperative form of business and its ability to escape from taxation, something not enjoyed by ordinary corporations.¹ The author makes his feelings known by stating:

“The exemption of cooperatives’ earnings or net margins from the corporation income tax is of greater importance than it may appear to be to the casual observer. The loss of revenue that it entails is a small matter compared with its effect on competition and the use of the nation’s resources, and perhaps also its implications for the future organization of our economy”.²

Written by an economist, the book is divided into twelve chapters, five of which directly relate to the title. The remaining seven chapters are devoted to supplementary material such as the effect of cooperatives on the economy, the nature of their earnings, and cooperative efficiency in a free enterprise system.

Chapter I gives a statement of the problem. Cooperatives can: (1) through disbursement of patronage dividends reduce their taxable income³ to a nominal amount, and (2) distribute patronage dividends in such forms⁴ that they are not currently taxable income to the recipients. Professor Patterson states that the tax exemption of cooperatives’ is one of equity and the economic use of resources. The problem is somewhat complex, not only in its legal aspects but also with respect to the economic analysis which is required for an understanding of the nature of the cooperatives’ earnings. Moreover, the ability of the cooperatives to adjust their prices to minimize net income, should it be subject to tax, makes less than perfect any relatively simple measure for taxing them on an equal basis with ordinary corporations.

*Second (Revised) Edition. By Robert T. Patterson. New York: University Publishers, 1961, 140 pages.

1. The author uses the term “ordinary corporations” to distinguish those corporate business enterprises that are not cooperatives from the cooperative associations, most of which also are incorporated.

2. PATTERSON, *THE TAX EXEMPTION OF COOPERATIVES*, Second (Revised) Edition, New York: University Publishers (1961) at ix of preface.

3. Int. Rev. Code of 1954, § 522.

4. *Commissioner v. Carpenter*, 219 F.2d 635 (5th Cir. 1955).

The next three chapters, by the authors own admission, add little to the knowledge of one already familiar with the development and present role of cooperatives in the United States. They are offered as information for those less well acquainted with the cooperative movement.

Chapter V deals with the problems of what could happen if cooperatives were to continue to be given the favored status they now enjoy. The terms "Cooperative Republic" and "Cooperative Commonwealth" are fully discussed and are compared with forms of socialism. This chapter seems only remotely connected with the main theme of the book and could well have been omitted.

The main subject is covered in the next five chapters. Here, Professor Patterson gives a historical analysis of the cooperative privilege, studies the tax liability of cooperatives from both the legal and economics point of view, discusses briefly the patrons' tax liability, and presents some tax alternatives and proposals. Particular attention is given to agricultural cooperatives since they represent the largest segment of all cooperatives.

Tax wise, cooperatives have been given preferred treatment since the turn of the century. Both federal and state government (including North Dakota)⁵ have taken this view. As time passed and as new revenue laws were enacted cooperatives retained their tax favored status. Those meeting certain requirements were thus exempt both from filing returns and from paying federal income tax.⁶ With respect to the taxability of their earnings—after exclusion of patronage dividends—cooperatives fell into two general classes: those that were commonly designated as "exempt" because they met certain statutory requirements, and those termed "nonexempt" because they did not come with the provisions of the law. In the Revenue Act of 1951 Congress undertook to end the fully tax exempt privilege of the exempt cooperatives and put them on the same basis as the nonexempt association. The 1951 legislation made the exempt cooperatives subject to the income tax, except that they were allowed to deduct dividends which they paid on their capital stock, and the amount of nonpatronage in-

5. N.D. Cent. Code § 57-38-09.

6. Int. Rev. Code of 1939, § 101 (12), 53 Stat. 33-34 (now Int. Rev. Code of 1954, § 521).

come which they allocated to patrons.⁷ The present law merely declares that the patronage dividends of the exempt cooperatives "shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521."⁸

In regard to patronage dividends the present law is that all cooperatives are permitted to deduct them from gross income.⁹ As to recipients, whether paid in cash or credited to the patron in one from or another, the Treasury has consistently held that they are subject to tax in the same way that other income is taxed.¹⁰ However, since many cooperatives allocate their earnings to patrons in "paper" the tax liability upon such payments has come under much protest. In recent years this has not stood up under the scrutiny of the courts. They have upheld the more realistic view that such payments, under definitely described conditions, do not meet the test of realization that determines taxable income.¹¹ Since it is also possible for cooperatives to allocate all, or practically all, of their earnings to their patrons and thereby avoid the corporation income tax, there is a double escape from federal taxation.

The author points out that any proposal to include patronage dividends as part of taxable income raises three issues. They are public policy, the concept and measurement of net income,¹² and constitutionality.¹³ The proponents of cooperative exemption argue that such payments, being in the nature of price rebates, cannot be considered income within the meaning of the Sixteenth Amendment. When the distribution is in some form other than cash it is supposed to constitute an immediate reinvestment on the part of the patron members. A further argument is that of agency where there exists a contractual obligation of the cooperative to distribute earnings or net margins to members as patronage dividends.

Professor Patterson states that from the economic side of the picture cooperatives have earnings in the same sense as

7. Int. Rev. Code of 1954, § 521.

8. *Supra* note 3.

9. *Ibid.*

10. T.D. 6014, 1 Cum. Bull. 110 (1953); Rev. Rul. 54-10, 1 Cum. Bull. 24 (1954).

11. *Supra* note 4. The effect of the Carpenter decision has been to make it possible for cooperatives to allocate their earnings in such forms that they are not taxable income to their patrons.

12. For a definition of income see *Elsner v. Macomber*, 252 U.S. 189, 207 (1920).

13. For a discussion of the broad power of Congress to determine to whom income should be taxed see *Burnet v. Wells*, 289 U.S. 670, 678 (1933).

ordinary corporations, and they should likewise be subject to taxation. The problem is to determine what part of the net margins of cooperatives is similar to the taxable income of ordinary corporations, and what part is properly to be ascribed to real price adjustment. He would agree that only that part of net margin that represents earnings should be subject to tax.

One solution, while less than perfect, is to have cooperatives set prices at approximately the prevailing competitive level. Whatever gain occurs, after allowance for all costs, including depreciation, would then represent earnings subject to tax on a par with ordinary corporations. However, this solution would be unmanageable in that market prices would be hard to control and it could not operate where a monopoly situation existed.

I feel that the author, as strong as he is for tax reform, has failed to set forth recommendations of his own for a new tax bill. At most he briefly sets forth the ideas of government officials, various committees of Congress, and other experts in the field. These proposals range from the abolition of the corporate income tax altogether to taxing cooperatives on the same basis as ordinary corporations.

While the book presents a good analysis of the problem it is not as objective as it might have been. A great number of practical considerations have been omitted for the strict, sometimes unrealistic, theories of an economist. However it can be said that the book is a very worthwhile one. The study has been made as readable as possible. The approach is from the simple to the complex, from the background of the problem to its present status. The book contains footnotes to Treasury, Appellate, and Tax Court decisions as authority for the author's observations and conclusions. The bibliography contains an excellent listing of current law reviews, books, documents, and other source material available for further study. It is a necessary source for anyone interested in proposing change in the law and could be a valuable reference for the tax practitioner.

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