AN ABSTRACT OF THE THESIS OF

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Title: TRANSFERABILITY OF EQUITIES OF OREGON AGRICULTURAL MARKETING AND SUPPLY COOPERATIVES

Abstract approved: ______________________________
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This thesis, although dealing specifically with Oregon Agricultural cooperatives, has significance for agricultural cooperatives on a national basis when discussing equity financing.

The central issue is whether a patron may in effect transfer his cooperative equity holding to another person without impairing the total function of the cooperative? To answer this question it is necessary to further define the nature of cooperative equities and also provide clearer information into the legal, tax, accounting and operational techniques used in cooperative equity financing.

This study examined cooperative bylaws which make specific references to the handling of equities including transfers under different circumstances.

The Internal Revenue Code provisions and specific IRS rulings with regard to equity issuance, transfer and redemption are dealt with in depth and summarized into probable tax consequences.

Securities regulation with respect to cooperative equity allocations are also examined. Existing statute and regulation as well as proposed reforms are reviewed and summarized.

Alternate methods of equity transfers are then identified and analyzed with respect to cash flow and taxation.

Alternate methods of equity transferability are identified and thoroughly analyzed with respect to taxation, investment opportunity and cash flow. Comparative illustrations are utilized to present differences in holding various equities versus transferring equities at a discounted value given assumptions of tax rates, investment opportunities, revolving periods, etc.

In conclusion, a number of decision criteria must be considered prior to evaluating a program of equity transferability which are as follows:

1) Cash Needs of Patrons - Cooperative patrons generally have a need for on-farm capital and may face a substantial opportunity cost in holding equities.

2) Distribution of Equity Holding - Certain patrons may be personally well-capitzlized and willing to finance equity holding while undercapitalized patrons, former patrons, and estates of deceased patrons may seek to redistribute equity holdings.

3) Establishment of a Market - Methods and standards of equity valuation in transfer which could be established in a market may lead to both beneficial and costly effects for the cooperative and patron in both the long and short term.

4) Cooperative Benefits - A number of benefits accrue to the patron through operation of a cooperative such as the effect on the market structure, economies of scale, farmer participation in ownership and control, etc. These benefits should be understood and evaluated when considering tradeoffs caused through potential costs associated with equity transferability

5) External Considerations - Perhaps the most important single factor is the effect of costs associated with potential alteration of government control or regulation of cooperative taxation, securities regulation, and marketing practices.

Recommendations in the area of equity transferability are intended to improve cooperative service and response to cash needs of patrons while limiting cooperative exosure to adverse or costly regulation. It is suggested that a judicious program of equity transferability may be feasible for "tax-exempt" (as defined by I.R.S.) cooperatives. Cooperative bylaws and operating procedures should be reviewed to assure the handling of transfers, the scope of transferability, the rights of non-patron equity holders, and adequate disclosure of information meets the approval of directors and/or legal counsel in limiting potential problem areas.

Consideration is also given to alternate capital programs and methods of equity distribution which may meet both cooperative and patron goals.

Transferability of Equities of Oregon Agricultural Marketing and Supply Cooperatives

by

John Richard Valpey

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CHAPTER I

INTRODUCTION

Many businesses in agricultural industry operate on a "cooperative basis". These cooperative associations are different from other forms of business organization and have instituted the use of unique operating practices. While the cooperative association is now, as in the past, philosophically an extension of the farm business, the increasing financial pressures and financial sophistication of both cooperative management and patrons increasingly challenges the traditional financing procedures and personal values concerning cooperative finance and control.

A cooperative can be broadly defined as a democratic association of persons organized to furnish themselves an economic service under a plan that (1) eliminates entrepreneur profit at the corporate level and (2) provides for substantial equality in ownership and control. (8, P. 2.). Operating on a "cooperative basis" usually means operating "at cost", apportioning all savings to patrons thus eliminating a corporate profit.

In setting forth the principles of a cooperative association the Capper Volstead Act authorized the association of agriculturalists to join together to provide an economic service on a cooperative basis. To insure that the cooperative preserved substantial equality in control and eliminate excessive profit on contributed capital, three requirements were set forth by the act. First, no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own in the association. Second, no dividends on stock or membership capital shall be in excess of eight per cent per annum. And third, the association shall not deal in the products of nonmembers to an amount greater in value than the products handled for members.

To provide equitable ownership, unique methods of capital accumulation have developed, giving rise to the use of so-called "equities".

EQUITIES DEFINED

There are generally two methods by which capital contributions are obtained from patrons. Both of these methods are based on a contractual relationship between the patron and the cooperative by which the patron agrees to contribute capital as a necessity of doing business on a cooperative basis.

In one method, the net margins (annual savings) generated by the cooperative accrue to the patrons in proportion to the amount of business done with the cooperative. These net margins may be returned to the patron as cash, or may be withheld as an equity contribution. The cash returned is called a "patronage refund" and the equity contribution is called an "allocated patronage refund".

In the alternate method of capital accumulation some cooperatives, especially processing and marketing cooperatives, retain equity contributions on a per-unit of product handled basis, independent of the cooperative's net margin. This equity contribution is usually a fixed amount per-unit of product processed or marketed and is called a "per-unit retain".

Both "allocated patronage refunds" and "per-unit retains" constitute a capital investment by the patrons in the cooperative and are commonly known as "equities", as they are titled in this thesis.

Equity is usually held by the cooperative under one of two plans - the "permanent capital" or "fair investment" plan (see Figure 1), and the "revolving fund" financing plan (see Figure 2). While the latter is the most widely used, the "permanent capital" plan is coming into more prevalent use.

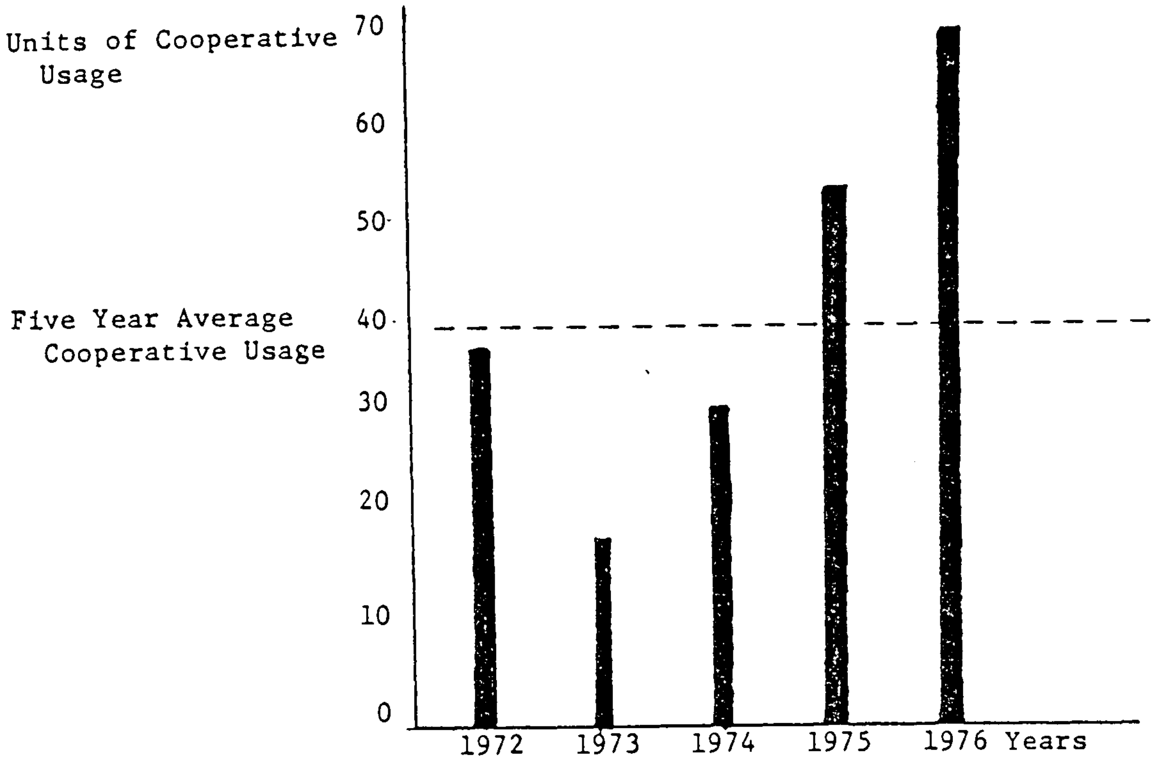

Figure 1. "Permanent Capital" or "Fair Investment" Capital Financing Plan

The "fair investment" or "permanent capital" plan is usually based on a rolling average quantity of cooperative usage of patronage. The investment of capital contribution may be based on a dollar amount per unit of average cooperative usage. Annual cooperative savings are contributed to the patrons capital account until the "fair investment" figure is reached, at which time any additional savings are returned in a cash form back to the patron. When average cooperative usage declines, excessive contributed capital is returned back to patrons from annual cooperative net savings.

In a "permanent capital" plan a certain level of investment, usually in proportion to the rolling average patronage of a person over a specified period of years, is deemed by the board of directors to be a fair investment in the cooperative. This capital is permanently held by the cooperative until the average patronage by a person decreases or the patron ceases to do business with the cooperative, at which time the capital is returned to the patron under a specified pay-back plan.

The most widely used financing is the "revolving fund" method (9,P. 337). The main features of revolving fund financing are (1) it places the responsibility of providing increased financing on the most current patrons and (2) patrons are responsible for financing in proportion to the quantity of business done with the cooperative.

Placing the responsibility of financing on the most current patrons is accomplished by obtaining equity contributions from patrons in the current year and using those funds until they can be returned. Also, in keeping financing equitable, each patrons' annual share of capital contribution is based on the proportion of business done with the cooperative.

As capital, accumulated through patron contributions, reaches a sufficient level to conduct cooperative business under sound conditions, the revolving procedure may begin. As new capital contributed exceeds the required captial, the oldest outstanding (longest held) equities are refunded to the patron. Thus, the "revolving fund" is characterized by a constant inflow and outflow of funds which keeps ownership in the hands of the most current cooperative patrons in proportion to

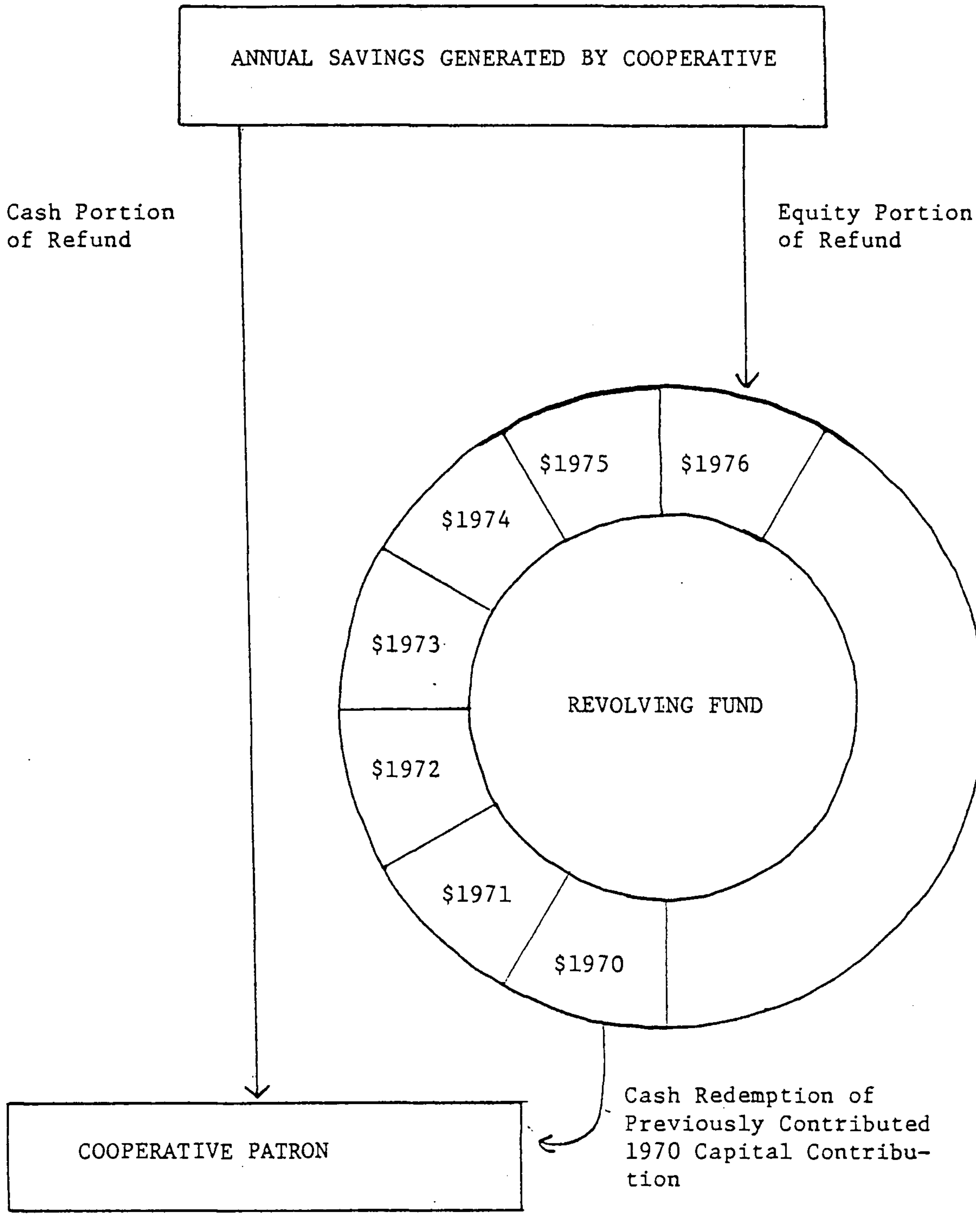

Figure 2. "Revolving Fund" Capital Financing Plan

their usage of the cooperative's functions.

Equity held in such a revolving fund gives rise to the possibility of transferring the equity interest at discount, with the expectation of the face value of the equity to be redeemed at the end of the revolving cycle.

Transferability of these cooperative equities is the central issue in this thesis.

SITUATION

Traditionally, because cooperatives have been viewed as member-owned and financed organizations, transfer of equity interest has occurred on a limited basis. Also, there are cases where cooperative bylaw provisions limit or prohibit equity transfer. Such provisions are generally justified on the basis that encouraging patrons to maintain equity interest instills greater personal interest and loyalty to the cooperative, and minimizes the likelihood of adverse influence by nonmember investors who may subsequently hold equity.

In more recent years, patrons are increasingly questioning whether it is essential for the patrons to personally hold their equity interest in cooperatives, especially since patrons' current benefits from the cooperative are not directly based on their personal equity interest in the organization. Patrons' current benefits are based on their quantity of business volume conducted with the cooperative and upon the effectiveness of the cooperative association in performing a service. The important point is that patrons are responsible for the financing of the cooperative; the question is, once the patron has incurred the responsiblity, is he obligated to maintain his individual equity contribution until it has revolved, or should there be an option to transfer the equity investment and thus shift the burden of long term financing to another person or entity?

The above transfer question is pursued more explicitly by cooperative equity holders when they have a significant personal need for cash to sustain or expand their farm operations. In addition, there are retired patrons, estates of deceased patrons and persons with discontinued memberships asking for immediate or accelerated redemption of the cash value of their accumulated equity interests. Although patrons, in agreeing to do business on a cooperative basis, are obligated to finance the cooperative, various circumstances appear to present a need to accelerate the returning of invested capital to patrons who cease to do business with the cooperative or has a current cash need.

Another factor which tends to intensify pressure for access to some means of obtaining the cash value of accumulated equity interests is the lengthening of a cooperatives' revolving cycle. Increasing capital needs, rising costs and below average market years, all of which stimulate additional capital needs or hinder generation of adequate current net margins, have tended to extend the revolving period by prolonging potential redemption of equity. This results in a larger investment by patrons and forces former patrons to hold equity interest longer, thereby lessening the financing responsibility of more current patrons.

Since there is no formal market for patron equities, and because the cooperative associations are not generally allowed to accelerate redemptions which would jeopardize the cooperatives long term viability, the holder of equity tends to have the value of such interests frozen into the cooperative. Thus, except in limited informal trading, the equity holder has few options to transfer equity interests for cash and must generally hold the equity until redemption or pledge the equity as collateral under a loan agreement. The latter has limited usefulness due to the uncertainty of a redemption date and the risk involved in the equity interest, which makes collateral valuation difficult.

Many cooperative members, directors and managers are quite concerned about the potential problems associated with freely transferable equity under current statute, tax regulations, traditional bylaw structure and cooperative philosophy. There are many unanswered questions as to potential State and Federal security registration and reporting requirements concerning equity allocation and transfer. Tax implications are not clearly interpreted in the event of equity transfer. There may be loss of loyalty to the cooperative in the case of a patron holding no equity interests. Potential pressure from non-farmer, non-patron investors may influence cooperative decisions if large equity holdings are transferred.

REVIEW OF LITERATURE

The literature available on the subject of equity transferability is usually included in publications dealing with cooperative finance or technical publications referring to specific tax or securities regulation. However, much of the technical knowledge needed in this study is contained in state and federal statutes which are reviewed in Chapters III and IV.

Much of the literature cited in this section will deal with cooperative finance and the implications made for equity transferability.

Tubbs, Alan Roy

In a Ph.D. dissertation entitled "Capital Investments in Agricultural Marketing Cooperatives: Implications for Farm Firm and Cooperative Finance", a thorough analysis of cooperative equity is undertaken. (14). Two of the major problems faced by farmer patrons financing the cooperative are a lack of cash flow and a loss of potential equity invested in the farm business to provide loan collateral or additional income. The lack of cash flow is caused by the annual cooperative investment made by patrons through retains or allocated margins and also delayed refunding of equity when the revolving period is extended.

The loss of adequate collateral for loan purposes by cooperative patrons was heavily stressed. As an example, typical New York bankers would be willing to accept equities at only ten percent of face value for collateral. If equities were transferable and possessed other desirable "investment characteristics", such as a due date and interest bearing, they would provide collateral of approximately 75 percent of face value.

Tubbs also suggested that substantial readjustment would occur if equities were transferable. Some cooperative members would favor further investing in the cooperative and others would benefit more by discounting equity for cash.

In conclusion it was stated that the most desirable characteristics equity investments could possess in order of importance are: (1) transferability, (2) reduced revolving periods, and (3) interest on equity investments.

Recommended further research stated "a study of how cooperatives might best establish a market for securities would be of great benefit". Also called for were "more imaginative ways to attract outside capital" and "how might some of the favorable investment characteristics found in this research be incorporated into the cooperative finance plan".

Marshall, Terry Dean

A 1970 master's thesis examined "cooperative equity certificate transferability and farmer preferences for selected means of financing cooperatives". It was concluded that transferability of equities would provide an opportunity for many farmers to allocate their own capital in a more profitable fashion. (6).

In conclusion it was stated that "in order for cooperatives to maintain viable memberships in the years to come, management must be increasingly attentive to the special situations in which their members become involved". These included (1) the cash needs of younger patrons, (2) the return of capital to retired or discontinued farmers, and (3) the opportunity for farmers to invest in the highest-paying alternative. Failure to recognize these needs may cause cooperatives to lose participation or experience diminishing member loyalty.

Weiss, Jerome P.

Mr. Weiss, one of the leading authorities on securities laws, has published several articles on this subject. A recent publication in the Cooperative Accountant suggests that cooperatives have demonstrated the ability to meet both its members' needs and satisfy high legal and social objectives. (15 p.3).

Cooperatives are currently being challenged in the area of securities regulation. "Cooperatives, as other corporations, have a responsibility to inform and deal fairly with members and patrons who purchase their securities". Whether or not a cooperative is currently exempted from SEC regulations or not, cooperatives have an obligation to treat investors fairly.

Since the existing cooperative exemption from SEC registration was partially upheld on the fact that there was limited or no trading in the equity securities of cooperatives, transferability of equities may put the exemption on shaky ground.

"Cooperatives in the future will be required to set forth their argument in intelligent and realistic terms and must seek to win their battles on merits".

Schrader, Lee F. and Goldberg, Ray A.

In a publication prepared under a research agreement between Harvard University and the Farmers Cooperative Service, the authors cover "Farmers' Cooperatives and Federal Income Taxes". (10).

It has been demonstrated in this study that the "advantage of cooperative tax status decreases as growth rates and patron tax rates increase". Therefore the evaluation of a cooperative enterprise must depend on "farmers' tax rates, capital costs and other factors external to the structure and operation of the firms involved".

With reference to capital costs, "Capital requirements per unit of labor at the farm level have been increasing rapidly and the return on incremental capital applied at the farm is often quite high". Todays aggressive, capital-short and financially aware farmers are paying strict attention to equity investment levels and the cost of losing liquidity.

Engberg, Russell C.

Mr. Engberg, in a book written for and published by the Banks for Cooperatives, suggests a move toward credit financing and away from equity capital accumulation. (1). He states competition and an urgent need for capital on the farm as a reason for difficulty in capital accumulation. A need to attract nonmember investment was also expressed.

With respect to Internal Revenue regulation Engberg states,

> "discussion is not possible because the IRS has not yet issued all regulations and interpretations. Another reason is that many of the questions involve technical and legal points; every cooperative should have the benefit of competent counseling when adjusting its particular financial plan to these requirements".

Wilson, E. Walter

In an article included in the American Institute of Cooperation's 1974-1975 annual yearbook, Mr. Wilson presents "A Basic Capital Financing Plan for Cooperatives". (18) One of the major features in this financing plan is to provide for marketability of debt and equity issues. Mr. Wilson indicates "certificates can and should be traded among members and the general public". The cooperative could serve as an intermediary between sellers and buyers until eventually the issues could be traded in the same manner as similar instruments of large non-cooperative corporations.

This marketability would significantly improve the individual patrons liquidity position and provide for a more fair and equitable treatment of all patrons.

Summary

It is evident that there is a great deal of concern about cooperative equity financing. Of the many proposed adjustments, transferability or marketability is the primary and most important adjustment. Without transferable equities the other adjustments, providing for desirable investment characteristics, would amount to taking money out of one pocket to put it in another.

Transferability of cooperative equities has many legal and philosophical implications which may have a severe impact on the short and long term viability of "doing business on a cooperative basis". This study will attempt to set forth the criteria for evaluating the costs and benefits associated with equity transferability and add greater insight into certain technical factors heretofore dealt with lightly.

RESEARCH OBJECTIVES AND METHODOLOGY

This project deals specifically with Oregon Agricultural Marketing and Supply Cooperatives who maintain and utilize patron's capital to sustain the financial base of the cooperative. Current interest in transferability of patrons capital interests (equities) has led to the need for research with the following objectives:

1. Define the nature and usage of allocated and retained equities with respect to cooperative bylaws; Internal Revenue Code and Rulings; Securities and Exchange Statute and Rulings; and from the viewpoint of knowledgeable cooperative managers, patrons, accountants, attorneys and bankers.
2. Identify the alternative methods of equity transfer available to cooperative patrons.
3. Evaluate the financial aspects of increasing cash flow to patrons versus the legal, taxation and long term philosophical consequences in allowing equity transfer.
4. As appropriate from the analysis, make recommendations concerning: a) specific decision-making criteria in equity transfers, b) by-law revisions which may protect the interest of cooperatives, c) optimum methods of increasing cash flow from transfers by equity holders, and d) avoidance of potential legal, accounting, and tax problems which may be faced by cooperatives, patrons and related parties.

The above mentioned research objectives are accomplished through the following methodology:

1. The subject, transferability of equities, is thoroughly defined

and all supporting and contributing literature is to be reviewed.

2. A number of Oregon agricultural cooperative bylaws are reviewed to ascertain the definition, the nature and usage of equities. Special emphasis is placed on characteristics that may affect the transfer or valuation of equities.
3. The Internal Revenue Code and Rulings are examined in order to, a) determine current taxation of cooperatives and patrons with regard to equity allocation and redemption, and b) identify the probable taxation that might occur should various forms of equity transfer be implemented.
4. Securities and Exchange Statute and Regulations are reviewed (state and federal) to identify a) the current regulation of cooperative's equities, and b) the future potential regulations that may occur under equity tranfer.
5. Alternate forms of equity transfers are examined with special emphasis on tax treatment which may affect cash flow. Alternative methods for improving cash flow are determined for patrons in various income levels and investment opportunities.
6. Conclusions and recommendations include a) identify criteria to be considered in allowing equity transfers, and b) list recommendations which may modify bylaws, limit cooperative exposure to adverse regulations, and improve cooperative service and response to cash needs of patrons.

CHAPTER II

REVIEW OF BYLAWS

The purpose of this review is to identify the general characteristics of equities as specified in the bylaw provisions of a sample of 20 Oregon agricultural cooperatives. The following Review of Bylaws comes from 20 Oregon Agricultural Cooperatives bylaws which have been accumulated by University personnel over the past year and are held in confidence. Bylaws reviewed come from approximately five marketing cooperatives, five supply cooperatives and ten cooperatives that are involved in both marketing and supply cooperatives. It should be noted that the major emphasis on these marketing/supply cooperatives range from large processing cooperatives to smaller supply cooperatives and cover a number of different commodities. There has been no random sampling nor will any statistical relationships be derived from these bylaws. The interpretation of bylaw provisions, which proved difficult in many instances, is the sole effort of the author in consultation with persons knowledgeable with regard to cooperatives.

In general, the bylaws constitute the governing rules applicable to the internal management of the cooperative (8, P.75). When a person becomes a member of the cooperative, the bylaws specify the rules by which the member and the cooperative agree to do business. Bylaws are subordinate to legislation and to the corporate charter but are superior to rules or regulations adopted by the cooperative unless the manner of adoption is the same as the manner by which the bylaws were adopted.

It is hoped that by reviewing the sample of bylaws, certain philosophical, operational and contractural rules can be generalized to better understand the nature and usage of "equities".

Factors to be specifically reviewed, with special emphasis on those factors affecting equity transferability and valuation for transfer purposes, are grouped into such areas as: (1) method of operation, (2) method of equity allocation, (3) clauses relating directly to transferability, (4) the revolving period, (5) redemption procedures of equities, (6) handling of losses, (7) liability of equity holder, (8) dissolution procedure, (9) death benefits to equity holders, (10) consent provisions, and (11) miscellaneous provisions.

All areas of operation not covered by bylaw provisions are assumed to have been left to the discretion of the Board of Directors of the cooperative.

BASIC BYLAW PROVISIONS

1. Method of Operation

   a) Fourteen cooperatives operate on a "distribution of net savings" basis with a revolving type capital plan.

   b) One operates specifically on a "per-unit retain" plan with three co-ops stating operating may be either on a "per-unit retain" or "distribution of net savings" basis. These four cooperatives also use a revolving capital plan.

   c) Two cooperatives have a "permanent capital" or "fair investment" financial structure with essentially no revolving capital while the patron maintains his average patronage.

2. Method of Equity Allocation

   a) Ten issue "certificates" evidencing equity allocation.

   b) Six issue "notices" declaring an amount placed on the patrons equity account (sometimes known as book credits).

   c) Two state that either a "certificate" or "notice" may be used, at the discretion of board of directors.

   d) Two cooperatives do not specify how an allocation is to be evidenced.

   e) Three indicate a distribution of stock may replace a "certificate" or "notice" of allocation.

3. Transferability Clauses Relating to Equities

   a) Five cooperatives do not mention transfer rights of equities.

   b) Of 15 cooperatives mentioning transfer rights, four restrict transfer in some way. Provisions restricting transfer include: (1) "assignable" only after certificate has been outstanding for four years, (2) no "assignment" after the death of patron-holder, (3) only "transferable" to the heirs of a patron upon death, (4) must offer the equity to the co-op first, then only to cooperative approved members, (5) eliminate "transferable" after a 30 day notification, (6) not transferable within 30 days of a declared redemption date, (7) transfer may be limited to agricultural producers.

c) Ten state specifically that "transfer" or "assignment" is possible only on the books of the cooperative upon proper notification by the holder.

d) Most cooperatives use the terms "assignment" or "transfer" to describe general transferability; one uses "sale". (footnote, P.56)

4. Revolving Period

a) Duration of the revolving period is set by the board of directors in all cases examined.

b) One cooperative suggests a ten year revolving period be maintained as closely as possible.

c) No cooperatives set a maximum or minimum duration for a revolving period.

5. Redemption of Allocated Equities

a) Revolving equities were all redeemed according to the year issued with the oldest being redeemed first.

b) The method of payment is usually not specified.

c) One cooperative states that equities may be redeemed with 15 year notes, the interest rate thereon being set by the board of directors.

6. Handling Losses

   a) Eight cooperatives do not have bylaw provisions covering handling of losses.

   b) Four specifically authorize losses to be allocated against outstanding equities, if necessary.

   c) Two cooperatives may allocate current losses to outstanding equities held by patrons.

   d) Three indicated losses may be charged to the current patrons in the year of the loss.

   e) In most cases the board of directors retain the authority to allocate losses as they see fit.

7. Liability of Equity

   a) In all co-ops, the equity held is subordinate to the creditors of a cooperative.

   b) In most cases equity redemption value may be reduced by the amount of the outstanding debt accumulated by the equity holder due and payable to the cooperative at the time of redemption.

8. Dissolution Procedure

   a) Five cooperative's bylaws did not mention dissolution procedure (dissolution provisions may be contained in the articles of incorporation which were not available).

   b) The remaining bylaws stated generally that all outstanding equities will be redeemed at face value if funds are available after paying co-op debts and redeeming capital stock. If funds are not available to redeem all the outstanding equities at face value they will be paid on a pro rata basis and not according to year of issue.

c) Any additional funds remaining from dissolution will generally be returned to the members or patrons of a specified period of time.

d) One co-op states that funds in excess of that necessary to redeem equities will be distributed to "members at time of dissolution...in proportion to their owned equity".

9. Death Benefits

a) Eight cooperatives did not mention death benefits to equity holders in their bylaws (death benefits could be covered in articles of incorporation).

b) Three cooperatives have a limited cash payoff available at the death of an equity holder. Most co-ops limit such death benefits to members or patrons (not heirs, investors, etc.).

10. Consent Provisions

a) All bylaws reviewed include a section constituting a consent of members to personally assume the tax liability on allocated equities in the year allocated.

11. Miscellaneous Provisions

a) One cooperative states specifically that an "equity certificate shall not constitute or evidence any debt by the cooperative to the owner or holder thereof".

b) Another indicates allocated equities will be considered a "contribution to the capital" of the cooperative.

SUMMARY

It can be readily observed that while cooperative bylaws do have much in common, they do not have a highly homogeneous set of rules governing the characteristics of equities. In most cases, determination of the manner in which equities are issued and redeemed is left to the board of directors. This suggests that the handling of equities can vary from year to year and from cooperative to cooperative.

The following outlines characteristics which "average" or "typical" equity will generally possess. An equity is a patronage refund or per-unit retain which has been allocated to the patron on a book credit basis as his proportional share of financing responsibility. This equity is allocated under terms of the contractual relationship between patron and cooperative which includes bylaw provision or board of director discretion where appropriate, such as determining the duration of the revolving period. Patrons generally agree to include properly allocated equities in their personal income rather than having the cooperative taxed on such capital.

As to the form of an equity allocation, it is evidenced by a notice or certificate which states the face amount of the equity allocated, possesses no due date, is generally non-interest bearing, its face value is subject to reduction in order to offset equity holder debt, cooperative debt, or cooperative losses and is subordinate to all creditors of the cooperative.

There is no specific standard to follow to determine or limit the number of unique properties an equity may possess, which often leads to difficulty in generalizing about them. However, there are several properties and terms which may be significant when dealing with legal applications. Such properties as possessing no due-date or interest takes equities out of a strict debtor-creditor relationship. Several cooperatives have stated expressly in bylaws that equities in no way represent a debt or obligation of the cooperative. The fact that it is "allocated" to patrons on a pre-determined basis rather than sold to the public leads to confusion over application of securities law. Terms expressing equities as "capital contributed back to the cooperative" may intensify the joint-venture nature of the cooperative rather than a detached investment. Equity interests which are generally "assignable" or "transferable" rather than "saleable" may also have legal implications, as these terms are not generally synonymous in law.

Factors contained in bylaws affecting transfer of value of an equity, assuming the equity interests are transferable, are such items as "non due-dated and non-interest-bearing," "prior written notice of intent to transfer," "no transfer within 30 days of redemption," and "transfer limited to agricultural producers." Cooperative operations which may affect transfer value are duration of revolving periods, method of handling losses and offsets, and dissolution procedures. In some rare cases, bylaws have been worded in such a way that excess funds in dissolution could go to equity holders, who may not have been patrons if an equity transfer has occurred. Most benefits in dissolution, or in the case of early repayment of equity because of a holder's death is limited to original equity holders (patrons).

In conclusion, bylaws generally do not detail equity transferability or clearly specify equity allocation methods and revolving fund operation. Many of the financing and policy decisions are left to the board of directors. This implies that cooperative management and boards of directors are responsible for being informed and aware of all pertinent factors related to their decisions.

CHAPTER III

TAXATION AND COOPERATIVE EQUITIES

PREFACE

One of the major benefits in operating on a cooperative basis is the realization of the special tax treatment provided for cooperatives and their patrons. The interpretation of tax laws relating to cooperative equity handling is at best very difficult and even more complicated when equity transferability is included. The following tax review will attempt to interpret the Federal tax handling of cooperatives, patrons and equity transfers. Since the tax treatment of cooperative equities in most states coincide with Federal tax regulation, state tax law will not be reviewed at this time.

TAX REVIEW

Farmers' cooperatives are differentiated in the Internal Revenue Code (IRC) and fall into two categories--"exempt and nonexempt". Requirements for classification as an exempt cooperative are contained in IRC Section 521, with all other cooperatives which do not qualify as exempt being nonexempt.

There are important differences between exempt and nonexempt cooperatives from the standpoint of both taxation and securities regulation. In taxation, exempt cooperatives are allowed specific deductions from gross income which are not allowed by nonexempt cooperatives. These deductions are such items as certain nonpatronage allocations, income received from doing business with the U.S. Government and limited dividends paid on capital stock.

Also, in the context of Securities and Exchange law, special treatment is currently afforded only to exempt cooperatives in certain situations which are examined in a later section.

Whether exempt or nonexempt, Subchapter 'T' regarding "Cooperatives and their Patrons" contains the major reference to cooperative tax procedures found in the IRC. This subchapter consists of three parts entitled "Tax Treatment of Cooperatives," "Tax Treatment by Patrons of Patronage Dividends" and "Definitions and Special Rules".

When discussing equities, the IRC recognizes two types of equity allocation. Equity allocation may be either "allocated patronage dividend" or "per-unit retain allocations" and, in some cases, a combination of both.

Allocated Patronage Dividends and Per-Unit Retain Allocations

The IRC defines patronage dividends as,

> "an amount paid to a patron by an organization to which part I (tax treatment of cooperatives) of this subchapter applies--(1) on the basis of quantity or value of business done with or for such patrons, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to net earnings of the organization from business done with or for its patrons...."
> [IRC, Sec. 1388(a)]

Equity allocations of all or a portion of a patronage dividend occurs through distribution of a "written notice of allocation", defined as follows,

> "...written notice of allocation means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him..." [IRC, Sec. 1388(b)]

The IRC defines per-unit retain allocation as,

> "...any allocation, by an organization to which part I (tax treatment of cooperatives) of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron". [IRC, Sec. 1388(f)]

Both "written notices of allocation" and "per-unit retain allocations" are evidenced by issuance of a written notice or certificate.

Qualified and Nonqualified Allocations

The allocated patronage dividends and per-unit retain allocations may be in one of two forms, "qualified" or "nonqualified".

Rules for determining "qualified" and "nonqualified" forms of equity allocation are contained in the IRC. A "qualified written notice of allocation", other than notices indicating cash disbursements available to the patron, is defined as follows,

> "a written notice of allocation which distributee has consented in the manner provided...to take into account at its stated dollar amount..." [IRC, Sec. 1388(c) (1) (B)]

Also, at least 20 percent of the total patronage dividend must be paid in cash or a cashable check to attain the "qualified" status. The patron must consent, as provided in the IRC, to include the stated dollar amount of the written notice of allocation in his ordinary taxable income in addition to the cash payment he receives.

A "qualified per-unit retain certificate" has the same requirements (patron consent) without any obligation on the part of the cooperative to make a cash payment during the current taxable period. [IRC, Sec. 1388(h)]

"Nonqualified" forms of equity allocation are defined in a negative manner. Nonqualified written notices of allocation and non-qualified per-unit retain certificates are essentially those which do not meet the requirements for qualified allocations. [IRC, Sec. 1388(d)& 1388(

In addition to the rules covering their determination, a significant difference between qualified and nonqualified is in the tax liability incurred by the patron and the cooperative in their issuance and redemption.

Since the Internal Revenue Service follows the "single current tax" concept, all cooperative earnings are included in either the cooperative's or the patron's taxable income in the year of such earnings. (13, p. 26). The cooperative's net earnings are not subject to double taxation if they are allowable allocations under the IRC regulations and are distributed properly to the patrons.

The most frequently used form of equity allocation is the "qualified written notice of allocation" or the "qualified per-unit retain certificate". This qualified form of equity allocation allows the cooperative to pass the full amount of allocation on to the patron. The general rule is that patrons shall include the face amount of any qualified equity allocations received by him during the taxable year in his ordinary individual gross income. [IRC, Sec. 1385(a)] The cooperative deducts the full amount of this allocation from its gross income.

When nonqualified notices of equity allocation are used, the cooperative includes the face amount of the allocation in its corporate taxable income for the current period while the patron is not taxed on this allocation. However, at the time of redemption of the nonqualified equity allocation the cooperative receives a tax deduction equivalent to the amount of equity redeemed in that period, while the patron includes the face amount of redeemed allocation in his current "ordinary" taxable income.

It should be noted that nonqualified equity allocations are rarely used as a practice in cooperative operations.

The tax treatment of cooperatives is more explicitly defined in the IRC as follows,

> "In determining the taxable income of an organization to which this part applies (farmers' cooperatives)... "such items are excluded" (1)...patronage dividends,

> to the extent paid in money, qualified written notices of allocation or other property (except nonqualified written notices of allocation) with respect to patronage occurring in such taxable year, (2)...money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation...(3) per-unit retain allocations to the extent paid in qualified per-unit retain certificates...or other property (except nonqualified per-unit retain certificates)...(4) in money or other property (except qualified per-unit retain certificates) in redemption of nonqualified per-unit retain certificate..." [IRC, Sec. 1382(b)]

The computation of tax where the cooperative redeems nonqualified equity allocations and receives a deduction for such amount is also covered by the IRC,

> "...the tax imposed...shall be the lesser of the following: (1) the tax for the taxable year with such deduction; or (2) an amount equal to--(a) the tax for the taxable year without such deduction, minus (b) the decrease in tax under this chapter for any prior taxable year (or years) which would result solely from nonqualified per-unit retain certificates as qualified written notices of allocation or qualified per-unit retain certificates (as the case may be)." [IRC, Sec. 1383(a)]

Tax Consequences in an Equity Transfer

The tax effect of equity transfers by cooperatives and patrons are of prime importance in this section. The following text will attempt to define a certain transfer of equity and summarize the tax treatment of such a transfer. In many cases IRC regulations will not be specific, at which time selected revenue rulings and certified public accountants' opinions will be drawn upon to ascertain probable tax consequences.

Transfers Affecting the Cooperative

In the event a properly allocated equity is transferred by any means among persons (other than the issuing cooperative), there is apparently no change in the tax liability of the cooperative in present or future periods.

In the case where a cooperative repurchases its previously issued equity allocations at a discount there would probably be no taxable gain. This opinion was voiced by certified public accountants having access to a 1975 private revenue ruling.[1]

Sale or Assignment of Equity for Value

When both "qualified" and "nonqualified" equity allocations are transferred by sale or assignment for value, it appears that the loss or gain incurred by the original equity holder (patron) shall be "ordinary" rather than "capital" in nature.[2] Section 1221 of the IRC defining capital assets excludes certain taxpayer's property "acquired in the ordinary course of trade or business" from treatment as a capital asset. Following this logic, it has been held by the IRS that any gain or loss in the redemption of patronage allocations will be ordinary. [Revenue Ruling (20-64)]

In the transfer for value of a "qualified" equity by an original holder, the ordinary gain or loss is determined by the difference be-

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[1]Careful attention by the cooperative and patron should be given to IRC Section 1091 - "Loss From Wash Sale of Stock or Securities" - When actually repurchasing issued equities within a short period of time.

[2]Some equities are given capital gain treatment if issued prior to December 2, 1959.

tween the selling price and the face value of such equity. [Private Revenue Ruling, 6/26/75] The equity in the hands of a subsequent purchaser of this "qualified" equity appears to be a capital asset with the tax basis equal to the purchase price. [40 T.C. 946] The subsequent gain or loss on the transfer or redemption of this "qualified" equity held as a capital asset would apparently be handled according to IRC procedures for any other capital asset.

Transfers of equity, distributed in the "nonqualified" form, are referred to specifically in the IRC.

> "gain on the redemption, sale or other disposition of such written notice of allocation or per-unit retain certificate by any person shall, to the extent that the stated dollar amount of such written notice of allocation or per-unit retain certificate exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset" [IRC, Sec. 1385(c) (2) (C)]

The tax basis of nonqualified forms of equity in the hands of the original holder is zero. [IRC, Sec. 1385(c) (2) (A)] Since the basis is zero the tax liability incurred, on <u>any gain</u> from the redemption, sale or other disposition of the equity, would apparently be the full face amount of such equity for the original holder.[3]

According to a professional accountant's opinion, in incurring a tax liability for the full face value of the nonqualified equity upon sale or other disposition, the patron may also declare a loss that would

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[3]It would appear that the term "other disposition" would apply to transfers not involving any gain such as gifts, donations or transfers in estate.

be incurred from selling the equity at discount. The net effect would require the patron to declare a full gain on the face value of the equity and also allow him to declare a normal loss on the difference between face and sale value. The overall handling of "nonqualified" equities in the first or subsequent years would essentially be the same as the treatment of "qualified" equities in the year of issuance.

According to a strict interpretation of IRC, SEc. 1385(c), previously quoted, in the event of a transfer for value the subsequent holder of the nonqualified equity would be subject to taxation on the difference between his basis and the "stated dollar amount" of the equity. The subsequent holder's basis would apparently be the value paid for such an equity. In this case, should the final redemption or subsequent resale price not equal the face value of such an equity, the person who held the equity could be taxed on an amount greater than the actual gain. This interpretation of tax law would severely hinder the trading of nonqualified equities.

In all cases it appears that gains or losses incurred in transfer or redemption of "nonqualified" equity would be "ordinary" rather than "capital" whether or not the holder of such equity was the original or subsequent holder.

Charitable Contributions

With respect to a charitable contribution of equity, the IRS has made their position clear in at least one available opinion. In a private opinion it has been held that a charitable contribution of a "qualified" equity allocation will constitute a tax deduction for the donor in an amount equal to the "fair market value" of such a contribution. Although the patron includes the face amount of the "qualified" equity as taxable income at the time of allocation he will only be allowed a deduction equal to the fair market value, according to the opinion. Following this same logic, it would appear that the deduction allowed to any holder of "qualified" or "nonqualified" equity would be the "fair market value" of such equity.

Gifts

The gift of an equity to any person or organization other than charitable contributions is taxable as a gift, as specified by IRC, Chapter 12-"Gift Tax." Assuming the gift is not included in the annual or lifetime gift exclusion, the donor is responsible for the tax imposed on the value of the gift. "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." [IRC, Sec. 2512(a)] The value of the equity on the date of the gift will apparently be represented by a "fair market value".

The donee is not liable for tax on the amount of the gift. However, he inherits the donor's tax basis for the determination of gain or loss in the eventual transfer or redemption of such an equity.

> "If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or last preceding owner by whom it was not acquired by gift, except that if such basis... is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value." [IRC, Sec. 1015(a)]

Assuming the basis of a "qualified" equity is the full face value of the equity in the hands of the first holder, the basis in the hands of the recipient of such a gift will be the full face amount.

A subsequent holder will also pass his tax basis, whatever it may be, on to the receipient in the case of a gift.

According to a professional accountants opinion, although the basis in the hands of an original holder of "nonqualified" equity is zero, upon gifting the property a disposition of a nonqualified equity has been made which triggers an income tax liability on the full face value of the equity. This then raises the basis from zero to the full face value which is passed on to the recipient of the gift.

As indicated in [Sec. 1015(a)], should any dispositon of this equity after the gifting cause a loss, this loss would be determined by using the fair market value of the equity at the time of the gift rather than the tax basis in the hands of the current holder.

Estate Transfers

Cooperative equities are included in the gross estate of a decedent at their fair market value prior to transfer, as covered by Part III--Gross Estate, of IRC Subtitle B., Chapter II--"Estate Taxes."

> "The value of the gross estate of the decedent shall be determined by including to the extent provided in this part, the value at the time of his death of all property, real or personal, tangible or intangible." [IRC, Sec. 2031(a)]

Generally, equity acquired from a decedent is held at a basis described as follows:

> "the basis of property in the hands of a person acquiring property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of decedent's death..." [IRC, Sec. 1014(a)]

This treatment of property acquired from a decedent apparently only applies to "qualified" forms of equity. Treatment of "nonqualified" forms of equity is specifically covered by the IRC in Subchapter 'T' as follows:

> "the basis of such written notice of allocation or per-unit retain certificate which was acquired from a decedent shall be its basis in the hands of the decedent." [IRC, Sec. 1385(c)]

Thus, the person who acquires this nonqualified equity holds it at the same basis as the decedent and is subject to all tax consequences upon further dispositon of the equity as described in the previous text.

CHAPTER IV

SECURITIES AND COOPERATIVE EQUITIES

At the time of this study (1976) there is a great deal of confusion concerning the status of cooperative equities under the current securities regulation. Recent developments have increased the controversy and speculation involving the total cooperative operation with respect to securities regulation and the handling of equities. These developments include the Securities and Exchange Commission (SEC), (1) instituting proceedings against a large bargaining cooperative under anti-fraud provisions of the 1933 and 1934 Securities Acts, (2) refusing to issue no-action letter[4] regarding the sale of cooperative memberships and patronage-type evidences of interest, and (3) requiring a large cooperative to take immediate steps to register its initial patronage equity instruments.[5]

The controversy, which encompasses regulation of all types of cooperative equity allocations in issuance and subsequent disposition, is not new. A 1958 publication states, with reference to equities, "courts have not infrequently been perplexed as to the character of particular forms of certificates which were before them, primarily because of their hybrid character and their ambiguous provisions." (12 P.228)

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[4]"No-action letter" refers to an acknowledgement by the SEC that their office will not construe a certain transaction of a security type instrument to be exempted from security regulation.

[5]"Agribusiness" Volume 2, No. 5, Touche Ross and Co., Aug./Sept. 1975.

In order to analyze the economic effects of equity transfer, the consequences of doing so must be weighed with as much knowledge as possible. Therefore this securities review will attempt to bring the subject of the issuance and transfer of equities into as accurate a current perspective as is possible, given available references. In doing so, current statute and regulations will be examined, opinions and positions of reputable sources will be cited and proposed future legislation will be reviewed.

FEDERAL SECURITIES LAW

Basic Acts

Federal law covering securities has been enacted in two primary segments, the Securities Act of 1933 and the Securities and Exchange Act of 1934. The 1933 Act provides for full disclosure in the public offering of securities and fraud prevention in the sale of securities. The 1934 Act regulates the trading of securities by brokers, dealers and the like and also authorized the establishment of a regulatory body known as the Securities and Exchange Commission. (15 P. 6) Both of these acts are combined under Title 15, Section 77 of the United States Code.

Registration and Reporting Requirements

Exemption from registration and periodic reporting requirements is generally extended to farmers' cooperatives by the acts. However, the 1933 law exempts only those cooperatives defined as "exempt" under Section 521 of the Internal Revenue Code (IRC). The 1934 act exempts those cooperatives as defined by the Agricultural Marketing Act of 1929, which is a broader interpretation that includes most farmer cooperatives.

Although tax "non-exempt" cooperatives (those not qualifying as exempt under Internal Revenue Code regulation) are not specifically exempted from securities registration under the 1933 law, they do not register equity allocations as a practice.[6]

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[6] Letter of opinion re: Mid-American Dairymen, National Council of Farmers Cooperatives. (Source confidential)

The main reason for not registering equity allocations is that the patron-cooperative relationship has not commonly been regarded as a "security relationship" and the instruments used in patronage distribution are not commonly known as "security instruments."[7] There are also two technical, legally based reasons for not registering equities: (1) since there may be "no offer to sell" equities to patrons in these allocations they may not fall under securities regulation, and (2) instruments of the cooperative equity character do not explicitly fall into the definition of a security. These reasons for not registering equity allocations are individual interpretations of the securities law which have not been sufficiently tested to either uphold or reject the practice. It is not suggested that these defenses be relied on to provide the sole basis for not registering an equity allocation.

Anti-Fraud Provisions

In any case, all cooperatives whether exempted under securities law or not, must be aware of the anti-fraud provisions concerning issuance and subsequent trading of securities. The fact that a security is exempted from registration does not protect the cooperative from misuse or misrepresentation of a security.

One liability provision of the 1933 act provides a purchaser with civil remedies for intentional or negligent misstatements or omissions by a person who offers or sells a security. Another provision contains general anti-fraud provisions which prohibit fraudulent schemes or

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[7] Letter of Opinion, Re: Mid-American Dairymen, National Council of Farmers Cooperatives. (Source confidential.)

misrepresentations in the sale of securities.

It is possible that in the case where a court declares the issuance of a cooperative equity instrument a security, the issuing cooperative may be held liable for civil remedies. The civil remedies include the right of the purchaser to recover the consideration paid for the security less any income derived from such security, and/or damages incurred in its purchase or subsequent disposition. This could essentially remove the entire capital base of a cooperative.

Other Exemptions

Some cooperatives may qualify for other registration exemptions or exempted transactions under the federal securities law or SEC regulatory rules. The following briefly summarizes the criteria for certain exemptions.

Registration requirements shall not apply to,

> "Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." [U.S.C. Title 15, Sec. 77C(a) (9)]

"Intrastate transactions" are generally exempted from federal securities requirements.[8] The offer and sale by a domestic cooperative doing business only in the state of their incorporation and with all patrons residing in that state may be an exempted transaction. [U.S.C. Title 15, Sec. 77c (a) (11) and SEC Rule 147]

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[8]It should be noted that the use of telephone communications or U.S. mail service in the distribution of equity instruments may be construed to be interstate because of these methods of communication being "instruments of interstate commerce."

Small dollar volumes of equity allocation may also be exempted. SEC Rule 240 and Regulation A contain rules for exempting issuances of up to $100,000 or $500,000, respectively.

Strict requirements followed in a transaction deemed not involving a public offering may also provide relief for a small cooperative. Such requirements are constructed to insure that the purchaser of the security is knowledgeable and has access to all information that would normally be available in a registration statement. There is also a limitation of 35 purchasers per offering and securities issued in this manner shall not be transferable. (SEC, Rule 146).

It has been noted that although these exemptions have been provided they are "often so severely conditioned in one way or another that they may not actually be available."[9]

[9] Personal letter from Professor Louis Loss, Harvard Law School, chairman of the committee to rewrite the new securities law for the U.S. Congress, in reply to questions concerning this study.

POPULAR OPINION

At this point in time there appear to be two different approaches taken by cooperative management and professional advisors to resolve the securities question. The first examines the philosophical basis of cooperative methods of operation and weighs this method of operation against the intent of the securities law. The second approach is based on an examination of legal cases involving securities definition and methods of offering, and testing cooperative operating methods against the legal criteria. Both of these approaches have merit and they both may eventually lead to the same conclusion.

Philosophical Approach

The philosophical approach is one taken by most persons seeking not to register cooperative instruments. This argument is probably best exemplified in a "Statement of National Council of Farmers Cooperatives-Re: Request of Mid-America Dairymen for 'No-Action Letter.'" The main thrust of the argument was to provide background information regarding the magnitude, complexity and practical implications of determining what constitutes a "security" in the context of the patron-cooperative relationship. The criteria for determining if an instrument or transaction constitute a "security" which are listed in this statement are summarized as follows.

A. Examples of Transaction Clearly Involving Offer or Sale of Securities:

(1) The interest is sold not as a condition of or an integral part of the patronage relationship, but

purchase is optional. (interests sold to patrons or non-patrons).

(2) By their terms the instruments provide income to the purchaser based on capital invested (profit based on capital investment).

B. Factors which tend to make Memberships, Patronage Contracts and Patronage Allocations Not a Security.

(1) All of the benefits of operation are returned on the basis of patronage. No return is based on capital supplied.

(2) Capital is not a material income producing factor and is a clearly subordinate factor to the primary function of selling farm products, procurring farm supplies or providing farm services at cost.

C. Facts to Consider in Determination of Existence of Security in Farmer Patron-Cooperative Context.

(1) Key factors to consider indicating consumption of services at cost rather than investment profit characterizes the relationship.

(a) Operation at cost for the benefit of producer-patrons as producers.

(b) Control by current producer patrons.

(c) Share in income from incidental profit activities not a material inducement.

(2) Factors Inclining toward the Possible Presence of a "security".

(a) Presence of a promoter.

(b) Profit on non-member non-patronage business as a material inducement.

(c) Ready marketability and existence of market for transfer of interest to outsiders.

(3) Factors that should not be Controlling.

(a) Retention of a portion of net proceeds.

(b) Size.

(c) Difference of degree of capital requirement due to basic cooperative activities.

(d) Title vrs. Agency in handling patrons product.

(e) Pooling products of many patrons.

(f) Pledge or gift of patronage interest.

Among the list of factors to consider in determining the existence of a security are two important points directly influencing transferability of equities. Under point C (2) (c), "Ready Marketability and Existence of a Market for Transfer of Interest to

Outsiders", the text goes on to say,

> "If an interest of a farmer-patron in a cooperative has characteristics designed to make the interest freely marketable, and there is a significant market with non-patrons, these facts may provide characteristics of an instrument or instruments commonly known as a 'security'. A combination of the following two characteristics would tend in this direction: (a) a return competitive in the current money market based on the amount of capital invested or retained, and (b) freedom to transfer."

"Pledge or gift of patronage interests", in point C (3) (f) continues as,

> "the existence of marketable terms on a patronage allocation may suggest that a portion of net margins or net proceeds has been paid by issuance of a conventional investment security, and existence of a material amount of trading with non-patrons may suggest that the patrons are underwriters in accomplishing a distribution. However, the incidental pledge of patronage interests as security or transfer by gift or operation of law (e.g. at death) should not suggest that interests arising as an integral part of the patronage relationship are a security."

Legal Approach

The alternate approach to the securities question is often taken by the person with a legal background and involves defining a genus of "securities" through the combination of statute and legal precedence criteria.

Among the most competent and influential lawyers commenting on this subject is Mr. Jerome P. Weiss. In a paper presented in 1975, (15 P. 3), he suggests that patronage distributions may contain basic investment characteristics and be called securities subject to federal regulation. Basic investment characteristics constituting a security, as determined by the U.S. Supreme Court, are (1) whether a person invests his money in a common enterprise, and (2) whether such a person is led to expect profits solely from the efforts of the promoter or third party. Point (2) has been broadened by the SEC indicating that if persons other than the investor render essential managerial efforts which produce the profits or other beneficial return, such an arrangement is an investment contract. (17, P. 8)

Another important fact mentioned by Mr. Weiss with respect to transferability of cooperative equities is as follows:

> "In contrast to the lack of deliberation on the cooperative exemption from registration under the 1933 Act, the hearings on the 1964 Act amendments to the 1934 Act indicate support for a cooperative exemption based on an evaluation of the objectives of the legislation and the nature of cooperative securities. However, the exemption was predicated upon the fact that cooperative securities customarily are held by farmers and contain restrictions on their transfer and the return that is paid upon them. These conclusions resulted in finding by the SEC that there was little or no trading in the equity securities of cooperatives, which finding has yet to be supported by fact. In fact, there apparently is a limited market for trading in the securities of cooperatives and this limited market places the 1964 Act exemption on rather shaky ground." (15 P. 14).

Another noted attorney speaking on the subject of cooperatives and securities regulation is Mr. Henry D. Shereff. In a presentation to the Practicing Law Institute in 1976, Mr. Shereff indicated that a thorough search of all existing legal tests of a security had been conducted and while none of these tests specifically classify equities as securities, there are many arguments that would tend to put them in the genus of securities.

In a summary section entitled, "Should the Non-Exempt Agricultural Cooperative Register", Mr. Shereff makes several points.

(1) The SEC staff has consistently stated its position in response to a series of no-action letter requests stating that cooperative memberships are securities and that savings of purchasing cooperatives and earnings of marketing cooperatives are profits. In one instance, the SEC staff has stated its position that retention instruments (equities) are securities.

(2) Failure to register securities that a cooperative has not been exempted from registering, may result in long expensive litigation. The cooperative may be forced to redeem outstanding unregistered securities and be subject to reparation of damages incurred by security holders.

(3) Registration is expensive but litigation is likely to be more expensive.

(4) The greatest risk, if registration should ultimately prove to be unnecessary will be a few red faces. The risk in failing to register may be an enormous financial distress for the cooperative.

(5) Small local cooperatives may find relief in other exemptions (many of which have been mentioned in an earlier section of this chapter).

In conclusion, Mr. Shereff states, "the agricultural cooperative must join with its attorneys and accountants in the risk-benefit anaylsis which should precede any decision whether or not to register." It should be noted that this suggestion was made with reference to currently tax non-exempt cooperatives who are not exempted from registration under the 1933 Securities Act.

PROPOSED FEDERAL LEGISLATION

At this time there is an effort underway by Professor Louis Loss of Harvard Law School to redraft a new Federal Securities Code which hopefully will clarify many of the controversial points and inconsistencies in the current law. The most recent draft of the proposed securities code with respect to cooperative exemptions from registration reads as follows:

> "(j) Cooperatives. A security issued by (1) a cooperative association as defined in the Agricultural Marketing Act approved June 15, 1929 or a federation of such associations that possesses no greater powers or purposes than such an association if the security (A) is part of a class issuable only to persons who deal in commodities with, or obtain services from, the issuer, and (B) is transferable by sale only to such persons or the issuer."[10]

This proposed language continues on to exempt from registration "mutual or cooperative organizations" such as cooperative consumer groups and cooperative housing corporations as defined in IRC, Sec. 216 (b) (1).

The important features of this redraft are: (1) the exemption for cooperative associations is based on the broader definition of cooperatives in the Agricultural Marketing Act of 1929. (2) The proposed exemption is not only extended to farmers' cooperatives but also consumer and housing cooperatives. This suggests that the exemption is predicated upon the existence of a unique patron-owner relationship rather than special recognition of farmers. (3) The

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[10] Louis Loss redraft, Reporters Revision of Text of Tentative Drafts Nos. 1-3, October 1, 1974

exemption applies only to securities issuable to and transferable among persons who deal in commodities with, or obtain services from the issuer. There is also a specific or implied limit on dividends received on the investment. Such an exemption would seem to include security issues to persons who seek or need a service provided by the cooperative and not issues held primarily for a profit or return on an investment in the cooperative itself. (4) It should finally be noted that the draft cited is a proposed draft.

Contingency plans are included to adjust the terms of the cooperative exemption, which will be available for Congressional debate. The narrowest exemption would change clause (j) (l) A, under the proposed cooperative exemption cited above, to "securities which qualifies its holder to be a member of the issuer." This would essentially exempt only cooperative membership contacts or possibly equity interests which "qualifies its holder to be a member" of the cooperative.

The next broader exemption would add the following clause to the narrowest exemption, "or, in the case of a patronage refund certificate or similar security." This would evidently exempt membership contracts and equity type evidences from registration.

A still broader exemption is the quoted exemption in (j) (l), cooperative exemption, cited in the previous section. This wording would apparently exempt all transactions occurring between the cooperative and only its patrons.

The broadest possible exemption would be a total exemption from registration of all cooperative securities. However, this exemption does not appear to be a viable alternate given the current controversy over cooperatives.

Under any circumstances, the proposed redraft of SEC Statutes would apparently not relieve the cooperative of any fraud or civil liability provisions.

OREGON SECURITIES LAW

Oregon's securities law is presented in Chapter 59, "Securities", in the Oregon Revised Statutes (ORS). This chapter includes the same definition of a security as the federal code, which does not expressly include or exclude cooperative equities. This leaves the same potential problem of determining where cooperative equities fall within the scope of the law.

Registration and Reporting Requirements

Notwithstanding the definitional question, there is a general exemption from registration and reporting requirements provided for cooperatives.

Exempted are,

> "stock or membership certificates issued by agricultural cooperative corporations or irrigation associations where such stock is issued to evidence membership in such cooperative or association or as patronage dividends and certificates issued to members or patrons by such a cooperative or association evidencing their respective interests in reserves or as patronage dividends..."
>
> (ORS 59.025 (9))

This exemption is apparently extended to cooperatives as defined in ORS, Chapter 62, "Cooperatives". Virtually all farmer cooperatives in Oregon are included under this chapter.

Fraud and Elimination of Exemptions

Although the exemption is broad and currently uncontested there are still particular provisions worth noting. (1) Cooperatives are still subject to anti-fraud provisions of the law. (2) Also, as provided in the statute,

> "The Corporation Commissioner may by rule or order as to any security or sale or any type of security or sale, deny, withdraw, or condition the exemption allowed by ORS 59.025."
>
> (ORS 59.045)

This gives the impression, by Executive Order of the Corporation Commissioner, such exemptions as are available under Oregon law may be discontinued, most likely in the protection of investors and/or in the public interest, criteria which are mentioned earlier.

SUMMARY

As is evident, the question of whether or not a cooperative issues securities in the allocation of equity is largely unanswered. From a recent U. S. Supreme Court decision, it is evident that a great deal of importance is placed on the "economic reality" of an instrument or transaction rather than the form or name of an instrument.[11] If court cases are initiated involving equity allocations and/or equity transfers, it is possible that the economic reality in similar situations may differ widely further confusing the issue.

It is comforting to note that many of the controversial areas of the existing securities law appear to be more clearly defined and dealt with in the proposed redraft of the SEC code. The draft indicates indirectly that cooperative equity allocations are securities and then goes on to propose exemptions of varying magnitudes, of which one is likely to be chosen by Congress. Whichever exemption from registration is granted will apparently be extended to all cooperatives as defined in the Agricultural Marketing Act of 1929 which covers all true farmer cooperatives.

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[11] Shereff, Henry D., Article entitled, "Agricultural Cooperatives - Do They Issue Securities?", examines the United Housing Foundation, Inc. versus Milton Forman [51 S. Ct. 2051 (1975)].

In the period prior to the enactment of a revised securities law, there is still a problem in determining securities regulation in equity transfer and registration requirements for tax "non-exempt" cooperatives. Should many cooperatives register equities as securities in "self-defense", it may set an industry-wide precedence which could ultimately shape the course of future legislation. Also, widespread transferability of equities could be best summarized by asking cooperatives to join with their attorneys and accountants in a risk-benefit analysis of their actions and weigh not just the individual decision but the aggregate implications to all cooperatives who face registration and reporting requirements which may become law.

CHAPTER V

ECONOMIC CONSEQUENCES OF EQUITY TRANSFER BY PATRONS

The major objective of this chapter is to illustrate the economic consequences incurred in the various forms of equity transfer.

Of primary importance is the analysis of the economic costs or forgone opportunities experienced by cooperative patrons who are obliged to hold equity investments in the cooperative. As will be demonstrated in this chapter, the allowance of freely transferable equities does have a distinct economic impact on the decision making process of cooperative organizations, patrons, investors and other entities to be discussed in a later section.

It has been determined in Chapter IV that the major influencing factor on the economic decision of whether to hold or transfer equity is the tax consequence incurred. Therefore, the primary emphasis in this chapter will be the analysis of various equity transfers with respect to the hypothesized tax effect. The balance of this chapter is devoted to presenting a detailed description and case analysis of equity transfer by sale or assignment, and other methods of equity transfer.

SALE OR ASSIGNMENT OF EQUITIES AT DISCOUNT: A CASE ANALYSIS

The method of equity tranfer currently creating the most interest and concern is the sale or assignment of the equity interest at a discount.[12] It is of prime interest because of the advantageous tax treatment of this particular transaction which offers the possibility of creating a positive cash flow for the cooperative patron. Conversely, concern is expressed regarding the deviation from past cooperative philosophy, securities regulation and related consequences, and potential long term tax reform.

Notwithstanding the aforementioned concerns, the following case analysis will present a hypothetical comparative analysis of holding cooperative equities until redemption versus investing in farm operations the cash generated from transfer of cooperative equities at a discount upon issuance.

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[12] The terms "sale" or "assignment" are utilized as they may have legal connotations. Blacks Law Dictionary defines "sale" and "assignment" as follows:

Assignment - A transfer or making over to another of the whole of any property, real or personal, in possession or in action, or of any estate or right therein...It includes transfers of all kinds of property...but is ordinarily limited to transfers of chooses in action and to rights in or connected with property, as distinguished from the particular item of property...It is generally appropriate to the transfer of equitable interests.

Sale - A contract whereby property is transferred from one person to another for a consideration of value, implying the passing of the general and absolute title, as distinguished from a special interest falling short of complete ownership...

There is a question as to whether or not equities, as they are defined and utilized, are transferable as to "general and absolute title" or as to transfer of a "right in or connected with property".

Assumptions

Sale or assignment of equities involves the use of a discounting method in determining the present value of an expected future cash flow. The equity holder releases all interests in the equity investment upon receipt of consideration equal to the discounted equity value. The patron who transfers equity by this method is allowed a normal tax loss on the difference between the face value of the equity allocation and the discounted value.

Consider the following analysis: Case I, the holding of qualified equity allocations until maturity; Case II, the holding nonqualified equity allocation until maturity; and Case III, the sale or assignment of equity at discount and investment of the funds generated. Results are based on the net cash value of the equity redemption or investment at the end of the revolving period.

The following assumptions are made for the purpose of analysis:

Cooperative Revolving Periods

In actual practice, cooperative revolving periods vary from just a few years to over 20 years. Many cooperatives have used ten years as a target and vary around this number of years depending on profitability. In this analysis, eight and 16 year revolving periods are hypothesized. Eight years represents the typical shorter revolving period. Sixteen years represents longer revolving periods used by cooperatives who rely heavily on contributed patron capital.

Internal Rate of Return for Marginal Investments

In determining the value of on-farm investment opportunities, it is necessary to assume an internal rate of return for marginal invested capital. Three internal rates of return are to be used in this analysis, 6%, 12% and 18% per annum. Six per cent represents a rate of return available for all patrons even at a bank certificate of deposit rate. Twelve per cent represents a minimum before tax return on farm invested capital that would be necessary to borrow funds for operating. Eighteen per cent return on investment represents the marginal return on profitable operations with expansionary potential. Many operations, on a marginal basis, may have internal rates of return far in excess of 18% but this would be difficult to maintain over a number of years. Internal rates of return are before tax.

Discount Rate in Valuation of Equities

The discount rate used by an investor to value the equity in question would depend substantially on the cooperative itself. If a cooperative is financially sound, has strong management and kept a constant revolving period over a number of years, a relatively low discount rate may be used. However, if the cooperative is unsound, either financially or in management and has varied revolving periods over a number of years, the discount rate will be high to compensate for high risk and uncertainty. Discount rates of 8% and 16% are used in this case analysis. Eight per cent is similar to quality corporate bond rates and sixteen per cent represents poor quality bond rates.

Marginal Tax Rate of Patrons

An extremely important factor in the decision to hold equity versus sell or assign equity is the marginal tax rate faced by the cooperative patron. Marginal tax rate affects the cash generating value of the normal loss write-off at sale or assignment, the after-tax profitability of marginal investments, and also the after-tax cost of borrowed funds.

In this analysis, Marginal Tax Rates, hereinafter referred to as MTR, of 31%, 48% and 66% are used, the 31% MTR corresponds to Heads of Households [IRC, Sec. 1 (d)] in the $12,000 to $14,000 taxable income bracket, a conservative family farm income. The 48% MTR corresponds to Heads of Households earning $32,000 to $36,000 annual income and also corporations earning in excess of $25,000 per year. This rate would apply to more profitable family farms and corporations. The 66% MTR corresponds to Heads of Households having taxable income of from $100,000 to $120,000 annually. These are high income operations and represent those persons who generally seek maximum tax advantage.

Bank Interest Rates or Opportunity Cost

This case analysis assumes that the patron in question has his capital fully invested and that in order to pay additional taxes on allocated equities, funds must either be borrowed or procured from another investment at an opportunity cost. This interest rate or opportunity cost is conservatively assumed to be 8% per year, assuming such funds would be taken from the lowest earning investment.

Other Assumptions

For purposes of analysis, all revolving periods, internal rates of return on marginal investments, discount rates in valuation of equities, marginal tax rates of patrons, and bank interest rates or opportunity costs remain constant over the stated revolving periods for all cases.

Taxation procedures are based upon the author's interpretation in Chapter III.

No consideration is given to external uncontrollable or unknown factors that may vary over time.

For comparative purposes, all equity allocations in question are assumed to be allocated at a $100 face value.

The following notation is used:

E, face amount of equity allocation (assumed to be $100).
t, marginal tax rate of patron holding equity.
i, interest rate adjusted to reflect the after-tax interest cost experienced by patron.[13]
r, internal rate of return for marginal investments adjusted to reflect the after-tax net gain per year.[14]
d, discount factors - fractional value of an equity after determining a discount rate and duration of the discounting period.[15]

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[13] i, interest rate adjusted to reflect the after tax interest cost experienced by patrons is calculated as follows:

i = annual interest rate (1-tax rate)

Example: at interest rate of 8% and marginal tax rate of 31%.

i = 8% (1-.31)
i = 0.0552

[14] r, internal rate of return for marginal investments adjusted to reflect the annual after-tax net gain is calculated as follows:

r = rate of return on investment (1-tax rate)

Example: at 6% internal rate of return on a marginal investment and marginal tax rate of 31%.

r = 6% (1-.31)
r - 0.0414

[15] d, discount factors obtained from standard tables denoting "Present Value of $1 Discounted by Compound Interest for n Years".

n, number of years to equity maturity.
Cn, net value of equity redemption or alternate investment value at redemption date.

Case I: Qualified Equity Held to Redemption

Patron holds qualified equity allocations until maturity. Either an opportunity cost or interest cost in borrowed funds is assumed in order to pay current additional taxes caused by holding equities. Cost of meeting tax obligations is compounded over the term of the revolving period and deducted from equity redemption value in order to show cash gain.

Future cash value of equity redemption is calculated as follows:

$$Cn = E-[Et\ (1 + i)^{n}]$$

Case IA - assuming
marginal tax rate = 31%
interest cost = 8%
revolving period = 8 years

Cn = $52.40

Case IB - assuming
marginal tax rate = 31%
interest cost = 8%
revolving period = 16 years

Cn = $26.80

Case IC - assuming
marginal tax rate = 48%
interest cost = 8%
revolving period = 8 years

Cn = $33.50

Case ID - assuming
marginal tax rate = 48%
interest cost = 8%
revolving period = 16 years

Cn = $7.86

Case IE - assuming
marginal tax rate = 66%
interest cost = 8%
revolving period = 8 years

Cn = $18.19

Case IF - assuming
marginal tax rate = 66%
interest cost = 8%
revolving period = 16 years

$$Cn = (-\$1.40)$$

Case II: Nonqualified Equity Held to Redemption

Patron holds nonqualified equity allocation and pays tax due at redemption.

Future cash value calculated as follows:

$$Cn = E\ (1-t)$$

Case IIA - assuming tax rate 31%

$$Cn = \$69.00$$

Case IIB - assuming tax rate 48%

$$Cn = \$52.00$$

Case IIC - assuming tax rate 66%

$$Cn = \$34.00$$

Case III: Qualified and Nonqualified Equities Transferred at Issuance for Discounted Cash Value

Patron sells or assigns his qualified or nonqualified equity interest at a discount and invests cash generated (net of taxes) in his most productive farm use. Funds are assumed to reinvested each year (net of taxes) for the period of what would have been the revolving period.

Future cash value of investment from funds generated by discounting equities as follows:

$$Cn = [E\ (1-d)\ t + E\ (d)\ (1 - t)]\ (1 + r)^n$$

Where: $E\ (1-d)\ t$, represents the additional cash generated from the tax loss write-off by discounting equities;

And $E\ (d)\ (1-t)$, represents the cash generated after taxes by the sale or assignment of an equity;

And $(1 + r)^n$ represents the compounding effect of reinvesting cash funds over number of years.

Case IIIA - assuming, tax rate = 31%
internal rate of return = 6%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $71.29.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $80.55.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $58.92.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $66.09.

Case IIIB - assuming tax rate = 31%
internal rate of return = 12%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $97.38.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $150.30.

3. When revolving period is eight years and equities are discounted at 16% Cn = $80.48.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $123.32.

Case IIIC - assuming tax rate = 31%
internal rate of return = 18%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $131.47.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $277.21.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $108.66.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $224.77.

Case IIID - assuming tax rate = 48%
internal rate of return = 6%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $64.14.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $80.38.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $62.93.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $79.08.

Case IIIE - assuming	tax rate	= 48%
	internal rate of return	= 12%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $81.41.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $129.51.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $79.88.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $127.41.

Case IIIF - assuming	tax rate	= 48%
	internal rate of return	= 18%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $102.62.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $205.79.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $100.70.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $202.46.

Case IIIG - assuming	tax rate	= 66%
	internal rate of return	= 6%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $57.25.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $78.27.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $66.10.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $87.06.

Case IIIH - assuming	tax rate	= 66%
	internal rate of return	= 12%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $67.07.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $107.44.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $77.44.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $119.50.

Case IIIi - assuming	tax rate	= 66%
	internal rate of return	= 18%

1. When revolving period is eight years and equities are discounted at 8%, Cn = $78.34.

2. When revolving period is 16 years and equities are discounted at 8%, Cn = $146.56.

3. When revolving period is eight years and equities are discounted at 16%, Cn = $90.45.

4. When revolving period is 16 years and equities are discounted at 16%, Cn = $163.03.

Table I through VI compare the holding of equities vs. selling or assigning equities under given tax conditions and revolving periods.

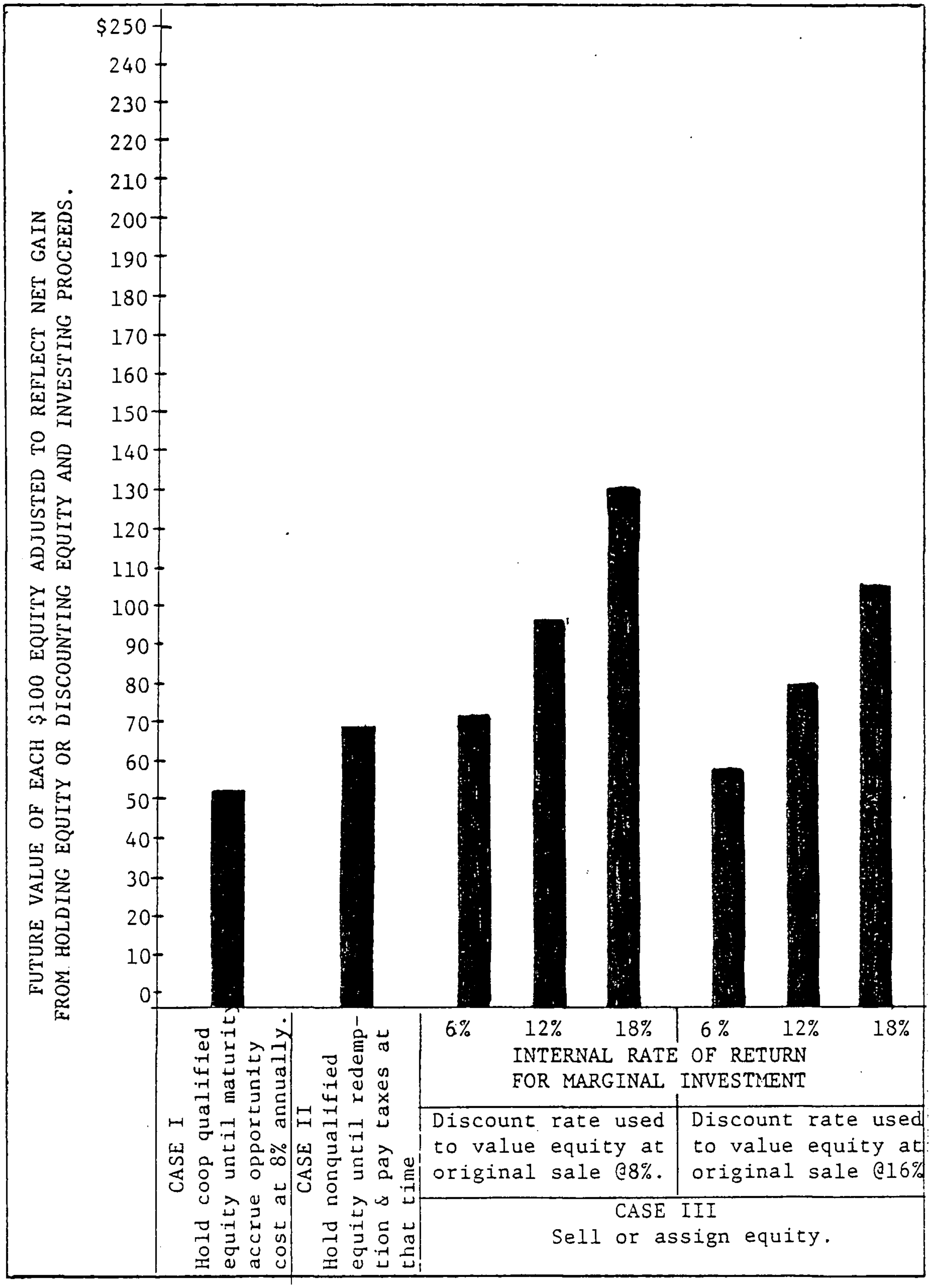

TABLE I , CASE I, II & III WITH MARGINAL TAX RATE AT 31% AND REVOLVING PERIOD OF 8 YEARS.

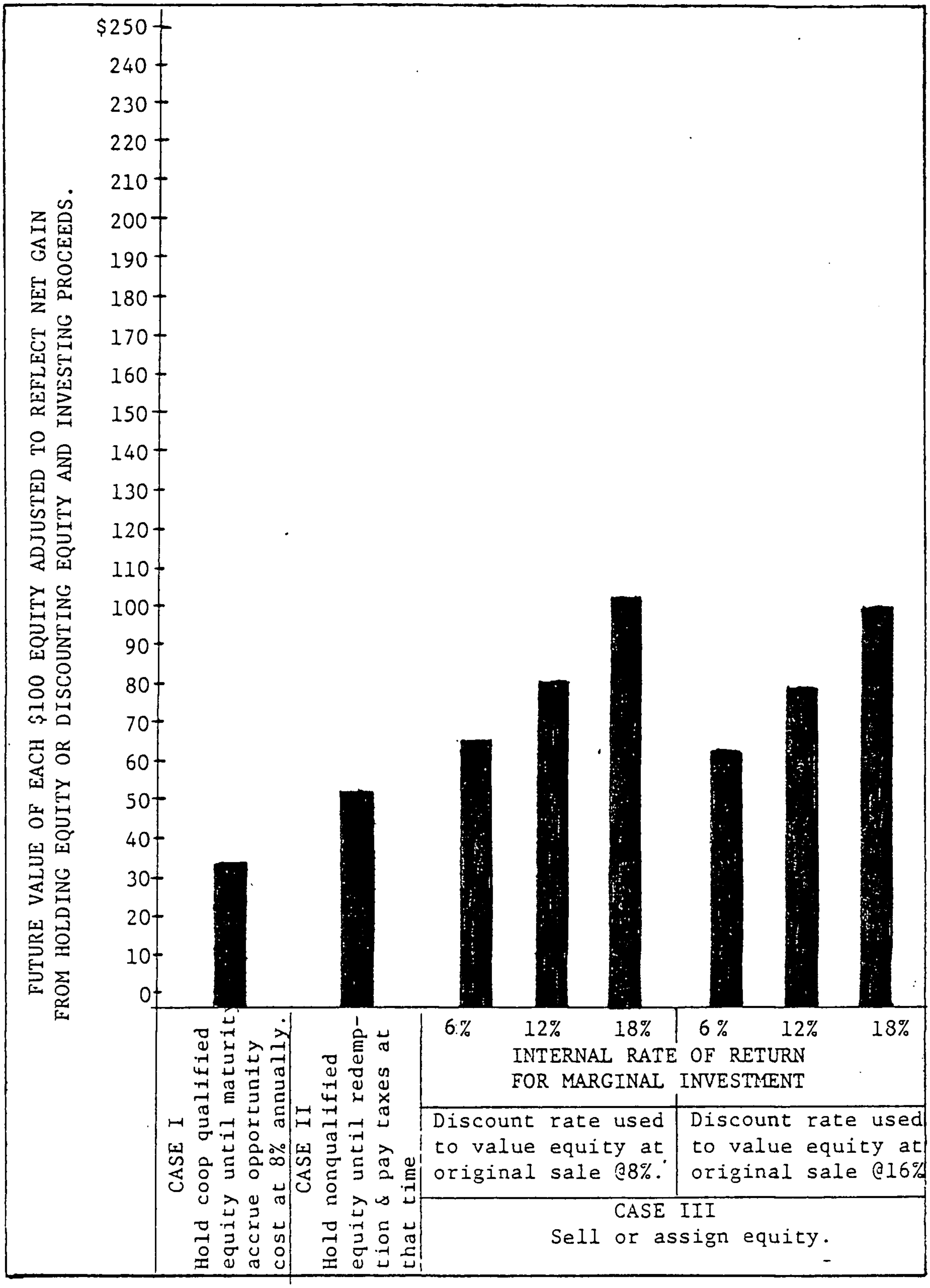

TABLE II, CASE I, II & III WITH MARGINAL TAX RATE AT 48% AND REVOLVING PERIOD OF 8 YEARS.

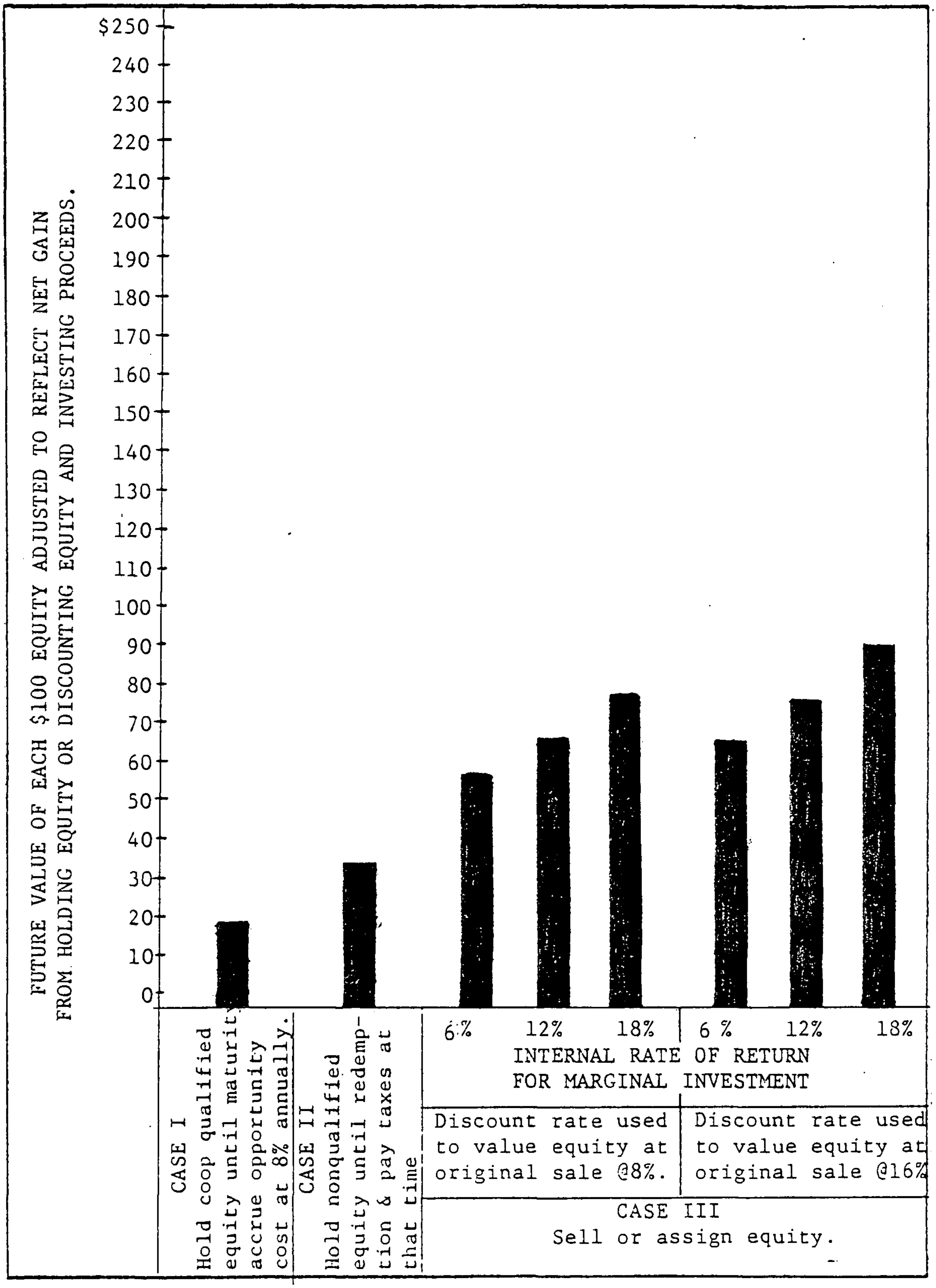

TABLE III, CASE I, II & III WITH MARGINAL TAX RATE AT 66% AND REVOLVING PERIOD OF 8 YEARS.

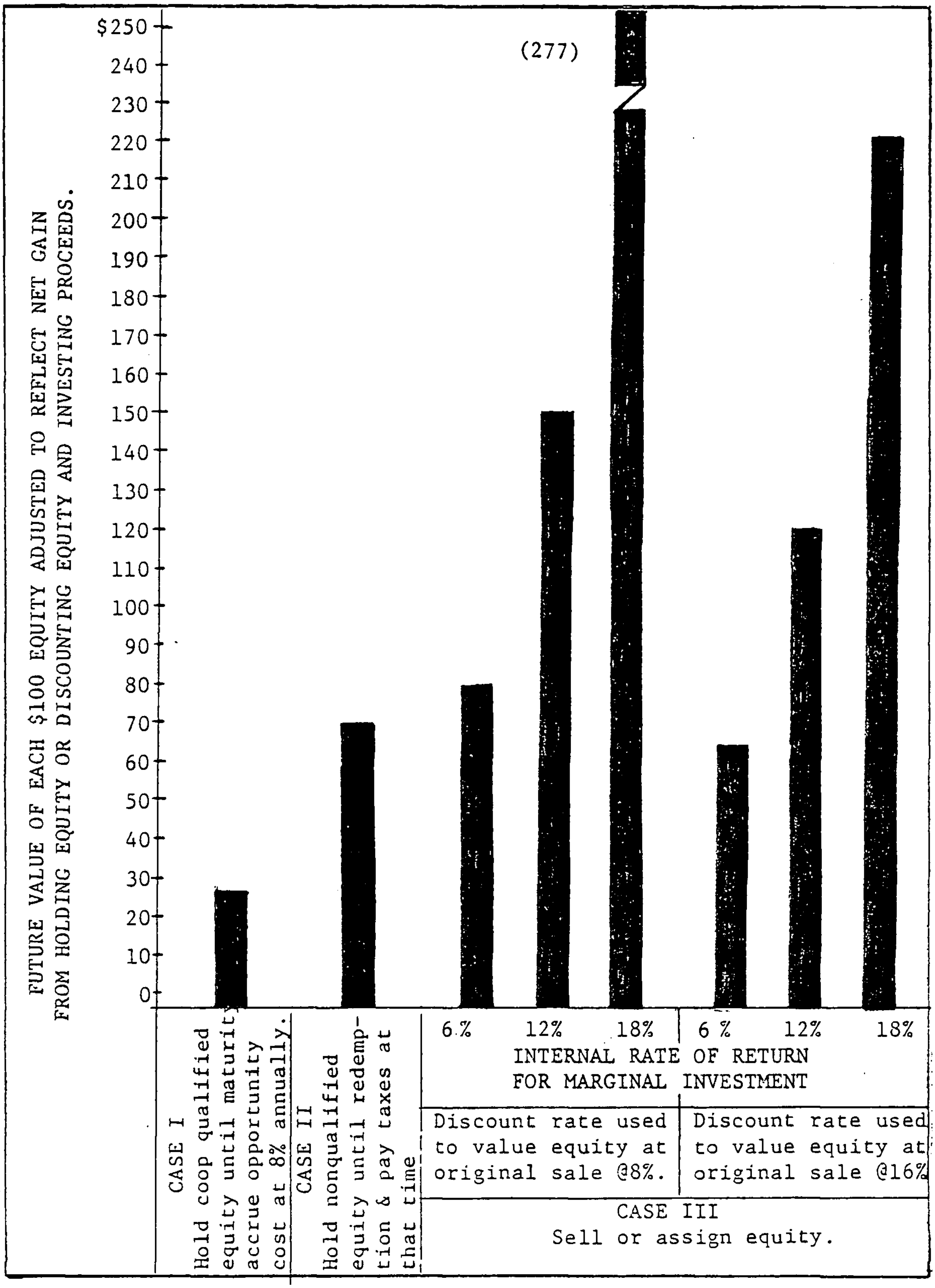

TABLE IV. CASE I, II & III WITH MARGINAL TAX RATE AT 31% AND REVOLVING PERIOD OF 16 YEARS.

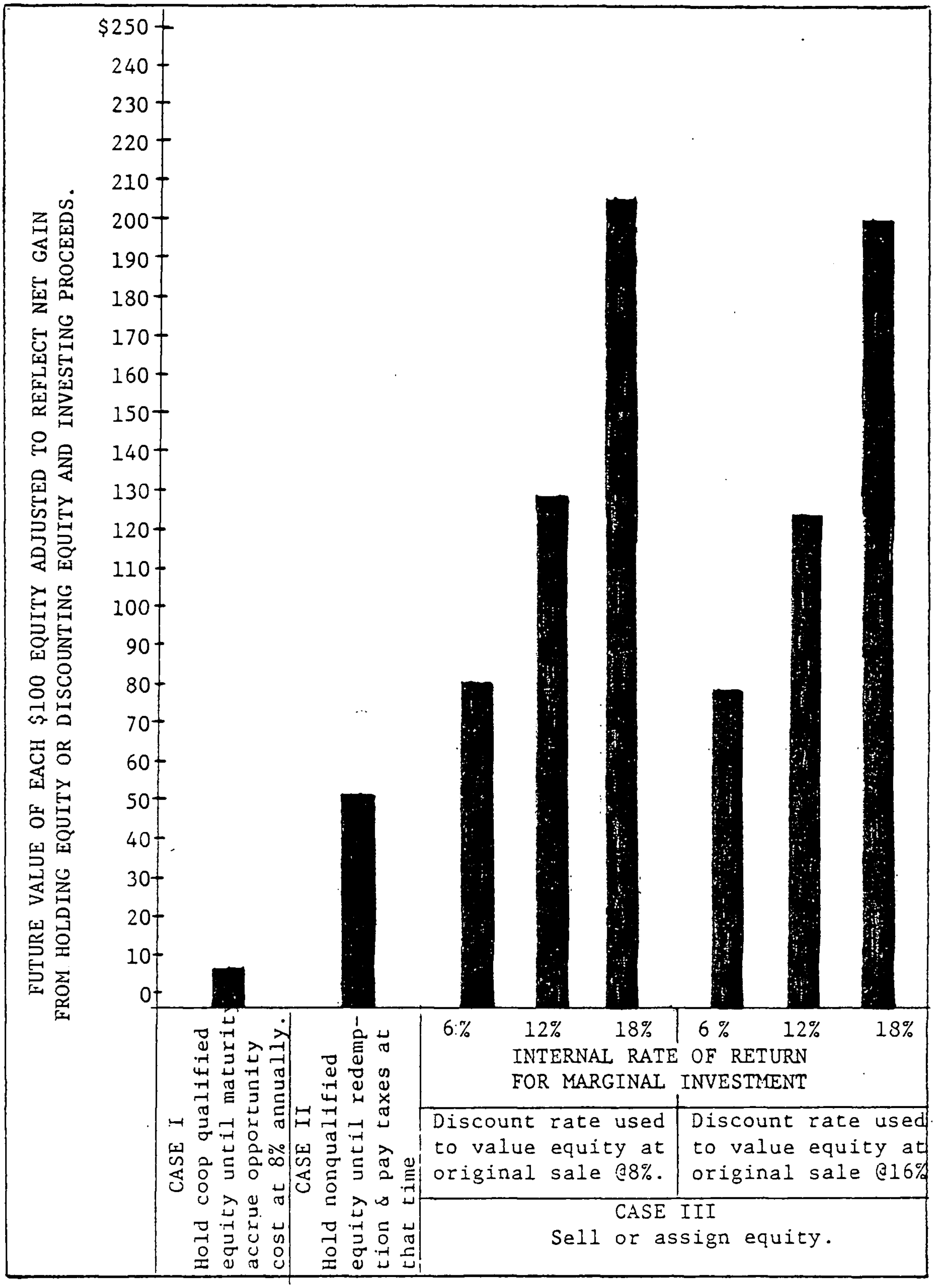

TABLE V'', CASE I, II & III WITH MARGINAL TAX RATE AT 48%
AND REVOLVING PERIOD OF 16 YEARS.

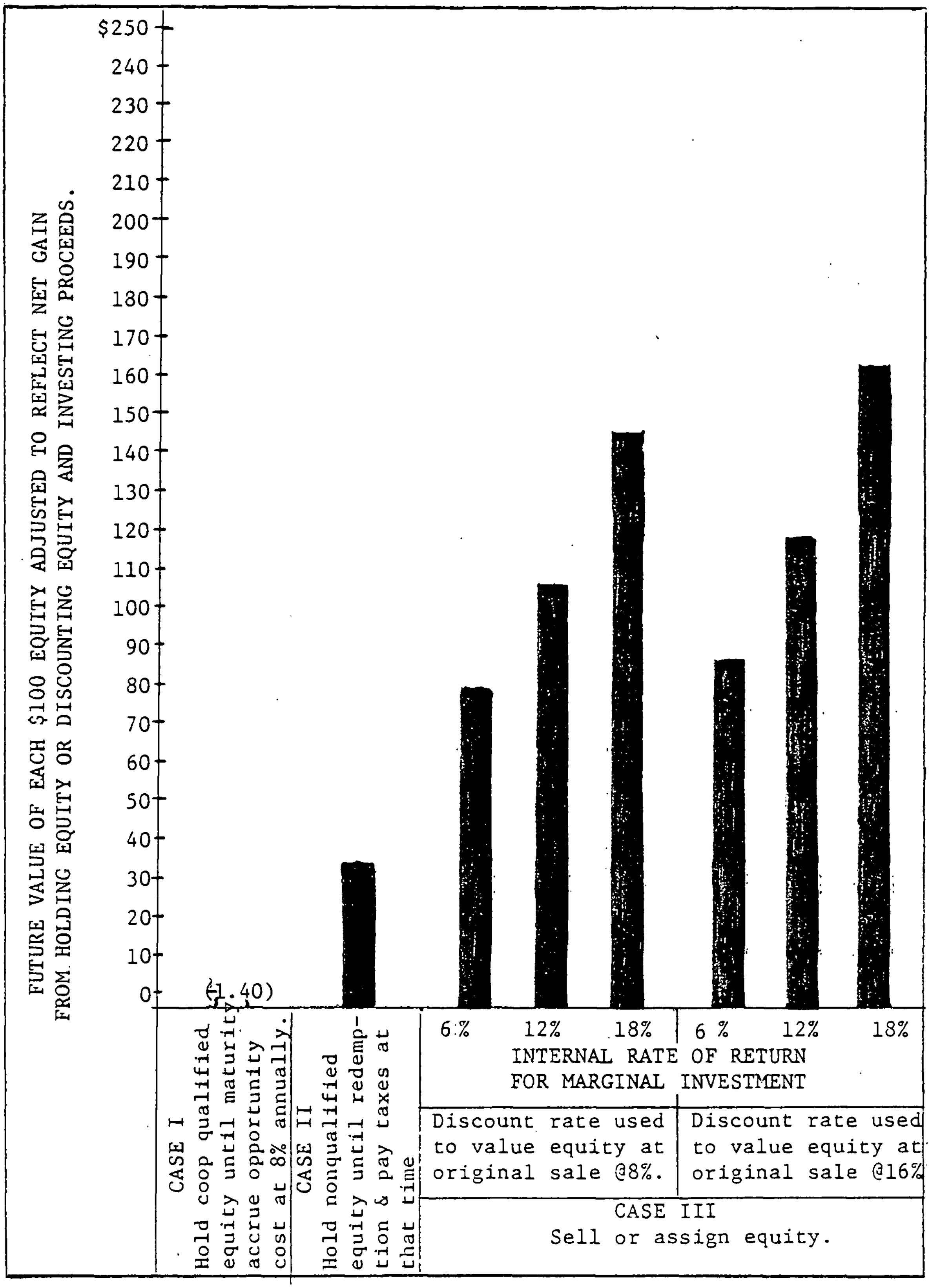

TABLE VI, CASE I, II & III WITH MARGINAL TAX RATE AT 66% AND REVOLVING PERIOD OF 16 YEARS.

It can be readily observed that holding cooperative equities until maturity, given the assumptions in this analysis, generally yield the least return to the cooperative patron. The exception is the comparison between holding nonqualified equities until maturity versus discounting equities at 16% with an internal rate of return of 8% and facing a marginal tax rate of 31% for both eight and 16 year revolving periods.

It should be noted that in comparing alternate handling of equities, the allocated amount of the equity in question is used in analyzing the net return to the patron at the end of a revolving period. If cooperatives did issue nonqualified equities, it is likely that the amount allocated would be greater than when issuing qualified equities. The cooperative would have to provide sufficient funds to pay income taxes on the equity and still net back the required operating funds for the current period. The net effect to the patron would probably show him receiving less cash savings and more allocated nonqualified equity. This would somewhat distort the analysis when comparing qualified versus nonqualified equity allocations.

In all cases, where qualified equity has been issued, the future cash value is substantially greater if equities are discounted and invested at even minimum (6%) annual return. The effects are even more dramatic when a 16 year revolving period is assumed due to the compounding of costs and investments.

Also, as the marginal tax rate of an individual increases, the proportional gain in future cash value by discounting equities and reinvesting funds increases. This is further dramatized over a 16 year revolving period where the future cash value by discounting equities is many times greater at higher tax brackets.

OTHER EQUITY TRANSFERS

Methods of transferring equities other than by sale or assignment are not as controversial nor do they provide advantageous tax treatment in most cases. The following text will outline considerations to make in other tranfers of equity.

Gifting

Gifting is the tranfer of property from one party to another without any consideration and without any recourse to the item gifted. A gift can be made for benevolent purposes or to avoid or reduce income and/or estate taxes.

The donor of a gift is taxed on the value of the gift that is in excess of his annual or lifetime gift tax exemption. The value of the gift is determined on a "fair market value" basis, which is difficult to determine in the absence of a market.[16]

Assuming a person had received a $100 qualified equity allocation, he would be obliged to pay the income tax on this full amount. Should he decide to gift this equity, a gift tax could be paid on the fair market value of the equity in question, which in many cases could be considered quite a low value. If the fair market value is determined at $20, the gift donor would be "gift taxed" on that amount while the recipient of the gift would be liable for tax on $80 income at the date

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[16] A fair market value may be determined by a discounting method or a comparison to a similar instrument that would have a future cash value.

of the \$100 equity redemption.

Obvious longer term advantages would occur if equities could be passed on at a low basis from taxpayers in higher tax brackets to donees in lower tax brackets. Gifting of equities should certainly be a consideration in any estate planning by current equity holders.

Charitable Contributions

In addition to philanthropic reasons for contributing property, many individuals do so to partially avoid or reduce taxes. In order to be exempt, charitable contributions must be made to Internal Revenue Service qualified charitable organizations.

Donors of equities to charitable organizations may receive tax relief amounting to the fair market value of the donated property. In the case of cooperative equities, a \$100 equity allocation may actually have a fair market value of \$20 on the date donated. Should this be the case, tax on \$80 income would be incurred, the difference between the \$100 income tax liability upon allocation less the \$20 deduction upon donation.

Estate Transfers

Equity transfers through estates generally provide little relief as they are liable for estate taxes based on the fair market value. Although the deceased holder of equity had paid income tax on the full amount of equity value, it appears that the heir would be liable for income taxes on any increase in redemption value over the "fair market value" in the estate. This is because the estate is taxed at the "fair market value" and does not rely on a stepped up basis for tax purposes.

The determination of a "fair market value" is the key variable in equity transfers other than sale or assignment when considering the tax consequences. Many reasons can be found to slant the "fair market value" either high or low depending on the particular situations involving the history of the issuing cooperative and duration of revolving period. As of yet, no one method of fair valuation has apparently proven totally acceptable.

CHAPTER VI

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This study was undertaken in order to provide a greater insight into various technical factors associated with cooperative equity transferability and to identify the present and potential costs and benefits in doing so. The methodology included defining the problem as it currently exists, presenting supporting literature, identifying and analyzing the major factors influencing equity transferability and illustrating the economic impact of more freely transferable equity.

The major factors identified and analyzed with regard to cooperative equity transferability are cooperative by-law provisions, income taxation, and securities regulation which are summarized as follows:

Bylaw Review

As revealed by a review of a sample of Oregon cooperative bylaws, generally, cooperative bylaws neither authorize nor forbid equity transfers and therefore do not provide the mechanics to do so. The board of directors have been delegated the bulk of authority, and a wide range of discretion to determine the amount of equity allocated, the revolving period, and any special provisions with regard to equities.

Some cooperatives require prior written notice of intent to transfer equities, deny transfers within 30 days of redemption, and/or limit transfers to agricultural producers.

As to the general form of an equity allocation, it is generally evidenced by a notice or certificate which states the face amount of the equity allocated, possesses no due date, and is generally non-interest bearing. The redemption value or "face value" can be subject to reduction in order to offset equity holder's debt, cooperative debt, or cooperative losses and is subordinate to all creditors of the cooperative.

Cooperative bylaws that state the philosophical relationship between patrons, their equities and the cooperative generally stress the joint venture aspect of the cooperative-patron relationship and refer to equity in the cooperative as capital contributions rather than a debt or third party investment in the operation.

Taxation

In general, the provisions of the Internal Revenue Code and regulations and rulings of the Internal Revenue Service are consequently consistent with regard to cooperative equity allocations and subsequent transfers. A detailed review of probable tax treatment is contained in Chapter III.

It has been found that for patrons, the major tax-related incentive in transferring equities lies in the "normal loss" allowance in the sale or assignment of equity at a discount. All receipients of cooperative patronage refunds, in the form of equity allocations, are eventually subject to income taxation on the full amount of the allocations. However, should a patron sell or assign his equity at a discount, he may offset his tax liability by incurring a normal loss equal to the difference between the cash and face value of the transferred equity. This advantageous tax treatment is allowed because patrons generate equity interest in the "normal course of doing business".

Other cooperative equity transfers provide little tax relief. The major factor in determining the potential tax relief or liability in a gift, donation, estate, etc., is the "fair market value" of an equity on which tax liability is computed, rather than face or stated value.

Taxation of qualified and non-qualified equity although quite different at equity issuance, appears to net a very similar tax effect in subsequent equity transfers by patrons. Cooperative accountants have generally seen very little use of non-qualified equity and take different approaches with regard to hypothesizing the accounting and taxation that would be incurred in the issuance, redemption and/or transfer of non-qualified equities.

Securities

A review of current and proposed securities regulation was undertaken in order to more fully identify and clarify the pending concern over potential securities registration with regard to cooperative equity allocation and transfer. Positions and opinions of qualified and reputable professional sources were also consulted.

It was found that federal law differentiated tax-exempt and tax non-exempt cooperative with regard to registration and reporting requirements. Cooperatives currently qualifying as tax-exempt have been exempted from registration and reporting requirements of the Securities Act of 1933. Cooperative as defined by the Agricultural Marketing Act of 1929 which includes most cooperatives, have been exempted from reporting and registration requirements of the Securities and Exchange Act of 1934. Other exemptions are available for businesses meeting strict requirements under which most cooperatives would find it extremely difficult to operate.

Oregon State Securities law provides exemptions from reporting and registration for virtually all agricultural cooperatives. However, it appears that the Corporation commissioner may at his discretion eliminate any exemption from registration and reporting if it is in his judgement in the "best interest of the public".

There appears to be two philosophical approaches taken in determining whether a cooperative equity is actually a "security". One approach considers cooperative equities in the context of the unique cooperative-patron relationship and stresses the joint venture farm business aspect of the relationship rather than a third party "investor" relationship.

The latter approach builds from general law and legal precedence which examines instruments and relationships which constitute a "security" and have some similarity to cooperative equities. The actual philosophical relationship is a sustantive question which encompasses a number of areas such as stockholder vrs. patron; investor vrs. joint-venturer; voting based on stockownership vrs. one vote per patron; and return based on investment vrs. net farm savings based on patronage.

CONCLUSIONS

The transfer of cooperative equity is a relatively new and largely untested concept. There are many factors which must be considered in determining the cost and benefits derived from transferable equities. This research strongly suggests the decision of whether or not to participate in a freely transferable equity program must be a joint cooperative-patron decision and all costs or benefits will ultimately accrue to the individual patron. The following considerations should be taken into account in an analysis of equity transferability.

Cash Needs of Patrons

The most significant factor in allowing transferability of equities is the economic welfare of the cooperative patron who contributes capital to the cooperative organization. It can generally be argued that the need for on-farm capital is increasing, especially in the case of younger farmers who have not yet had time to accumulate a substantial net worth of their own. As was demonstrated in Chapter V, a significant opportunity cost may be incurred by such patrons who hold equity in cooperatives.

Overall, the allowance of freely transferable equities would allow patrons more flexibility to utilize funds according to their personal needs.

Distribution of Equity Holdings

As cooperative patrons are responsible for financing the cooperative in proportion to their patronage, there is no distinction between patrons who are personally well capitalized or undercapitalized in their farm operation. It is apparent that some redistribution of equity holding may be in order, especially since patron's benefits from annual cooperative services are totally independent of individual equity holdings. Capital-short patrons may be experiencing a high opportunity cost for holding equity. Conversely, there may be capital-abundant patrons or outside investors who could benefit from the purchase of cooperative equity at a discount, and may actually be experiencing an opportunity cost should they be unable to purchase equity at a discount.

As indicated in Chapter V, economic gains can be realized from selling equity at a very low present value should the patron face high tax brackets, high return on investment and/or long revolving periods. Purchasers of equity may also realize high net yields on purchased equity should they be highly discounted at purchase and taxed on capital gains at redemption.

Redistribution of equity holding are important to former patrons or deceased patrons who are no longer utilizing cooperative facilities. Most cooperatives do not provide adequate methods of retiring larger portions of equity held by these patrons who no longer have a need for an equity investment. Transferability would provide a method which could be utilized to redistribute equity regardless of the revolving program or provisions for accelerated equity redemption.

Establishment of a Market

The free exchange of cooperative equities by patrons and/or investors would require some form of a "market" for cooperative equities in order to facilitate trading with any regularity. Currently, no such formal market exists and it is likely that securities regulation will become a necessity if such a market were developed.

There are several management problems that could develop in the event that equities are freely transferable or marketable. Cooperatives are currently member-owned and controlled entities. Members generally possess one vote no matter how much business they do, or equity they hold, with the cooperative. However, in the event that substantial quantities of equity are transferred outside the membership, certain external pressures on management may occur. Political and/or personal interests may affect decision making and thus undermine sound cooperative policy which has been based on a service and not an investment.

The cooperative could also become dependent on securing non-patron capital flow into the system which may alter operating practices. Cooperative philosophy is not based on returns on investment but efficient service to patron members which produces annual savings. It is possible that in order to obtain maximum returns for investors the service of the cooperative would become less effective for patrons.

Currently, cooperatives are treated as special corporations under the tax law. Cooperatives are currently allowed tax deductions on income properly apportioned or allocated to patrons in the form of equity. "Tax-exempt" cooperatives are granted additional exemptions for specified purposes. In all, cooperatives pass a major portion of their income on to individuals for tax purposes. Should equities become prevalent on the money market, the Internal Revenue Service and other corporations may question the need for these special exemptions which cooperatives now have, and may seek taxation of the cooperative under standard corporate procedures.

Also, if a patron transfers his equity holding in a cooperative he may not have the same incentive to stay with the cooperative, especially during cyclical trends in market conditions. The cooperative, without a consistent patronage, would be difficult to manage with any degree of stability necessary for long term viability. A lack of interest in the cooperative management and sporadic patronage may prove hazardous to cooperative business in both long and short terms.

Cooperative Benefits

One of the most important factors, and the most difficult to quantify, is the benefit derived from the cooperative method of doing business. Benefits may accrue to patrons in such forms as increased farm revenue; advantageous effects on the overall market structure; economies of scale, not realizable by individual farmers; providing services not otherwise consistently available; and enabling farmers to participate actively in the ownership and operation of the cooperative in the marketing of their commondities or procurement of supplies. Benefits of this nature are often variable among industries, cooperatives and patrons, but are apparently quite significant.

A long term benefit may be realized from a competitive atmosphere that could develop in the face of marketable equity. Cooperative management may be forced into improving their performance, financial reporting, etc., in order to maintain the value of their equity holdings in a market.

External Considerations

In examining the technical and practical aspects of cooperative operation it has been found that considerable regulatory and competitive pressure is being placed on the cooperative form of doing business. In order to remain at an economical scale, competition has forced many cooperatives to a size that rivals large corporations. This size and competitive atmosphere has also gained attention from competing businesses and government regulatory bodies. The most significant regulatory considerations include cooperative tax treatment, securities regulation, and product marketing practices; the latter drawing a great deal of attention at the present.

Summary

In summary, there are a number of reasons to advocate and promote the free transfer of cooperative equities. Personal benefits to individual patrons would be greatly enhanced in the area of financial flexibility and liquidity, and in tax and estate planning.

The major drawback to the allowance of freely transferable equities lies with the suspected potential costly effects of competition and government regulation, that may be accelerated by equity marketability. Regardless of the effect of equity transferability, if cooperatives are to withstand tests of validity under future regulation they must be willing to re-examine the philosophical and practical relationship between the cooperative and patron. If it is determined that this coop-patron relationship is indeed a special relationship that necessitates equity contributions to be held by the patron, then equity transferability should probably be limited, if not eliminated.

If it is found that the coop-patron relationship is unique, yet it is not essential for the patron to maintain his holding of issued equity to perpetuate this relationship, then equity transferability should be incorporated into cooperative operations.

RECOMMENDATIONS

In general it is recommended that a judicious program of equity transferability be provided by "tax exempt" cooperatives, as currently defined by the Internal Revenue Code. Tax exempt cooperatives are explicitly exempted from registration requirements of the 1933 securities law. "Tax nonexempt" cooperatives should likely avoid widespread transferability since they are not explicitly exempted from potential securities registration and reporting requirements under the letter of the law.

A judicious program of equity transferability should involve several practices which will insure a minimum risk exposure to adverse regulatory encounters. Recommended practices by the cooperative include defining the scope of transferability and providing the operational mechanics to transfer equity. This may be accomplished by amending bylaws to provide consistent handling of equities at issuance, redemption and specify clearly the transfer rights. Also voting rights, distribution of residual assets at liquidation and rights of debt offset should be excluded from equity holders who are not cooperative patrons. Perhaps most important is providing an adequate program of disclosure to holders of equity, especially third parties who are less aware of cooperative type operations. Practices which provide less than full disclosure may at the least cause unwanted attention and should be avoided.

The scope of equity transferability may need to be limited in order to avoid regulatory controversy. Limitations may be imposed such as allowing equity transfers only among patrons, among agriculturalists, specific organizations, or allowing transfers only upon director approval in accordance with some criteria for allowing transferability which should be worded in such a way as to avoid any "discriminatory practice".

Recommended properties which could enhance the value of discounted equities should they become more freely traded include such items as target due-dates for equities, shorter revolving periods, limited off-sets against non-patron held equity, and adequate disclosure of information.

With regard to taxation, it is suggested that more attention be given to the use of nonqualified equity allocations. Should the net tax effect of transferring nonqualified equity prove to be similar to that of qualified equity to the patron, as hypothesized in this thesis, a much broader decision making time frame could be realized by patrons. While cooperatives incur tax liability at issuance of nonqualified equity, patrons do not incur tax liability until redemption or <u>other disposition</u> of the equity holding. (Other disposition meaning transfer of equity by any means). This tax treatment would allow patrons to pick the year he would incur the tax liability as long as he discounted, gifted, donated, etc., the nonqualified euqity prior to redemption by the cooperative. It should be noted that cooperatives who issue non-qualified equity will most likely incur a significant temporary tax liability that would reduce current internal equity funding. Income tax credits are received when nonqualified equity is redeemed; hence, in future periods, the cooperative tax liability may be reduced by the tax credit for nonqualified equity redemption.

Another alternative is to split the issuance between qualified and nonqualified equity. Although the cooperatives accounting process may become cumbersome, by doing so, this practice may provide additional flexibility for patrons.

The tax benefits received by patrons transferring equities through sale or discount were fully illustrated in Chapter V, and found to be significant. There are also potential estate planning strategies with regard to equities which could be quite beneficial. Depending on the tax brackets of equity holders and their heirs, advance planning could save considerable tax dollars. (New 1977 gift tax reform laws should be reviewed in depth.)

Securities regulation is perhaps the greatest immediate concern in equity transferability. It is suggested that equities be conservatively and judiciously transferred so as to minimize potential problem areas and avoid adverse publicity. Cooperatives and patrons should make the maximum effort to guide legislation into realistic and just treatment of cooperative capitalization and equity transfer. Over-reaction to proposed control of equity as a security may possibly widen the gap between pro and anti coop groups and may lessen the chance of favorable consequences for cooperatives and patrons.

Regarding the overall capitalization of cooperatives, this study has demonstrated that equity held in cooperatives is often at a high cost to patrons. This would suggest that the utilization of methods to allow more flexibility in equity holding, such as transferability, faster revolving cycles, etc., may be beneficial to the coop-patron relationship.

Other forms of equity holding and distribution should be explored under the permanent capital plans. Should securities registration become necessary, the fewer the numbers of stock issuances, the lower the cost of registration. Original stock issuances may be made large enough to meet the equity participation needs at plant capacity.

Regulation of cooperatives under marketing, securities, and tax law and rulings is being examined and reexamined; and presumably will be more severly imposed on the cooperative eventually. Although additional expense will probably be incurred in bringing operations within the scope of increased regulations, it is suggested that beneficial aspects not be overlooked. In the area of securities registration, cooperatives must be prepared to take full advantage of the use of registered instruments. Sound operations and full disclosure may likely enhance the procurement of equity capital.

Future Study

Continued study and attention is recommended with regard to all aspects of government regulation of agricultural cooperatives. Along with securities and tax regulation, antitrust laws and Federal Trade Commission regulation are becoming a prime concern of many cooperative managers also. Methods of operation should be continuously reviewed in order to assure the cooperative that its function lies within acceptable bounds with regard to regulatory agencies.

Specifically, the accounting procedure, tax treatment and transfer of nonqualified cooperative equities require further study and confirmation of results in this study. The 1977 reformed gift tax laws may also lead to favorable estate planning suggestions relative to equity transfer under more liveral lifetime exemptions for giftying.

Cost of securities registration should be examined and documented.

Alternative capital financing plans which provide patron ownership and minimize long term taxation and registration expense should be sought.

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