
Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

SFA**BILL ANALYSIS**

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bill 116 (Substitute S-3 as passed by the Senate)
Sponsor: Senator Joel D. Gougeon
Committee: Finance

Date Completed: 6-20-97

RATIONALE

The Internal Revenue Code defines farmers' cooperative corporations as farmers', fruit growers', or like associations organized and operated on a cooperative basis for the purpose of: marketing the products of the members or other producers, and returning to them the proceeds of sales less necessary expenses on the basis of either the quantity or the value of the products; or, purchasing supplies and equipment for the use of members or other persons and providing them at actual cost, plus necessary expenses. Under the Code, a farmers' cooperative can be either tax-exempt or nonexempt. A tax-exempt farmers' cooperative must conform to numerous requirements specified in the Code. A nonexempt cooperative, though not exempt from Federal corporate income tax, if properly run can avoid paying most of the tax.

When a nonexempt cooperative distributes its earnings to its members in the form of a "patronage dividend", the earnings are subject to the Federal income tax only once (payable by the patron), and the earnings may be considered tax-exempt for the cooperative. Under the Internal Revenue Code, a "patronage dividend" is an amount paid to a patron of an organization on the basis of quantity or value of business done with or for the patron, under an obligation of the organization to pay an amount, and that is determined by reference to the organization's net earnings from business done with or for its patrons. A patronage dividend can be made in the form of cash or in a certificate of allocation (to be paid later). To remain exempt, a cooperative's dividend can be distributed only on the basis of patron use, not on membership shares; thus, a patronage dividend is based upon the business activity the patron conducted with the cooperative in any given year, rather than (as with a typical company with publicly owned stock) a distribution based on shares owned. The Code allows the cooperative to deduct from its business

income all patronage dividends, whether in cash or certificates of allocation, and the patrons must include the dividend on their returns as income, whether received in cash or certificates. Returning all earnings to members thus leaves the nonexempt cooperative with little or no taxable income. (Nonexempt cooperatives may distribute earnings only to members; any profits from transactions with nonmembers are taxable to the cooperative, and if these profits are distributed to members, then the distributions also are taxable.)

The treatment of tax-exempt farmers' cooperatives versus nonexempt cooperatives under the Single Business Tax (SBT) Act has resulted in confusion and dispute. In general, a taxpayer who is exempt from Federal corporate income tax is exempt from the SBT, so exempt farmers' cooperatives are exempt from the SBT. Since the SBT Act does not contain language that specifically exempts nonexempt cooperatives, even though those cooperatives often have little or no Federal tax liability, those cooperatives traditionally have been required to include in their tax bases revenue and expenses attributable to business transacted with their patrons. According to the Michigan Farm Bureau, after a Department of Treasury audit of a farmers' cooperative concluded in 1992, the cooperative was told by the Department that it should deduct revenue and expenses from its tax base, rather than include them. Reportedly, the cooperative complied with the advice, as did other cooperatives that were informed of the Department's decision; however, a subsequent audit of another cooperative for later years advised the cooperative that, since the SBT Act has no language to allow a cooperative to exclude revenue and expenses from its tax base, revenue and expenses must be included. It has been suggested that to clarify the situation, since many farmers' cooperatives have for several years excluded

revenue and expenses from their tax bases, the Act should be amended specifically to allow for such an exemption.

CONTENT

The bill would amend the SBT Act to provide that, effective for tax years after 1990, a farmers' cooperative corporation would have to exclude from its adjusted SBT base revenue and expenses attributable to business transacted with farmer or farmer cooperative corporation patrons, to whom net earnings were allocated in the form of patronage dividends as defined in the Internal Revenue Code. The bill would prescribe a formula to be used in computing the corporation's adjusted tax base: Specific additions and deductions currently in the Act (as cited by the bill) would have to be multiplied by a fraction, the numerator of which consisted of the corporation's gross profit of its nonpatronage-sourced business, and the denominator of which was its gross profits.

"Farmers' cooperative corporation" would mean a cooperative association as described in Section 98 of Public Act 327 of 1931, which provides that a corporation must be governed under the Act if it is organized to conduct a lawful business that limits the dividends, payable upon stock investment in the case of a corporation with capital stock, or membership investment in the case of a membership corporation without capital stock, not to exceed 8% per annum; or that limits the voting rights of stockholders or members to one vote regardless of the number of shares of stock or membership held; and that in any case does not conduct more than 50% of its business or services with nonstockholders or nonmembers.

Currently, certain farmers' cooperative corporations that are exempt from Federal income taxes, and that are organized under certain limitations of Public Act 327 of 1931, are exempt from the SBT. This exemption does not apply to a farmers' cooperative corporation if the total dollar value of its incidental and emergency purchases (of commodities from nonproducers to facilitate the manufacture or marketing of commodities purchased from producers) is at least 5% of the total dollar value of its repurchases (from nonproducer customers of commodities the corporation markets to nonproducer customers and the corporation's subsequent manufacture or marketing of the repurchased commodities). Under the bill, for tax years ending after 1994, the exemption would not apply if the incidental and emergency purchases were at least 5% of the

corporation's total purchases.

MCL 208.35 et al.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The tax treatment under the SBT Act of Federally nonexempt farmers' cooperatives has become the subject of dispute. Under Federal law, a nonexempt cooperative that distributes its profits to its members based on membership activity can deduct those distributions from its tax base, leaving the cooperative itself with little or no tax liability, while the members who received the distributions assume liability for tax on them. In this manner the income is taxed only once at the Federal level. Under the SBT, a farmers' cooperative that is exempt from Federal taxation also is exempt from the SBT; however, the Act does not offer the same specific exemption to a farmers' cooperative that is nonexempt for Federal tax purposes. This means, then, that while a nonexempt cooperative may have no Federal tax liability it may have to include in its SBT base revenue and expenses that were deducted on its Federal return.

Reportedly, a 1992 Department of Treasury audit of a nonexempt farmers' cooperative advised the cooperative that it should exclude from its SBT base revenue and expenses attributable to transactions with patrons. In an audit of another cooperative some years later, the cooperative was advised that it could not exclude such revenue and expenses since the Act does not specifically allow such an exclusion. Many cooperatives, having been informed of the Department's first advice to exclude revenue and expenses, have not included those items on returns in recent years, thus potentially leaving them liable for substantial back taxes, interest, and penalties. The bill would clear up the current confusion over whether revenue and expenses should be included in a cooperative's tax base, relieve those cooperatives that have been excluding revenue and expenses from having to file costly amended returns, and make Michigan's tax treatment of nonexempt cooperatives parallel to that of the Federal government.

Opposing Argument

Under the SBT Act those cooperatives that maintain their Federal tax-exempt status specifically are exempt from the SBT, but those that do not have a Federal exemption or lose their Federal exemption have no specific tax exemption under the Act. As such, the Department of Treasury is bound to administer the provisions of the Act as written. Those nonexempt farmers' cooperatives that have not included in their tax bases revenue and expenses, attributable to business transacted with cooperative patrons who received patronage dividends, have not been following the law and are therefore liable for the resultant taxes, interest, and penalties. The bill would eliminate the Department's ability to enforce the Act as it is written.

Response: Because there has been confusion over the interpretation of what a cooperative should and should not include in its tax base, the fair course of action would be to clarify the language of the Act and make it conform with the recent filing practices of certain cooperatives.

Legislative Analyst: G. Towne

FISCAL IMPACT

A Department of Treasury audit revealed that farmers' cooperative corporations have been underpaying their SBT liabilities by excluding from the tax base certain income received from transactions involving patrons who receive dividends from the cooperative. This bill proposes to make the SBT Act consistent with the way farmers' cooperative corporations have actually been filing the single business tax. As a result, under this bill, the SBT liabilities of farmers' cooperative corporations would decline by an estimated \$2 million in FY 1997-98 compared with what their liabilities will be under current law. This bill has an effective date for tax years ending after December 31, 1990, but the Department of Treasury estimates that very little or no refunds would have to be paid because most farmers' cooperative corporations have not been paying the SBT consistent with current law.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.