

DESCRIPTION OF S. 1819

RELATING TO

TAX TREATMENT OF CRUDE OIL PURCHASING COOPERATIVES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

ON

MARCH 30, 1982

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 29, 1982

JCX-3-82

C O N T E N T S

	Page
INTRODUCTION	i
I. Summary of the Bill	1
II. Description of the Bill	3
A. Present Law	3
B. Issues	5
C. Explanation of the Bill	5
D. Effective Date.	7

INTRODUCTION

The Senate Finance Subcommittee on Energy and Agricultural Taxation has scheduled a hearing on S. 1819 (introduced by Senators Wallop, Symms, Long, Boren, Matsunaga, Johnston, and Bentsen) on March 30, 1982. This pamphlet has been prepared by the staff of the Joint Committee on Taxation in connection with this hearing.

The first part of this document is a summary of the bill. The second part is a description of the bill, including present law, issue, explanation of the bill, and effective date.

I. SUMMARY OF THE BILL

Under present law, cooperatives generally are treated as conduit entities for Federal income tax purposes. Amounts derived from transactions with patrons (i.e., persons doing business with the cooperative) which are distributed or allocated currently to patrons are not taxable to the cooperative. In other respects, cooperatives generally are taxed as corporations. Thus, income distributed to members (i.e., the persons who share in the cooperative's profits and are entitled to participate in the management of the cooperative) derived from transactions with nonmembers is not deductible and is taxed both to the cooperative and to the members.

An exception to this treatment is accorded to certain farm cooperatives (referred to as "exempt farmers' cooperatives"). Exempt farmers' cooperatives are cooperatives of farmers, fruit growers, or similar producers which are organized (1) to market the products of producers and to turn back the proceeds less necessary operating expenses or (2) to purchase supplies and equipment for patrons at a price equal to actual cost plus necessary expenses. In addition to the deductions allowed to regular cooperatives for amounts returned to patrons, exempt farmers' cooperatives are allowed deductions for earnings distributed to members on capital stock and to patrons on income derived from transactions with the United States Government or from nonpatronage sources. However, the volume of purchase transactions that an exempt farmers' cooperative can have with nonmembers is restricted to (1) an unlimited amount with the United States Government plus (2) an amount with other nonmembers equal to 15 percent of the value of all purchases.

The bill would provide special rules for the taxation of "crude oil purchasing cooperatives." A crude oil purchasing cooperative would be a cooperative formed for the purpose of-- (1) purchasing and selling crude oil to a "qualified group" consisting of members, nonmember independent refiners, and nonmember cooperatives; (2) purchasing supplies and equipment for the use of the qualified group at cost plus necessary expenses; (3) trading crude oil; (4) storing crude oil; (5) insuring against risks involved with any of these activities; and (6) any activity incidental to the foregoing purposes. The members of a crude oil purchasing cooperative must be independent refiners (defined as refiners where 70 percent of its crude oil purchases in any calendar quarter since June 30, 1973, are from unrelated sources) or other cooperatives.

Under the bill crude oil purchasing cooperatives would be accorded tax treatment similar to exempt farmers' cooperatives. Thus, a crude oil purchasing cooperative would be allowed a deduction for distributions to its members on capital stock and to patrons on income derived from transactions with the United States Government or from nonpatronage sources. Under the bill, the volume of purchase transactions that the crude oil purchasing

cooperatives could have with nonmembers would be restricted to (1) an unlimited amount with the United States Government, all nonmember cooperatives, and nonmember independent refineries plus (2) an amount with other nonmembers equal to 25 percent of all of its purchases. Under the bill, "necessary expenses" would be automatically deemed to be 15 percent of purchase costs. The bill would also allow crude oil purchasing cooperatives to operate in federated form.

The bill would apply with respect to taxable years beginning after the date of enactment.

II. DESCRIPTION OF THE BILL

A. Present law

Overview

The Internal Revenue Code provides special rules for the taxation of cooperatives (secs. 1381-1388).^{1/} For Federal income tax purposes, cooperatives are taxed as conduits in that they are not taxed on amounts derived from transactions with patrons to the extent that such amounts are returned to the patrons. This conduit treatment is granted on the basis that the cooperative is acting as the agent of the patron and, thus, the "patronage earnings" are not income of the cooperative.

Generally, conduit treatment is not accorded to distributions of income to members of a cooperative derived from transactions involving nonmembers since such income cannot be viewed as derived by the cooperative in its capacity as an agent. An exception to this treatment is accorded to so-called "exempt farmers' cooperatives." Exempt farmers' cooperatives are cooperatives created for farmers, fruit growers, livestock growers, dairymen, etc., for the purpose of (1) marketing the products of such persons and (2) purchasing supplies and equipment for such persons. Exempt farmers' cooperatives are entitled to a deduction for distributions to members of income derived from transactions with nonmembers. However, the volume of business that an exempt farmers' cooperative can engage in with nonmembers is restricted to (1) an unlimited amount with the United States Government plus (2) an amount with other nonmembers equal to 15 percent of the total value of its purchases.

Rules Applicable to the Taxation of Regular Cooperatives

Applicability.--The special tax treatment provided cooperatives (secs. 1381-1388) applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of amount of the business done with or for such patron.

^{1/} A cooperative is a business entity created by persons in an attempt to use the increased purchasing power, marketing power, and efficiency associated with the use of a larger economic entity to generate savings for such persons. A "patron" is the person who produces or consumes the cooperative's products or services. A "member" is the person who shares in earnings not returned to patrons and is entitled to participate in the management of the cooperative.

In a cooperative arrangement, the benefits attributable to any purchasing and marketing economies generally accrue to the benefit of the cooperative's patrons in proportion to the business done with the cooperative (referred to as "patronage") during the year. However, some cooperatives are organized so that earnings from business with certain groups is not returned to those groups but is distributed to the cooperative's members.

However, this special treatment does not apply to (1) organizations which are exempt from tax, (2) mutual savings banks, building and loan associations, and cooperative banks, (3) insurance companies, or (4) certain organizations engaged in furnishing electric energy or telephone service to persons in rural areas (sec. 1381).

Taxation of the Cooperative.--The taxable income of a cooperative is determined in the same manner as a corporation, except that the gross income of a cooperative is determined without regard to (i.e., after reduction or exclusion of) amounts paid within the current taxable year or within the first eight and one-half months of the succeeding taxable year, in cash or other property (as a "patronage dividend," as a "per-unit retain allocation, or as a redemption of "nonqualified written notice of allocation" or "nonqualified per-unit retain certificates") or in certain types of qualified script (called "qualified written notices of allocation," or "qualified per-unit retain allocations").

Rules Applicable to the Taxation of Exempt Farmers' Cooperatives

In addition to the deductions and exclusions allowed to regular cooperatives, exempt farmers' cooperatives are entitled to deductions for (1) dividends on its capital stock and (2) amounts paid (or redemptions of nonqualified written notices of allocation) on a patronage basis to patrons from earnings derived from transactions with the United States or from nonpatronage resources.

Exempt farmers' cooperatives are associations of farmers organized on a cooperative basis for the purpose of (1) marketing products of members or other patrons and returning any proceeds therefrom (less necessary expenses) or (2) purchasing supplies and equipment for the use of members or other persons and turning such items over to the patrons at actual cost plus necessary expenses. Any capital stock of an exempt farmers' cooperative must not bear a dividend rate of the greater of the State's legal interest rate or 8 percent and generally must be owned by persons who patronize the cooperative.

Exempt farmers' cooperatives are limited in the amount of transactions that they can have with nonmembers. With respect to marketing transactions, the value of products marketed for nonmembers (other than the United States Government) cannot exceed the value of products marketed for members. With respect to purchase transactions, the value of supplies and equipment sold to nonmembers (other than the United States Government) cannot exceed the lesser of (1) the value of supplies and equipment sold to members or (2) 15 percent of the value of all of its purchases.

Taxation of Patrons

The provisions dealing with the taxation of patrons of both regular cooperatives and exempt farmers' cooperatives generally mirror the provisions dealing with amounts excludable or deductible from the gross income of a cooperative. Thus, a patron must include in income--

(1) any patronage dividend paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) received during the taxable year.

(2) the amount of any per-unit retain allocation paid in qualified per-unit retain certificates and received during the taxable year; and

(3) in the case of an exempt farmers' cooperative, any nonpatronage distribution (amounts earned with respect to nonpatronage transactions and business done with the United States or any of its agencies).

Amounts which would otherwise be gross income to a patron as a patronage dividend or redemption of a nonqualified written notice of allocation received as a patronage dividend, are excludable from gross income to the extent such amount is properly used to reduce the basis of property or is attributable to personal, living, or family items.

Because patronage dividends, per-unit retain allocations, etc., are deductible if paid within eight and one-half months after the close of the taxable year of the cooperative but such items are not includible in the patrons' income until the taxable year of payment, a deferral of tax on such items is possible under present law. This deferral period can be lengthened by use of fiscal years and operating on a federated basis.

B. Issues

The principal issue is whether cooperatives formed by independent refiners and cooperatives for the purpose of purchasing crude oil, equipment and supplies should be allowed deductions for distributions on a nonpatronage basis of earnings derived from transactions with the United States Government or from nonpatronage sources and, if so, what should be the restrictions on the volume of business done with nonmembers. A subsidiary issue is whether such cooperatives should be permitted to operate in federated form.

C. Explanation of the bill

In general.--The bill would provide rules for the tax treatment of "crude oil purchasing cooperatives" which are similar to the rules presently provided for exempt farmers' cooperatives. Thus, a crude oil purchasing cooperative would be allowed a deduction

for distributions to its members on capital stock and to patrons on a patronage basis on income derived from transactions with the United States Government and from nonpatronage sources. In order to qualify for this treatment, the cooperative must meet certain restrictions regarding its membership and capital stock, the purposes for which it is organized and operated, and the amount of transactions that it can have with nonmembers.

Membership and capital stock--In order for a cooperative to be a crude oil purchasing cooperative, all of its members would have to be either (1) "independent refiners" or (2) nonmember crude oil purchasing cooperatives, regular cooperatives, or exempt farmers' cooperatives (collectively called "subchapter T cooperatives"). An "independent refiner" would be defined as any refiner who for any single calendar quarter after June 30, 1973, obtained more than 70 percent of its refinery input of domestic crude oil or domestic plus imported crude oil from unrelated producers.

Any capital stock of a crude oil purchasing cooperative generally must be owned by persons who patronize the cooperative and cannot have a dividend rate which exceeds the greater of the legal interest rate in the State of incorporation or 8 percent.

Qualifying purposes--A crude oil purchasing cooperative would have to be organized and operated for the following purposes: (1) purchasing and reselling crude oil to a "qualified group" consisting of members, nonmember independent refiners, and nonmember subchapter T cooperatives at cost plus necessary expenses; (2) purchasing supplies and equipment for the use of the qualified group at cost plus necessary expenses; (3) trading crude oil; (4) storing crude oil; and (5) insuring all of the above activities. In addition, the trading and transportation of crude oil, the insurance of risks associated with trading and transportation of crude oil, and any other activities incidental to any qualifying purposes or designed to increase the efficiency of the cooperative in carrying out any qualifying purposes also would be treated as a qualifying purpose.

The bill would provide a "safe harbor" rule under which "necessary costs" would be deemed to be the greater of 15 percent of an activity's cost or an amount shown to the Secretary of the Treasury as being properly allocable to that activity.

Limitations on transactions with nonmembers--The bill would impose the following restrictions on the volume of transactions with nonmembers: (1) the value of crude oil purchased for nonmembers could not exceed the value of crude oil purchased for members; (2) the value of supplies and equipment purchased for nonmembers could not exceed the value of purchases for members; and (3) the value of all purchases for nonmembers could not exceed an unlimited amount for nonmember independent refiners and nonmember subchapter T cooperatives plus an amount equal to 25 percent of the value of all its purchases.

Operation in federated form.--The bill would permit a cooperative to be a crude oil purchasing cooperative where it is doing business on a federated form on the basis of geography, regions, qualities of crude oil, or any other reasonable basis.

D. Effective date

The bill would apply to taxable years beginning after the date of enactment.