Form F. R. 511(a)

TO Mr. Lindholm

FROM Governor Eccles

REMARKS:

I will appreciate it if you will go over this letter and its two enclosures, and let me have your views on them, particularly on the point where he says "I cannot see the difference between the earnings of a co-op corporation and that of a private tax paying organization".

I will also appreciate your drafting a reply for my signature.

GOVERNOR ECCLES' OFFICE

NATIONAL TAX EQUALITY ASSOCIATION
INCORPORATED
231 SOUTH LA SALLE STREET
CHICAGO 4

GARNER M. LESTER
PRESIDENT
SETH MARSHALL
CHAIRMAN OF THE
EXECUTIVE COMMITTEE
VERNON SCOTT
VICE PRESIDENT

October 16, 1950

Mr. Marriner Eccles
Federal Reserve Board
Washington, D. C.

Dear Mr. Eccles:

This organization is very much interested in the statements attributed to you which appear in the Chicago Tribune as a result of your recent speech before the Cooperative League of the United States.

There are a number of points mentioned in this publicity on which we would very much appreciate an extension of your views and we would, therefore, welcome an opportunity for such a discussion with you.

After many years of careful research and legal study, we have arrived at definite conclusions about this matter, which are set out in the enclosed studies.

We hope that you will take the time to read these statements and I have asked Mr. Vernon Scott, Vice-President of our organization, to seek an appointment with you so that these questions may be discussed.

Sincerely,

G M Lester

G. M. Lester

GML
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October 20, 1950.

Mr. G. M. Lester, President,
National Tax Equality Association, Inc.,
231 South La Salle Street,
Chicago 4, Illinois.

Dear Mr. Lester:

I appreciated receiving your letter of October 16, relative to my recent speech before the Cooperative League of the United States and a copy of the studies your association has made on taxing cooperatives.

I have not yet had time to go over the studies as I am trying to get my desk cleared prior to leaving for the West this weekend. I am sure I will find them interesting. During my absence I am having one of our Research men go over your studies and give me his comments on it.

I will be glad to see your Mr. Vernon Scott some time the latter part of November or the first part of December when I expect to be back in Washington.

My address before the Cooperative League was extemporaneous and, therefore, I do not have a written copy of it. However, I do have a press release covering it with the exception of what I said about taxing cooperatives. Thinking you may be interested in seeing it I am enclosing a copy of the release herewith.

Sincerely yours,

M. S. Eccles.

Enclosure

VE:dls

How cooperatives ESCAPE the INCOME TAX

National Tax Equality Association
231 South LaSalle Street • Chicago 4

A condensed statement about the
Federal income tax
exemption of
cooperative corporations,
its effect
and
the remedy.

How Cooperatives Escape the Income Tax

The income-tax escape of cooperatives, mutuals and other tax-exempt organizations and institutions which are engaged in business activities in competition with taxpaying companies has created a two-fold problem that seriously affects the American economy:

1. Taxpaying concerns, in their competition with tax-exempt competitors, are forced to operate under the disadvantage of a Federal income tax that ranged as high as 80 per cent during World War II, has recently been 38 per cent, now increased to 45 per cent and is about to rise again to wartime levels.

2. The Treasury is losing more than $1 Billion a year of highly needed revenue.

Current changes in the law tax the business earning of colleges, charities and labor unions, but continue the tax freedom of cooperatives, mutuals, building and loan associations and Government owned corporations.

The simple justice of tax equality demands that these must also be taxed.

LARGEST TAX ESCAPE

Among the tax-avoiders, cooperatives have grown most rapidly and their tax advantage deprives the Treasury of the largest amount of revenue.

They were first legally exempted in 1916, three years after the Federal income tax amendment was adopted.

At that time, the tax rate was only one per cent, the cooperative volume of business was small, and the exemption was specifically limited to the marketing agents of farm groups.

In the next ten years, however, the character and extent of the exemption changed almost completely. In a series of amendments, promoted by cooperatives and spurred on in many instances by Treasury rulings that far exceeded the law, the exemption was extended to pur-

chasing co-ops; the agency requirement was abolished; co-ops were permitted to become corporations, enjoying all the benefits of a corporate entity, and encouraged to become monopolies; they were allowed to set up reserves; they were given the right to do business with 50 per cent of non-members without losing their tax privilege.

ENORMOUS ADVANTAGE

As the income tax rate increased the advantage of tax avoidance became greater. In 1942, at the beginning of World War II, Mr. A. G. Black, then Governor of the Farm Credit Administration, was able to say with great accuracy that "...when taxes are absorbing a large part of the earnings of private business, the cooperative form of business really provides an enormous advantage."

In the four war years, the cooperatives practically doubled their volume of business—from $5.4 billion in 1942 to $10.5 billion in 1945.

In the next four years, the co-op volume of business again nearly doubled—to more than $18 billion in 1949.

Largely, this stupendous growth is the result of tax exemption, which has permitted the ultra-rapid accumulation of capital and reserves out of untaxed earnings, and the consequent increases of facilities, often through the buying out of taxpaying competitors.

TWO AVENUES OF ESCAPE

There are two ways by which cooperative corporations are able to escape Federal income taxes. Approximately half of all the farmers marketing and purchasing cooperatives obtain total exemption from income taxes by qualifying for tax exemption under Section 101 (12) of the Internal Revenue Code. This section provides an absolute and outright exemption from filing regular income tax returns and from paying Federal income taxes to those farmers cooperatives which meet the requirements of the section.

In order to qualify for this exemption from filing returns or paying income taxes, the cooperative corporations must conform to the following requirements:

(1) Basically, the organization must be a bona fide farmers', fruit growers', or like association, organized and operated on a true cooperative basis.

(2) All of the voting membership, or voting stock, must be owned by bona fide producers of agricultural products, who market their products or purchase their supplies through the cooperative.

(3) If organized on a capital-stock basis, dividends thereon shall not exceed 8 percent per annum on the consideration for which the shares were issued, or the legal rate of interest of the State of incorporation.

(4) The volume of business done with non-members must not exceed the volume of business done with members, and, as to purchasing activities, the volume of purchases made for non-members, who are not farmers, shall not exceed 15 percent of the total volume.

(5) In the payment and crediting of patronage refunds, all patrons must be treated alike, whether they be members or non-members. Absolutely no preferential treatment can be given a member patron over a non-member patron in the distribution or crediting of patronage refunds.

(6) Reserves, if any, shall be limited to those required by State law, or such as are reasonable and for any necessary purpose.

(7) Records shall be kept to show the patronage refunds and credits of all member and non-member patrons, and, also, the interest of each member or non-member in retained reserves or assets of the association.

The statute further provides that substantially all of the voting stock must be owned by producers of agricultural products, who market their products or purchase their supplies and equipment through the association. Preferred stock may be owned by non-producers, with the proviso that preferred shareholders shall not participate in the assets or profits of the cooperative in excess of the par value of the preferred shares, plus accrued and unpaid dividends.

Corporations qualifying for complete tax exemption are called "tax-exempt cooperatives."

An example of this type is Southern States Cooperative of Richmond, Virginia, which does business in a five-state area; operates through seven subsidiary corporations, 107 retail stores, 10 freezer plants and 27 petroleum co-ops; has assets of $18,800,000; made $1,865,000 pr[illegible] in 1949; has never paid Federal income tax.

"NON-EXEMPT" CO-OPS

That half of the farmers cooperative corporations which does not operate in accordance with the statute, the wholesale industrial cooperatives, the urban consumers cooperatives, and all other types of cooperatives which fall outside the statute are classified as "non-exempt cooperatives." They file income tax returns and make the claim that they pay income taxes just as private corporations do. The fact of the matter is, however, that they pay little or none of the income taxes that an ordinary corporation would pay. They are able to avoid all or nearly all of their Federal income taxes because of a tax loophole set up in the law by Treasury rulings.

The Cooperative Grange-League-Federation Exchange of Ithaca, New York, and the Consumers Cooperative Association of Kansas City are examples of big cooperatives that have given up their total exemption and are now paying some tax, though by no means as much as regular corporations pay on the same pro[illegible]

DIFFERENCE APPEARS

A cooperative corporation carries on its business operations in the same manner as any other business corporation. At the end of its fiscal year it determines its net profits and out of them sets aside sums for capital reserves and pays dividends of not more than 8 per cent on outstanding capital stock. The difference between a cooperative corporation and ordinary corporation appears at this point. The regular corporation can pay any amount it pleases as dividends on outstanding capital stock. The cooperative corporation in accordance with

charter provisions, or its by-laws, or the agreement which it has entered into with its members, pays limited dividends on its capital stock and is obligated to distribute the remainder of its profits to its patrons in a manner proportional to the amount of business they have done with it.

The Treasury Department with what has been called in Congress and the courts "great liberality" allows cooperative corporations to deduct or exclude from their taxable income the amounts thereof that are allocated or distributed as a dividend on patronage in accordance with the provisions of their charter, by-laws or contracts. No law passed by the Congress allows the deduction or exclusion of patronage dividends from the taxable income of a cooperative corporation, however, the Treasury Department justifies its failure to tax this income upon the ground that it represents a rebate or an additional cost of goods sold.

In 1937, a Treasury ruling referred to as G.C.M. 17895, C.B. 1937-1 p. 56 was promulgated which sets forth the attitude of the Treasury Department:

"So-called patronage dividends have long been recognized by the Bureau to be rebates on purchases made in the case of a cooperative purchasing organization, or an additional cost of goods sold in case of a cooperative marketing organization, when paid with respect to purchases made by, or sales made on account of the distributees. For purposes of administration of the Federal income tax laws, such distributions have been treated as deductions in determining the taxable net income of the distributing cooperative organization. Such distributions, however, when made pursuant to a proir agreement between the cooperative organization and its patrons are more properly to be treated as exclusions from gross income of the cooperative organization. (I.T. 1499; S.M. 2595; G.C.M. 12393.) It follows, therefore, that such patronage dividends, rebates, or refunds due patrons of a cooperative organization are not profits of the cooperative organization notwithstanding the amount due such patrons cannot be determined until after the closing of the books of the cooperative organization for a particular taxable period."

Because of this Treasury practice, income tax must be paid by a non-exempt cooperative only on such small amounts as are paid in dividends on stock and on reserves which are retained without being allocated to patrons. It is, therefore, the general practice of non-exempt city co-ops to pay out practically all profits in tax-free patronage dividends.

NO BASIS IN FACT

Since it is corporate net income which, when distributed on a patronage basis, gives rise to the "patronage dividends," the Treasury position has no basis in fact. Dividends on capital stock are paid out of profits first and only when there are profits left over can the cooperative corporation distribute them as patronage dividends. The refusal of the Treasury to recognize patronage dividends as profits has no rational justification. An examination of the operations of a cooperative shows that patronage dividends are distributions of over-all profits which arise from all the business transactions entered into by the corporation. Sometimes these profits arise from transactions wholly unrelated to business done by members, such as bringing in oil wells, or selling facilities for a large capital gain, or receiving rents from the storage of government wheat.

TAX-FREE EXPANSION

The reason for the tremendous growth of cooperative corporations is that they are able to expand on tax-free income. Cooperative leaders claim this is not the case because Section 101 (12) of the Internal Revenue Code requires cooperatives to turn back to their members all net proceeds remaining after setting up reserves. The Treasury Department rulings allow only those profits to escape taxes which are distributed as patronage dividends. If cooperative corporations are required to return net proceeds to their members or to distribute profits as patronage dividends, how can they retain them for business purposes?

The answer is that it is not necessary for the avoidance of income taxes that the distribution of corporate income on a patronage basis be made in cash; it is sufficient if the money is allocated to the patrons on the books of the corporation and the corporation keeps the money for expansion purposes. Payments may also be made in stock, scrip, or other evidence of equity which does not require an actual distribution of cash.

Many big cooperative corporations have carried on a pyramidical accumulation of untaxed earnings for years until they have become dominant in their industries. As they grow they buy out their large and small competitors taking them off the tax rolls too and paying for them with money that other corporations would be required to use for income tax purposes.

FALSE COMPROMISES

Frequently a compromise solution to the co-op tax controversy is put forward whereby cooperative corporations would be subject to Federal income taxes on all retained earnings and profits except those distributed as cash patronage dividends. Such a proposal is meaningless as far as it accomplishes real tax equality. In fact, such a compromise or any similar to it would offer no solution at all in most instances and very little in others. In other words, it is not a compromise, but rather is a fallacious approach both in prinicple and as to practical result.

The Treasury department, itself, in a study of this oft-proposed "compromise" stated:

"...A requirement that non-cash distributions of patronage dividends be included in the income of cooperative associations, while cash dividends were excluded, would not prevent cooperatives from building up substantial amounts of capital out of earnings not taxed to the association."

The reason is that the courts and the Treasury are disposed to rule that the issuance of such things as "scrip," certificates of indebted-

ness, stock, or merely credit entries on the books of the cooperatives are the same as a distribution of cash and the reinvestment thereof by the recipient. Hence, under such a "compromise," the cooperative would merely issue such items in lieu of actual money to patrons and keep the cash, tax-free, for any purpose to which it desired to put it. In fact, many cooperatives follow this identical practice today under present laws and regulations. The "compromise" would not affect them and most other co-ops could follow the same plan with little or no difficulty. Cooperative spokesmen agree that such a law would have little or no effect on their present ability to escape income taxes.

NOTABLE EXAMPLES

A notable example of the way cooperative corporations expand on tax-free income is found in the Farmers Union Grain Terminal Association. This cooperative corporation began operations in 1938 with $30,000 of capital. During the ten succeeding years it increased its net worth to a total of $17,012,313 or 566 times its original capital. Practically all of this increase in net worth was built up through the retention of untaxed earnings.

In its process of growth it has bought out one big line elevator company and it now owns lumber yards, a flour mill, feed mills and other enterprises on whose earnings no income is paid.

Other big co-ops, too, have bought out large and small competitors, paying for them out of tax-free earnings and taking them off the tax rolls in the process. And numerous concerns have voluntarily shifted from taxpaying status to cooperative tax-free status—admittedly for the sole purpose of avoiding taxes.

* * *

In the case of the Consumers Cooperative Association of North Kansas City, Missouri, net worth grew from $251,849 at the close of 1935 to $7,321,867 at the close of 1945. Again,

most of the increase in net worth was built up out of retained earnings that escaped Federal income taxes.

During the four years of World War II, cooperatives did a total volume of business amounting to nearly $33,000,000,000 escaped Federal income tax of about $855,200,000 figured at regular rates.

AMOUNT OF TAX ESCAPE

Much of this $855 million of unpaid income tax, along with a major proportion of the tax-free profits themselves, was retained in the cooperatives' businesses by the simple device of issuing scrip or allocating book credits to patrons in place of money. That's how cooperative business has grown so fast.

Profits from their present volume of business are estimated at about $875,000,000 a year, on which the Federal income tax would be about $320,000,000 at the regular corporate rates of 21 to 35 percent.

(Add $50,000,000 or more to the find the co-ops' tax liability under the new rates of the first war-time tax bill.)

CO-OP BUSINESS VOLUME

In 1948, cooperative business volume reached a total of nearly $17 billion, as follows:

Farmers Marketing Co-ops at local level	$6,989,919,500
Farmers Purchasing Co-ops at local level	1,858,080,000
Manufacturing Co-ops	1,296,231,926
Wholesale Co-ops	1,296,231,927
Commission Business	3,752,471,978
Consumer Cooperatives	1,020,740,100
Retailer-owned Cooperatives	595,400,000
	$16,809,075,431

To promote the ideology of cooperation and to protect the various statutory advantages that have been secured, several big and powerful organizations have been set up, skillful attorneys and lobbyists are employed, the assistance of the farm bloc in Congress has been wooed and won, political strength has been developed all the way from the Nation's Capital to the grassroots, and a language of economic doubletalk has been created to confuse the issue.

Cooperative leaders use this double talk in order to justify their unfair tax privileges to the public. We have seen how profits are "distributed" by keeping the profits in the corporation and making book entries allocating them to patrons. Similarly when a co-op leader talks about the profits of a cooperative, they are likely to be very low because he has excluded therefrom the profits that have been distributed as dividends on patronage. Co-ops like to conceal the fact that they are escaping income taxes by calling their profits "savings," "net margins," "rebates," "price adjustments," "over-deposits" and other terms which camouflage the fact that their corporate profits are unfairly escaping income taxes.

Most cooperatives are corporations because of the protection that corporate set-up gives to officers and members. For tax purposes—and for tax purposes only—they like to call themselves "partnerships," which they are not.

In the first place, they have none of the personal liabilities of a partnership. In the second place, a cooperative corporation is a corporation and it would be most unfair if such corporations were enabled to avoid corporate income taxes and only be taxed on a partnership basis. However, they have tax advantages over partnerships too.

The opinion of the staff of tax experts of the Congressional Joint Committee was explained in a report to the House Ways and Means Committee during consideration of the current tax bill as follows:

"Cooperatives now have a tax advantage over both corporations and partnerships. Moreover, this advantage is not merely due to the fact that corporate earnings paid out as dividends are subject to double tax. A tax must be paid by a corporation on earnings retained for expansion, and even though there is no double tax involved in these particular earnings so long as they are retained, the tax that is paid decreases the funds available for expansion are likely to be depleted by the amount of the tax which the partners must pay on these earnings. In the case of the cooperatives, however, this is not the case."

FALSE JUSTIFICATION

Cooperative leaders frequently attempt to justify their tax privileges upon the ground that their corporations act merely as agents for their members. This claim has no foundation in fact. Cooperative corporations make no attempt to act as mere agents. They buy and sell for their own account, not that of principals. They commingle transactions, take title in their own name, buy from and sell to members and nonmembers, make purchases, sales and other decisions without consulting members. They do not account to each member for the profit and loss incurred in carrying out particular business and they are not reimbursed by their members for losses incurred. In other words, they act in the same manner as any other corporation.

Cooperative leaders claim that by anticipatory arrangements and contracts, their corporations have a legal obligation to turn over their profits to their members and that, therefore, it would not be constitutional to tax their income to them. They conveniently overlook, in their argument, the fact that the Supreme Court of the United States had held time and time again that income taxes cannot be escaped by "anticipatory arrangements and contracts however skillfully devised."

The cooperative statement that "we pay all taxes" applies generally to local taxes, but excludes payment of Federal taxes on all income and at full rates. In states that have state net income taxes, they escape these also.

TAX WILL NOT DESTROY

Paying full Federal income taxes would not destroy any cooperative, any more than it destroys competing businesses.

Neither NTEA nor any other organization seeking tax equality aims or desires to "kill the cooperative movement." The sole objective is tax equality.

In the opinion of eminent tax attorneys, including Mr. Randolph E. Paul for the Farmers Union Grain Terminal Association, it would

not be unconstitutional to impose income tax on the earnings of cooperatives.

In order to correct the present tax injustice, two things will have to be done: First, it will be necessary to repeal Section 101 (12) and 101 (13) of the Internal Revenue Code because these sections grant absolute tax-exemption to cooperatives and corporations organized by them to finance co-op corporations. Second, it will be necessary to close the tax loopholes created by Treasury rulings. This can be done by a law making it clear that cooperative corporations are to be taxed like other corporations on their full income, including that part of their income which is subsequently distributed as a dividend on patronage. H. R. 5064 which was filed by Congressman Noah Mason of Illinois would bring about tax equality by accomplishing these two steps.

This is the only way by which tax equality can be brought about. Any so-called compromise, such as the "cash dividend" compromise previously outlined, is utterly meaningless.

Probably the chief reason why Congress has failed so far to close the cooperative tax loophole and end this obvious injustice is politics.

Three decades of co-ops lobbyists have cajoled and threatened the members of Congress, demanding their continued support of tax exemption as the price of the farm vote.

Only recently has it been disclosed that co-op political power is actually exceedingly thin.

Testifying before the Senate Finance Committee in opposition to the Treasury requested withholding tax on patronage dividends, Mr. Karl D. Loos, attorney for three big co-op groups, presented his own careful calculation of 929,000 payments of patronage dividends.

Of these, 563,000 were for less than $1 and 285,000 were between $1 and $10. In other words, 91.4 percent of these payments were for less than $10.

Further, Mr. Loos revealed that the recipients

of the 8.6 percent of patronage dividends amounting to more than $10 collected 76 percent of the profits paid out by the co-ops.

Economically, it is interesting to learn that so large a part of the profits of cooperative business is paid to so very few members.

Politically, it is highly significant that the great number of farmer-voters get so very little value from cooperative membership, and that the chief beneficiaries of the system are so few in number as to be politically impotent.

It is evident that no Congressman has much to fear from threats of cooperative reprisal!

CO-OPS ESCAPED TAX IN TWO WORLD WARS

* * *

IT MUST NOT HAPPEN AGAIN

The cooperatives were given their first tax exemption just before the U. S. went into World War I.

They made their biggest gains in World War II, when they paid little or no tax on earnings while other corporations were paying up to 80 percent.

That must not happen again!

This time, cooperatives and all other tax exempts must share the costs of war by paying full income tax on all their earnings.

Neither political fears nor economic double-talk should be permitted to continue tax exemption for any business.

In the very next tax bill considered by the Congress the cooperatives must be taxed.

No one can be allowed to make tax-free profits, especially in wartime!

* * *

Additional copies of this booklet are available at no cost from the

NATIONAL TAX EQUALITY ASSOCIATION

231 South LaSalle Street • Chicago 4

HOW PARTNERSHIPS ARE TAXED

A partnership is not a legal entity separate and distinct from its partners. The income tax law regards the partners as businessmen who are working together, each of whom is taxable upon his distributive share of the net income of the partnership, whether distributed or not.

Section 181 of the Internal Revenue Code states:

> "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

This means that partners are obliged to report as an item of their income from all sources (partnership and non-partnership) their distributive share of the net income of the partnership of which they are members. Whether or not there is actual distribution of profits is immaterial. This process of taxing the partners of a partnership has been called looking through the fiction of the partnership /Helvering v. Waldridge, CCA 2 (1934) 70 F. (2d) 683, cert. den. 293 U. S. 594/.

Under present law, partnership income is computed under the same provisions as those applicable to individuals, with the following exceptions:

(1) Capital net gains and losses of the partnership are segregated from ordinary net income and carried into the income of the individual partners. There they are treated in the same manner as other capital gains and losses of an individual.

(2) Charitable contributions, etc. of the partnership are not allowable in computing partnership income, but each partner deducts his distributive portion of such contributions in his individual return.

The general rule for the taxing of partners is to include in computing the net income of each partner, whether or not distribution is made to him,

(a) his distributive share of the net short-term and long-term capital gain or loss and

(b) his distributive share of the partnership net income or the ordinary net loss of the partnership computed as specifically provided in the statute.

The partners may take the profits in whatever form and manner and in such proportions as they may agree upon, assuming an arm's length agreement. The statute holds each partner accountable for the tax upon his proportion of the profits.

The statute follows the general principal of treating a partner's distributive share of partnership income on the same basis as income received by him individually and of allowing every deduction from partnership income which he might take from his individual income, unless the contrary clearly appears in the statute /Craik v. U. S., 31 F. Supp., 132 (1940)/.

Although partnerships as such are not taxable, a number of special rules apply to the taxation of the partner thereof. The difficulties in connection with the treatment of partnerships and their members relate sometimes to:

(a) the period in which the partner's distributive share is to be included in income

(b) the complications arising when a partnership is dissolved by death or otherwise, and

(c) complications resulting from the use of different methods of accounting of the partner and its members, as where the partnership is on the accrual basis and the partner is on the cash basis.

If the taxable year of a partnership is different from that of a partner, the share of the firm's income to be reported by a member thereof is based upon the income of the partnership for any taxable year of the partnership ending within the member's taxable year.

When a member of a partnership dies, his distributive share of the income to the date of his death should be included in the return of his income to the date of his death.

A partner must report his distributive share of the net income of the firm, despite the fact that he may employ an accounting basis (cash receipts) different from that of the partnership (accrual basis).

Salaries paid to partners are not treated as such but are returned as part of partnership profits. The same is true of interest on capital contributions.

There are other rules relating to particular situations, but I think the above are sufficient to present a picture of how partnerships are treated under the Internal Revenue Code.

What Relationship between Individuals Constitutes a Partnership for Tax Purposes

The Code and the Revenue Acts, since 1932, define the term "partnership" as including:

". . . a syndicate group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture, carried on, and which is not, within the

meaning of this title, a trust or estate or a corporation". /I.R.C., Section 3797 (a) (2)/.

For purposes of Federal taxation, the Internal Revenue Code makes its own classifications and prescribes its own standards for qualification as a "partnership". The term "partnership" as used in the statute is not limited to its common-law meaning, but is broader in scope and includes groups not commonly called partnerships. The statutory definition is not an exclusive definition. One must explore the common-law, the various uniform partnership laws, and decisions under the various Revenue Acts, and resolve many virtually irreconcilable decisions. The rules of law determining whether a partnership may or does not exist are in confusion, and factually the existence of a partnership is often "problematical and difficult to determine" /W. N. Buchanan v. Comm., 20 BTA, 210/.

There is no one test to apply to determine whether or not a given association is a partnership; however, the following tests are among those frequently applied:

1. The profit-sharing test. There must be a mutual interest in the profits. In Howard Coombs v. Comm., 20 BTA, 1021, the Board of Tax Appeals on page 1025 quotes from Meehan v. Valentine, 145 U. S. 611, as follows:

> "The requisites of a partnership are that the parties must have joined together to carry on a trade or adventure for their common benefit, each contributing profit or services, and having a community of interests in the profits."

2. The mutual liability test. Every partner must be personally liable for all the debts of the partnership.

3. The mutual agency test. The common-law type of partnership has been defined as "a business organization in which every partner possesses full power and absolute authority to bind all the partners by his acts or contracts in relation to the business of the firm, in the same manner and to the same extent as if he held full power of attorney from them (letter from the Treasury Department dated January 19, 1916).

4. The common contribution test. A contribution by all partners concerned of assets to the partnership. This test is of slight value, since one partner may contribute services only.

5. The service contribution test. It is customarily for all partners to contribute services to the partnership. It must be remembered, however, that there may be inactive partners.

6. The alienability of interest test. The rights of a partner in a partnership are determined by a personal contract and are non-alienable.

A partnership is a matter of contract but no particular form or contract is necessary to its creation. A partnership may exist without any formal agreement. It may be oral. In determining whether or not a partnership exists,

courts consider evidences of conduct and circumstance and, after a consideration of all the evidence and all the partnership tests, comes to a decision. No rigid rule is applied. The particular facts are considered in the light of partnership law and a conclusion is reached which may or may not follow precedence.

When does a Partnership become subject to Corporate Income Taxes?

A partnership is taxed like an association or corporation when it conducts its business so as to obtain for itself the advantages that go with that form of doing business. The main factors to be considered as set out in the leading case on this subject, Morrissey et al Trustees v. Comm., 296 U. S. 344 (1935) are:

1. Centralized management.

2. Title to property in trustees or agents with provision for succession.

3. Security from termination of association by death of a beneficial owner.

4. Facility of transferring the beneficial interests without affecting the continuity of the enterprise.

5. Limitation of personal liability.

The limitation of personal liability is particularly important.

A question may be raised about so-called "limited partnerships". These may be taxed as ordinary partnerships or as corporations, depending on their character. Reg. 103, Section 19.3797.5 of the Internal Revenue Code states:

> "If the organization is not interrupted by the death of a particular partner or by a change in the ownership or his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation".

An association taxable like a corporation is defined in the regulations as follows: (Reg. 103, Sec. 19.3797-2)

> "The term 'association' is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, . . . a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership. . . ."

The Morrissey Case, supra., indicates the features which make an association taxable as a corporation, but it does not indicate how many of the attributes are indispensable. From subsequent decisions, it may be gathered that the question is still one of degree, that one or more of these attributes may be absent without affecting the determination that the organization was sufficiently analagous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of a corporation.

The difference between corporations and partnerships must be kept in mind when determining whether a given border line organization is more like a corporation and so should be taxed as such or, more like a partnership and so should be taxed as such. In making this decision, the following distinctions are usually kept in mind by judges making the decision:

1. A corporation continues until it is dissolved by law and so the continuity of its business is a certainty. A partnership is for an agreed term, within which death may intervene and dissolve the business. Continuity of its business is uncertain, since death may terminate it.

2. A corporation has an entity separate and distinct from its stockholders. It has the right to sue and be sued and to hold and deal it property as a separate entity. A partnership has no entity separate from its personnel and the individual members of a partnership are responsible for its every activity.

3. The stockholders of a corporation are exempt from the liabilities of the corporation. In a partnership, each member is individually liable for all the obligations of the partnership, notwithstanding agreements to the contrary between the partners and regardless of the capital contributions made by various partners.

4. Stock certificates are ordinarily transferable to strangers. Ownership interests are thus very readily transferred. In the partnership, the transfer of a partnership interest affects a new partnership. The consent of the other partners is necessary plus involved arrangements to provide against the former members continuing liability for partnership debts.

5. A corporation has great ease in obtaining capital by the sale of stock or bonds. A partnership can secure new and necessary capital only by loan or by remaking the partnership or upon contributions of its members.

6. A majority of the Board of Directors assures prompt and timely business action by the corporation. Partnership action is usually dependent upon the unanimous agreement of its membership, and in addition to material objectives, problems of disagreements, unity of policy, and difficult personnel equations may be involved.

7. Stock certificates may be used as collateral. Interests in partnerships are not ordinarily pledgible for loans or credit.

8. Stockholders do not directly share in the responsibility of management. Investment in a partnership involves responsibility for management and a participation therein.

9. A corporation is a creature of the state from which its powers are received. A partnership is a contractual relationship between individuals, within, which the members ordinarily possess the power to do, in business, what individuals can and usually do in such business.

Applying the above nine tests to a given organization usually resolves the question as to how it should be taxed. If it more nearly resembles a corporation than it does a partnership, the association itself is regarded as an entity whose income is subject to tax and that same income is taxed again in the hands of individuals receiving distributions thereof as dividends.

If the organization is more like a partnership than a corporation, each member thereof is taxed for his proportionate share in the partnership income, whether distributed or not. Salaries paid to members are disregarded and are included in the full income of the partnership to be taxed to the partners individually as if distributed in the proportions fixed by the partnership contract.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 1, 1950.

To Governor Eccles

From R. W. Lindholm

Subject: Comments on three enclosures sent by the National Tax Equality Association.

The tax analyses prepared for the National Tax Equality Association, Inc. by Mr. Lester and Mr. Adcock are not a compromise of the cooperative tax problem such as have been advocated and reached in a number of countries. The recommendation is that all earnings including what is classified as patronage dividends be taxed to the cooperative in a manner similar to corporate earnings. This "solution" would undoubtedly raise the maximum amount of revenues from cooperatives and would eliminate any complaints from corporations that cooperatives were undertaxed. In doing this, however, it would be necessary to eliminate consideration of one major difference between cooperatives and corporations which does exist despite disclaimers; namely, the portion of cooperative earnings correctly labeled patronage dividends are paid on the basis of business done with the cooperative while corporate dividends are paid on the basis of shares of stock owned. This difference is too fundamental to be excluded entirely from consideration in writing tax legislation.

As the cooperative movement has developed and corporate tax rates have increased the tax advantage of the cooperative method of organizing economic activity has become widely recognized as worthy of attention by businessmen and Government officials. It, however, is not the only and more than likely not the largest of existing tax loopholes. The National Tax Equality Association to live up to the purpose indicated in its name should also be making studies to show the tax avoidance of insurance companies, oil companies, educational and charitable economic activities, and the like.

The position taken in the NTEA literature has the publicity advantage of being simple and direct -- treat patronage dividends as earnings subject to the corporate income tax. It also has the inherent disadvantage of avoiding complicating realities -- of simplifying tax proposals to increase public appeal.

A preferable approach would be to accept the basic idea of the cooperative plea that patronage dividends are different from regular corporate earnings. Then it should be pointed out that the recognition of this fact does not also necessitate tax exemption of cooperative earnings not paid out in dividends to patrons, nor does it also follow that patronage dividends should be tax-exempt if they arise from earnings on activities not closely associated with purchases or sales made for the patron. Finally, it can be emphasized that there is no relationship between the recognition that patronage dividends should be tax-exempt and the exemption of dividends paid on cooperative capital stock.

RWL

December 6, 1950.

Mr. G. M. Lester, President,
National Tax Equality Association, Inc.,
231 South La Salle Street,
Chicago 4, Illinois.

Dear Mr. Lester:

In response to your letter of October 16, relative to a speech which I made before the Cooperative League of the United States, I advised you in my reply of October 20 that I would have one of our Research men go over and give me his comments on the material which you sent to me.

Our tax man on the staff has gone over the material and given me a very brief memorandum on your three studies. Thinking you may be interested in his comments I am enclosing herewith a copy of his memorandum.

Sincerely yours,

M. S. Eccles.

Enclosure

VE:dls

Comment on a Memorandum Prepared for M. S. Eccles

The essential point made in the comment prepared for Mr. Eccles is that:

> "...the portion of cooperative earnings correctly labeled patronage dividends are paid on the basis of business done with the cooperative while corporate dividends are paid on the basis of shares of stock owned. This difference is too fundamental to be excluded entirely from consideration in writing tax legislation."

Is this difference really "too fundamental"? It is true the corporate profits of the cooperative are not distributed on the basis of stockholdings; but why should this difference in the pattern of distribution affect corporate income tax liability? It is a well established law that:

> "A distribution of profits may be made on a basis other than stock holdings and still be a dividend distribution" Juneau Dairy Inc. vs Commissioner 44 B. T. A. 759.

With other corporations the income tax applies to earnings regardless of the pattern in which they are distributed. They may be put into a special reserve fund or distributed to stockholders, or put into working capital, or any number of things. Under the income tax law, however, the earning of the profit determines the income tax liability, and that tax liability is not changed by the subsequent use of the funds. Why should it be any different with cooperative corporations?

Cooperative spokesmen point out that their payments to members are made pursuant to a contract and that they call them "savings" instead

of profits. The courts, however, say:

> "Payments by a corporation to its shareholders pursuant to a contract may constitute dividend distributions notwithstanding that they are labeled expenses or something else"
> Ingle Coal Corporation vs Commissioner 174F (2d) 569(1949)

In the above case royalty payments were subjected to corporate income taxes even though royalties are ordinarily deducted as business expenses.

The distribution of corporate dividends to customers rather than stockholders would have more significance in the case of cooperative corporations if the two groups were not substantially the same. The fact of the matter is, however, that the profits distributions to the customers of a cooperative are in the main also distributions to members and shareholders, because cooperative corporations deal principally with their members. The reason the stockholders of a cooperative corporation do not object to their corporate profits being distributed under the guise of price adjustment to customers is that the shareholders are the customers and it makes little difference to them whether the dividend they receive is on stock ownership or on patronage.

It must be remembered that when members of a cooperative corporation adopt by-laws directing that the corporate profits be distributed to them as a dividend on patronage, they are not contracting with a stranger. The agreement is made by the shareholders with an entity of their own creation, an organization operated and controlled by them. They may decide that the corporate profits shall be distributed to them on some basis other than stock ownership, but that does not

alter the fact that the distribution is being made to shareholders; hence the difference in pattern between distribution of a cooperative corporation and an ordinary corporation is not as "fundamental" as it might seem at first glance.

The memorandum prepared for Mr. Eccles states that a "profitable approach" to taxing the income of all corporations alike would be to continue to allow the corporation income of cooperatives to escape federal income taxation when it is distributed as dividends on patronage, but to narrow this tax loophole. The difficulty with this approach is that after such legislation has been passed, the cooperative corporations, by exercising a little ingenuity, would still be able to have their income classified as tax exempt and would therefore continue to be unfair competition for fully taxed businesses.

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NATIONAL TAX EQUALITY ASSOCIATION
INCORPORATED
231 SOUTH LA SALLE STREET
CHICAGO 4

December 12, 1950

Mr. M.S. Eccles
Board of Governors
Federal Reserve System
Washington, D.C.

Dear Mr. Eccles:

Thank you very much for your letter of December 6, 1950, enclosing the comments of the tax man on your staff with respect to the enclosures we previously sent to you.

I note that the comment states that if the National Tax Equality Association lived up to its name it should also be making studies relative to the tax disparities of various insurance companies, educational and charitable economic activities, and the like. The fact of the matter is that the National Tax Equality Association has been making such studies but did not send such material to you inasmuch as our correspondence resulted from a speech which you made before the Cooperative League of the United States and these other matters were not involved.

I asked our general counsel, Mr. A.W. Adcock, to briefly comment on the comments you sent me and I am enclosing his memorandum on them. I think you will be interested in the points he brings out.

Cordially,

G.M. Lester

G. M. Lester
President

gml
ep

January 17, 1951.

Mr. G. M. Lester, President,
National Tax Equality Association,
231 South La Salle Street,
Chicago 4, Illinois.

Dear Mr. Lester:

I am glad to have the comments of your letter of December 12, 1950, and the attached memorandum prepared by your general counsel, Mr. A. W. Adcock. It is useful to know that you are working on a number of aspects of the tax equality question in addition to the cooperative problem.

The position taken by Mr. Adcock on the difference between patronage dividends and investment dividends is a legal one related to labels attached to business distributions. These points are well taken but the fact remains, even despite court decisions, that a fundamental economic difference exists between dividends based on patronage and dividends based on investment. However, it is also true that patronage dividends paid from receipts arising from activities other than the recipient's patronage and patronage dividends not paid in cash fall outside the scope of the economic concept of patronage dividends to which I refer. This difference should be recognized in tax legislation. I believe that it should be possible to take account of both sound economic and legal differences in tax legislation in a practical and workable form.

Sincerely yours,

M. S. Eccles.

RVL/CKY:vl

FILE COPY

NATIONAL TAX EQUALITY ASSOCIATION
INCORPORATED
231 SOUTH LA SALLE STREET
CHICAGO 4

January 24, 1951

Mr. M.S. Eccles
Board of Governors
Federal Reserve System
Washington, D.C.

Dear Mr. Eccles:

Thank you for your letter of January 17th.

I am deeply appreciative of two things; first, that you would take the time, busy as you are, to maintain correspondence with me on the subject of tax equality, and second, I am mindful of your open minded attitude.

Attached are two enclosures; one is the article from the Michigan Law Review by Roswell Magill, former under secretary of the Treasury, and the other is a statement by Professor Guthmann of Northwestern University. Each of these gentlemen cover the points mentioned in your letter with respect to their belief that the income of co-ops is the same for tax purposes as that of any other corporation.

I would appreciate it very much, if you do not have the time to go into this yourself, that you refer it to your research staff. We would be very much interested in their views as well as your own, with respect to the opinions advanced by these gentlemen.

Personally, I cannot see any difference between the earnings of a co-op corporation and that of a private tax paying organization. I believe the Treasury and the Courts have ruled time and time again that the taxability of income is determined by the way it is earned and not by the manner of its distribution.

Sincerely,

G.M. Lester
President

gml
ep

February 13, 1951.

Mr. G. M. Lester, President,
National Tax Equality Association, Inc.,
231 South La Salle Street,
Chicago 4, Illinois.

Dear Mr. Lester:

Thank you for forwarding to me the discussions of the desirability of taxing cooperative patronage dividends. Both of the papers have been carefully prepared and show an understanding of the problems related to the treatment of cooperative patronage dividends for income taxation purposes. The general conclusion of both able studies is to substantiate the opinion I previously expressed; namely, that cooperative tax burdens should be increased. It may be a desirable practical program in reaching this goal to advocate taxing cooperative patronage dividend payments at the regular corporation income tax rate and then compromise with the taxation of only retained earnings and those earnings paid as dividends on preferred stock. However, in using this approach it should be fully realized that the foundation of the argument is open to serious attack.

The basic point of both papers is that the cooperative arrangement is merely a method of reducing taxable income by self-dealing between related taxpayers. The relationship between a cooperative and its hundreds and maybe thousands of patrons is made out to be the same as the relationship between a parent corporation and its subsidiaries. This is, of course, partially true but in extending the concept to include cooperatives the same type of error is being made as when the concept of the cash discount is stretched to include cooperative patronage dividends.

The basic shortcoming of both arguments is that patronage dividends of a true cooperative arrangement are not adequately described by legal rules related to production facilities owned and controlled by persons who are only incidentally consumers of the services or products produced. That is, court decisions and legislation aimed at explaining and controlling operations of business firms established largely to serve customers other than owners must be considerably revised to become applicable to firms organized to provide goods and services only to its owners.

It is because a true cooperative produces only services consumed by its owners that patronage dividends are sufficiently different from the income of a corporation, partnership, and proprietorship to justify different tax treatment. Patronage dividends are not the same as trade discounts, also, the relationship between a cooperative and its patrons is not the same as that between a parent corporation and its subsidiaries or a corporation and its stockholders. This fact justifies a treatment of cooperative patronage dividends different from the treatment of regular business profits, although it does not provide a basis for complete exemption of cooperative patronage dividends from taxation.

Sincerely yours,

M. S. Eccles.

RWL

RWL:rvl