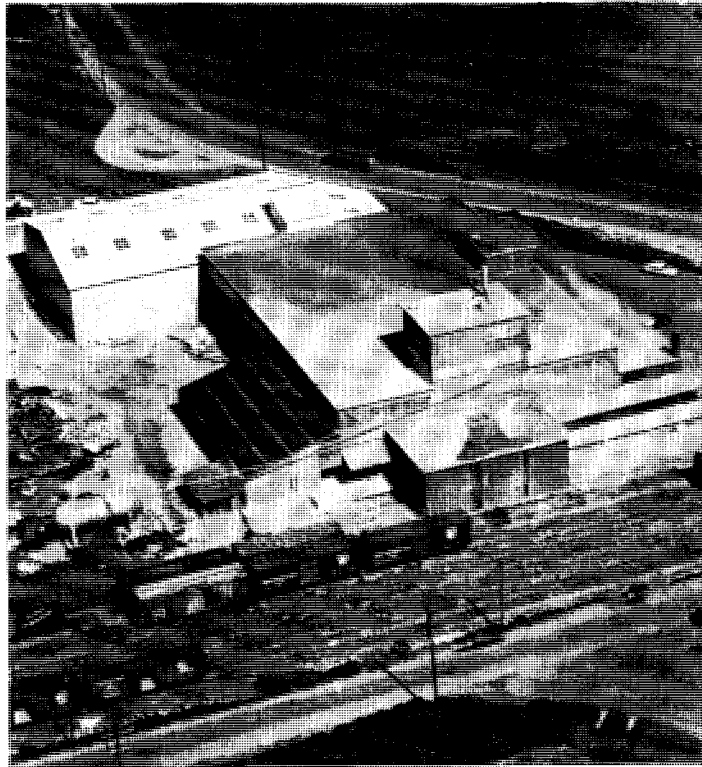
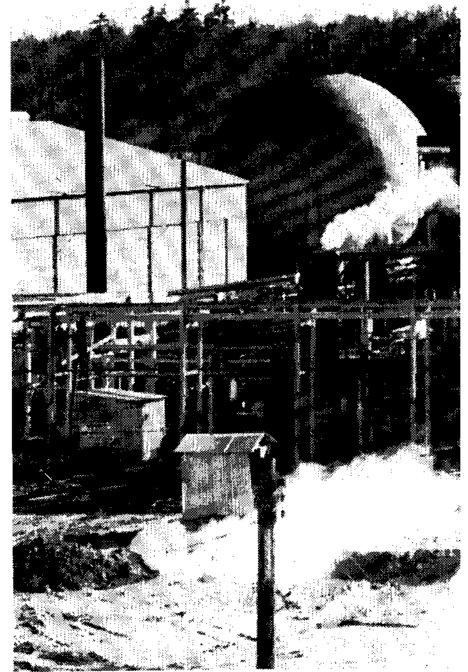
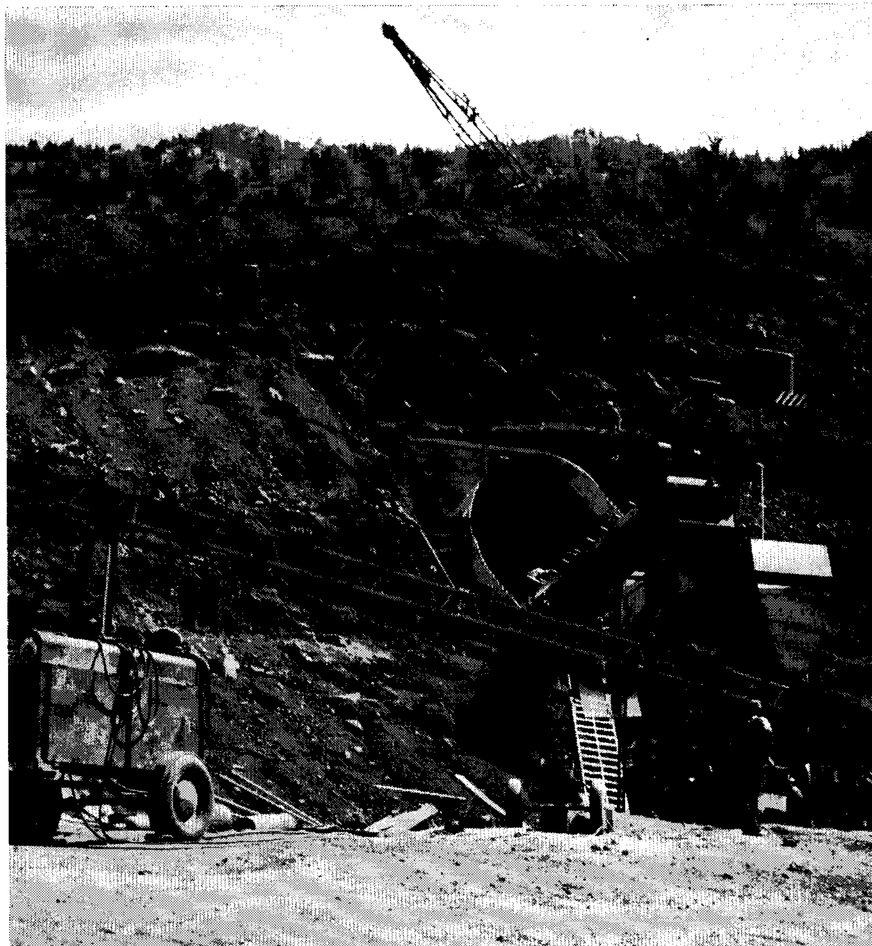


Wilmington, Del., plant of Eastern States Farmers' Exchange



Hopper loads ore on conveyor at mine of Central Farmers in Idaho

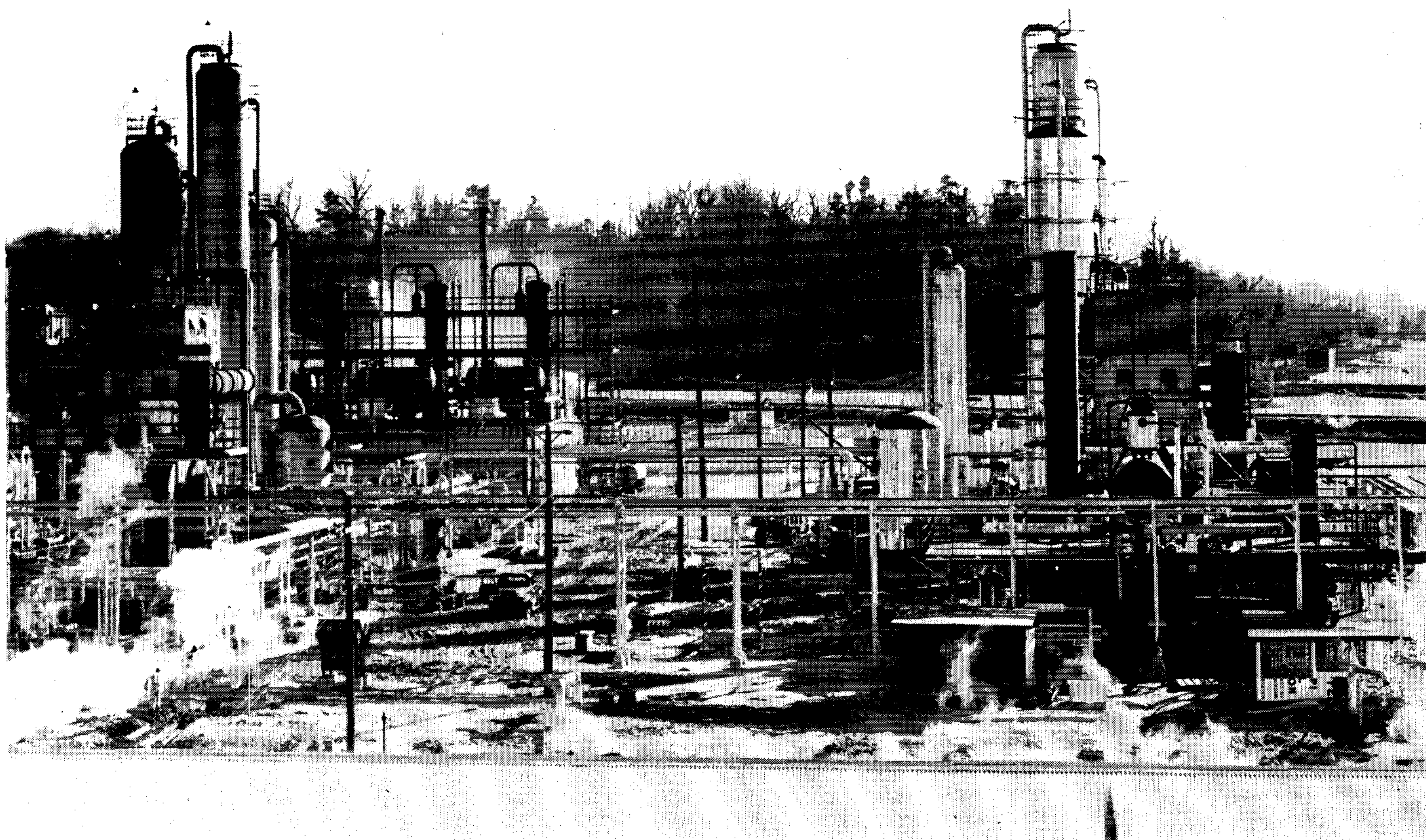


Co-ops: Threat

Farm cooperatives boom, step up their fertilizer producing activities, and draw criticism from non-co-op business men

As the 86th Congress moves into its fourth month of operations, money—where to get it and how to spend it—is still a big issue. One of the money questions to be decided: should Congress change the tax laws which affect agricultural cooperatives? The likely outcome will be a modest change: more than the co-ops are willing to give up, but less than the other side wants to take.

A change in tax laws will remove the surface friction between co-op and nonco-op businesses. But none of the conceivable tax changes will have much effect on the differences that lie beneath the surface. Extremists on one side say that co-ops are socialistic, and will eventually wipe out conventional business activity in American agriculture. From the other side come expressions of an equally strong con-



Construction at the Yazoo City, Miss., ammonia plant of Mississippi Chemical Co.

3lessing, or Both

A STAFF REPORT

viction that cooperatives are an integral part of a free enterprise economy.

AG AND FOOD has talked with co-op leaders, their nonco-op competitors, the associations that represent each side, legislators, and neutral groups that sit on the fence. Fact and opinion are presented here to appraise the 1959 agricultural cooperative picture with particular attention focused on competition between co-op and nonco-op plant food manufacturers.

The latest report of the Farmer Cooperative Service, USDA, shows that the net business handled by co-ops in 1956–57 reached $10.4 billion. Nearly $8 billion of this total came from marketing farm production, e.g., dairy products, grains, and livestock. Aside from this activity, co-ops purchased $2.1 billions' worth of farm supplies for their patrons, and performed services that cost $235 million.

Feed accounts for the largest share of what co-ops purchase, $804 million in 1956–57. Next come petroleum products which total $530 million. In third place at $275 million are fertilizers; this figure is the immediate target of criticism from nonco-op fertilizer makers. Next to the bottom of the list of nine major items purchased by co-ops are farm chemicals. They total $40 million.

The $275-million figure for fertilizers is the retail value of fertilizers sold to farmers by co-ops. It is about 22% of the $1.2 billion farmers spent on fertilizer in 1956–57. There are no firm figures available on what portion of the fertilizer handled by co-ops is actually produced by co-ops. Some say that two-thirds of the total is basic production and formulation. A more moderate view places the portion at half of the total. Co-op plants, then, account for 10 to 15% of total fertilizer production.

Stated this way the productive capacity of co-ops would seem to be a relatively minor force in the fertilizer industry. But this is not the case, and certainly not the complete story. Nonco-op businessmen are sincerely worried about co-ops' rapid growth into the producing end of plant foods. During the past six years, dollar volume of farm supplies purchased by co-ops has increased 27%. In the same period, the fertilizer portion of purchases has swelled 76%. Even when the figures are judged in the light of how total purchases by farmers have grown, the increase for fertilizers handled by co-ops is startling. And much of it represents new primary production.

Until about 10 years ago, co-ops did not make basic fertilizer materials, and thus were valued customers of nonco-op producers. Co-op business is still valued, but there is less of it as co-ops themselves expand into primary production. Recent news items tell the story: Central Farmers Fertilizer buys stock in National Potash, and signs an agreement to distribute the potash maker's production; Valley Nitrogen Producers breaks ground at Helm, Calif. for a $9-million plant which will make 50,000 tons per year of anhydrous ammonia, plus liquid mixes and some dry formulations; Cooperative Farm Chemicals spends $5 million to add to its nitrogen facilities at Lawrence, Kans.; Southern States Cooperative builds a 60,000-tons-per-year granular fertilizer plant near Russellville, Ky.; Mississippi Chemical hikes capacity of its Yazoo City plant by 12%; Coastal Chemical finishes a $2-million phosphate fertilizer plant at Pascagoula, Miss.

Meanwhile, news about nonco-op expansions is rather scarce, relatively speaking. Profit-seeking companies find it increasingly hard to make a profit in fertilizers, and unanimously report that they have lost business to cooperatives.

What is the co-op's secret to success—the tax advantage that lets a co-op lay up capital for expansion, a pricing advantage through patronage refunds, help from the Government, a "built-in" marketing advantage? Or is it that co-ops have out-played nonco-op business at its own game? The answer depends, at least partly, on where one's sympathies lie.

Focal Point

The Federal income taxes that co-ops pay, or do not pay, provide the focal point of any discussion of co-ops. In 1916 Congress gave farmer cooperatives an exemption from corporate income taxes. At the time it was a fair move to aid the troubled farmer. Times change, though, and when corporate taxes rose to 52%, exempt co-ops had a 2-to-1 advantage in piling up growth capital. Between 1947 and 1951 the House Ways and Means Committee held 31 days of hearings on the tax treatment of co-ops, filled 2955 pages with testimony, and then decided that there should be no change in the law.

The Senate was not so liberal. Later in 1951 an amendment was made to the co-op tax law. The new provision held that exempt co-ops must pay tax on all unallocated margins. Other margins distributed to members under a contract would be taxable income only to the members. Thus, if a co-op wanted to keep cash in the business for expansion or other needs, it would have to pay 52% on this amount.

But it didn't work out this way. Courts have held that a co-op can issue certificates which state the member's share of earnings. The co-op does not pay tax on earnings allocated this way, but still has the use of the money. The member who receives such a certificate does not pay tax on its value until some unspecified time when the member might redeem the certificate. This is the tax loophole.

Under present laws, a portion of co-op earnings is taxed at the full 52% corporate rate. Another portion is taxed at the member level according to personal income tax rates which usually are less than the corporate rate. And a third portion of earnings in effect escapes Federal taxes.

Accurate, over-all data on just what happens to co-op earnings taxwise would do much to clear the air. The opponents of co-ops say that the major portion of earnings is not taxed at all, or at relatively light personal rates; that part that gets nicked for 52% is almost nil. The co-op partisans, on the other hand, say just the opposite: only a handful of co-ops take full advantage of the present law; most make patronage refunds in cash, and pay tax on what is left.

During last year's Congressional tax hearings, the Manufacturing Chemists' Association urged a "thorough re-examination of the role cooperatives occupy . . . with a view toward eliminating the inequitable tax advantage . . ." As part of its case, the MCA referred to a Mississippi co-op with gross income of over $12 million, whose return on investment before and after taxes was 20.9%. This co-op's annual report specifically stated that no provision was made for current income taxes. To contrast with the co-op's return on investment, the MCA said that a typical group of chemical companies showed an after-tax return of 6.4%.

There are other, similar examples of co-ops that escape taxes. But co-ops counter these examples by referring to cases in which fairly heavy tax bills are paid. Most often mentioned is the Grange League Federation, a marketing and supply co-op which serves 115,000 farmers in New York, New Jersey, and Pennsylvania. GLF voluntarily gave up its exemption in 1947, and since then has paid income tax on all earnings except those distributed as cash patronage refunds and discounts. In 1958 GLF had net earnings of $7.6 million, gave out $1 million in refunds, and then paid taxes of $3.1 million. The $3.5 million that remained after taxes and refunds was split evenly between stock dividends and retained earnings.

GLF is above average among co-ops when it comes to paying taxes. For instance, Illinois Farm Supply last year had net earnings of $5.6 million, distributed $2.5 million in cash refunds, and paid federal income taxes of $1.4 million. At Consumers Cooperative income and tax figures were $5.2 million and $601,000 (Consumers points out that its tax position is helped by the depletion allowance on its oil drilling operations). Eastern States Farmers' Exchange says it makes no profits. The difference between costs and receipts, says Eastern, is a combination of capital supplied by the owners and overpayments returned to patrons.

Tax Changes Proposed and Opposed

Obviously, co-ops pay less tax than nonco-op businesses. The tax question boils down to two points: is the tax advantage unfair, and, if it is, how should laws be changed? Because nonco-op fertilizer companies have no great quarrel with marketing and purchasing activities of co-ops, one way to change the law would be to require only manufacturing co-ops to pay full corporate income taxes. There are, however, several reasons why this is not likely to happen. One is that many co-ops take part in all three activities, and it would be difficult to single out manufacturing as a tax target.

Proposed tax changes are aimed at co-ops across the board, and are designed to tighten up on taxing of the certificates which some co-ops issue in place of cash refunds to members. The Treasury Department suggests a requirement that these certificates bear interest of at least 4%, and be redeemed for cash within three years. This kind of change would complete the intent of the 1951 amendment by seeing that no part of co-op earnings slips through the tax laws.

A change such as the one proposed by the Treasury Department would add millions to tax revenue, and would satisfy some competitors of co-ops. Yet it would not put co-ops on an equal footing with other businesses. Co-ops would still not need to pay tax on patronage refunds.

Harry Meloy, an attorney who represents several co-ops through the Illinois Agricultural Association, gives the co-op view on this point. "The right of a cooperative to deduct as a business expense those earnings distributed to members under a prior contract is not the same thing as an income tax exemption. It is not a privilege that belongs exclusively to co-ops. General Motors, or any company you might name, can do this if it desires. This principle has been recognized by the law for many years, and originated independently of the cooperative."

One rebuttal to Meloy's comment comes from Garner Lester, president of the National Tax Equality Association, who says: "This amounts to saying that private businesses, by becoming cooperatives, can enjoy the tax advantages of co-ops. This is small comfort to those businesses not owned by customers."

The National Council of Farmer Cooperatives is opposed to the latest Treasury Department proposal, and all similar ones. It says that the proposals are arbitrary, have no sound legal basis, are designed to subject co-ops to a corporate tax on money which is income only to farmer-patrons, and to subject patrons to an individual tax on what remains of their patronage refunds after the co-ops pay a corporate tax. The Council adds that the effect of tax changes would

Kiln at beneficiation building of Central Farmers' new facilities in Idaho

be to pressure the farmers into patronizing nonco-op businesses. Ralph Douglass, chairman of the board, Smith-Douglass Co., poses a question on this last point: "Does not the farmer who fully subscribes to the co-op principle, in effect, say 'I want to make a profit for myself, but I do not wish anyone to make a profit on me, either in merchandising the things I produce or on the things I buy'?"

An integral part of the co-op tax question is the price edge a co-op has through its patronage refunds. To mention just one of many examples, Mid-South Chemical Corp. tells how it lost a forty-car ammonia account. "The customer bought stock in a co-op producer. The co-op paid in excess of $30.00 per ton dividends; thus we had no alternative but to retreat and allow the co-op to take the account."

Even if tax laws governing co-ops were completely revised, many worry that co-ops could make the changes ineffective through "pricing out"—setting prices so that there would be no earnings or net margins left over to tax. Apparently, there is no practical way to prevent a co-op from setting its prices so that income does not substantially exceed business costs. Pricing out might blunt the effect of new tax laws in some cases. But co-op management as a whole knows that profits are a necessary part of sound financial policy; thus, pricing out is probably not a great obstacle to taxing co-ops.

Taxes are at the root of most of the differences between co-ops and other businesses. But there are other things, too. Some mention, even before taxes, the help co-ops get from county agents and other government employees. Another often heard point is research. One man asks what would happen if all nonco-op fertilizer manufacturers halted their research work? Would co-ops step in and do the research that must be done? Co-ops, recently, are giving more attention to research and development, but on the whole have lagged. Also, co-ops tend to emphasize cash sales, and have not done so much in the credit field as have other businesses.

The Road Ahead

What of the future? The nonco-op fertilizer makers are, to a man, deeply concerned about the inroads co-ops have made. They view co-ops as an unfair form of competition which, if left unchecked, will eventually become the dominant force in plant food manufacture. Estimates of the portion of fertilizer business that co-ops will handle 10 years from now run all the way up to 95%. Even conservative guesses run from 30 to 40%—a substantial increase over the present level.

Co-op spokesmen think that such opinions are unjustified. They point to other fields, dairying for instance, where both kinds of businesses have existed for years without either's being "wiped out." They say that merely being a co-op is no magical key to success—co-ops will fail or prosper according to business practices that have no connection with the co-op structure itself. Bruce McCully of Consumers Cooperative feels this way: "Cooperatives are the very essence of free enterprise, and they are embedded in our rural, social, and economic structure to the extent that they will survive wherever they render a service."

One thing seems certain; tax laws will be altered. A few years back, the basic producers of fertilizer materials did not want to stand up and be counted because co-ops were customers as well as competitors. Industry's mood is different now. Irrational, across the board stabs at co-ops, made only in private, are being replaced by open efforts toward specific objectives. One basic producer puts it this way: "In the past we've been firing blind with a shotgun. Now it's time to take careful aim with a rifle."

This kind of attitude is well stated by Joe Culpepper, Spencer's marketing vice president. Says Culpepper: "I believe it is not in the public interest for business organizations who pay income taxes up to 52% to be forced to compete with large, commercial, tax-favored organizations. If the present inequality in taxes continues, we, and others like us, who do pay taxes at the full rate, will be forced out of business. But in this position industry is not an enemy of cooperatives. If I believe my neighbor should be subject to the same tax rates as I, does this mean I am my neighbor's enemy?" J. D. Stewart, Jr., president of Federal Chemical, adds: "We don't object to paying income taxes, but we think it only fair that our competitors do the same."

The future, as always, is not clear. But the best of present thinking paints a picture something like this: a moderate change in tax laws will come within a year or two. Co-ops will then be able to deduct from taxable income only cash refunds and certificates with a definite market value. Nonco-op interests will continue to hammer away at patronage deductions, and will achieve some success within five or ten years.

And regardless of legislation, there will always be a basic difference in philosophy between co-ops and nonco-ops. The cooperative's main purpose is to make maximum savings for its owner-patrons, while the nonco-op business must strive to make maximum profits for its stockholders.