

Report for Congress

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Passthrough Organizations Not Taxed As Corporations

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Summary

Corporations are treated as taxpaying persons separate from their owners and taxed under the corporation income tax rate schedule. Dividends and capital gains received by individual stockholders are taxed again under the individual income tax rate schedule. But some entities that conduct business or hold property escape this double taxation by passing their income through directly to individual owners. These are called “passthrough” or “conduit” entities.

Partnerships are unincorporated groups that conduct business or hold property jointly, but pass net operating profit or loss, portfolio income and deductions, and other tax attributes through to the partners. The partners are liable for any resulting income tax. However, if the partnership’s shares are publicly traded, it is taxed as a corporation.

S corporations are incorporated businesses with no more than 75 shareholders who elect to be taxed as partnerships. Only individuals and certain trusts and nonprofit organizations may be shareholders. Like partnerships, they pass all of their income and tax attributes through to their shareholders, who are liable for the tax. This arrangement allows the shareholders the limited liability and other advantages of a corporation without paying the corporate tax. This form has become increasingly popular in recent years; more than half of all corporations now file their tax returns as S corporations (although they account for only 3% of corporate assets).

Limited liability companies are a relatively new form of organization that are corporations for all purposes except the federal income tax. They give their owners the protection of limited liability but are allowed to elect to be treated as partnerships for tax purposes. There are no restrictions on the number or type of owners they may have. They are subject to the partnership tax rules unless they elect to be taxed as corporations.

Regulated investment companies are mutual funds or venture capital companies that invest pooled funds in financial securities. They are subject to the corporation income tax, but are allowed to deduct amounts distributed to their shareholders if they distribute at least 90% of their income each year and meet other restrictions. Real estate investment trusts are similar organizations that invest in real estate or real estate mortgages. They also are not taxed on amounts distributed to their investors if they distribute at least 90% of their income. The investors are taxable on amounts credited to them each year (separately for ordinary income and capital gains).

Some cooperative and mutual organizations are treated as conduits (farmers’ cooperatives, for example), some are taxed as corporations (e.g., mutual insurance companies), and some are tax exempt (credit unions and rural electrical cooperatives are the most important). Other entities that serve as conduits under the tax law are some trusts, real estate mortgage investment conduits (REMICs) and financial asset securitization investment trusts (FASITs).

This report is for background purposes and will not be updated. For more information on this topic, contact James M. Bickley of the Government and Finance Division.

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Passthrough Organizations Not Taxed as Corporations

Individuals and corporations are treated as separate taxpaying entities under the Internal Revenue Code (IRC), each with their own tax rate schedule. But after-tax corporate income is also subject to tax at the individual level if it is distributed as dividends or contributes to a realized capital gain for the stockholder. In addition, the tax rate schedules differ and the definitions of taxable income differ. Taxpayers with businesses or investment portfolios must take these tax factors into account in choosing how to organize their businesses or investments. Tax law writers seeking to preserve tax revenue must decide how much choice to allow them.

The result is that the IRC contains rules placing almost all the ways a for-profit business or investment venture can be organized under either the individual income tax or the corporation income tax. The IRC and the Internal Revenue Service (IRS) regulations recognize numerous types of organizations that do not pay the corporation income tax but merely serve as conduits of the business's income or loss, which is passed through to be included on the separate owners' tax returns.

This report describes the various forms of tax conduit organizations found in the IRC or the IRS regulations and discusses how the form of organization affects the tax situation of the owners. It is organized according to the major types of conduit organization.

Business Organizations under the IRC

The default regime for taxing businesses, in the absence of special elections or special provisions, is simple. An unincorporated, single-owner business, or "sole proprietorship," is treated as identical with its owner; its income is included on the owner's tax return and taxed under the individual tax rate schedule. An unincorporated business with more than one owner is a partnership for tax purposes; its income is passed through to the partners and included on their tax returns. An incorporated business entity is treated as a taxpayer entirely separate from its owners and taxed under the corporation income tax rate schedule. Amounts paid out as dividends or retained within the corporation are thus after-tax amounts; individual owners receiving dividends or selling appreciated corporate stock pay an additional tax, with no credit for corporate taxes already paid.

However, a number of special tax provisions alter this basic tax scheme. Some closely held corporations can elect to be taxed as partnerships ("S corporations"); some mutual investment corporations are not taxed at the corporate level on distributions (mutual funds and real estate investment trusts); some companies can

have the characteristics of corporations but elect to be treated as partnerships (“limited liability companies”). On the other hand, any association of persons doing business together can be classified under the tax rules as a corporation if it has too many corporate characteristics, even if it is not a corporation under state law; for example, large partnerships with publicly traded shares are taxed as corporations by law.

There are other, less prevalent, business forms recognized in the IRC. Corporations that are organized as cooperatives are taxed as corporations under special rules. Many mutual organizations were once tax exempt and some are still accorded special tax treatment (some mutual insurance companies, for example). Credit unions are tax exempt under present law. Trusts and estates can own businesses and serve as investment conduits; some are taxed at the entity level using the individual income tax rate schedule and some are taxed to their beneficiaries or grantors. Nonprofit organizations can own businesses; some are taxed (at corporate rates) if their business activity is unrelated to their exempt purpose.

The tax rules covering these entities evolved separately and have never been fully integrated. In general, the rules spell out how the items of income, deductions, and credits are to be allocated between the business and its owners; whether the net taxable income will be taxed under the individual or the corporation rate schedules; and whether employment taxes are to be paid and by whom. The exact answer to these questions differs by type of business organization.

Partnerships

In the IRC, a partnership is “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not ... a trust or estate or a corporation,” and a partner is a member of such an entity. (IRC section 7701(a)(2).) A partner can be an individual, a trust, another partnership, a corporation, or another entity (such as a limited liability company). A partner can also be a nominee, such as a broker, holding a partnership interest for an unnamed partner. Partnerships are established under the laws of the individual states, although the tax treatment is not governed by an entity’s characterization under state law. Under state law, partnerships can be either general partnerships, limited partnerships, or limited liability partnerships; the IRC also distinguishes other categories. Over 1.9 million partnership returns were filed with IRS in 1999, reporting 15.9 million partners.¹

Tax Treatment of Partnerships

A partnership is not a taxable entity as such; instead it serves as a conduit for passing income, deductions, and credits to the partners. (IRC section 701.) The partnership calculates net income or loss for the business (less those items to be separately stated) and allocates it to the partners as agreed in the partnership

¹All partnership statistics are from: Alan Zemple and Tim Wheeler, “Partnership Returns, 1999,” *SOI Bulletin*, vol. 21, no. 2 (fall 2001), p. 48.

agreement. The partners then include their shares of the income or loss on their own tax returns. The partners are taxed on their shares each year, whether or not distributed; when the previously taxed amounts are actually distributed, there is no additional tax. The partnership reports partnership level calculations and each partner's allocation to IRS and to the partners.

Generally, income and deductions attributable to the partnership's business operations are netted at the partnership level and the net operating income or loss allocated to the partners; however, items limited or otherwise specially treated at the partner level, as well as portfolio income, are allocated to the partners item by item. These "separately stated items" include capital gains and losses, dividends, interest, rents, royalties, deductions attributable to portfolio income, charitable contributions, foreign taxes paid, and other items affecting the tax liability of the separate partners. Oil and gas partnerships, for example, must allocate depletion deductions and intangible drilling costs separately because these may be subject to limitations for the partners. The partnership agreement may call for other items to be separately allocated to some or all partners. Allocated items retain their character in the hands of the partners (i.e., an allocated long-term gain is still a long-term gain).

The separately stated items and the partnership income or loss can be allocated to the partners by special agreement. For example, profits may be allocated in one proportion but losses allocated differently. IRS generally allows any allocation the partners use on their own books of account. However, the allocation must have "substantial economic effect" (and not be merely for the purpose of reducing taxes). (IR Reg. 704-1(b).) If the partnership agreement does not specify the allocation, or if IRS disallows it, it must be made according to the partners' ownership interests in the partnership. (IRC section 704(b).)

In addition to being entitled to a share of the partnership's profits or losses, partners may also be given guaranteed payments for their capital or services. These are payments of fixed amounts that do not depend on the profits of the business. The value of fringe benefits given partners in return for their services, such as health insurance, is also considered a guaranteed payment. The partnership deducts guaranteed payments as ordinary business expenses, and the partners include them in income as ordinary (self-employment) income.

A partner's basis in his or her interest in a partnership, for calculating gain or loss when the interest is sold or cashed in, consists of his or her original contribution to the partnership, increased by each year's distributive share of the partnership's total income or decreased by each year's distributive share of total loss. It is also decreased by any actual distributions (cash withdrawals, for example) and increased by any additional capital contributions. A partner's basis also includes a share of the debts of the partnership. Partners may deduct allocated losses from other income only up to the extent of their basis; since basis can never be less than zero, a partner's basis thus effectively limits the deductibility of losses.

General Partnerships

A general partnership is one in which all the partners are legally equal; all are liable for the actions and debts of the business. All are also responsible for the management of the company and for the tax reporting required of the partnership by IRS; even if they agree differently among themselves, IRS considers them all responsible.

The individual partners in a general partnership are each considered self-employed businessmen, not only liable for the individual income tax on their share of the profits of the business but also subject to the Social Security and Medicare (FICA) self-employment tax.

There were 898,000 general partnerships with 3.5 million partners in the 1999 tax return statistics.

Limited Liability Partnerships

A limited liability partnership (“LLP”) is a general partnership, usually a professional firm, in which the partners are mutually liable for the partnership's debts but are not liable for wrongful actions of the other partners that cause harm (torts). Each partner is liable only for damages arising from his or her own torts and those of subordinates, just as in an individual practice. These partnerships are in all other ways like general partnerships. They are a recent creation of state law and not all states allow them. They have become especially popular with law and accounting firms (which most states do not allow to incorporate); most large accounting firms are now limited liability partnerships. There were 42,000 limited liability partnerships with 206,000 partners in 1999.

Limited Partnerships

A limited partnership consists of at least one general partner, who is liable for the partnership's debts and provides the partnership's management, and one or more limited partners, whose liability is limited to their contribution to the partnership and any additional amounts specified in the agreement. Limited partners cannot take part in the partnership's management. The general partners are responsible for the partnership's return and other reports to IRS. Limited partnerships are often used as investment vehicles in such ventures as oil and gas exploration, with the actual drilling company serving as the general partner and the investors owning shares of the venture as limited partners.

The partnership's income and losses can be allocated among the general and limited partners by agreement, just as for a general partnership, with all the partners liable for any income tax on their shares. However, the limited partners who perform no services for the partnership are not considered self-employed persons and are not liable for FICA taxes.

There were 354,000 limited partnership returns reporting 8.9 million partners in the 1999 statistics.

Electing Large Partnerships

“Electing large partnerships” is a category created by the Taxpayer Relief Act of 1997 (P.L. 105-34) to simplify the reporting requirements for investors in large partnerships. Any partnership with 100 or more partners who do not perform services for the partnership can elect the simplified reporting rules. (IRC section 771-777.)

Electing large partnerships are not required to report separately on most portfolio or rental income and report capital gains after netting gains and losses at the partnership level. Separate allocation is required only for tax exempt interest, passive loss limitation and alternative minimum tax items, foreign taxes, and some tax credits. Everything else is netted at the partnership level and the net income or loss allocated to the partners (except large oil and gas partnerships, which must continue to report depletion and intangible drilling costs under the old rules for some partners). Most tax audits and tax adjustments take place at the partnership level, with the partners notified of their share of any changes.

One hundred partnerships, with 31,000 partners, reported as electing large partnerships in 1999.

Publicly Traded Partnerships

Partnerships whose interests are traded on an established exchange or in a secondary market or its equivalent are, with two exceptions, treated as corporations for tax purposes and subject to the corporation income tax. (IRC section 7704.) One exception consists of those partnerships that were publicly traded on December 17, 1987; these partnerships, originally grandfathered in for 10 years, may now elect to retain partnership treatment by paying a tax of 3.5 % of gross income from the active conduct of business. The second exception is partnerships with at least 90% of their gross income from passive investments, such as dividends, interest, rents, capital gains, and mining and natural resources income. The number of publicly traded partnerships was not reported for 1999.

Partnership Tax Issues

Although not taxable themselves, partnerships figure importantly in the tax situations of their partners. Most partnerships are simply straightforward conduits of taxable income or loss and tax attributes. However, they can also be used to manipulate the allocation of tax attributes and the sheltering of income and assets from taxation. Most of these issues also apply to limited liability companies, discussed below, but generally not to other passthrough entities that are treated as partnerships for tax purposes.

A corporation distributing appreciated assets to its stockholders may be taxed on the gain, as if the assets had been sold and the money distributed. But if it instead contributes the assets to a partnership in return for an interest in the partnership, it is not taxed on the appreciation until the partnership disposes of the property. This rule

discrepancy has been used, especially by closely held corporations, to effect a virtual tax-free distribution.

A partner's basis in a partnership includes money borrowed by the partnership as well as his or her own investment. Thus it is possible to invest a very small amount of one's own money and receive a large share of a partnership's losses. These losses were once deductible from other income to the extent of basis, including the debt. In the past, many tax shelter operations, some of which allowed tax savings greater than the initial investment, were based on this rule. The vehicle for these tax shelters was usually a limited partnership, so the investor was not risking much.

A number of IRC provisions have been devised to address these situations. The "at-risk" rules of section 465 limit the deduction for losses to the amount of the investor's own investment plus loans for which he or she is personally liable or has pledged other property. Specifically for limited partners, the "passive activity loss" rules of section 469 limit the deduction for losses from any activity in which the investor does not materially participate to income from that activity.

The partners can agree to allocate income, deductions, and tax attributes in any way they choose, subject only to the IRS requirement that the allocation have "substantial economic effect." This is often used to allocate income to low-tax partners and losses or deductions to high-tax ones. It can be used with any type of partnership or similar organization, and has been especially important in limited partnership tax shelters. (However, it is generally not useful for S corporations; see the next section.) If a partnership engaging in hedging transactions allocates more than 35% of its losses to limited partners, however, the partners may not deduct these losses from income from other sources (IRC section 1256(e)). Likewise, a "farming syndicate" allocating more than 35% of its losses to limited partners faces restrictions on its deductible expenses (IRC section 464).

S Corporations

An S corporation is a closely held corporation (or association treated as a corporation for tax purposes) that elects to be treated as a passthrough entity like a partnership. (S corporations are named for "Subchapter S" of the IRC, sec. 1361-1379, which governs them. Ordinary corporations are called "C corporations," after Subchapter C of the IRC.) S corporation status enables the business's owners to retain the nontax advantages of limited liability and other corporate attributes without the tax disadvantages of double taxation of profits and limited deductibility of losses. S corporations have been an increasingly popular form of organization for many years, especially after the tax rate increases in 1993 (although their popularity may be diminished by the growing use of limited liability companies, discussed in the next section). In 1999, more than 2.7 million S corporation returns were filed, accounting for more than half of all corporation returns (but only about 3% of all corporate assets).²

²Internal Revenue Service, *1999 Corporation Source Book of Statistics of Income*, (continued...)

Corporations must meet a number of restrictive criteria to elect S corporation status. They must be domestic corporations or associations with only one class of stock and no more than 75 shareholders (husbands and wives and their estates are counted as one shareholder for this purpose). The shareholders must be individuals, estates, certain types of trusts, or tax-exempt pension funds or charitable organizations. Shareholders must all be U.S. citizens or residents.

S corporations cannot be banks using the reserve method of accounting, insurance companies, or corporations eligible for the possessions tax credit. An S corporation can own a C corporation subsidiary but cannot file a consolidated return with it; an S corporation can file consolidated with a 100%-owned S corporation subsidiary (a “qualified Subchapter S subsidiary”).

The corporation makes the election to be treated as an S corporation, but each shareholder must consent, in writing, to the election. In consenting to the election, the shareholders agree to report and pay tax on their shares of the corporation’s income. The election can be revoked with the consent of shareholders holding more than 50% of the outstanding shares of stock. If an election is revoked, the corporation cannot elect S status again for 5 years without IRS consent.

S corporations, like partnerships, calculate operating income or loss at the company level and pass the net amounts through to the shareholders. They also pass through separately those items that may have special tax attributes at the shareholder level, including portfolio income, capital gains and losses, items involved in passive loss or alternative minimum tax computations, and the like, just as partnerships do. The allocated amounts retain their character in the hands of the shareholders, and the shareholders report the amounts and pay any tax on their own returns. S corporations may not make uneven allocations, however; because there can be only one class of stock, all allocations have to be proportionate to ownership. S corporation shareholders are not subject to self-employment taxes on amounts passed through to them.

Distributions to shareholders made from accumulated earnings that have already been taxed to the shareholders are not taxed again. Like partners, shareholders who are also employees of the corporation may receive guaranteed salaries and fringe benefits; these are deductible by the corporation and taxable to the shareholder (fringe benefits only if the shareholder owns 2% or more of the stock). The S corporation pays employment taxes and withholds income and FICA taxes on shareholder-employees’ wages.

The basis of a shareholder’s stock is increased by positive amounts allocated to the shareholder and decreased by actual distributions and allocated losses and deductions. As with partnerships, losses are deductible only to the extent of basis; unlike partnerships, however, debt does not increase a shareholder’s basis.

²(...continued)

Publication 1053 (Rev. 4-2002), p. 535.

Special rules apply when corporations that were once C corporations become S corporations. Earnings and profits accumulated while in a C corporation status must be separately accounted for under rules that prevent their receiving a tax advantage from the conversion. If a corporation has such earnings and profits, and for three consecutive years more than 25% of its gross receipts consists of passive investment income, its election as an S corporation automatically terminates. Distributions from such earnings and profits may be taxable dividends to the shareholders. And some attributes carried over from the C corporation status may trigger tax at the corporation level.

As passthrough entities, S corporations are generally not subject to the corporation income tax. However, an S corporation that was once a C corporation (or that bought out a C corporation) may be taxable on some carryovers from the C corporation. If the corporation disposes of an appreciated asset within 10 years of converting, any gain attributable to appreciation in the C corporation period is taxed at the highest rate applicable to corporations. Any losses and credits carried over from the C corporation may be used to offset this tax, however. Taxes may also be imposed to recapture previous benefits from the use of investment credits or the last-in-first-out inventory method by the C corporation. And if more than 25% of a converted corporation's gross receipts consist of "passive investment income" (dividends, interest, rents, royalties, and capital gains), net income attributable to the excess over 25% of gross receipts is taxed at the highest corporate tax rate. (As mentioned above, if this situation continues for three consecutive years, the corporation's election will be terminated.)

Limited Liability Companies

Limited liability companies (LLCs) are recent creations of state law designed to be corporations for all purposes except the federal income tax. The first such statute was enacted in Wyoming in 1977, followed by a similar law Florida in 1982.³ By the mid-1990s, LLC laws had been enacted in all states.⁴

For many years, IRS had held that any organization would be taxed as a corporation if it had the major characteristics of a corporation: associates, an objective of carrying on a business and dividing the profits, continuity of life, centralized management, limited liability for its owners, and free transferability of interest. LLCs were designed to fail on enough of these points to avoid being classified as a corporation. Most of the statutes accomplished this by having the company nominally cease to exist upon the withdrawal of a member, placing restrictions on the transferability of interest, or designating all the members as

³Larry E. Ribstein, "The Emergence of the Limited Liability Company," *The Business Lawyer*, Nov. 1995, p. 1.

⁴Paul A. McDaniel, Martin J. McMahon, Jr., and Daniel L. Simmons, *Federal Income Taxation of Business Organizations*, 3rd ed. (New York: Foundation Press, 1999), p. 8.

nominal managers. IRS issued a number of letter rulings allowing these companies to file as partnerships (although some rulings went the other way).⁵

In 1997, IRS issued final regulations (IR Reg. 301.7701-3) that in effect allowed such entities to elect how they would be taxed by simply checking a box on a form. (These are referred to as the “check-the-box” regulations.) A single-owner LLC can elect to be taxed as either a corporation or a sole proprietorship; a multi-owner LLC can elect to be considered either a partnership or an association taxable as a C corporation. These rules apply to any entity that is not otherwise required to file as a corporation or a trust.

An LLC electing to be treated as a partnership (as almost all of them do) is subject to all of the partnership rules discussed above. Such an LLC achieves the limited liability of a corporation without the double taxation and the restrictions on pass-through of losses of a C corporation. An LLC may have an unlimited number of shareholders and is not subject to restrictions on who may be a shareholder, in contrast to an S corporation. Amounts borrowed by the LLC are added to the members’ bases in the company.

The interests in most LLCs cannot be traded on a market (or it would be treated as a publicly traded partnership and taxed as a corporation anyway). The members of an LLC may be subject to self-employment taxes, as active partners are but S corporation shareholders are not.

There were 589,000 limited liability companies filing as partnerships in 1999, reporting 2.27 million members.

Regulated Investment Companies (Mutual Funds)

Regulated investment companies (IRC section 851-855), most of which are mutual funds or venture capital companies, are corporations or associations that invest their members’ money in securities and pass the dividends, interest, and capital gains through to their investors. If they meet the requirements of the IRC, the amounts distributed to the investors are not subject to the corporation income tax.

A regulated investment company (RIC) must derive at least 90% of its gross income from dividends, interest, gains from the sale of securities, and other income from the handling or holding of cash and securities (foreign currency transactions, loans of securities, etc.). At least 50% of its assets must be invested in securities and cash, and no more than 25% can be invested in the securities of one issuer. Except for certified venture capital companies, the company may not own more than 10% of the voting stock of another corporation.

Regulated investment companies are subject to the corporation income tax on undistributed taxable income (less capital gains). However, if they distribute each year at least 90% of their income (excluding capital gains) to their shareholders as

⁵Ibid., p. 9.

dividends, the amounts distributed are deductible. In fact, almost all mutual funds distribute all of their income (by crediting it to shareholders' accounts) and so pay no corporate tax. The shareholders include the dividends credited to them in their own incomes and are liable for any tax the dividend income generates.

Capital gains on the company's securities trades are accounted for separately and are paid out to shareholders as capital gains dividends. Capital gains dividends are treated by the shareholders as long-term capital gains. Because the mutual fund's trading can generate capital gains even when the its own shares have lost value, shareholders can have taxable capital gain dividends in a year when their overall investments in the fund have fallen in value. They cannot net the unrealized loss on their mutual fund shares against their capital gains dividends, which represent realized capital gains of the fund.

RICs have the option of retaining capital gains and paying the corporate capital gains tax on them. In this case, the gains are allocated to the shareholders as if paid out in dividends and included in the shareholder's income; however, shareholders are allowed a credit for their share of taxes paid by the RIC.

There were 10,318 RIC tax returns filed for 1999, reporting \$7.1 trillion in assets.⁶

Real Estate Investment Trusts

A real estate investment trust (REIT) is a domestic corporation, trust, or association with at least 100 shareholders that elects to be taxed as REIT and meets the requirements of IRC sections 856-859. It must derive at least 95% of its gross income from dividends, interest, capital gains, and qualified real estate income, and at least 75% of its gross income from real estate rents, mortgage interest, sales of real estate and mortgages, and other income related to real estate, including income from foreclosure property. The REIT must not directly perform management or other services for its rental properties. At least 75% of the REIT's assets must consist of real estate and mortgages, cash and cash items, and government securities.

The taxation of a REIT and its shareholders (the IRC calls them "beneficiaries") is similar to that of a RIC. If the REIT distributes at least 90% (95% before 2001) of its net income to its shareholders, it is not subject to corporate taxation on the amounts distributed, which are taxed to the shareholders. As with RICs, capital gains are accounted for separately and are considered long-term gain when distributed to shareholders. REITs may also elect to retain capital gains and pay tax at the corporate level, which is then passed on to shareholders as a credit. Like RICs, almost all REITs distribute all of their income to escape the corporate tax.

⁶*Corporation Source Book*, p. 213.

There were 1,071 returns filed with IRS for REITs for 1999, reporting over \$5.25 trillion in assets.⁷

REITs have been used in recent years by C corporations to divest themselves of company-owned real estate, either to streamline company operations or to reduce the total tax burden on the stockholders. In a typical arrangement, a REIT is created with the C corporation shareholders as the REIT's beneficiaries; some or all of the corporation's real estate is transferred to the new REIT; the corporation then rents the real estate from the REIT. If structured carefully, such divestitures can be tax free.⁸

The advantage is that a part of a regular C corporation can become a pass-through entity. Office buildings, timber and other land holdings, and other real estate spun off from the C corporation are rented by the corporation from the REIT, which then passes the rent payments through to its beneficiaries (the corporation's shareholders) free of the corporate tax. A drawback could be that the payments are taxable currently to the shareholders. Tax-exempt shareholders or shareholders who hold stock for long-term appreciation rather than dividend income might not see any advantage in the REIT spinoff.

Cooperative and Mutual Organizations

Originally, most mutual and cooperative undertakings were treated as nonprofit organizations under the income tax laws and therefore not subject to tax. It was assumed that any surplus of receipts over expenses would be returned to the members and generate no taxable income for anyone.

In many areas, however, these organizations were in direct competition with for-profit businesses that were subject to tax, and their competitors argued that it was unfair to tax one segment of the industry but not another. Banks objected to mutual financial institutions being tax favored, and eventually all except credit unions were subjected to tax. Stock insurance companies urged the full taxation of mutual companies, and there is still argument over whether this was achieved (or overdone). Many such organizations simply grew too large to operate on a cooperative basis and converted to another form of business. Many of the entities remaining under the mutual and cooperative rules are therefore small and specialized. Except for credit unions, rural electrical cooperatives, and perhaps farmers' cooperatives, most of these entities are generally not very controversial.

Cooperatives (Subchapter T)

Cooperatives are, with some exceptions, subject to the corporation income tax, but only on income not derived from transactions with their own members and patrons. Any excess of income over expenses (cooperatives call this a "surplus")

⁷Ibid., p.214.

⁸Robert Willens and Harley G. A. Wright, "Tax-Free Real Estate Spinoffs: Will They Catch On?" *Tax Notes*, Feb. 4, 2002, p. 619.

derived from dealings with members and patrons is returned to the patrons and is not taxable at the cooperative level. (IRC Subchapter T, sections 1381-1388)

Cooperatives included under Subchapter T include “exempt” farmers’ cooperatives and other corporations “operating on a cooperative basis” except other tax-exempt organizations, mutual financial organizations, mutual insurance companies, and rural electrical and telephone cooperatives. A corporation operates on a cooperative basis if its stock is owned by the patrons who market their products or purchase their supplies through the corporation and substantially all of its income is derived from these activities (or other dealings with or for patrons). Doing business with patrons who are not members is permitted, but they must be treated equally with members. Certain types of nonpatronage income is allowed, such as business conducted for a government.

Cooperatives compute their taxable income by deducting patronage dividends and per-unit retains paid to their members. Patronage dividends are the members’ shares of the cooperative’s surplus, based on a member’s patronage with the cooperative during the year and paid in money, written notices of allocation redeemable in money, or other property. Per-unit retains are certificates whose amounts are based on the value of products marketed by the cooperative for the member, payable in cash at some fixed time. Amounts paid in cash are deductible by the cooperative for the year of the patronage; certificates and notices are deductible when allocated if the patron agrees to include the amounts in income in the same year (“qualified” certificates) or when redeemed in cash if the patron does not agree (“nonqualified” certificates).

The patrons and members of a cooperative association are taxed on their share of the cooperative’s surplus allocated to them. If they agree to “qualified” notices and certificates, they are taxable for the year for which the cooperative makes its allocation (i.e., the year in which the patronage took place). For cash dividends or for cash redemptions of “nonqualified” certificates, they are taxed in the year the money is received.

Exempt farmers’ cooperatives

Cooperatives are especially important in agriculture, where they are sometimes very large businesses. Despite being described as “exempt” (IRC section 521), farmers’ cooperatives are subject to the corporation income tax on amounts of surplus not allocated to members. Unlike other cooperatives, however, they are considered exempt organizations for other IRC sections (such as the dividends received deduction). To retain this exempt status, however, they must meet certain extra rules; for example, a marketing cooperative must not do more than one half of its business (by value) with nonmembers, and a purchasing cooperative must not make purchases for nonmembers that exceed 15% of the value of all its purchases.

Mutual and cooperative utility companies

Rural electrical cooperatives, mutual telephone companies, mutual irrigation companies, and similar organizations are tax exempt under IRC section 501(c)(12) if at least 85% of their income consists of amounts collected from members for the purpose of meeting expenses. Electrical cooperatives and telephone companies do not have to count pole rentals to other companies in calculating the 85% limit. Surpluses are not allocated to patrons, and no one pays tax on them. Some electrical cooperatives are very large businesses.

Mutual and cooperative financial institutions

Mutual savings banks, cooperative banks, savings and loan associations, and credit unions were all once tax exempt as cooperative, nonprofit organizations. All except credit unions were long ago made taxable, although with special provisions. (IRC sections 591-597) The taxable institutions are allowed to deduct “dividends” paid depositors, which is really no different from banks deducting interest, and all except very large ones are allowed to use the reserve method of accounting for bad debts allowed small banks.

Credit unions remain tax exempt under IRC section 501(c)(14), so long as they are member owned (with no capital stock) and operated on a “nonprofit” basis.

Depositors are, of course, taxable on the “dividends” they receive from such institutions. (The IRS instructs taxpayers to report these amounts as “interest.”)

Mutual insurance companies

Insurance is by its nature a type of mutual undertaking; its purpose is the pooling of financial risks. Some companies, however, are “mutual” in organization, having no stockholders. Buying a policy gives the purchaser an ownership interest in the company, and any surplus not needed for company operations, expansions, or additional reserves is returned to policyholders as dividends. (Stock companies may also issue “participating” policies that pay policyholder dividends if the company’s loss experience is smaller or their investment earnings greater than anticipated when the policy premiums were set.)

Although once treated as if they were cooperatives, mutual insurance companies are now subject to the corporation income tax like stock companies, but with a few additional rules. (The very complex rules for taxing insurance companies are in IRC Subchapter L, sections 801-848.) Policyholder dividends are allowed as a deduction in computing insurance company taxable income. However, the deduction allowed a mutual life insurance company is restricted by a set of elaborate rules (section 809) designed to distinguish the portion that is a return of excess premiums (which is deductible) and the portion that is the equivalent of a stock dividend (which is not deductible).

Policyholder dividends are not taxable to the policyholders until they total more than the policyholder's total premiums paid. No distinction is made between returned excess premiums and dividend equivalents.

Mutual property and casualty insurance companies with total annual premium income of \$350,000 or less are tax exempt as nonprofit organizations (IRC section 501(c)(15)). Those with annual premiums of \$350,000 to \$1,200,000 may elect to be taxed only on investment income (IRC section 831(b)).

Other Conduit Entities

Trusts

Trusts are entities that hold title to property for other persons; they are not supposed to be associations or conduct business (IR reg. 301.7701-1). They either distribute or credit their income to beneficiaries, who are taxable on it, or pay tax themselves under a special individual income tax rate schedule (IRC section 1(e)). There are many kinds of trusts and extensive tax rules to govern them (IRC Subchapter J). (The word "trust" is used in the IRC for many dissimilar entities, some of which are taxed as corporations.)

REMICs

Real estate mortgage investment conduits, or REMICs, are pools of mortgages that sell shares to investors and pass the mortgage interest income through to the investors. Investors holding "regular interests" receive fixed payments, deductible by the REMIC and taxable as interest income to the investor. "Residual interest" holders are allocated a pro-rata share of the remaining income, taxable to them as ordinary income. The REMIC is not allowed to trade in mortgages; such activity would be a "prohibited transaction" taxed at 100% of any gain. (IRC section 860A-860G.)

FASITs

Financial asset securitization investment trusts, or FASITs, are entities owned by C corporations and used to hold the C corporation's securitized credit card receivables, auto loans, home equity loans, and other consumer debt. Its operation is similar to a REMIC, with "regular interests" receiving fixed payments taxable as interest income and an "ownership interest" (the C corporation) taxable on any remainder. "Prohibited transactions," including trading securities and receiving income from any other assets, are taxed at 100% of any gain. (IRC section 860L.)

Fraternal benefit associations

A fraternal lodge or its equivalent providing life or health insurance or other benefits for its members is tax exempt under IRC section 501(c)(8). The benefits provided are not taxable to the members.