Chapter 23

BRINGING ALL CO-OPERATIVES INTO THE NEW ENTITY REGIME

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A case for reform

Some co-operatives are taxed wholly like companies — others are not

23.1 Co-operative companies that meet the criteria in Division 9 of the 1936 Act are subject to some alternative tax rules to those applying to companies generally. Such 'tax co-operatives' may be established either under State legislation governing the formation and conduct of co-operatives or under the Corporations Law with their articles or constitutions specifically based on co-operative principles.

23.2 The criteria for falling within Division 9 require that the 'tax co-operative':

- has limitations on the number of shares any one shareholder can have and on the trading of shares;
- has as its primary object or objects such things as:
  - acquiring commodities or animals from its shareholders for disposal or distribution among its shareholders; or
  - the storage, marketing, packing or processing of commodities of its shareholders; and
- carries 90 per cent or more of its ordinary business with its members.

23.3 Many large co-operatives, although registered under co-operative legislation in their State, do not meet the criteria set out in Division 9 and are accordingly taxed as ordinary companies. In some cases, these entities have actively sought to remove themselves from the 'tax co-operative' rules to achieve a better commercial outcome for themselves and their shareholders.

23.4 Tax co-operatives are taxed like other companies, in most respects, including treatment of depreciation and other deductions. However, they receive a deduction for certain distributions of assessable income, and these deductible distributions cannot be franked. Such distributions are deductible up to the assessable income of the co-operative and can include dividends and rebates or bonuses based on business done with members. The distributions are fully assessable to the members.

23.5 A sub-set of tax co-operatives also receive a deduction for capital repayments on certain government loans.

23.6 Although tax co-operatives are established according to a broad principle of mutual involvement and participation, the tax principle of mutuality does not necessarily apply to them.

Inconsistency adds complexity and uncertainty

23.7 The treatment of tax co-operatives is inconsistent with the treatment of other co-operatives and companies. The actual benefit provided to tax co-operatives is limited, and would be negligible under a redesigned imputation system with refundable franking credits.

23.8 Compliance and administrative costs and uncertainty arise from the need to determine whether entities fall in or out of Division 9. In addition, where a tax co-operative does not distribute all of its taxable income (and there are complexities here in relation to the timing of distributions), it is subject to company tax which gives rise to associated franking credits and a franking account. Problems arise from having this mix of two systems. For example, tax co-operatives receiving franked distributions from companies can currently have a problem with excess franking credits, given their limited ability to distribute them to their members.

A strategy for reform

Treat all co-operatives like companies

23.9 Taxing all co-operatives like companies would remove the complexities associated with Division 9 and make the taxation of co-operative distributions consistent with that of other entities. This is consistent with the 'limited policy differentiation' legislative design principle of *A Strong Foundation*.

23.10 Imputation, with refundable imputation credits, would achieve an equivalent outcome to the current Division 9 treatment for tax co-operatives and members in terms of overall tax on co-operative distributions. The major difference would be that the initial taxing point of taxable income would move to the entity (as could the taxing point for tax-preferred income, depending on the option chosen for achieving integrity through the entity chain as discussed in Chapter 15).

23.11 The redesigned imputation system would provide for a taxation outcome that is simpler, more structured and consistent with that applying to other entities (including co-operatives currently taxed wholly like companies). It would address the practical compliance problems that currently arise with the operation of Division 9, such as tax co-operatives also having franking credits, and from the application of the criteria for falling within Division 9.

23.12 Taxing tax co-operatives like companies under a new entity tax system is a separate issue from the deduction that some tax co-operatives receive for capital repayments of certain government loans.

Key policy issues

How would dividends from tax co-operatives be affected?

23.13 Under a new entity tax system, distributions to and from what are currently tax co-operatives would be treated in the same way as distributions from companies, trusts and limited partnerships. Distributions of income from a co-operative would be treated as a profit distribution and would be subject to the redesigned imputation system.

23.14 For taxable shareholders imputation treatment, when combined with refundable imputation credits, would result in the same overall tax payable as the existing treatment of deductible dividends paid by tax co-operatives. The main effect would partly be to change the taxing point from members to the co-operatives.

23.15 Table 23.1 compares the current treatment of distributions for tax co-operatives with an imputation treatment as proposed in *A New Tax System*. The example assumes that the co-operative derives $100 of assessable income which is all distributed to individual members, and that members have a marginal tax rate of 30 per cent. A distribution to a corporate member would also result in an equivalent outcome to that under current arrangements in terms of overall tax payable.

Table 23.1: Comparison between current and proposed treatment of tax co-operatives

	Current treatment $	Proposed treatment $
Tax co-operative		
Assessable income	100	100
Deduction for distribution	-100	-
Taxable income of co-operative	**nil**	**100**
Tax payment of co-operative	nil	-36
Dividend paid to shareholder	**100**	**64**
Individual member — tax rate of 30 per cent		
Cash dividend received	**100**	**64**
Gross-up	na	36
Taxable income	100	**100**
Personal tax	30	30
Imputation credit	na	-36
Net personal tax payable	**30**	**-6**
After-tax income of shareholder	**70**	**70**

23.16 An imputation regime would also not involve a substantively different tax treatment for tax-preferred income than currently applies for tax co-operatives. This is because income freed by tax preferences from tax in a tax co-operative is currently taxed when distributed to members.

23.17 Tax co-operatives would need to establish a franking account if they do not already have one. As noted, however, many tax co-operatives would already have a franking account. This is because where a co-operative does not distribute all of its taxable income it is subject to company tax which gives rise to associated franking credits and a franking account.

How would rebates and bonuses provided by tax co-operatives be affected?

23.18 Currently tax co-operatives are allowed a deduction for rebates or bonuses paid to members based on business done by members with the tax co-operative. The deduction is allowable to the tax co-operative in the year in which the rebate or bonus is either paid or becomes payable. The amount of the rebate or credit must represent a bonus on, or a reduction of, amounts paid by members of the tax co-operative in the course of their business activities with the tax co-operative. The rebate or bonus can relate to current year or a previous year's activities.

23.19 The amount of the rebate or bonus received by a particular member does not have to be directly related to that member's activities with the tax co-operative. Under the reformed arrangements, therefore, the treatment of the rebates or bonuses received would differ depending upon whether they are linked to the commercial operations of each individual member undertaking business with the co-operative or whether they are provided to members in their capacity as shareholders of the co-operative.

23.20 If the rebates or bonuses are provided solely due to capacity as a shareholder, rather than by reference to actual business activities conducted with the co-operative, the amount could be treated as a distribution. The first two options for the definition of distribution under the new entity regime discussed in Chapter 18, for example, would treat these rebates or bonuses as distributions. Under those two options the amount of the distribution would be the amount of the rebate or bonus. Under the third option discussed in Chapter 18, the rebate or bonus might be subject to the FBT rules, rather than be treated as a distribution. Under each option, no deduction would be available to the tax co-operative.

23.21 This is not an issue unique to tax co-operatives as such rebates have much in common with shareholder discounts offered by some companies. Whether the rebates or bonuses would be taxed in the hands of the members (with imputation credits attached if classed as a dividend) would depend on any

monetary threshold applying to such payments – such as the proposed $1,000 FBT threshold referred to in Chapter 18.

23.22 If the amount of the rebate or credit is calculated by reference to that member's actual activities with the tax co-operative, where the rebate or bonus is provided on a 'commercial basis' having regard to the overall circumstances, the amount would not be treated as a distribution of profits. It would also not be subject to the FBT rules. In these circumstances, the general deductibility provisions would apply. Rebates and bonuses that are not provided on a 'commercial basis' would be treated either as a distribution, or as subject to the FBT rules, depending on which definition of distribution is adopted.

Should tax co-operatives be treated differently on the basis of the mutuality principle?

23.23 In the absence of Division 9, tax co-operatives would normally be taxed as companies for tax purposes. As they are established for the purpose of conducting trading activities with their members (and others, depending on their purpose), their income is derived in the same way as for other businesses carrying on similar activities. Members enter into co-operatives for similar commercial purposes as they enter into other companies with which they may trade.

23.24 Co-operatives are established according to broad principles of mutual involvement and participation. This does not mean, however, that the tax principle of mutuality applies to them. The mutuality tax principle determines that some accretions to a common fund are not income. Trading, even with members, however, produces income according to the current law. Moreover, the mutual involvement and participation of co-operatives do not appear to provide a basis for taxing tax co-operatives differently from companies.

How would the deduction to tax co-operatives for the repayment of government loans be affected?

Current treatment

23.25 Division 9 allows eligible tax co-operatives a tax deduction for repayments of loans made by a government. That is, it is an outright deduction for principal repayments of borrowings.

23.26 An eligible tax co-operative must have as its primary object the acquisition of commodities or animals from its shareholders for disposal or distribution. Members who supply the company with the commodities or animals must hold not less than 90 per cent of the company's paid up capital. Not all Division 9 co-operatives will satisfy the eligibility criteria. Eligible co-operatives are predominantly rural-based.

23.27 The provision was originally introduced in 1930 to facilitate the transfer of government infrastructure, such as mills and factories, into the hands of producers' marketing co-operatives.

23.28 Repealing this deduction provision was recommended by the 1932-34 Royal Commission on Taxation, and by the 1950-54 Commonwealth Committee on Taxation. It was considered that there was no further justification for continuing a concession of this nature to co-operative companies.

23.29 The Government sought to repeal the provision in the 1996-97 Budget but the legislation was blocked in the Senate. It was argued that the provision was necessary because of the important role of tax co-operatives in regional and rural industries.

Abolition of deduction not essential

23.30 This special provision for eligible tax co-operatives provides benefits for a very narrow group of taxpayers. It provides a generous double deduction for capital purchases funded by government loans — it allows tax co-operatives deductions for loan interest payments, depreciation of the asset and for the loan repayments themselves. Only the first two deductions are available to other taxpayers.

23.31 Not only are ordinary business taxpayers denied these double deductions, but also many tax co-operatives themselves do not meet the eligibility criteria. Its limited application is further reinforced by the fact that only a limited number of State governments currently provide such loans.

23.32 Co-operatives have still managed to flourish in those States which have rarely (or never) provided such loans. The provision would therefore appear to have very little relevance in today's circumstances and its retention is difficult to justify against the objectives and principles proposed in *A Strong Foundation*.

23.33 Although the Review considers that the deduction has limited practical applicability or justification, the continuation of the deduction is a separate issue from extending a new entity tax system to tax co-operatives. The deduction could therefore be maintained even if tax co-operatives were otherwise taxed like companies.