

## House Passes Dividend Allocation Rule Legislation

*by J. Gary McDavid*

On March 19, 2003, the House of Representatives passed a tax provision cooperatives have been seeking for many years. This provision will repeal the dividend allocation rule (DAR) – a rule that imposes an additional tax on cooperatives if they pay a dividend on capital stock or other proprietary capital interest (a “Dividend on Capital Stock”). The DAR makes equity financing more expensive for cooperatives and is particularly harmful because cooperatives have difficulty obtaining equity financing from outside the membership. This House action is a step forward for coops, but most coops will need to change their corporate documents to take advantage of this legislation, and they should begin planning for those changes.

### Background

One of the overall policy goals of Subchapter T of the Internal Revenue Code (the “Code”) is to subject a cooperative’s “patronage income” to one level of tax and “nonpatronage income” to regular corporate income taxation. In general, “patronage income” is income determined by reference to the net earnings of the cooperative from business done with or for its patrons, and “nonpatronage income” is all other income derived by the cooperative (such as investment income unrelated to the patronage operation). Distributions to patrons on a patronage basis from patronage income are “patronage dividends.”

As enacted, Subchapter T of the Code eliminates the corporate level tax imposed on a cooperative’s patronage income by allowing a cooperative to exclude patronage dividends paid to its patrons. No similar exclusion exists for dividends paid to stockholders from nonpatronage earnings.

Thus, nonpatronage income is subject to two levels of tax. However, if a cooperative pays a Dividend on Capital Stock, an additional tax is imposed at the cooperative level.

### Summary of the DAR

If a cooperative pays a Dividend on Capital Stock, the DAR requires:

1. that the amount of the Dividend on Capital Stock be allocated between the cooperative’s patronage and nonpatronage business in proportion to the relative amount of patronage/nonpatronage business done by the cooperative; and
2. that the amount of the cooperative’s net earnings available for the patronage dividend deduction be reduced by the portion of the Dividend on Capital Stock allocated to the cooperative’s patronage business.

The reduction of the cooperative’s net earnings eligible for the patronage dividend deduction can reduce the amount of patronage income paid to coop members/patrons (where patronage dividends are based on net earnings determined using Federal income tax principles), and it can make the cooperative taxable on a portion of its patronage income that would otherwise qualify for the patronage dividend deduction. The additional tax on this income makes the equity financing on which the dividend is paid more expensive (the amount of the dividend plus additional tax). This tax has a negative impact on a cooperative’s ability to raise equity capital, which is much needed in today’s business environment.<sup>1</sup>

<sup>1</sup> In the 106th Congress, Congressman Bill Thomas introduced a bill (H.R. 1914) to modify the dividend allocation rule. The language of Congressman Thomas’s bill was identical to legislation now being proposed by Congressman Herger and Senators Grassley and Baucus. In the 107th Congress, the text of H.R. 1914 was included as Section 12 of S. 312, introduced by Senators Grassley and Baucus and co-sponsored by 24 Senators. Also in the 107th Congress, the text of H.R. 1914 was introduced by Congressman Wally Herger and co-sponsored by 10 members of the Ways and Means Committee as H.R. 2280.

### The Latest House Action

The provision repealing the DAR is found as Section 603 of the Tax Relief, Simplification, and Equity Act of 2003 (H.R. 1308). It states:

#### **SEC. 603. PAYMENT OF DIVIDENDS ON STOCK OF COOPERATIVES WITHOUT REDUCING PATRONAGE DIVIDENDS.**

(a) IN GENERAL. - Subsection (a) of section 1388 (relating to patronage dividend defined) is amended by adding at the end the following: "For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to the amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year."

(b) EFFECTIVE DATE. - The amendment made by this section shall apply to distributions in taxable years beginning after the date of the enactment of this Act.

The Ways and Means Committee Report accompanying the bill explained the provision as follows:

**Reduces Multi-Level Tax on Cooperatives** - Under present law, cooperatives face up to three levels of tax penalties. The provision reduces one of these levels by providing that patronage dividends of cooperatives will not be reduced by stock dividends to the extent the stock dividends are in addition to the amounts otherwise payable. (This provision passed the Senate twice in 1999 and passed the House once. The conference report was vetoed.)

### The Effect of Proposed Legislation

The proposed legislation would allow cooperatives to more easily create a class of preferred stock or other proprietary capital interest on which dividends could be paid. The

benefits to the cooperative could be substantial. The cooperative could:

1. more easily raise capital from outside investors without giving up any ownership or control of the cooperative by the farmers who patronize the cooperative;
2. create a class of preferred stock that could be traded on capital markets, thereby providing liquidity to the cooperative's interests;
3. create a preferred stock program for management and employees, which would improve incentive programs;
4. repurchase a departing member's interests for dividend paying stock (which adds equity to the balance sheet), rather than creating debt to the cooperative; and
5. develop its nonpatronage operation to more efficiently bear the burden of capitalizing the cooperative.

### Likely Action by the Senate

On March 19, 2003, the DAR legislation was introduced by Senator Grassley, Chairman of the Senate Finance Committee, as Section 12 of the Tax Empowerment and Relief for Farmers and Fishermen Act (S. 665). This bill had 13 co-sponsors, including Senators Baucus, Dorgan and Daschle. It is not clear how fast this legislation will move or when the Senate might take up the recent House bill including the DAR legislation, H.R. 1308.

### Action to be Taken by Cooperatives

When the DAR legislation ultimately passes, most cooperatives will need to amend their articles, bylaws or other contracts with members to take advantage of this new legislation. Since it often takes cooperatives some time to amend their corporate documents, it is not too soon to begin thinking about this. If you have questions, we would be happy to be of assistance. Please contact any one of the following persons:

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