

*Cooperatives – Australians
Extending their own Business*

*Submission to the
Review of Business Taxation*

*from the
Cooperatives Council of Australia Inc*

FOREWORD

COOPERATIVES COUNCIL OF AUSTRALIA

The Cooperatives Council of Australia (CCA) is the representative body of cooperatives throughout Australia. Its board is made up of elected directors from each of the State Cooperative Federations who individually represent cooperatives large and small in each of the States.

COOPERATIVES AND THE PRINCIPLE OF MUTUALITY

Cooperatives are diverse in both nature and size.

They are the backbone of many industries and are traditionally represented in many sectors including primary industries, consumer cooperatives, worker or enterprise cooperatives, finance or banking cooperatives and community cooperatives.

Cooperatives are extremely well represented in the primary industry sector with major players who turnover billions of dollars. Cooperatives (farmer owned businesses) are major players in dairy, fruit processing, sugar, cotton, fishing, nut, meat and pork processing and many others and are prevalent amongst Australia's major exporters.

Cooperatives are formed on the basis of the mutuality principle and are an ideal entity for the formation of enterprises by small groups of Australians. The largest Primary Producer cooperative like the smallest community cooperative will undoubtedly have had roots established as a small enterprise formed by Australians under the principle of mutual ownership and operation. They are Australian owned enterprises big and small which are vibrant and flourishing in the competitive world in which Australia participates.

Cooperatives are owned by hundreds of thousands of Australians and as a sector is one of the major employers.

The backbone of Australian owned Cooperative enterprises - cooperation and mutuality - is however now under critical attack by way of the Ralph Committee "Review of Business Taxation".

DIVISION 9 OF THE INCOME TAX ASSESSMENT ACT 1997

This area of the current Taxation Act is specifically aimed at and addresses Cooperatives as they operate pursuant to the principle of cooperation and mutuality. It recognises that enterprises formed under the principle of cooperation and mutuality are different in their operating principle to those that are simply profit based.

A NEW TAX SYSTEM

The government's review of the business tax system is based on the white paper "**Tax reform not a new tax a new tax system**".

The principle of the review is that the same tax arrangements should apply to cooperatives or mutuals as apply to all business entities that offer limited liability to their owners companies, public companies etc.

This principle does not recognise the basis on which the enterprise operates and does not recognise that cooperatives do not operate on the same basis as profit motivated companies. Therefore, the principle under which the business review is operating is flawed in its approach and the outcomes will be unnecessarily destructive in their impact on the cooperative movement unless the review recognises Cooperatives and the basic principle of mutuality.

This submission proposes that Division 9 should not only be retained but should be enhanced so that cooperatives and the principles of mutuality are supported as a means of Australian owned enterprises flourishing in the world economy.

Executive summary

The Government intends to abolish Division 9 of the Income Tax Assessment Act under the principle that the same tax arrangements should apply to cooperatives and mutuals as applies to companies.

The CCA submits that the principle on which the review is based is flawed in that it does not recognise the principles under which cooperatives operate.

The nature and objectives of cooperatives provide the basis for the way in which they should be treated under the taxation regime. The fundamental point is that the primary purpose of a cooperative is to provide services to its members, whereas the primary purpose of a company is create profits for its shareholders.

Cooperatives operate under the cooperation and mutuality principle and should be recognised as distinctly different business entities under the new tax system.

The present Act affords a choice for business to operate either on the basis of the 'profit first' rule, or as a cooperative 'mutual' enterprise. Under the Government's proposed reforms, business would lose that choice; all business entities including not for profit organisations will be considered as operating under the 'profit first' rule. (White paper - Chapter 3)

The provisions in Division 9 of the Income Tax Assessment Act do not convey special privileges to cooperatives. Rather, cooperatives are taxed in this way because of the long established and accepted "principle of mutuality", which is intrinsic to the nature of all cooperative enterprises throughout the world. Cooperatives serve their members as an extension of their business activity.

Similar cooperative taxation provisions to that found in Division 9 are found in the Income Tax Acts of nearly all the countries that are Australia's trading partners and recognise the cooperative enterprise.

The removal of Division 9 would severely weaken the cooperative sector, at a time when

Australia needs strong cooperatives to meet the demands of the global market.

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Cooperatives are even more relevant today than they were 70 years ago; as evidenced by the number of cooperatives still operating and new ones being formed and the status they hold within the Australian economy.

All state and territory governments have recognised the unique character of cooperatives and their importance to their economies by adopting in 1996, a national scheme for consistent cooperative legislation around Australia

Cooperatives are subject to specific controls not applicable to other business entities, imposed by State Cooperatives Acts.

The tax system would not be able to achieve the objectives of the Government unless it recognises cooperatives as a distinct entity that contribute to the economy and to the taxation revenue base.

Cooperatives are a viable alternative to major overseas ownership, keeping Australian owned and operated enterprises in Australian hands.

RECOMMENDATIONS

1. That any new tax legislation will continue to recognise the principle of cooperation and mutuality.
2. That any new tax act recognises the principles of co-operation as adopted by the International Cooperative Alliance as defining a cooperative enterprise for the purposes of the act.
3. That Division 9 of the *Income Tax Assessment Act* be retained, with the following improvements:
 - distributions by way of rebate or bonus based on business done by the member with the cooperative, should be clearly an allowed deduction in the year in which the business was done to earn the rebate or bonus.
 - the issuing of shares to members of a cooperative out of retained earnings should not be treated as taxable income in the hands of the members. Members should be taxed when the shares are sold by the member and the proceeds received.
 - Section 120(1)(c) should be enhanced to allow all cooperatives the same deduction, not

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only those which comply with Section 117(1)(b)

- the Taxation Department should work with the cooperative movement to determine a set of guidelines for the operation of Division 9 and subsequently release a public ruling which supports the guideline.

BODY OF SUBMISSION

OBSERVATIONS

TAX REFORM NOT A NEW TAX A NEW TAX SYSTEM

Treasurer Peter Costello released a briefing paper on the GST and Tax Reform - "Tax Reform not a new tax a new tax system" which indicated that there would be changes to the company tax system. The first discussion paper released from the Ralph committee, whilst being fairly general in its content, supports the principles espoused in the Costello paper.

There are a number of specific areas in which cooperatives, as an entity, are identified and affected.

The paper has identified under the heading of "Taxation of business entities is inconsistent"; three areas that will be targeted (page 109):

- (a) *inconsistent entity treatment,*
- (b) *inappropriate taxation of company groups, and;*
- (c) *inconsistent treatment of distributions*

Cooperatives are specifically referred to in the following areas within the targets identified above: -

BUSINESS TAX SYSTEM

The paper indicates that the government intends to redesign the company tax arrangements and has specifically identified trusts as the target area, however within the plan the following appears on page 115:

*The government intends to broaden the benefits of these redesigned tax arrangements by applying them to other business entities offering limited liability to their owners: limited partnerships, cooperatives and life insurers. This would mean that life insurers income would be taxed uniformly at the company tax rate (with imputation credits for investment policyholders). **Cooperatives are already taxed like other companies if less than 90 percent of their business is with their members.***

DIFFERENTIAL TREATMENT OF ENTITIES - DISTRIBUTIONS

"Some cooperatives are taxed differently again from companies under complex arrangements that can result in different outcomes depending on the timing of distributions" (page 109)

"The benchmark for consistent treatment across dividends, share buy-backs and liquidations is to be the current treatment of dividends. The central element of relevance here is the capital loss allowed to the shareholder who buys shares cum dividend and sells when the shares fall in value post dividend. That capital loss is needed to ensure that double tax does not occur, over time, on retained company income."

The paper's response to this problem is the introduction of a **full imputation system**. This measure intends that all distributions of profits would be taxed at the company tax rate at the entity (cooperative) level rather than at the shareholder level with the result that all distributions of profit would be fully franked.

REVIEW OF BUSINESS TAXATION

The Review of Business Taxation group within Treasury were asked to comment on the impact on cooperatives of the "The new Tax System" and the Ralph enquiry and their response is clear on the impact and principle which the review will adopt. The Secretary of the Review of Business Taxation replied:

"A New Tax System indicated that the Government intended to apply the same redesigned company tax arrangements to cooperatives as to other entities offering limited liability to their owners, such as other companies, trusts and limited partnerships. Those redesigned arrangements would supersede unique tax rules for cooperatives."

ECONOMIC SUBSTANCE OVER FORM

A *Strong Foundation* has suggested that one of the policy design principles of any new tax legislation be *economic substance over form*:

Economic transactions should be taxed on the basis of their economic substance – not their legal form.... If there are tax advantages in deriving income through one type of entity rather than the other, that output puts form (the type of entity) before substance (economic income). (6.84, pp78)

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The CCA agrees with the above policy design principle, as the current tax recognises this principle in its treatment of mutual enterprises. Division 9 does not focus on the entity, as both cooperatives and companies can qualify, under specified circumstances, for deductions under the division. Division 9 focuses on the economic transaction and the nature of the relationship between the taxpayer and the entity.

Economic transactions with members of a cooperative are generally regarded as being on an *at cost basis*, with any surplus distributed to members being regarded as a 'rebate', which is in effect a means of returning the difference between the final cost and the price charged to the member.

It is essential that any new tax legislation recognise entities that operate under "mutuality" principle.

AIM OF THIS SUBMISSION

The CCA submits that cooperatives should be more positively encouraged by means of the taxation system to ensure that they are in a position to develop in the global economy and retain ownership of Australian business by Australians.

The CCA submits that *the retention and improvement of Division 9 in the new tax system will assist the Government achieve the objectives of tax reform, in particular, improving the competitiveness and efficiency of Australia business, and thereby the competitiveness of the Australian economy.*

The market reality is that most small businesses (including primary producers) are not of a sufficient size to compete effectively with larger corporations or gain access to overseas markets. Only by achieving economies of scale can small business become a player in the international market. The cooperative model is an ideal vehicle to promote Australian ownership.

There are many examples in Australia where cooperatives play a vital role in enabling small business to be a player in the market and the success of many major Australian Cooperatives;

- Mackay Sugar,
- Golden Circle,
- Bega,
- University Cooperative Bookshop
- Australian Wine Consumers' Cooperative Society
- Plumbers Supplies Cooperative
- The Independent Liquor Group
- Australian Cooperative Foods (The Dairy Farmers Group),
- UMT,

- Fremantle Fisherman's Cooperative

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and many more show the viability and resilience of cooperatives as business entities.

WHAT IS A COOPERATIVE?

A cooperative can be defined as an autonomous association of persons, united voluntarily to meet their economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

The fundamental objective of a cooperative is to serve the member to ensure the continuance and improvement of the individual members' businesses, which results in Australians owning and developing entities that contribute in a major way to the Australian economy and taxation base.

THE AUSTRALIAN COOPERATIVE SECTOR

Since the inclusion of Division 9 in the current act in 1936, cooperatives have flourished in Australia. The benefits of the reforms in 1936 are demonstrated by the size of the cooperative movement and its contribution to the Australian economy.

Cooperatives represent hundreds of thousands of individual taxpayers and turnover billions of dollars each year. Cooperative entities are also the backbone of many Australian agricultural industries and a number of the supporting regional service industries related thereto are made up of cooperatives.

Australia has an international reputation for producing and exporting high quality agricultural products from a wide range of sectors. Cooperatives are formed by many small businesses and individuals based on a mutual relationship that enables the small Australians to compete on the world economy. Cooperatives in fact have been recognised as leaders in export development.

Worker cooperatives and community cooperatives have flourished in Australia as they have in many parts of the world and they are an important part of the communities in which they participate. The worker cooperatives of the beginning of the century are now the successful exporters of today.

The financial sector still has many smaller cooperatives operating and on a world stage cooperative banks are amongst the top five banks in the world.

Cooperatives are extremely viable and successful enterprises and important and should be

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encouraged to grow as means of ensuring Australian business remains Australian owned and are a way of expansion and wealth creation for Australians that should be encouraged. People do not lose control and they can share in the cost of expansion, diversification or service provision.

There is no limit to the co-operative way. In Australia today there are agricultural, credit, retail, purchasing, marketing, transport, electricity, water, health, housing, child care, radio, investment, cost sharing (or minimisation), joint processing operations, infrastructure, industry organisations, technology sharing, cultural and community service co-operatives. The opportunities are widespread.

LEGISLATION GOVERNING COOPERATIVES

Most cooperatives are registered under State Cooperatives Acts or are formed under corporations law with their articles specifically based on cooperative principles, both as described by Division 9 of the Taxation Act. These acts define the structure of cooperatives and govern how they operate. The main features of the legislation, for the purposes of this review, relate to the purpose of a cooperative, its ownership, capital formation and distribution of surplus. Division 9 of the Taxation Act, in particular Sections 117 and 118, reinforce these features and place specific restrictions on the type of entity that can qualify for tax purposes as a cooperative.

PURPOSE

A cooperative is an extension of the businesses of its owners. Its primary purpose is to provide services to assist members and their operations gain access to previously inaccessible markets, achieve savings on inputs to the members' businesses, and provide services that are not available from other sources.

OWNERS

The owners of a cooperative are those people, entities or businesses that use its services. The Cooperatives Act requires that any person who ceases to use a cooperative's services then ceases to be an owner (member) of a cooperative. Section 118 of the Income Tax Act requires that 90% of the business done by the cooperative must be with its members or it ceases to be a cooperative for tax purposes.

CAPITAL FORMATION

Consistent with the cooperation and mutuality principle, the cooperatives act defines the manner of acquiring, transferring and redeeming shares in a cooperative. The key elements in the act are:

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- shares are held only by members who conduct business with the cooperative.
- limiting the number of shares held by any one person to 20% of the issued capital.
- shares are purchased and redeemed at their issued nominal price.
- capital base not protected by law; issued capital varies according to the number of members a cooperative has at a particular time.
- share transfers must be first approved by the cooperative.
- dividend on share capital capped.

DISTRIBUTION OF SURPLUS FUNDS

Under the cooperatives act, as under Division 9, a trading cooperative can apply a part of the *surplus* arising in any year from the business of the cooperative or a part of the reserves of the cooperative by:

- distribution to members as a rebate on the basis of business done with the cooperatives;
or
- the issue of bonus shares to members to fund future growth; or
- the issue to members of a limited dividend.

COOPERATIVES ARE DIFFERENT TO COMPANIES

While cooperatives and cooperative companies have similarities (both are corporate bodies), they differ in a number of fundamental ways. The key differences are:

- cooperatives operate under the principle of *mutuality* whereas a company operates under the *profit first* principle.
- a cooperative earns its income from its member owners who participate in the services or processes of the cooperative. A company earns its income in the main from persons who are remote investors and are not the owners of the company.
- as mutual enterprises, cooperatives do not have access to the range of financing instruments available to companies.
- the capital base of a company is protected by law. This affords protection for creditors making it relatively easy for such a company to raise debt finance to expand its activities. The capital base of a cooperative, however, is *not* protected by law. The number of issued shares in a cooperative varies according to how many persons are members of a cooperative at a particular time. Multinational companies can raise funds at much lower margins than in Australia and quite often pay no tax in Australia.
- shares in a cooperative can only be held by persons who uses the services of a cooperative, whereas shares in a company are available to anyone who can afford to purchase them.
- distributions made by a cooperative are largely treated as rebate to the member in proportion to the business done by them with the cooperative.

THE COOPERATIVE TAXATION POSITION

THE PRINCIPLE OF COOPERATION AND MUTUALITY

The existing taxation legislation recognises the need to differentiate between entities set up for profit purposes and entities that are set up as Cooperatives or mutuals.

The provisions in the current act do not convey special privileges. Rather, cooperatives are taxed in this way because of the long established and accepted “principle of mutuality” which is intrinsic to the nature of all cooperatives around the world.

DIVISION 9 OF THE INCOME TAX ASSESSMENT

Division 9 had its origins in 1918, when the Commonwealth Income Tax Act first recognised a cooperative as a distinct business entity. After a series of amendments during the 1920's, the present Division 9 was part of a number of recommendations of the Ferguson Royal Commission 1932- 34.

Section 117 defines cooperative for the purpose of the Taxation Act. It limits the number of shares held by any one shareholder, prohibits the quotation of shares for sale or purchase on a stock exchange or in any public manner. It also requires that the primary object/s of the cooperative must be to acquire, dispose, store, market, pack, and process the commodities of its shareholders or to render services its shareholders. It establishes the mutual relationship.

Section 118 reinforces the principle of mutuality by requiring that 90% of the services provided or the storage, marketing, packing or processing of commodities by the cooperative must be provided to the members or shareholders (some cooperatives have no shares).

Section 119 separates a cooperative from the basic tenet “that a person’s income consists only of monies derived from sources other than him or her self” by requiring the cooperative to declare as assessable income all sums received by the cooperative for rendering of services or storage, marketing, packing or processing of commodities from all sources including its members. Section 120 however, then establishes the basic deductions because of the cooperative mutuality principle under which a cooperative operates.

There are two specific differences derived by cooperatives under Section 120.

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The first allows those cooperatives who meet the primary objects defined in section 117 and section 118 of the Income Tax Assessment Act the deductibility of distributions amongst its shareholders or members in the form of rebates or bonuses based on the business done with its shareholders or interest or dividend on shares.

This difference clearly derives from the principle of mutuality.

The second allows cooperatives that comply with section 117(b) the deductibility of the repayment of certain loans defined under section 120(1)(c).

The principle of mutuality is again evident in section 120(1)(c) because of the further requirement that 90% of the value of the cooperative must be held by the persons who supply the commodities or animals which the cooperative requires for the purposes of its business.

Section 120(1)(c) is principally in place because of the restrictions which mutuals (cooperatives) have in place from a fund raising point of view. The deduction enables cooperatives to direct retained earnings back into development that has a direct benefit to the economy and the tax base.

Thus the entity for taxation purposes is defined in the manner that a cooperative is structured as an extension of its members activities and the business done is by all members collectively as a cooperative. The entity is the members.

The current Income Tax Assessment Act is divided into a number of separate Divisions in order to allow every business to voluntarily chose the purpose and operation of its undertaking in order that the business may be taxed under that particular Division.

The proposed reforms, by primarily focusing on the profit first principle, ignore the validity of cooperative (mutual) enterprises.

Cooperatives (based on mutuality) are a modern form of business, and can continue to be, a valid and viable form of business entity. Indeed, cooperatives have a number of highly desirable aspects for wealth creation for Australian owned businesses and thus the taxes are paid by the members. This is similar to elsewhere in the world.

REBATES OR BONUSES

As a cooperative is an extension of members' businesses, the rebates or bonuses received from distributions are treated as a refund or bonus on goods or services purchased or sold by the

cooperative.

In 1921 rebates received by members of a cooperative based on their purchases from the cooperative, where the cooperative was one that usually sold goods only to its members, were excluded from the definition of "income" of a cooperative. In 1922 this provision was amended to exempt rebates of this kind where the Commissioner of Taxation was satisfied that 90% of the cooperative's sales were made to its own members. In 1927 the Act was amended to provide that rebates based on purchases by shareholders were added to the specific deductions that had been provided in the 1925 amendments.

Rebates and bonuses distributed by a cooperative to its shareholders, based on the business done with the cooperative, are deductible from the assessable income derived by the cooperative, being similar in nature to a trade discount granted by an ordinary business to a customer. The 1932-1934 Royal Commission on Taxation commented that these rebates were clearly not profit, but merely the adjustments of the sale or purchase price.

DIVIDEND ON SHARE CAPITAL

In the original Commonwealth Income Tax legislation, all companies were entitled to a deduction in respect of the amounts distributed as dividends to shareholders or members. This deduction was removed by the amendment of the Act in 1923, so that companies were taxed on the whole of their income regardless of the dividends distributed to shareholders.

In 1925 a provision was inserted to allow deductions to cooperatives for amounts distributed among members.

Thus, the intent of Division 9 with regard to dividends is that the share capital contribution to a cooperative is for the purpose of qualification for a shareholder to use the cooperative's services, in contrast to a company in which share capital is a profit earning investment in itself.

The vital distinction of cooperatives in this area has been evidenced in various Boards of Review and High Court cases. In the A.S. Ruffy case, Justices Dixon, Williams and Webb found:

"Every paragraph (Division 9) emphasises the relation to a shareholder to the activity which represents the business. The business must be conducted for performing a particular function for the shareholders....."

It is because the (...cooperative..) company's business is to render what in a wide sense may be called the services to the shareholders that it is considered proper for it to return the profits to them as

dividends, etc., without paying tax upon them.”

It must, however, also be clearly understood that while the dividend, rebate and bonus of a cooperative is a tax deduction available to the cooperative, in all instances the dividend, rebate and bonus is regarded as taxable income in the hands of the recipient member.

The tax deductibility of rebates and bonuses is logical for agricultural cooperatives. In many sectors of primary industry, goods/commodities are supplied to the cooperative by supplier/members before the selling price is known. When prices are finalised the cooperative has a choice, in the case where payments have proved to be conservative and surpluses result, and the choices are as follows:

- earned surpluses either in full or part retained as profit in which case it will then be subject to corporate tax; or
- earned surplus either in full or part accounted for as profit and forwarded to farmers as return on their capital, i.e. as dividends. These dividends are tax deductible to the Cooperative but assessable to the shareholder (Cooperative principles dictate that dividends are limited and thus are minimal in value); or
- earned surpluses either in full or part returned to the farmer suppliers in proportion to the business conducted. In this case the resulting rebates, bonuses or back pays will be deemed to be purchase expenses and reduce the profit of the cooperative. The taxation of the cooperative is reduced but increased for the supplier.

The emphasis of cooperatives is to return surpluses as a proportion of business conducted rather than as a return on capital. Thus rebates, bonuses and back pays feature prominently in the expense section of the profit and loss statements of most cooperatives.

IMPROVEMENTS TO DIVISION 9

The CCA submits the following recommendations.

That any revision of the tax legislation continues to recognise the principle of mutuality in accordance with the current Division 9. This amendment would enact the current interpretations of the taxation office consistent with cooperative operations.

That any revision of the tax act recognises the principles of co-operation as adopted by the International Cooperative Alliance as defining a cooperative enterprise for the purposes of the Act.

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That Division 9 of the *Income Tax Assessment Act* be retained, with the following improvements:

- distributions by way of rebate or bonus based on business done by the member with the cooperative, should be clearly an allowed deduction in the year in which the business was done to earn the rebate or bonus.
- the issuing of shares to members of a cooperative out of retained earnings should not be treated as taxable income in the hands of the members. Members should be taxed (if at all) when the shares are sold by the member and the proceeds received.
- Section 120(1)(c) should be enhanced to allow all cooperatives the same deduction not only those which comply with Section 117(1)(b)
- the Taxation Department should work with the cooperative movement to detail a set of guidelines for the operation of Division 9 and subsequently release a public ruling which supports the guideline.

Appendix 1

BACKGROUND TO DIVISION 9

1918 - 1936

The first reference to cooperatives in the Commonwealth Income Tax legislation appeared in 1918 when the definition of *income* contained in the Act was amended to include, in the case of a cooperative, all sums received from its members in respect of commodities, animals or land sold or supplied to or on behalf of the members.

This amendment was thought necessary to prevent the possible loss of revenue from tax on the income of a cooperative that could have occurred had not the law made specific provision for its inclusion. Doubts had arisen, as a result of a High Court Judgement that members' subscriptions received by a club did not constitute income of the club. It was thought that the judgement also applied to cooperative companies and associations and would render them exempt from tax on amounts received from trading with members. The amendment to the definition of *income* prevented such an effect.

In 1921, rebates received by members of a cooperative based on their purchases from the cooperative, where the cooperative was one that usually sold goods only to its members, were excluded from the definition of *income* in the Act.

In 1922, this provision was amended to exempt rebates of this kind where the Commissioner of Taxation was satisfied that 90% of the cooperatives sales were made to its members.

In the original Commonwealth Income Tax legislation, all companies were entitled to a deduction in respect of amounts distributed as dividends to shareholders or members.

This deduction was removed in 1923, so that companies were taxed on the whole of their income regardless of dividends distributed to shareholders.

This basis of assessment, although in conformity with the views of the Royal Commission on Taxation in 1922, proved to be a heavy burden on many cooperatives, and in 1925 a provision was inserted to allow deductions to cooperatives for amounts distributed among shareholders as interest or dividends on shares.

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In 1927, the Act was amended again to provide that rebates based on purchases by shareholders were added to the specific deduction that had been provided in 1925 amendments.

In 1930, further amendments were made to include provision of deductions in respect of amounts repaid on Commonwealth or State bank loans. This provision was implemented in recognition of the cooperative movements limited ability to access outside capital without endangering the mutuality principle

1936 - 1998

The 1932-1934 Ferguson Royal Commission on taxation commented that these rebates were clearly not profit, but merely the adjustments of the sale or purchase price.

Division 9 of the present Act was inserted into the Act of 1936, resulting from the recommendations of the Royal Commission.

The Act was again amended in 1996 to clarify section 120(1)(c) after a treasury led move to attempt to abolish the section was rejected by the Senate. The addition of 120(3) was only necessary because and I quote Senator Brian Harradine " the Australian Taxation Office has put forward outrageous interpretations of paragraph 120(1)(c)

Appendix 2

OVERSEAS TAX LEGISLATION

Nearly all countries that are Australia's trading partners recognise cooperative enterprises in their income tax acts. The following is a summary of the tax provisions available to cooperatives in the countries extracted from the following publications: -

1. THE FINANCING AND TAXATION OF CO-OPERATIVES IN THE UNITED KINGDOM
A report arising from a study commissioned by The UK Co-operative Council (UKCC) June 1996

prepared by the PLUNKETT FOUNDATION in association with Genesis Business Development Ltd.
2. ROLE OF GOVERNMENT IN PROMOTING COOPERATIVE DEVELOPMENT IN ASIA
Report of the Asian Regional Consultation Singapore 1988
Editor Dr R.C. Dwivedi, Consultant ICA ROA
INTERNATIONAL COOPERATIVE ALLIANCE, Regional Office for Asia

BELGIUM

In Belgium, the Corporation tax for cooperatives is the same (at 39%) as for other enterprises. On top of this there is a recession tax bringing the rate to 40.17%. There is also a system of progressive rate reductions when the taxable revenue does not exceed Bfr. 13 million. The lowest rate is 28% for profits up to Bfr. 1 million. There are various tax advantages for cooperatives in Belgium to be accredited by the National Cooperative Council, including access to intermediary tax rates, although these tax advantages are limited in extent. In Belgium, businesses wishing to be taxed at the intermediary rates do have by law, to make up payment of Bfr. 1 million to at least 1 director. Accredited cooperatives are exempt from this ruling. In terms of tax liability, the tax base of cooperatives in Belgium includes the dividends (share income) paid to members, although for accredited cooperatives, the first Bfr. 5,000 is tax exempt per year and per family. Above this amount cooperatives in Belgium do tax dividends at source at an investment tax rate of 13% (for shares issued as of 1st January 1994). No distinction is made in tax liability concerning the origin of profit (e.g. transactions with members and non members is not separated) or purpose; in Belgium all funds put in the reserve are taxable, as is the case for all other businesses. Since 1992, deduction from the tax base of previous years' losses has been restricted, the legislation stipulating a maximum loss that can be recovered per year.

CHINA

In China cooperatives are exempted from industrial and commercial tax for three years and 20% reduction in business tax.

DEMOCRATIC PEOPLES REPUBLIC OF KOREA

In *Democratic Peoples Republic of Korea* cooperatives pay to the government a definite sum from their profits, but fishery and industrial cooperatives are exempted from this obligation for 6 months or one year after their formation. There is no registration fee.

DENMARK

Under tax laws in Denmark, cooperative businesses have generally been viewed as an extension of the members own individual businesses, hence profits distributed to members are considered to be an adjustment to the price of products purchased or supplied. However, the tax laws are also based on the premise that cooperatives must be taxed on the interest advantage which the organisation gains by having its own capital available, rather than having to borrow. Currently, some cooperatives, specifically farmer - owned, are taxed at a lower Corporation tax (14.3%) rate than investor led companies (34%) but a higher rate of tax is paid on profits which are distributed; 60% for cooperatives, 40% for investor - led companies. Cooperatives within the utilities sector comprising power, water and district heating stations are not subject to taxation. For consumer cooperatives, transactions with non members are taxed at 34%. Across the cooperative sector as a whole the limitation on turnover with non members at 25% has been maintained under tax laws since May 1994. In terms of tax liability, consumer groups are allowed a deduction from the tax base for dividends or bonuses given to members, and producer groups can deduct corrective payments to members. Under Danish tax laws, the dividend cannot be increased at a later date. These dividends are tax free for individuals when it is a matter of private house - keeping. Cooperative dividends paid out to business enterprises are taxable income. Generally members are not taxed on allocations of profits to accounts held as the organisations equity capital until the time of payment. Cooperative shareholders benefit from fiscal abatement on capital gains or shares owned for mere than three years.

FINLAND

In Finland, the flat rate of tax levied on cooperatives and investor - led businesses is the same at 25%. Both types of businesses are also taxed on property, at up to 0.8%. In terms of tax liability, the base of cooperatives does not include patronage refunds. These are taxed at the individual member level if they form part of their business e.g. payment to farmers. For consumer group members, patronage refunds are tax free if treated as part of private house - keeping. The tax

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base does include interest on share capital, but the tax paid by the cooperative is deductible from the members' assessment. There is full taxation at 25% of funds put to reserve. Cooperatives in Finland would like at the least the obligatory amount of 5% of yearly income transferred to be tax exempt but this has not yet been achieved.

FRANCE

There is a Corporation tax of 33% currently applicable in France, and cooperatives set up by farmers (SICA) have to pay this rate as their rules are not as restrictive as other cooperatives. Under French cooperative law and tax rules, adhering to a more restrictive constitution, will allow cooperatives exemption from Corporation tax, although a basic tax on the value of investments held, and the wage bill will still be imposed. In terms of tax liability, cooperatives in the agricultural sector are allowed to deduct payments to members based on transactions made, from their tax base, but interest paid in share capital is liable for tax. Transactions with members must not drop below a minimum of 80% of the cooperatives total turnover. All funds put in the reserve are taxed, as well as all subsidies received. All payments received by farmers from cooperatives are taxed as the farm business level, although, for members of cooperatives liable for Corporation tax, a tax credit equal to half of the amount of interest bearing share capital can be claimed.

GERMANY

Cooperatives in Germany are subject to Corporation tax at the same rate (30%) as investor-led businesses unless they are registered housing, agricultural and / or forestry cooperatives which meet certain specified requirements. These cooperatives have a partial Corporation tax liability; that is in income derived from transactions with non members only. There is a current maximum limit of 10% income allowed from transactions with non members in order to remain eligible for tax relief. Where a cooperative is compelled by law to have transactions with non members e.g. milk quality testing, artificial insemination services, the 10% limit is not strictly enforced. The tax base does not include patronage refunds to members. These are considered in Germany's tax laws to be an operating cost, but the tax base does not include interest on share capital. These latter dividends are considered to be genuine funds and are liable for the tax (30%) on distributed capital. In some parts of Germany, an additional dividend tax of 25% has to be paid on the gross dividend. Those receiving dividends can add a tax credit to their own income tax liability. In Germany, the tax base of cooperatives does include sums put to reserves, but there is a variation in the tax rate applied depending on the local legislation, ranging from rates lower than 30% up to 60%. German cooperatives are also liable for a business tax and property tax. The laws relating to these taxes apply the same conditions for tax exemption for registered cooperatives as the Corporation tax law. For new self help organisations comprising groups of farmers and foresters and animal husbandry groups, Germany has instigated a tax abatement of DM30,000 per year

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for the first nine years after formation. These new groups which are essentially rural cooperatives are also fully and permanently exempt from the business tax.

GREECE

There is a similar tax rate for cooperatives and investor -led businesses, set at 35%. Cooperative's tax base includes sums paid to members. Funds put into the reserve may be taxed in part but as a general rule they are **not** taxed.

INDIA

In India exemption from Income Tax is given to :-

- (i) cooperatives engaged in business of banking or providing credit facilities to their members, cottage industries, agricultural marketing, purchase of agricultural inputs for supply to members, collective disposal of labour, agricultural processing without power, fishing, providing that voting rights in such cooperatives are restricted to individual members, cooperative credit societies which provide financial assistance to assess society and the State government;
- (ii) primary societies supplying milk, oil seeds, fruits and vegetables raised or grown by members to federal cooperatives, government and government company. Consumer cooperatives are exempted up to an annual income of RS 40,000. The exemption limit of other societies is RS 20,000.

Cooperatives are also exempted from registration fee.

INDONESIA

In *Indonesia*, the tax relief is to the extent of the business transactions between cooperatives and their members. The cooperatives are also exempted in Indonesia from licensing fee.

ITALY

Producer cooperatives and agricultural processing cooperatives are exempt from tax in Italy providing they do not take more than 50% of their products for processing from non members. Income derived from cooperative membership is taxed at the individual member level. Taxation of share interest paid to members is very low in Italy, at 12.5%. There is a 25% tax relief on members' income where the land is farmed jointly.

JAPAN

In *Japan* the Agricultural Cooperative Societies Law provides “The amount equivalent to the surplus dividend to be paid to cooperative members in proportion to the rate at which the cooperative members have made use of the business of the cooperative, shall, in accordance with the provision of the corporation law tax, be counted as the amount of loss on the income tax of the said cooperative”.

MALAYSIA

In *Malaysia*, the income of any cooperative society is exempted from income tax for a period of five years commencing from the date of registration of such cooperative society; there-after, where the member’s funds of such cooperative society as at the first day of the basis period for the year of assessment is less than five hundred thousand ringgit. Otherwise, income tax is charged upon the chargeable income of every cooperative society at the appropriate rates.

NORWAY

Norway introduced a revised taxation policy for cooperatives in 1992, in order to equalise tax treatment of cooperatives and investor - led businesses. Currently all cooperatives are taxed by the same rules as investor - led businesses using a Corporation tax rate at 28%. In terms of tax liability, the tax base of cooperatives in Norway can be reduced by 15% if this proportion of surplus is retained annually as a means of jointly funding the business, and the 15% proportion is shown to come from income from transactions with members. Investor led businesses are not able to reduce their tax liability in this way. Since 1992 there are no limitations imposed on percentage transactions with non members. Cooperatives are allowed a deduction from the tax base for dividends paid to members and these are taxable at the individual member level. Investor led businesses are not able to classify dividends as an operating cost and they are subject to the 28% tax. There is a 1% property tax for cooperatives under the 1992 tax reform, contrasting with a zero property tax for investor - led businesses.

REPUBLIC OF IRELAND

Cooperatives in the Republic of Ireland are assessable for Corporation tax at the same rate (40%) as investor - led companies. Manufacturing cooperatives within the dairy sector are the only cooperatives to receive a concessionary rate (20%). There are anomalies in the legal definition of manufacturing that have to be surmounted however. Cooperatives in the dairy and processing sector are able to make distributions of additional payments to members on operating costs, thereby reducing tax liability. These sums are taxable at the individual member level.

REPUBLIC OF KOREA

The agricultural Cooperative Law in *Republic of Korea* provides “The business and the property of cooperatives and the federation shall be exempted from taxes and other public assessment of the state or local autonomous entities except in the case of custom duties and commodity tax”. Article 9 of the Fisheries Cooperative Law contains similar provisions. With the promulgation of the Tax Exemption Regulation Law on December 20, 1965 the cooperatives, were deprived of the tax privileges prescribed for them in the Cooperative Laws. In the process of the implementation of Five-Year Economic Development Plans, the government felt a need to enhance the efficiency of its tax policy through the readjustment and consolidation of diversified tax exemption articles of various laws and cooperatives, as did other groups, became subject to taxation. Thus during the period from 1966 to 1981 cooperatives had to pay all kinds of taxes except for corporation tax. With the introduction of the Minimum Tax System in January, 1982 the cooperatives have been forced to pay even the corporation tax, but a preferential rate has been applied to them. For example, if the standard of assessment is less than 50 million won, the corporation tax is 20 percent for profit-making corporations, while it is only 5 percent for cooperatives.

PHILIPPINES

In *Philippines* the income tax exemption is given to all non-profit organisations including the cooperatives, if they qualify as such and to farmers cooperatives which merely act as sales agent to such farmers. There is also the tax exemption to electric cooperatives, except income tax, import duties and fees. The transport cooperatives are exempted from income tax for five years and carriers tax. Local governments (provinces, cities, municipalities, barrios) have no authority to impose tax on cooperatives.

PORTUGAL

Cooperatives in Portugal have the same tax rate (36%) applied as other businesses, although there have been reductions in recent years for cooperatives in the agricultural sector, according to yields. All funds put into the reserve are taxed at the 36% rate.

SPAIN

In Spain the Corporate Income Tax levied on cooperatives and investor - led businesses is the same at 35%. However the 1990 Cooperative Tax Law for all of Spain, does entitle registered cooperatives (“protected cooperatives”) to tax advantages providing they meet requirements established by law. One of the main benefits is a reduced rate of Corporation Tax (20%) on profits arising from transactions with members, as long as those transactions do not drop below a minimum of 50% of total transactions. “Protected cooperatives” are also exempt from the Transfer

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Tax and Stamp Duties. The rate of 35% Corporation Income tax remains for profits arising from transactions with non - members, rental of premises income, and interest from investments. "Specially Protected " cooperatives as defined in Spanish Law receive a 50% tax rebate in respect of Corporate Income tax payable, giving a real rate of 17.5%. They are also exempt from Transfer Tax and Stamp Duty on all goods acquired for the purpose of furthering the cooperative's activities. Worker cooperatives have a three year Corporate Income Tax - exempt period at their start-up phase, as all the equipment purchased may be depreciated and offset against tax liability during this period. In terms of calculating the tax base of cooperatives in Spain, the amounts which obligatorily have to be put up into the Education and Promotion Fund can be deducted but the rest going into reserves cannot be deducted. All subsidies received are taxable. Cooperatives can deduct the interest paid to members, if incorporated as capital share. Dividends to members are taxed at source at 15%.

SWEDEN

In Sweden there is a corporation tax rate at 28% and all cooperatives are assessable at this rate. Dividends on purchases of sales transactions are deductible from the tax base. Tax is then paid by the individual if the goods are used for business purposes. If however the amount that the board has recommended as dividend on purchases is not entirely expended on that purpose, the amount not disposed of must be declared as income in the next tax return. No distinction is made between refunds in cash or refunds transferred to members' share accounts; the right to make a deduction holds good in either case. Currently dividends distributed in proportion to the amount of share capital paid up have to be included in the cooperative's tax base. Attempts are presently being made by the cooperative sector in Sweden to have the tax rules changed to that they are tax exempt. Cooperatives are able to receive tax exempt dividends from Swedish companies e.g. subsidiaries, if the holding in the company is above certain levels. Dividends from foreign subsidiaries (minimum 25% holding) are tax exempt provided that the subsidiary is taxed at a minimum 15% rate. A cooperative can be a member of a qualified group consisting of a mixture of other cooperatives and companies. Such a group may equalise profits and losses each year for tax purposes as long as it fulfils a 90% ownership of share capital test. Since 1994, a tax deduction of 25% of taxable income can be allocated to a special timing reserve. The allocation must be reversed within 5 years. This option is available for all businesses in Sweden. In Sweden, regulations concerning cooperative principles have not been applied particularly strictly by the tax courts.

THAILAND

In *Thailand*, the cooperatives are exempted from Income Tax and registration fee. However, they

have to pay business taxes except in the case of agricultural cooperatives for the business transactions between cooperatives and their members.

UNITED STATES OF AMERICA

Income taxation of cooperatives is similar to most other forms of U.S. business in that a single tax is paid on earnings at the ownership level. Only general investment corporations such as General Motors and IBM have their earnings taxed at both organisational and ownership levels. Other types of businesses that pay income tax only at the ownership level are individual proprietorship's, partnerships and small investor type firms. Cooperatives also pay all other types of taxes that businesses pay, such as property, sales, employment and fuel taxes. Taxes are levied at both state and federal levels. Most states follow federal rules in taxation of cooperatives earnings or margins.

In the tax code rules, the reference is made to "patrons" as opposed to members. Some cooperatives only conduct business with members, while others may do business with members and non members. As long as the cooperative refunds its margins to members and non members in the proper way, it can deduct these patronage refunds from income for tax purposes.

A cooperative's margin on business done with or for patrons are not taxable to the cooperative if they are distributed or allocated to patrons on the basis of business done with the cooperative. At the foundation of these rules is the recognition of the cooperative operating principle of providing services at cost. Therefore, earnings refunded to patrons on a patronage basis are taxable to the patron and not to the cooperative.

One important characteristic that distinguishes the cooperative way of doing business is that the distribution of net margins is made on the basis of the quantity or value of business done with or for patrons. If distributions made to patrons are not made in this manner, then these distributions are not considered as patronage refunds. As an example, dividends paid on capital stock are not considered as patronage refunds because they are determined on a basis other than the amount of business done with the cooperative.

Financial benefits must be distributed to patrons based on their use of the cooperatives services rather than on the basis of investment, as is the case in a investor - owner firm.

Another important rule is that there must be a formal obligation on the part of the cooperative to pay net margins to patrons. This obligation must exist before a patronage distribution takes place. The obligation must be in writing and the patron must have knowledge of it. Usually this written obligation is found in a cooperatives by-laws or marketing agreement.

Patronage refunds must result from business done with or for patrons. Any income the cooperative earns from other sources cannot be included as part of the patronage distribution.

How cooperatives handle the distribution of patronage refunds also impacts on their deductibility for income tax purposes. There are several options available that qualify under tax code rules. A cooperative must pay all of its patronage refund to patrons in cash or it may pay a portion in cash and retain the remainder as allocated capital retains. Regardless of the option chosen, the cooperative must pay the patron a minimum of 20 percent of the patronage refund in cash for the refund to be deductible.

Patronage refunds are evidenced to the patron as notices of allocation. These must be in writing to the patron. The cooperative has a limited period from the end of its fiscal year to make this allocation. The refunds become part of the patron's taxable income in the year received.

If the cooperative utilises per-unit retains, the tax treatment is very similar to patronage refunds if the amount of the retain is taken from the proceeds of sale. The difference is that there is not the requirement to pay 20 percent in cash. The patron, however, agrees to include the amount of the retain as income for the year in which the retain was deducted.

Allocations are classified as either qualified or non-qualified. A qualified allocation is one in which members agree to include the allocation as income for the tax year involved. Consent can also be obtained, through a statement on the cheques issued for the cash portion of the patronage refund, which says the patron gives consent by endorsing and cashing the cheque. The certificates issued to evidence as per-unit retain contain a qualification clause that achieves the same result.

Some cooperatives utilise non qualified allocations. In this case the patrons do not include the allocation as part of their income at the time of the allocation. The cooperative pays tax on the amount being allocated. When a cooperative pays out the patronage refund or per-unit retain to members, it then claims a refund to the amount of the tax it paid when the non - qualified allocations were issued. The patrons must include this amount in their taxable income in the year received. This method gives the cooperative considerable flexibility in managing its tax obligations. For example, non- qualified written notices might be used to permit the cooperative to offset tax credits available to it.

Some specific types of cooperatives are exempt from income tax if they meet certain requirements, such as rural electricity distribution cooperatives, rural telephone cooperatives etc.