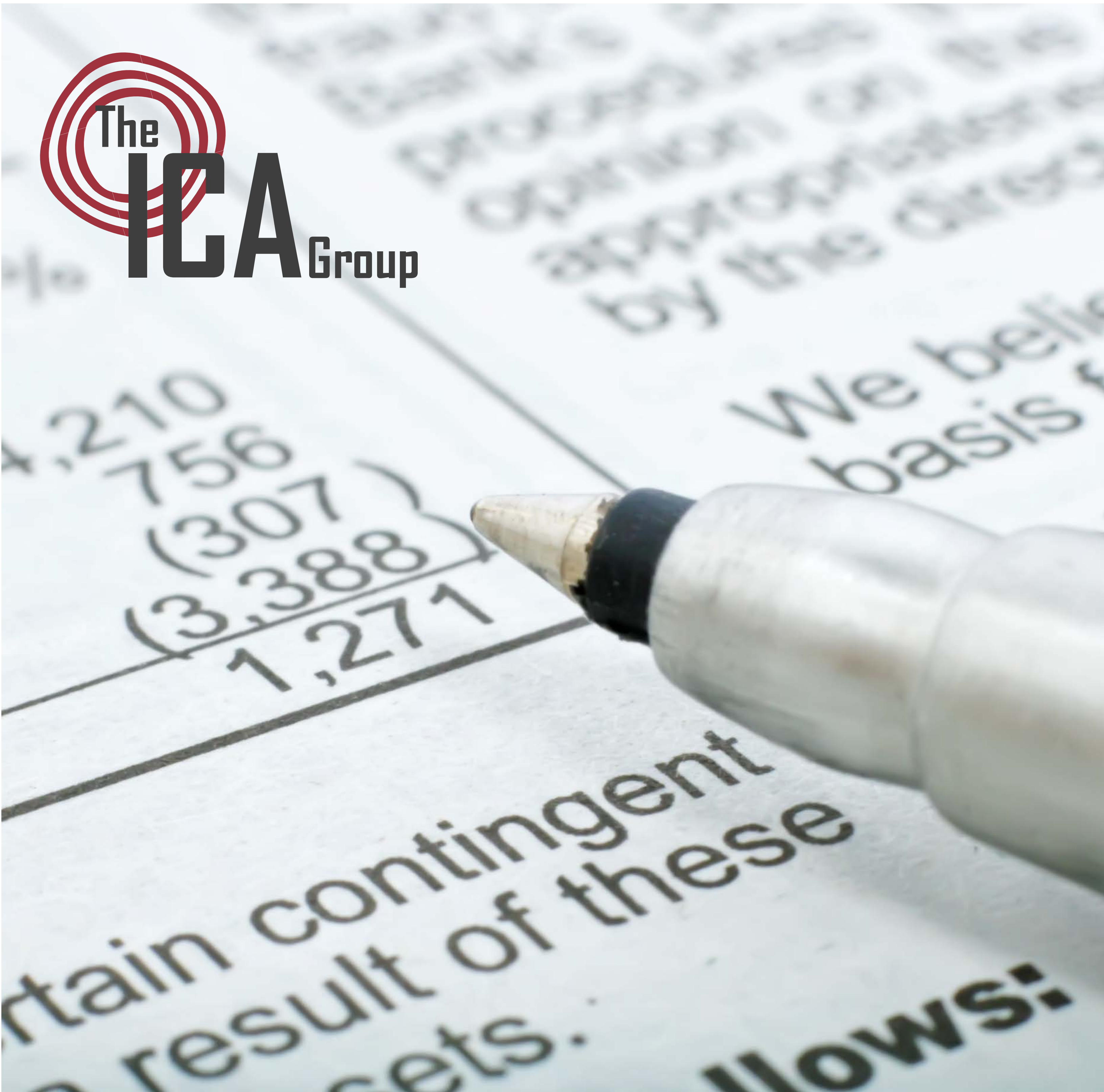

Taxation of Worker Cooperatives:

An Introduction to Subchapter T

TAXATION OF WORKER COOPERATIVES

BY PETER PITEGOFF

A worker cooperative, like any business, faces a battery of Federal and state taxes. Careful tax planning can minimize this burden, through special tax benefits for cooperatives as well as tax breaks available for any corporate enterprise. This article presents a brief introduction to the primary cooperative tax advantage: Subchapter T of the Federal Internal Revenue Code.

Ordinarily, corporate earnings are subject to double taxation. The corporation pays corporate income tax on its taxable income and individual shareholders pay personal income tax on their share of corporate earnings distributed as dividends. Subchapter T enables a co-op to avoid this double taxation, by legally avoiding the corporate level tax.

Subchapter T works as follows. The worker cooperative deducts from corporate taxable income any earnings allocated to members on the basis of work performed (called "patronage," often measured by hours worked). These allocations or "patronage dividends" may be in the form of cash distributions. Alternatively, patronage dividends may be in the form of written obligations ("written notices of allocation") credited to members' individual capital accounts. Thus, Subchapter T can provide a dual benefit. The cooperative can avoid double taxation and, at the same time, retain and reinvest a portion of the earnings allocated to members. Such allocations, of course, would be in addition to ordinary cash wages. There are two different ways to use Subchapter T, each with different cash flow implications depending on the particular tax brackets of the cooperative and the members. Patronage dividends in the form of "qualified" written notices of allocation are currently deductible by the corporation.

However, the member must pay personal tax currently on any allocations, and the corporation must pay at least 20% of the dividend in cash to the member immediately, presumably to enable the member to pay the personal tax. Alternatively, "non-qualified" written notices require no upfront personal tax payment, but also offer no current corporate deduction for the patronage dividend. In a later year, when the written notice is paid out in cash to the member, the member pays personal tax, and the cooperative deducts the amount of the cash pay-out. The choice between qualified and non-qualified written notices requires careful attention to Subchapter T provisions and to a cash-flow analysis.

The benefits of Subchapter T are available, in the words of the Tax Code, to "any corporation operating on a cooperative basis." Unfortunately, the IRS and the courts have produced no precise definition of "operating on a cooperative basis." Nonetheless, IRS rulings and court cases tend to cite certain criteria for use of Subchapter T. Two criteria appear to be most important:

(1) A worker cooperative must allocate earnings on the basis of patronage, as opposed to relative capital investment; and
(2) The cooperative must be democratically controlled by the members.

Clearly, some variation from these criteria will not necessarily preclude use of Subchapter T — courts have allowed non-cooperative elements within corporations using Subchapter T. But, the tax benefit becomes less certain as one strays away from patronage allocations and democratic structure. A note of caution: consult with your lawyer before relying on Subchapter T.

Two other important points are established by case law. First, Subchapter T is expressly available to worker cooperatives, although it originated as a tax break for agricultural cooperatives. Second, the particular state-level incorporation statute is not controlling for Federal tax purposes. For instance, if an enterprise is incorporated as a business corporation but operates in substance on a cooperative basis, can still qualify under Subchapter T.

The mechanics of using Subchapter T are simple. No prior election or approval is required. A corporation that is operating on a cooperative basis simply files the appropriate IRS forms (1099-PATR and 1066) when paying taxes.

The potential for creative tax planning by a worker cooperative extends far beyond Subchapter T. This article merely scratches the surface. For more information on cooperative taxation, please contact the ICA Group, refer to the ICA Publication Internal Capital Accounts, or consult with your lawyer or accountant.

About the Author: Peter Pitegoff served as the ICA Group's General Counsel from the ICA's founding through the 1980's. He served as Dean of the University of Maine School of Law until June 2015 and previously was a law professor at the State University of New York Buffalo.

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The Democratic Corporation: Model By-Laws for a Worker Cooperative: This publication provides a comprehensive introduction to worker cooperatives as well as annotations to by-laws for stock corporations, LLCs, and non-profits. It also includes a multitude of sample legal forms.

A comparison of Employee Ownership Models: This publication provides a basic overview of the key differences between worker cooperatives, ESOPs, and hybrid models. It walks through the details of the various forms to help business owners weigh the financial and tax impact of a sale.

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