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NatAgLaw@uark.edu | (479) 575-7646

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**Current Issues Concerning  
Cooperatives in the United States**

by

James B. Dean

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# CURRENT ISSUES CONCERNING COOPERATIVES IN THE UNITED STATES

JAMES B. DEAN\*

Current issues affecting cooperatives in the United States are relatively modest in number but are potentially serious in nature. These vary in intensity in various parts of the country. Not all relate to agricultural cooperatives but this discussion, with one exception, will be confined to some of the more salient legal issues facing agricultural cooperatives. Each of the issues which will be mentioned could require a complete discussion by itself. In an effort, however, to note areas of current concern within the cooperative community the issues will only be identified.

The cooperative movement in the United States has developed largely in agricultural cooperatives. In the 1950s a significant number of housing cooperatives were developed.<sup>1</sup> With passage of legislation authorizing the creation of the National Consumer Cooperative Bank in 1978,<sup>2</sup> serious efforts have been made to create various forms of consumer cooperatives. The consumer cooperative movement has, probably for many reasons, not been a strong one in the United States. There are, of course, cooperative insurance companies, savings associations, credit unions and other endeavors,<sup>3</sup> but most of the law relating to cooperatives, at least outside the insurance field, has related to and been focused upon agricultural cooperatives.

## *Lack of Public Understanding*

One difficulty facing cooperatives in the United States is a lack of knowledge of the true nature of a cooperative on the part of the general public. The economic, philosophical, tax and legal bases for cooperative enterprises are often unknown, confused or openly opposed. As a result, there is much confusion about cooperatives outside of the cooperative world itself. This leads to far too little support for cooperatives from the general public.

Even within governmental bodies charged with examining the activities of cooperatives (such as the Internal Revenue Service,<sup>4</sup> the United State De-

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\* Dean & Shapiro, P.C., Denver, Colorado. B.A. Kansas State University, 1962. J.D. Harvard University, 1965.

1. For background, see generally Castle, *Legal Phases of Co-operative Buildings*, 2 S. CAL. L. REV. 1 (1928); Hershman, *The How and Why of Real Estate Cooperatives*, 5 PRAC. LAW. 59 (Nov. 1959); Whitebrook, *The Cooperative Apartment*, 9 PRAC. LAW. 25 (April 1963); Note, *Co-Operative Apartment Housing*, 61 HARV. L. REV. 1407 (1948); Note, *The Cooperative Apartment in Government-Assisted Low-Middle Income Housing*, 111 U. PA. L. REV. 638 (1963).

2. National Consumer Cooperative Bank Act, 12 U.S.C. §§ 3001-51 (1982).

3. See generally PACKEL, *THE ORGANIZATION AND OPERATION OF COOPERATIVES* 10-23 (4th ed. 1970).

4. See 26 U.S.C. § 521 (1982) (exemption of farmers' cooperatives from tax); *id.* at §§ 1381-83, 85, 88 (Subchapter T).

partment of Justice with respect to antitrust actions<sup>5</sup> and the Federal Trade Commission,<sup>6</sup> there is often a lack of understanding of the cooperative enterprise. Interestingly, many members of the general public patronize cooperative enterprises without recognizing their cooperative nature. Advertisements can be seen everyday on television promoting cooperative products such as Sunkist oranges and orange drinks and Ocean Spray cranberry products. Cooperatives handle most of the milk consumed in many parts of the country. Yet the vast majority of consumers do not recognize the role cooperatives play in the food and fiber industry. If they were recognized, it might well be that cooperatives would have far stronger support in state and federal legislatures and administrative bodies.

### *"Tracing Issue"*

The Internal Revenue Service in Revenue Ruling 79-45<sup>7</sup> and Letter Ruling 8023023<sup>8</sup> has taken a position that income items of a cooperative should be traced and are to be allocated to the members of the cooperative whose patronage gave rise to the income. From an accounting standpoint this could create a nightmare. In response to these rulings, a request for a revenue ruling was filed on behalf of a Nebraska cooperative on January 28, 1982 asking the Internal Revenue Service to deal with this matter in a clear and practical way. Despite many conferences with the Internal Revenue Service regarding the issue, the Service continuously refused to take any action on the ruling request.<sup>9</sup>

In 1982 the audit review of cooperatives was transferred to the exempt organizations and employee plans section of the Internal Revenue Service. Following that transfer the Service launched a rather intense program of auditing cooperatives in which this "tracing issue" was raised and tax deficiencies asserted with respect to it. In the state of Colorado alone, \$679,535.75 were asserted in tax deficiencies from eight cooperatives over a period of four years.<sup>10</sup> The magnitude was substantially greater in other states.

In response to these assessments, a case was brought on behalf of the Kingfisher (Oklahoma) Cooperative Elevator Association seeking a judicial determination of the issue.<sup>11</sup> The Service subsequently dropped virtually all of the assessments which it had previously made based on the tracing issue and sought to have the case dismissed. Recognizing that the Service had delayed in addressing this issue and had given no assurance that it would be addressed

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5. See 15 U.S.C. § 1-7 (1982) (Sherman Act); *id.* at §§ 12-27 (Clayton Act).

6. See 15 U.S.C. §§ 41-58 (1982) (Federal Trade Commission Act).

7. Rev. Rule 45, 1979-1 C.B. 284.

8. 1980 PRIVATE LETTER RULINGS (P-H) ¶ 2850(80).

9. Affidavit of Donald E. Graham, Exhibit D to Exhibit 2 to Petitioner's Objection to Motion to Enter Decision, Kingfisher Coop. Elev. Ass'n v. Comm'r, (T.C. Doc. No. 5569-83).

10. Affidavit of James B. Dean, Exhibit A-1 to Exhibit 2 to Petitioner's Objection to Motion to Enter Decision, Kingfisher Coop. Elev. Ass'n. v. Comm'r, (T.C. Doc. No. 5569-83).

11. Kingfisher Coop. Elev. Ass'n. v. Comm'r, (T.C. Doc. No. 5569-83).

once and for all, the United States Tax Court ordered the case to trial.<sup>12</sup> A trial was held in Oklahoma City on June 6, 1984. The results of the trial are not expected to be known until sometime in early 1985.

It can be argued that the position of the Internal Revenue Service is not in accordance with Section 1382(f) of the Internal Revenue Code. This particular issue could cause substantial accounting problems for cooperatives. If the position of the Service is not in accordance with the statute, why should the Service be entitled to impose difficult and complex accounting procedures on cooperatives?

### *Investment Tax Credit*

Another important tax issue for cooperatives was the adoption in 1978 of Section 46(h)<sup>13</sup> of the Internal Revenue Code. This section includes specific provisions relating to the investment tax credit for cooperatives. After substantial delays, the Internal Revenue Service published proposed regulations under that section.<sup>14</sup> The statute essentially provided for a broader use of the investment tax credit for cooperatives that had previously been permitted. To the extent the cooperative cannot use the investment tax credit to offset its own taxable income (most cooperatives do not have substantial taxable income by virtue of being able to allocate their income to members under Subchapter T),<sup>15</sup> the cooperative is required to allocate the excess investment tax credit to its members. At such time as the investment tax credit is to be recaptured, it will be recaptured at the cooperative level unless there is an adjustment in the amount of cooperative credit *de novo*, in which case the individual patrons may find themselves subject to recoupment by the Internal Revenue Service.<sup>16</sup> The National Council of Farmer Cooperatives (NCFC) has established a Subcommittee on cooperative investment tax credits which is chaired by Robert C. Estes, a partner in Touche, Ross & Co., San Francisco, California. Mr. Estes has reviewed the proposed regulations in a succinct article in *The Cooperative Accountant*.<sup>17</sup>

The discussion here cannot cover all of the technical points which should be examined in connection with the proposed regulations. It is to be noted, however, that the proposed regulations follow in many respects recommendations of the NCFC and the Senate Finance Committee, but deviate in sufficient degree to leave some areas unclear and to cause potential difficulties in others.<sup>18</sup>

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12. Memorandum Sur Order, April 11, 1984, Kingfisher Coop. Elev. Ass'n. v. Comm'r (T.C. Doc. No. 5569-83).

13. 26 U.S.C. § 46(h) (1982).

14. 48 Fed. Reg. 56,965, 56,967 (proposed § 1.46-10) (Dec. 27, 1983).

15. 26 U.S.C. § 1382(b)(1) (1982).

16. 48 Fed. Reg. 56,969 (proposed § 1.46-10(f)). See Estes, *Analysis and Commentary on Proposed Regulations for Investment Tax Credit for Cooperatives*, 37 COOP. ACCT. 15, 24-25 (Spring 1984).

17. Estes, *supra* note 16.

18. See generally *id.*

As examples of some of the areas in which the proposed regulations appear to be insufficient, they do not address the situation where an investment tax credit will expire in the hands of a patron due to the carry-over period limitation. Nor do they address the allocation of an investment tax credit to nonqualifying organizations (such as exempt organizations and foreign patrons) which have no United States source of income and cannot therefore utilize investment tax credit. Where there exists a noncooperative subsidiary, may the noncooperative subsidiary's investment tax credit be allocated to the parent cooperative's patrons or must it be retained at the corporate level for carry-back and carry-over purposes? Where investment tax credit is generated within a cooperative with various divisions or groups, the regulations do not deal with how to handle investment tax credit generated by one division or group when none is generated by another. It is impossible to reach a fair and equitable result among all members if the regulations simply apply the investment tax credit across the board among the various groups irrespective of who may have generated the revenues or capital to provide the facility that created the investment tax credit.<sup>19</sup> A variety of these issues exist. It is hoped that clarification of many of these issues will occur following the examination by the Service of the responses which have been submitted with respect to the proposed regulations.

### *Bargaining Cooperatives*

Within the sugarbeet industry in the midwest and in many fruit and vegetable cooperatives on the west coast, bargaining cooperatives exist to negotiate contracts for and the actual sale of farm produce to handlers, manufacturers and processors. The federal Agricultural Fair Practices Act<sup>20</sup> (AFPA) has been adopted in part to provide for fair dealing between the farmers and their cooperatives on the one hand and the purchaser or handler of products on the other. This Act is relatively ineffective and there have been few cases which have sought to enforce its provisions.

In recent years, some states have sought to adopt stronger legislation, the leading example being the state of Michigan. The United States Supreme Court, however, has recently held that certain provisions of the Michigan Agricultural Marketing and Bargaining Act<sup>21</sup> were preempted by the AFPA.<sup>22</sup> The AFPA makes it unlawful for either processor or producer associations to coerce farmers or other producers to join or belong to a producer association. In reversing the Supreme Court of Michigan, the United States Supreme Court held that the Michigan act operated to bind producers to an accredited

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19. *Id.*

20. 7 U.S.C. §§ 2301-06 (1982).

21. MICH. COMP. LAWS §§ 290.701-.727 (1981); (MICH. STAT. ANN. §§ 12.94(101)-(127) (1981).

22. *Mich. Canners and Freezers Ass'n, Inc. v. Agricultural Marketing and Bargaining Bd.*, — U.S. —, 104 S. Ct. 2518 (1984).

association's marketing contract and precluded producers from marketing their goods themselves, in contravention of the AFPA.

A statute in the state of Maine<sup>23</sup> is similar to the Michigan act but does not contain the provisions which were found offensive by the Supreme Court. It has been noted by one writer that the limitations contained in the Maine act which preclude a handler from contracting with others while negotiating with the bargaining association and which limit the contract terms that handlers may offer persons not in a bargaining association may violate AFPA.<sup>24</sup> An Oregon statute<sup>25</sup> does not grant the bargaining associations any powers regarding coercion of other producers and may, therefore, not be affected by the Supreme Court decision according to this same writer.<sup>26</sup> The full impact of the Supreme Court's decision is not yet known but does place limitations on the ability of farmers to join together in bargaining for better prices and handling of their products.

There is also pending in the State of Colorado litigation between sugarbeet grower bargaining associations and The Great Western Sugar Company.<sup>27</sup> Many issues have been raised in that case but of significance are a challenge to the cooperative organization under the antitrust laws and allegations of false reports made by processors during contract negotiations concerning the processors' finances and actions of the bargaining associations.

The issues so raised would appear to cover wider geographical areas than simply the states of Colorado, Nebraska, Montana and Wyoming, in which the growers affected by this pending litigation are located. Growers in California are finding similar issues being raised with handlers and processors there.<sup>28</sup> The thrust of the Colorado litigation, which is also a point that has been made on the west coast, is to challenge the under-pinnings of cooperative organizations in general and the rights of bargaining cooperatives in particular. For this reason the case must be considered of some concern.

### *Equity Retirement*

A final area to be mentioned in this discussion is the broad subject of equity retirement within cooperatives. In the last few years a great deal of time and attention has been focused on this issue. In 1979 a General Accounting Office report dealt with this problem.<sup>29</sup> The Agricultural Cooperative Service of the United States Department of Agriculture also undertook an

23. Maine Agricultural Marketing and Bargaining Act of 1973, ME. REV. STAT. ANN. tit. 13, §§ 1953-65 (1981).

24. Centner, *State Cooperative Bargaining Act Preempted by Federal Law*, AGRIC. L. UPDATE 2, 5 (Aug. 1984).

25. Producers' Cooperative Bargaining Associations Act, OR. REV. STAT. §§ 646.515-.545 (1983).

26. Centner, *supra* note 24.

27. Mountain States Beet Growers Marketing Ass'n v. Great Western Sugar Co., Civ. Action No. 82-Z-1942 (D. Colo.).

28. Letter from Gerald D. Marcus to James B. Dean, September 10, 1984.

29. *Equity Redemption Issues and Alternatives for Cooperatives*, ACS RESEARCH REPORT No. 23, i (Oct. 1982).

extensive study which is now producing numerous reports with respect to equity retirement programs.<sup>30</sup> A previous study in 1974 indicated that only thirty-two percent of agricultural cooperatives operated *systematic* equity retirement programs, carried out under a definite plan with a fair degree of regularity, providing fairly predictable financial requirements that could be taken into account in the cooperative's financial budgeting process. An additional thirty-nine percent of the cooperatives surveyed in 1974 indicated they did not operate systematic programs but did have special programs which were carried out with predictable regularity or which involved predictable amounts to be redeemed in response to certain circumstances such as redemption of equities held by estates or patrons over a certain age.<sup>31</sup>

Numerous problems arise when a cooperative fails to have an adequate equity redemption program. First, under the cooperative tax system, members are taxed on amounts of equities retained by the coops but allocated to the members. If the member has no hope of obtaining these equities in the future, this investment will be costly in terms of taxes paid. In addition, failure of a cooperative to find a means of redeeming equities of members who are no longer active not only can create dissatisfaction among the membership, but may also run afoul of statutory or regulatory provisions. For example, some governmental agencies wish to see that only cooperatives keeping membership active be considered as operating on a cooperative basis and may seek to require that equities are retired promptly upon a member becoming inactive. Finally, it may be suggested that cooperatives are not operating on a sound financial basis if they are unable to raise sufficient equity from their active members.

This last point also indicates another current problem in the cooperative area which will not be discussed here. That is the problem of capital formation as cooperatives become more capital intensive and capital improvements become more expensive. This discussion will not permit a thorough analysis of the problem and it can only be identified. Nevertheless, it is important for cooperatives to deal with the problem of equity redemptions and examine potential issues and alternatives involved in this area.

The equity retirement problem appears to be of growing concern since many farmers having financial difficulty seek to reclaim their equities or set them off against debts due the cooperative. These actions call into question many cooperative equity redemption practices. They may have the ultimate effect of bringing the matter to the attention of the courts where decisions may affect all cooperative enterprises. Significant financial problems for cooperatives may be created if courts rule that equities cannot be retained or must be redeemed at times which are not financially appropriate for particular cooperatives.

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30. *Id.*

31. *Id.* at vii.

*Conclusion*

Identified herein are only some of the more salient issues facing cooperatives in the United States today. Addressing a lack of awareness of cooperative philosophy and operations is paramount in dealing with virtually all of these problems. Cooperatives should actively seek to educate the general population regarding their organizational structure and activities in hopes of soliciting broad-based popular support for the efforts being made by cooperatives and agriculture.