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SFA**BILL ANALYSIS**

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Senate Bill 116 (as enrolled)
Sponsor: Senator Joel D. Gougeon
Senate Committee: Finance
House Committee: Tax Policy

PUBLIC ACT 240 of 1998

Date Completed: 8-3-98

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 did not contain language that specifically exempted nonexempt cooperatives, even though they often have little or no Federal tax liability, those cooperatives were in the past advised by the Department of Treasury 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 had no language to allow a cooperative to

exclude revenue and expenses from its tax base, revenue and expenses had to be included. It was suggested that to clarify the situation, since many farmers' cooperatives had for several years excluded revenue and expenses from their tax bases, the Act be amended specifically to allow for such an exemption. This exemption was placed into the SBT Act by Public Act 124 of 1997, to apply to tax years after 1996. Subsequently, some people felt that the Act should be further amended to make the exemption retroactive.

CONTENT

The bill amended the SBT Act to provide that, effective for tax years after 1990, a farmers' cooperative corporation must exclude from its adjusted SBT base revenue and expenses attributable to business transacted with farmer or farmer cooperative corporation patrons, to whom net earnings are allocated in the form of patronage dividends as defined in the Internal Revenue Code.

MCL 208.35

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 became the subject of dispute. 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 did not specifically allow such an exclusion. Some cooperatives, having been informed of the Department's first advice to exclude revenue and expenses, did not include those items on returns in recent years, thus potentially leaving them liable for substantial back taxes, interest, and penalties. The bill, by making the exemption retroactive to 1990, relieves those cooperatives that have been excluding revenue and expenses from having to file costly amended returns.

Opposing Argument

It is a mistake to allow the exemption retroactively. Those cooperatives that incorrectly used a diminished tax base were not following the law, and thus should pay the taxes owed. The bill eliminates the Department's ability to enforce the Act as it was written.

Response: Because there was confusion over the interpretation of what a cooperative should and should not include in its tax base, the fair course of action is to make the exemption apply retroactively to 1990, thus allowing the Act to 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 underpaid their single business tax liabilities in past years by excluding from the tax base certain income received from transactions involving patrons who received dividends from the cooperative. This new law makes the Single Business Tax Act consistent with the way farmers' cooperative corporations have actually been filing the single business tax. While this new law is retroactive to tax years that ended after December 31, 1990, it is estimated that very little or no refunds will have to be paid because most farmers' cooperative corporations were already calculating their single business tax liability consistent with this new change.

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.