

Commentary and Overview for the

# Tennessee Processing Cooperative Law

# Foreword

During 2003 and 2004, the *Center for Profitable Agriculture* ventured into a new arena of Extension programming with the creation of a program referred to as the “cooperative development emphasis.” The cooperative development program was initiated as a 15-month pilot project, developed with six program strategies and funded in-part by the Tennessee Department of Agriculture’s Agricultural Development Fund, the *Kentucky Center for Cooperative Development* and the *Center for Profitable Agriculture*.



Planned strategies for the program included conducting mini-conferences and training sessions to improve the understanding of cooperative forms of business organization, facilitating group-specific strategy sessions with producer groups considering a cooperative organization, developing a Web-based listing/library of educational resources regarding cooperative development and publishing a commentary on the Tennessee processing cooperative law. Specific objectives for the project described this commentary as a: “*summary (brochure-type) to compare the Tennessee processing cooperative law with other types of business formations . . . to include an illustration and differentiation of key elements of business formation options, advantages and disadvantages, discussions and comparisons.*”

After a lengthy and detailed review and study of the cooperative industry, this commentary on the new processing cooperative law is published in response to the specific program strategy presented above. However, because a review and discussion of the new law is best presented in comparison and consideration of the overall cooperative environment, this commentary also presents a significant detail of cooperative history.

The history of rural cooperatives in the United States is well documented and has been thoroughly studied and debated in the discipline of both agriculture policy and business organization. The history of cooperatives includes numerous case studies of successful and failed ventures across the country. The history also reports modifications to basic cooperative models that were implemented to accommodate various changes in both the economic and agricultural environments. The history sheds light on the fact that agricultural cooperatives in the United States have represented more than just another legal business organization and have received special federal tax considerations, favorable antitrust protection, direct government funding and have been steeped in a heritage of business organization and operating principles unlike other business structures.

Some folks may agree or disagree that the cooperative form of legal business formation is *unique* compared to other business structures. However, most all folks would agree that a quick and easy documentation and explanation of all facets, implications and comparisons of cooperatives is *complex*. Nonetheless, in this publication, we attempt to build a basis of understanding about the cooperative business, to present the primary characteristics of cooperative organization and to explain the characteristics of the new Tennessee processing cooperative law with respect to the traditional cooperative environment.

I have concluded that you cannot begin to consider the opportunities or advantages offered by the “processing cooperative” law in Tennessee until you first have a good understanding of the history, principles and culture of traditional cooperatives. In addition, I estimate that 90 percent of the history, literature and description of cooperatives is of a national perspective, while actual cooperative organization begins with state statute. This commentary first presents and builds on the available national perspective then specifies state-level applications.

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# Commentary and Overview for the Tennessee Processing Cooperative Law

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Support for this publication was provided by The Tennessee Department of Agriculture  
Division of Market Development and the *Center for Profitable Agriculture*.

Funding for this project was made possible by the sale of agriculture specialty license plates  
(the “Ag Tag”). Funds received from “Ag Tag” sales are returned to the agricultural community  
in the form of grants for youth programs, market development projects and other agricultural projects.

**This commentary is intended for use in educational programs of the  
*Center for Profitable Agriculture*.**

# Acknowledgments

Appreciation is expressed to numerous associates who provided a significant amount of assistance in the development of this publication. A special thanks goes to Ms. Megan Bruch for her assistance in authoring the publication.

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Appreciation is also extended to Chris Clark, Burt English, Joe Gaines, Peggy Hamlett, Heath Hoagland, Rhedona Rose, Wanda Russell and Amanda Ziehl for their participation in the review process and to Donna Hundley for her layout and design work. Also, a special thanks to Joe Gaines, Julius Johnson, Larry Snell and Dan Wheeler for their leadership and assistance in the overall project administration.

# Disclaimer

The information contained in this commentary is deemed correct and accurate to the best of the ability of the authors and based on information utilized at the time of their review. The commentary was developed to serve as a guide to streamline and clarify consideration of legislation developing the “Tennessee Processing Cooperative Law” that was proposed in the 103<sup>rd</sup> Tennessee General Assembly during the winter of 2004. The bill was signed into law in April 2004.

This commentary is for educational purposes and is not a legal interpretation of the law. This commentary is intended for use in educational programs only. More than 40 sources were utilized, reviewed and consulted in the development of this commentary – each of these is listed in the sources section. Specific references and quotes are footnoted throughout the document.

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## Executive Summary for the “Tennessee Processing Cooperative Law”<sup>1</sup>

*The Farm Bureau-supported “new age co-op” legislation passed the Senate Commerce, Labor and Agricultural committee with a unanimous vote. A “new age co-op” is a hybrid between the structure allowed under the current co-op law and the structure allowed for Limited Liability Companies (LLC). The key component of this legislation is that farmer, “patron” members are allowed to accept outside investor dollars. The owners are divided into patron and non-patron members. Patron members have rights and obligations of delivery of the product to the cooperative. Non-patron members do not have product delivery obligations, rather they are primarily “investment” members. Patron members also have the option of participating as investment members. The patron members have preference in both governance and financial rights. Neither patron members nor investment members have any personal liability for the debts of the cooperative. The voting rights of the members are differentiated between patron and investment members. Patron members vote on a democratic basis of one vote per member, subject to certain exceptions. The patron member vote is counted collectively, based on a majority of the patron members voting on an issue. Investment members’ voting rights are prescribed in the bylaws of the cooperative. The collective nature of the patron member’s vote assures patron members’ maximum representation in cooperative voting. Directors elected by the patron members have at least 51 percent of the voting power of the board or voting power on an equal governance basis.*

# Introduction

It has not been that long ago when the options for organizing a business were fairly straightforward. The list began with sole proprietorships and partnerships and then included cooperatives and corporations. This simplified list has become a bit more complex in recent years, and now includes limited liability companies and multiple subclassifications of corporations, partnerships and cooperatives. To complicate matters even more, the precise descriptions of any of these business organizations are often state-specific. That is, the definition and organizational details of a limited liability company or a cooperative in one state are not necessarily the same as in other states.

Accelerated developments in value-added agriculture enterprises in Tennessee in recent years have contributed to an increased interest in the organization of cooperative agriculture ventures. Recent interest in new-generation cooperatives has caused even more confusion in various business structures authorized under state and federal statutes. Specifically, recent research and development of bio-fuel manufacturing operations has increased the consideration of new business structures for more modern business practices. These developments have presented a significant division between traditional and modern cooperative concepts.

Structural changes from the traditional farm gate to retail shelves are impacting the markets in which cooperatives and farmer members operate. The rapid pace of advances in information technology is making the world smaller and changing traditional business communication and transactions. Consolidation of agribusinesses, food manufacturers and food retailers is resulting in fewer, larger buyers for commodities. Simultaneously, farmers are gaining more control of niche-market opportunities. The need and opportunity to add value and differentiate products is becoming much more commonplace in most levels of

agribusiness. The traditional roles of commodity producers and commodity handlers are much different than in the past. Similarly, much of the organizational system for cooperative business formation was created in response to, and in support of, the traditional family farm.

Consolidation of agribusiness firms at the marketing, processing, wholesale and retail levels has resulted in drastic overall changes in the traditional agriculture and food marketing system. Vertical integration due to economies of scale has allowed food processors to have more control over distribution channels and profit margins. However, the opportunities afforded by integration often have come with the challenge of raising sufficient capital, particularly equity, to finance initial investment, improvements and expansions.

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In the past, farmers have been able to develop cooperative ventures to do together what individually would have been difficult or impossible. This has been the primary motive of farmers organizing cooperatives to process commodities into value-added products. However, the start-up investment requirements for value-added processing cooperatives are significantly

larger than the start-up costs for traditional non-processing farmer cooperatives. Another impediment to cooperative formation is potential farmer reluctance to finance new initiatives, especially unfamiliar and risky activities, such as vertical integration and value-added processing.

This document attempts to summarize and clarify the Tennessee Processing Cooperative Law, which was introduced in 2004 as Senate Bill 1161 and House Bill 1675. However, to accomplish this, a comparison with other business structures is needed. And, in order to effectively make such comparison, it is important to establish benchmark descriptions of all the business formation options.

# Traditional Types of Business Entities

Until recently, the most common types of business structures included sole proprietorships, partnerships, corporations and cooperatives. In recent years, formation of limited liability companies (LLC) has become one of the standard business structures.

While the formation of each business entity is somewhat unique, the ultimate selection of business structure is most often a reflection of the best option for the overall business needs. The selection of a business structure is one of the most important decisions in the life of

a new business. This process is often time-consuming, and each one has unique associated costs and benefits. Therefore, the decision should be made with due care and diligence.

Some of the most common factors considered in the selection of a specific business structure include control, capital, liability, earnings, taxes and business lifespan. Each of the traditional types of business organizations is described in the remainder of this section, presenting each type's characteristics in terms of these six factors.<sup>2</sup>



## Sole Proprietorship

The sole proprietorship is the oldest and most common form of legally organized business. In the sole proprietorship, one person owns, controls and conducts the business. Other characteristics of the sole proprietorship include:

- **Control.** The owner is responsible for management, makes all the major operational decisions and sets the business policies.
- **Capital.** The owner supplies the equity.
- **Liability.** The owner is responsible for all debts of the business.
- **Earnings.** Profits belong to the owner.
- **Tennessee State Taxes.** Not subject to franchise and excise taxes.
- **Federal Taxes.** Profits are taxed once, as income of the owner.
- **Business Lifespan.** The life of the individually owned business is tied to the one owner. It continues until the owner sells the business, retires or dies. At that point, the business is either taken over by a new owner or discontinued.

Many farms are operated as sole proprietorships. In fact, 95 percent of Tennessee farms are classified as "family or individual owned," and 80 percent of Tennessee forest land is held by individual landowners. Other examples of businesses commonly operated by sole proprietors include "main street" retail stores, restaurants, flower shops and dry cleaners.



## Partnerships

Partnerships consist of two or more people who jointly own, control and operate a business. The responsibilities of each are usually based on a partnership agreement. Characteristics of partnerships include:

- **Control.** Partners usually share management and make policy decisions by mutual agreement or majority vote. Some agreements provide for senior partners whose votes may carry greater degrees of weight.
- **Capital.** Partners provide the equity capital.
- **Liability.** The partners are usually liable, up to the value of all the property (s)he owns (both within and outside the partnership), for the debts of the partnership. Some partnerships have "limited" partners, who give up day-to-day management of the business in exchange for a limit on their personal liability.
- **Earning.** Profits (or losses) are shared by the partners in accordance with the terms of the partnership agreement. This is usually determined by the amount of capital invested and the nature of the work performed by each partner.
- **Tennessee State Taxes.** General partnerships are not subject to Tennessee franchise and excise taxes. Limited partnerships are subject to Tennessee franchise and excise taxes.
- **Federal Taxes.** Earnings are taxed once, as income of the partners.
- **Life.** The life of the partnership as a business is determined by the life of the partners. If one of the partners dies or leaves the organization, the partnership must be dissolved and a new business entity formed.

Some farms are owned and operated on a partnership basis. Other examples include some law and accounting firms, insurance and real estate companies, auto repair firms, and retail stores.

# General Business Corporations

Most businesses that have more than a small number of owners are organized as corporations. Corporations are legal entities, authorized by law to act much like an individual person. A corporation has the right to provide services, own property, borrow money, enter into contracts and is liable for its own debts.

A general business corporation operates as a profit-making enterprise for its investors, who are also referred to as stockholders. Most of the major companies in the United States operate as general business corporations. Their characteristics include:

- **Control.** Management is controlled by a board of directors and officers who are elected by the stockholders. Each stockholder usually has as many votes as the number of shares of voting stock (s)he owns. The board and officers make business decisions and policy. The board members have no obligation to use the firm's products or services and may have no contact with the firm outside of board meetings.
- **Capital.** Equity is raised by selling shares of stock to investors for their profit-making potential.
- **Liability.** The stockholders of the business are generally limited in their liability for the debts of the business. The corporation as a business entity is normally responsible for its own debts. If the business fails, each owner of stock can lose only the amount invested.
- **Earnings.** Profits are distributed to stockholders as dividends according to the number of shares of stock owned or used to expand the business. The board decides the timing and amount of such dividend distributions.
- **Tennessee State Taxes.** Earnings are subject to Tennessee franchise and excise taxes.
- **Federal Taxes.** Earnings are normally taxed twice, as income of the corporation when earned and as income of the stockholders when distributed as dividends.
- **Life.** A corporation enjoys a continuing existence, regardless of changes that may occur in the ranks of its stockholders.

Examples of investor-oriented corporations are large department stores, chain grocery stores, regional banks, automobile manufacturers and much of the communications industry.



# Limited Liability Company

A relatively new form of business structure in Tennessee that continues to gain widespread attention is the limited liability company (LLC). It combines the single-tax treatment of a partnership and the limited personal liability of owners of a corporation. Characteristics of an LLC include:

- **Control.** The owners, called members as in a cooperative, may share management and make policy decisions by mutual agreement or majority vote, or turn the management over to nonmembers. The operating agreement among the members determines the voting rights of each member.
- **Capital.** Members usually provide the equity capital.
- **Liability.** The owners of a LLC business are limited in their liability for the debts and obligations of the business. The LLC, as a business entity, is responsible for its own debts.
- **Earnings.** Profits (or losses) are shared by the members in accordance with the terms of the operating agreement. This is usually based on the amount of capital invested and the nature of the work performed by each member.
- **Tennessee State Taxes.** Earnings are subject to Tennessee franchise and excise taxes.
- **Federal Taxes.** The Treasury Department assumes an LLC wants to be taxed as a partnership. However, an LLC has the option to elect to be taxed as a general business corporation.
- **Life.** An LLC may have a perpetual existence, or the members may choose to be governed by the partnership rules.



The LLC has become a main-stream business structure in Tennessee and provides a useful vehicle for organizing joint ventures among established corporations, including those involving cooperative and non-cooperative firms. Whether it can be used to organize a number of individuals, who may want the flexibility to join and leave the venture at will, is undetermined at this time.



## Cooperative

A cooperative is also a state-chartered business, organized and operated as a corporation under applicable state laws. Cooperative attributes are:

- **Control.** Management is controlled by a board of directors (board) elected by the cooperative members. One unique feature of a cooperative is that each member usually has only one vote in selecting directors, regardless of the amount of equity that member has in the cooperative. Another is that all or most of the directors must be members of the cooperative. Thus, the leaders of the cooperative are regular users of the products or services that the cooperative provides.
- **Capital.** Equity comes from the members, rather than from outside investors. It is obtained by direct contributions through membership fees or sale of stock, by agreement with members to withhold a portion of net income based on patronage, or through retention of a portion of sales proceeds for each unit of product marketed.
- **Liability.** The liability of the members of a cooperative is limited. If a cooperative fails, each member is liable only for the amount (s)he has invested in the cooperative.
- **Earnings.** Earnings (or losses) on business conducted on a cooperative basis, often called margins, are allocated to the members on the basis of the use they made of the cooperative during the year, not on the basis of equity held. The allocations may be distributed in cash or retained as additional equity. Members usually receive a combination of cash and an allocation of equity.
- **Tennessee State Taxes.** Earnings are exempt from Tennessee franchise and excise taxes.
- **Federal Taxes.** Earnings from business with members are taxed once, either as income of the cooperative when earned or as income of the members when allocated to them.
- **Life.** A cooperative usually has a perpetual existence. Members can routinely join or resign without disrupting ongoing operations.

Examples of businesses that operate as cooperatives include agricultural marketing, purchasing and service organizations; credit unions; health care providers; and multi-unit housing facilities.

# Traditional Types of Agricultural Cooperatives

It has been stated that cooperatives have been developed as a way to guide, influence and shape opportunities in a changing world. The history of cooperatives is packed with modifications and adjustments to the organization and operation of these businesses due to economic and social transformations. “Members and leaders (of cooperatives) cannot understand co-ops unless they understand the wider economy and society of which co-ops are one part.”<sup>3</sup>

Although many modifications have occurred in two centuries of cooperatives in the United States, the two decades of the 1920s and 1930s are sometimes referred to as the golden age of agriculture cooperative development. This was a period of strong federal government support of cooperatives through favorable antitrust legislation in 1914 and 1922, the establishment of the farm credit system for cooperative credit in 1933 and the development of rural electric cooperative programs in 1935.

The list of specific cooperatives developed in the U.S. spans from insurance companies and financial institutions to commodity marketing cooperatives and consumer

cooperatives. In general, the three types of traditional agricultural cooperatives are often classified as marketing, supply and service.<sup>4</sup>

**Marketing:** Marketing cooperatives allow members who do not produce enough volume individually to pool their products to allow direct business with wholesalers and retailers. Today’s cooperatives integrate processing, canning, concentrating, freezing, packaging and storage of dairy, grain, fish, meat, poultry, fruit and vegetable products. The cooperative assists members in meeting market and government standards for their products.

**Supply:** A supply cooperative is probably the type of cooperative with which most Tennesseans are familiar. Supply cooperatives allow members to pool their resources to buy production supplies, including seed, fertilizer, petroleum products, farming equipment, heating oil and hardware for farm businesses. Quantity purchasing realizes savings and assures quality for the cooperative members. These cooperatives frequently affiliate with other cooperatives in the United States and overseas to own phosphate deposits, fertilizer plants, research laboratories, petroleum refineries and other similar facilities.

**Service:** Working in conjunction with other types of agricultural cooperatives, service cooperatives provide specialized programs such as feed mixing, pesticide applications, crop harvesting, artificial breeding and dairy herd improvements for their members. Specific service cooperatives include the Farm Credit system and the rural electric and telephone cooperatives.

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# Traditional Agricultural Cooperatives

by Phil Kenkel

The cooperative form of business is used successfully in many industries. Approximately 48,000 cooperative businesses operate in the U.S. with more than 100 million members and revenues of almost \$150 billion. In 2001, there were more than 3,200 agricultural cooperatives with more than 3 million farmer members and \$123 billion in gross revenue.

Agricultural cooperatives are formed because they allow farmers to pool their financial resources and carry out business activities more economically than they could individually. Historically, agricultural cooperatives are often formed because the existing business structures did not provide farmers with needed inputs and/or outlets to market their crops. Agricultural producers also perceived (many times correctly) that existing businesses used monopolistic practices to benefit at their expense.

Economies of scale were clearly a driving force behind the formation of most “traditional” agricultural cooperatives. The business functions of these firms revolved around providing farm inputs and in marketing bulk commodities. This business focus impacted the membership structure, pricing philosophy and equity system of these firms. Traditional agricultural cooperatives generally use an open membership structure. Producers can join the cooperative at any time, often at a nominal membership fee. These firms generally buy or sell at market prices. The cooperative member does not have a contractual obligation to deliver commodities or to purchase inputs with the cooperative. The structure of a traditional cooperative encourages new members to join the cooperative and spread the fixed costs over additional units.

Because traditional cooperatives price at market levels, a member’s benefit comes when year-end profits are returned in the form of patronage refunds. Most cooperative firms also do a portion of business with non-members. The cooperative’s services are therefore available to members and non-members alike. However, only cooperative members receive year-end patronage returns. There are several rationales for not attempting to build in the member’s benefit into the pricing strategy. First, the cooperative cannot accurately determine the profit level until year-end. Second, pricing at below market levels would invite reactions from other firms. Finally, pricing at below market would extend the cooperative benefits to its non-member customers and this would decrease incentives for membership.

The traditional cooperative’s strategy of maintaining a low initial investment led to the unique equity structure

*continued on p.15*

# Underlying Principles of Traditional Cooperatives

Historically, cooperatives have followed some notable underlying principles. Brett Fairbairn comments on the importance of remembering these principles in his article, *History of Cooperatives*. An excerpt from the article is given below:

*“Co-ops have learned and must remember enduring lessons from each stage of their development. The culture of cooperatives – the stories cooperators tell about themselves – must continue to incorporate all of the hard-won experiences of their history. The most important challenge for cooperatives is to remember who and what they are while also innovating and changing. There is nothing sacred about the way co-ops were structured or the things they did in the 1880s, the 1920s or the 1950s. Each cooperative model is an adaption to a specific set of circumstances and to the needs associated with a particular wave of economic transformation.”* (Fairbairn, 2004)

Cooperation among individuals in agricultural communities in pursuit of greater mutual benefits than from single efforts dates back to early settlers. Perhaps the first organized cooperative business in the United States was the “Philadelphia Contributionship for the Insurance of Houses from Loss by Fire” founded in 1752 by Benjamin Franklin. The insurance company, which is still in existence today, was established on the forerunner principles and practices of the legal cooperative entities that followed<sup>5</sup>. In 1804, a group of Connecticut dairy farmers organized a cooperative association to market their milk<sup>6</sup>. Many cooperative businesses were established in the 1800s, with significant growth occurring at the turn of the century.

In 1844, workers in England organized a cooperative store called the Rochdale Society of Equitable Pioneers. The business plan for the organization called for profits to be distributed according to the amount of business conducted with the co-op by members rather than based on the amount of each member’s investment in the co-op. This principle of profit distribution formed the basis of the definition and differentiation of what has come to be known as “Rochdale” cooperation. This cooperative later published 12 primary business principles, four of which served as the foundation for the boom of cooperative businesses organized in the U.S. The following “Rochdale Principles” continue to serve as a foundation for the organization and operation of many cooperative businesses.<sup>7</sup>

*continued from p.14*

associated with these firms. Sub-Chapter T of the Internal Revenue Service (IRS) tax code allows cooperatives to avoid taxes at the corporate level only when the profits of the business are allocated to the member/owners. These allocated distributions are called patronage refunds and they can be paid in both cash and stock. Traditional agricultural cooperatives have relied upon stock patronage refunds to provide much of the capitalization for the firm. The majority of the equity is created out of the profit stream as the cooperative issues stock for a portion of the member's profit allocation. The stock generally does not appreciate in value and is returned to the member under a prescribed system based on the age of the member or the age of the stock. The length of the revolving period is impacted by both the cooperative's profitability and proportion of annual profits that are retained. Cooperatives operating in competitive market areas and/or paying a higher proportion of cash patronage refunds may have revolving periods of 30 years or longer.

The traditional cooperative structure has been used quite effectively for cooperatives providing marketing, inputs and services associated with agricultural commodities. In recent years, producers' interest in participating in value-added and processing activities has increased. Some traditional structured cooperatives have successfully diversified into value-added enterprises. However, in the context of value-added business activities, the traditional structure has several weaknesses. First, the open membership structure and lack of equity appreciation provided a disincentive for members to invest in risky and long-time horizon projects. In a traditional cooperative, a producer joining the cooperative after a value-added business was successfully developed would receive the same benefit as the producer who risked the development investment funds. Second, the voluntary usage structure made it difficult for the cooperative to assure sufficient quantity and quality of commodities to meet its processing needs. Equally important, when the value-added processing proved profitable, the traditional cooperative structure provides no mechanism to ration the plant's capacity. Thirdly, because cooperative stock is not bought and sold, individual members have no mechanism to transfer their equity investment. Members also cannot use stock price changes to assess the value of the cooperative as a going concern. This lack of transferability can also increase governance problems, because members who have different time horizons and/or risk tolerance cannot cash in their investment and exit the cooperative. Finally, the system of capitalization through the profit stream makes it difficult to finance value-added processing projects that typically involve large investments in plant, equipment and start-up expenses.

- **Open Voluntary Membership:** Membership in a cooperative society should be voluntary and available without artificial restriction or any social, political, racial or religious discrimination, to all persons who can make use of its services and are willing to accept the responsibilities of membership.
- **Democratic Control:** Cooperative societies are democratic organizations. Their affairs should be administered by persons elected or appointed in a manner agreed to by the members and accountable to them. Members of primary societies should enjoy equal rights of voting (one member, one vote) and participation in decisions affecting their societies. In other than primary societies, the administration should be conducted on a democratic basis in suitable form.
- **Limited Return, If Any, on Equity Capital:** Share capital should only receive a strictly limited rate of interest.
- **Net Surplus Belongs to User-owners:** The economic results arising out of the operations of a cooperative belong to the members of that cooperative and should be distributed in such a manner as would avoid one member gaining at the expense of others. This may be done by decision of the members as follows: a) by provision for development of the business of the cooperative; b) by provision of common services; or c) by distribution among the members in proportion to their transactions with the cooperative.
- **Honest Business Practices:** Cooperatives should deal openly, honestly and honorably with their members and the general public.
- **Ultimate Aim Is to Advance Common Good:** The ultimate aim of all cooperatives should be to aid in the participatory definition and the advancement of the common good.
- **Education:** All cooperative societies should make provision for the education of their members, officers and employees and of the general public in the principles and techniques of cooperation, both economic and democratic.

- **Cooperation among Cooperatives:** All cooperative organizations, to best serve the interest of their members and their communities, should actively cooperate in every practical way with other cooperatives at local, national and international levels.

The first federal legislation specifically allowing farmers to cooperate in joint ventures came in the form of the 1914 Clayton Act, followed by the Capper-Volstead Act of 1922. These acts provided specific legal protection to farmers from prosecution under antitrust laws<sup>8</sup>. With this special protection of cooperative farmer ventures from antitrust laws and other factors, farmer cooperatives flourished after the 1920s. In many states, the basic laws governing cooperatives have been relatively unchanged since the 1920s; a result of the sound principles on which the first cooperatives were formed.

Cooperatives are user-driven businesses that have contributed greatly to the development of one of the world's most productive and scientific-based agricultural systems. They have played an important role in strengthening market access and competitive returns for independent farm operators during the 20th century. They adapted

their operations to agricultural technological innovations, such as the use of fertilizers, plant and livestock breeding, agricultural mechanization, electricity and other new sources of energy, and to new information systems. Cooperatives have also played an important role in rural communities, where they are an integral part of the social fabric. They encourage democratic decision-making processes, leadership development and education.



## The Value-Added Cooperative Model

by Phil Kenkel

The recent trend in value-added cooperatives has involved a different type of cooperative structure. These cooperatives are often referred to as "new wave cooperatives," "new generation cooperatives" and/or contract cooperatives. There are substantial differences in the membership, investment, delivery and profit distribution practices of new wave cooperatives relative to traditional cooperative organizations.

Most new wave cooperatives are formed as closed cooperatives and hence membership numbers are limited. The cooperative members are required to make a substantial initial investment. This structure provides the members with more incentive to invest in long-range investment and market development than in traditional cooperatives.

Another difference between contract marketing cooperatives and traditional marketing cooperatives concerns the patrons' right and obligation to deliver product. Under the traditional structure, members have no obligation to deliver a specific quality or quantity of product to the cooperative. Generally, there is no upper limit on the amount of product that they can deliver. Under the new wave cooperative structure, each share of stock carries both the right and the obligation to deliver a specified quality and quantity of product. The member is required to arrange delivery even if the cooperative price is below the market price. If the member does not produce a sufficient quantity or quality of the commodity they are responsible for purchasing the contracted amount on the open market and arranging delivery.

Substantial initial grower-member investment means that new wave cooperatives are generally well-capitalized. This results in low levels of debt, which allow them to aggressively pursue investment opportunities. New wave cooperatives also tend to pursue an aggressive policy of returning cash profits to their members. Commonly, the "right to deliver" can be rented or sold by member-growers. This means that if the new wave cooperative is successful in adding value, then the contracted right to deliver can appreciate in value because profit distribution is linked to the quantity delivered. The delivery rights structure provides the members with incentives for the cooperative to invest in long-run, value-added activities.

# Overview of New-Generation Cooperatives

The 1980s and 1990s witnessed the continuation of modifications to traditional organizational features of agricultural cooperatives. During this time, new cooperatives were formed featuring a strong vertical integration around a narrow focus, oftentimes a processing focus, with large start-up investments. While the creation of traditional agricultural cooperatives typically centers around commodity marketing, the new-generation cooperatives (NGC) differ significantly due to membership shares carrying specified delivery requirements and profit distribution based on the same “required amount of delivery” system. Members of this NGC model are allowed to purchase various equity units, but each unit carries with it a legal requirement to deliver the predetermined amount of the commodity to be processed by the cooperative. The NGC model has been largely used in the upper Midwestern states by groups of farmers starting a processing business to add value to a certain commodity. While these cooperatives may represent a non-traditional approach to cooperative membership and profit sharing, they have mostly held with the organization and operating principles that distinguish cooperatives from other forms of business organizations.

A NGC embodies more organization and operational characteristics than traditional cooperatives. A NGC primarily provides a new relationship between the firm and its members

and how the firm is financed. Unlike traditional cooperatives, in which start-up expenses are minimal and growth is financed through members’ retained earnings, permanent equity to fund start-up and growth of a NGC is financed through the sale of delivery rights. These delivery rights represent a member’s right to deliver a specific amount of commodity(ies) to the cooperative and the cooperative’s rights to expect delivery of that commodity from the member.<sup>9</sup>



The NGC has several significant similarities and differences with traditional cooperatives. In most cases, the NGC is similar to traditional marketing cooperatives in that only farmers may be voting members; voting is based on the one-member, one-vote concept; dividends on equity units may not exceed 8 percent per year; the value of products handled for members exceeds that handled for nonmembers; and earnings are allocated to patrons on the basis of patronage. The NGC differs from the traditional cooperative model in its focus, membership make-up, membership delivery obligations, equity investment and equity transferability. Table 1 compares various characteristics of new-generation cooperatives and traditional cooperatives. A comparison of business characteristics for traditional and new generation type cooperatives is presented in Table 2.

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**P**ermanent equity to fund start-up and growth of a New-Generation Cooperative is financed through the sale of delivery rights.

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**Table 1: How Traditional Cooperatives Differ from New-Generation Cooperatives<sup>10</sup>**

	<b>Traditional Cooperatives</b>	<b>New-Generation Cooperatives</b>
<b>Focus</b>	Traditional agricultural marketing associations usually seek to maximize the volume of product handled to secure economies of scale and market power.	A NGC seeks to identify and obtain the volume of farm production that can be processed and sold consistently at a profit.
<b>Membership</b>	Traditional cooperatives usually have an "open" membership. They seek to sign up the largest possible number of eligible producers to maximize the volume of product handled.	A NGC has a limited or "closed" membership. Once eligible producers have contracted to deliver the desired level of product, membership is closed.
<b>Member Delivery Obligations</b>	Traditional cooperatives usually either accept (a) whatever production the members choose to deliver or (b) require the members to deliver all they produce or whatever is grown on designated land. Under any of these scenarios, the cooperative receives an uncertain and varying amount of product each year that is expected to "move" before the next crop arrives.	In a NGC, each member has the right to and is obligated to deliver a fixed quantity of product each year. This is true whether the member produces more or less of that product in a given year. Meeting a production shortfall or "moving" surplus production is the responsibility of the producer-member, not the cooperative.
<b>Member Equity Investment</b>	Traditional cooperatives usually require a minimal, uniform investment to join. This is consistent with recruiting the largest possible membership base and volume of production. Equity is accumulated over time through retained earnings.	A NGC usually requires a substantial up-front investment. The individual investments are not uniform but differ in proportion to the amount of product the member agrees to deliver to the association each year.
<b>Equity Transferability</b>	In a traditional cooperative, both the up-front investment and member equity accumulated through retained patronage refunds and per-unit retains can only be redeemed by selling it back to the cooperative at face value.	In a NGC, equity tied to the right-to-deliver product can only be resold to other producers eligible to use the service of the cooperative. Subject to approval from the board of directors, the transfer can take place at a price the parties can agree to, whether it is more or less than the price paid by the seller.



**Table 2: Characteristics of Traditional Cooperatives and New-Generation Cooperatives<sup>11</sup>**

<b>Characteristics</b>	<b>Traditional Cooperatives</b>	<b>New Generation Cooperatives</b>
<b>Customer Marketing Transactions</b>		
<b>Delivery Rights</b>	Unlimited	Limited to purchased
<b>Delivery Obligation</b>	None	Required
<b>Quality Accepted</b>	Broad	Narrow
<b>Identity Preserved</b>	Usually not	Usually is
<b>Initial Payment</b>	Market price	Contract price
<b>Patron Profit Distributions</b>		
<b>Cash Patronage Rate</b>	Low	High
<b>Investment or Retained Profits</b>	High	Low
<b>Pooling Distributions</b>	Rare	Common
<b>Owner Investment Obligations</b>		
<b>Initial Investment</b>	Very low	Very high
<b>Proportionality to Use</b>	Low to high	Very high
<b>Liquidity of Exchangeability</b>	Low	High
<b>Exchange Value</b>	Fixed at par	Variable at market
<b>Redemption Obligation</b>	Ability to pay	None
<b>Business Expansion Investment</b>	None	High for delivery rights
<b>Member Voting Control</b>		
<b>Eligibility Restrictions</b>	Low	High
<b>Voting Power</b>	Usually one vote	Variable number

# New Cooperative Statutes

by Phil Kenkel

While the new-generation cooperative model structure eliminated some of the challenges of organizing a cooperative value-added business, structural difficulties remained. The focus on patronage-based returns coupled with statutory limitations on stock dividends makes it difficult to attract outside equity. Additionally, while cooperatives can achieve pass through taxation at the federal level, (similar to that of limited liability companies) they must meet the restrictions of IRS's Sub-Chapter T. These restrictions, which specify profit distribution in proportion to patronage, make it difficult to structure payments to non-patron investors. Most state cooperative statutes limit stock dividends to 8 percent. This restriction makes issuance of preferred stock unattractive. Most state cooperative statutes also specify a one-member-one-vote structure, with only producer-members having voting rights. This structure is obviously unattractive to outside investors who may want investment-based voting structures. Similar issues often emerge concerning the composition of the board of directors, which is often statutorily limited to member-producers. The new-generation cooperative structure also does not provide a vehicle to offer management and employees investment-related returns or stock options. This may make it more difficult for a new generation cooperative to attract and retain qualified officers and employees.

Because of these issues, producer-driven, value-added projects are often structured as joint ventures involving both a cooperative and a partnership or LLC. Some existing new-generation cooperatives have also converted their business form to the more flexible LLC format. Many existing cooperatives, including traditional cooperatives, have also turned to the LLC structure when setting up joint ventures or new, wholly owned, non-member business ventures. These issues have also spurred a movement in several states to create new, more flexible, cooperative statutes that better facilitate outside equity investment.

## Wyoming Processing Cooperative Law<sup>12</sup>

In July 2001, the state of Wyoming enacted a statute to authorize a new legal business structure. The new business structure is called a cooperative, but its design was more from the NGC model than the traditional cooperative model and varied in many ways from the traditional perception of an agricultural marketing cooperative. Like the motivation of the new-generation model, the Wyoming processing cooperative was developed for the primary purpose of forming a business to process farm commodities. In addition, the Wyoming processing law specified the two membership classifications as patrons and non-patrons. Both membership classifications are owners of the cooperative as investing members. Patron members have the obligation to deliver a pre-defined (and legally binding) amount of commodity to the cooperative for processing. The non-patron members do not have a delivery obligation and are involved primarily for investment purposes.

Patron members have preference over non-patron members in both governance and financial rights. Patron members vote on the democratic basis of one vote per member. However, patron-member votes are counted collectively based on a majority of the patron votes. Non-patron votes are proportionate to their level of investment or as other-

wise described in the bylaws of the organization. Financial rights for patron members are based on patronage, while non-patron members have financial rights based on their level of capital investment.

Under the Wyoming law, a cooperative can have an unlimited number of investor "non-patron" members who are not required to do business with the association, but are entitled to vote and share in its earnings based on their level of investment. Patron members are limited to one vote each, while non-patron members may have unlimited votes based on investment.

Only one of an unlimited number of directors must be elected by producer-patron members. Director(s) chosen by the producer patron members are entitled to 50 percent of the voting power on the board according to the processing cooperative law. This may fall short, however, of the level of producer control necessary to be operating as a farmer cooperative, as defined in other statutes.

No limit is imposed on the rate of return investor members can realize on their investment. However, only up to 85 percent of each year's earnings may be distributed to investor members based on their level of investment.

# Consideration of Federal Laws on Cooperatives<sup>13</sup>

Legally organized cooperatives must be organized according to the laws of the state in which they are chartered. While some state cooperative statutes may offer more flexibility than others, federal laws apply to all state-chartered cooperatives and require certain legal-structure characteristics to be eligible for federal benefits offered to cooperatives. The primary federal benefits for cooperatives are related to antitrust protection, limited exemption from security and exchange commission registration, taxation and funding/financial assistance.

Cooperatives that meet certain organizational and operational conditions are provided a limited antitrust exemption that other business organizations do not enjoy. The protection has been available to cooperatives since the federal Capper-Volstead Act was passed in 1922. The act responded to rulings in the early 1900s that farmer cooperation activities illegally restricted trade. The Capper-Volstead Act requires that cooperatives protected by the act meet four criteria:

1. Membership in the cooperative must be limited to producers of agricultural products.
2. The cooperative must operate for the benefit of its members as producers.
3. The cooperative must restrict voting rights to one member, one vote or limit dividends on equity to 8 percent per year.
4. The cooperative must handle products for members that have a value exceeding the value of products handled for nonmembers.

For a state-chartered cooperative not to be taxed as a corporation at the federal level, it must be organized and operated on a “cooperative basis.” Operation on a cooperative basis is subject to a case-by-case interpretation by the IRS according

## Anti-Trust Issues

by Phil Kenkel

The Capper-Volstead Act provides limited exemption from anti-trust regulations for farmer-owned organizations that are collectively processing, handling and marketing their products. In essence, anti-trust regulations prohibit firms within the same industry from “colluding” to improve prices. Prior to the Capper-Volstead Act, this prohibition was interpreted as prohibiting association of farmer producers from pursuing collective marketing strategies if the objective of the action was to improve prices for the participating producers. The Capper-Volstead Act is often referred to as providing limited exemption from anti-trust regulations because it allows producers to enhance prices but not to “unduly enhance” prices.

To qualify for Capper-Volstead exemption, an association must be “operated for the mutual benefit of the members” and (1) not deal in the products of non-members to an amount greater in value than such as are handled by it for members and (2) either limit dividends to 8 percent or use a one-member-one vote governance system. In the past, the courts have stringently adhered to the restriction that the members must be engaged in agricultural production and that the firm is marketing member products. The existence of even a single non-producer member resulted in a complete loss of anti-trust immunity for the entire organization.

The determination of whether a Tennessee cooperative organized under the new processing cooperative law qualifies for Capper-Volstead exemption is often a complex issue. The new processing cooperative statute was designed to facilitate the existence of outside, non-producer members. It would appear that the existence of these members eliminates the anti-trust exemption of these organizations. The importance of Capper-Volstead to the typical value-added effort is obviously open to debate.

to provisions described in Sub-Chapter T of the federal IRS code. Generally, the provisions for operating on a cooperative basis include open membership, democratic control, net returns returned to members and other basic cooperative principles.

The federal security and exchange commission also uses the IRS ruling for cooperatives to grant exemptions from full registration. That is, businesses that satisfy the IRS provisions for a cooperative are also exempt from full registration with the SEC.

# State Tax Issues<sup>14</sup>

In Tennessee, the most common state tax issues for cooperatives are the franchise and excise tax. According to the Tennessee Department of Revenue, the excise tax is a tax imposed on the privilege of doing business in Tennessee. General partnerships and sole proprietorships are not subject to the tax. The tax is based on net earnings or income for the tax year. The franchise tax is also levied upon the privilege of doing business in Tennessee and is based on the greater of net worth or the book value of real or tangible personal property owned or used. For this purpose, net worth or property values at the end of the taxable period are used.

Although the franchise and excise taxes are two separate taxes, the intention of the state legislature, and the policy of the Department of Revenue, is that they are part of the same taxing scheme. Generally, any taxpayer who is liable for one will be liable for both. The use of the terms “franchise and excise tax” or “the tax” is normally indicative of applicability to both taxes. Persons liable for the tax will register for both taxes on one form with the Tennessee Department of Revenue and must file returns on one form.



## Legal and Consulting Costs

by Phil Kenkel

The new Tennessee Processing Cooperative Law, and similar new laws in other states are fairly complex statutes. Many lenders and investors are likely to be unfamiliar with the structure. Before investing substantial funds, outside investors may require substantial documentation on the projected risks and returns of the business. A cooperative structured under the new act may not qualify for loans from traditional cooperative banks and/or certain cooperative related government programs. Cooperative organizers are likely to find it necessary to educate producers, potential outside investors and potential lenders as to the proposed structure of the firm. The outside investors may also have a substantial impact on the final business structure.

## Federal Tax Issues for Cooperatives<sup>15</sup>

A more complicated tax issue is whether or not cooperatives are subject to federal income tax at both the cooperative and patron-member level (dual-taxation). Since 1951, agricultural cooperatives that meet specific organizational and operational standards set by the IRS have enjoyed a special status under federal tax law. Prior to 1951, agricultural cooperatives that met the IRS standards were truly exempt from federal income taxes. Since then, cooperatives have been subject to certain income taxation advantages that are not available to other businesses. The IRS standards for qualification for the special deductions are in section 521 of the IRS Code. As with any special tax status, the requirements of Section 521 are the burden of the cooperative and rulings by the IRS over the years have made it increasingly difficult for cooperatives to qualify for Section 521 status. Some cooperatives that are eligible for the Section 521 status may give up the status because the cost of compliance may exceed the benefits. However, special rules tied to the 521 status still make it appealing in certain situations.

Cooperatives that qualify for Section 521 status must meet the following organizational conditions:

1. It must be an association for farmers, fruit growers or similar groups organized and operated on a cooperative basis to
  - a. market the products of members or other producers, or
  - b. purchase supplies and equipment for the use of members or other persons.
2. Substantially all of its stock (other than preferred non-voting stock) must be owned by producers marketing products or purchasing supplies through it, if it is organized on a capital share basis.
3. The dividend rate on capital shares must not exceed the legal rate of interest in the state of organization, or 8 percent a year, whichever is the greater, based on the value of the consideration for which the capital share was issued.

4. Financial reserves are restricted to those required by state laws or those that are reasonable and necessary and must be allocated to patrons unless the cooperative includes them in computing taxable income.
5. The business with nonmembers may not exceed 50 percent of the cooperative's total business, and the purchasing for persons who are neither members or producers may not exceed 15 percent of the cooperative's total purchases.
6. Nonmembers are to be treated the same as members in such business transactions as pricing, pooling or payment of sales proceeds, in price of supplies and equipment, in fees charged for services or in the allocation of patronage refunds to patrons.
7. Permanent records of the patronage and equity interests of all members and nonmembers must be maintained.
8. The legal structure of the organization must be cooperative in character and contain no provision inconsistent with these requirements, and the association must actually operate in the manner and for the purpose outlined in the requirements.

Cooperatives wishing to qualify for the Section 521 status must request a ruling by the IRS. The burden is on the cooperative to show initial and continual compliance with the requirements of Section 521.

## Tax and Security Issues

by Phil Kenkel

A value-added cooperative incorporated under Tennessee's new Processing Cooperative statute with investor-members would probably not qualify for Section 521 tax status. The entity would therefore probably be unable to make use of the "cooperative exemption" from federal security laws. Project organizers would therefore have to determine if a private placement, small offering or intra-state offering exemption might be appropriate. Otherwise, the project would have to pursue the full security registration process.

Subject to a few exceptions, the offering or sale of an equity interest in any business venture is considered a security offering and is regulated by state and federal security laws. Registration of a security offering requires the preparation of a detailed registration statement and prospectus. A security offering is expensive (\$150,000 or more) and usually requires several months. Given the time and expense involved, most value-added agricultural ventures seek a structure that is exempt from at least some of the registration regulations. On the federal level, there are four primary categories of exemptions. Private offering exemptions allow entities involving a small number of investors to avoid registration. Small offering exemptions offer reduced

regulations for projects seeking less than \$1 million investment. A "mini-registration" option is also offered for projects with investment of less than \$5 million. An "intrastate exemption" may also be an option for a project if all of the investors are located in a single state. Firms using this exemption must prohibit the sale of shares outside their home state for a specified period of time.

The Security Exchange Act of 1933 also provided a security registration exemption for cooperatives that met the restrictions of Section 521 of the Internal Revenue Code. The cooperative exemption has been attractive for value-added businesses because it does not place a limitation on the amount of funds solicited, nor on the number or location of investors. The prerequisite for obtaining the cooperative exemption is meeting the Section 521 restrictions. These restrictions include:

1. At least 85 percent of equity held by farmer members.
2. Stock dividends limited to 8 percent.
3. Maximum of 50 percent non-member business.
4. Non-members must be treated like members for allocation of patronage refunds, pricing, pooling or payment of sales proceeds.

5. Business activities restricted to marketing and processing farm products, providing farm supplies and equipment, and providing related services.

Cooperatives able to meet the Section 521 restrictions enjoy some tax advantages in addition to the potential security exchange exemption. Cooperatives qualifying under Section 521 are able to deduct dividends paid on invested capital from taxable income. Many traditional cooperatives choose not to seek Section 521 status. The requirement of paying patronage refunds on non-member business makes Section 521 status unattractive to many farm and supply cooperatives. Because of their structure, new generation cooperatives find it relatively easy to meet the Section 521 restrictions. The "pure" new generation cooperative has no non-farmer investors, does business only with members holding delivery rights and is generally focused on processing an agricultural product. The ability of new generation cooperatives to meet Section 521 restrictions and ultimately achieve an exemption from security registration provided another advantage for organizing a value-added business as a new generation cooperative.

# Likely Applications for the New Tennessee Processing Cooperative

by Phil Kenkel

New cooperative legislation such as Tennessee's Processing Cooperative Law essentially allows cooperatives to create two classes of stock: one for patrons and one for outside investors. The statute provides producer groups that are attempting to form value-added businesses much more flexibility in structuring their business to attract both producer and non-producer investment. For example, a producer group that could only raise 50 percent of the necessary equity could find an outside investor and structure a business under the new act. The new statute will also offer a new mechanism for existing cooperatives to pursue joint ventures. Many cooperatives that currently form joint ventures do so by forming a limited liability company (LLC). The LLCs inherent flexibility in designing the investment and return structure is undoubtedly one of the rationales for selecting the LLC structure. New cooperative statutes, such as the Tennessee Processing Cooperative Law, potentially allow two cooperatives or even a cooperative and a third party to form a joint venture and structure the venture as a cooperative.

## Issues Under the New Act

The Tennessee Processing Cooperative legislation provides the opportunity for non-farmer owned businesses, including large corporations, to join with farmers or cooperatives and form a new entity. The entity would be classified as a cooperative even if it were almost entirely investor-owned. A cooperative with a multi-national corporation investor is not structurally different from any other patron/non-patron investor cooperative formed under the new law. However, some producers might object to this structure and claim that the new enterprise will capitalize on the goodwill associated with the label of a farmer-owned cooperative. The new cooperative statutes developed in Tennessee and other states raise the issue "what does the term cooperative mean?"

## Conversion Issues

In theory, existing Tennessee cooperatives could convert or reform under the new Processing Cooperative statute. It is likely that the IRS would view such a conversion as a liquidation with significant taxable consequences. Because of the tax implications, it is unlikely that the new cooperative statute will directly impact existing Tennessee cooperative firms.



# Types of Legal Business Entities in Tennessee

Tennessee recognizes five primary forms of legal business organizations. They are the sole proprietorship, partnership, corporation, cooperative and limited liability company.

A general list of the five possible business organizations in Tennessee is presented below. Citation of specific state statutes governing cooperatives and corporations is also provided.

1. Sole Proprietorship
2. Partnership
3. Cooperative
  - Electric [Title 65, Chapter 25]
  - Telephone [Title 65, Chapter 29]
  - Marketing [Title 43, Chapter 16]
  - Education [Title 49, Chapter 2, Section 1304]
  - Processing [Title 43, Chapter 38-70]
4. Corporation
  - For-Profit [Title 48, Chapter 11-50]
  - Nonprofit [Title 48, Chapter 51-100]
  - Miscellaneous [Title 48, Chapter 101-200]
5. Limited Liability Company [Title 48, Chapter 201-300]

To be recognized as a legal entity, the business must either obtain a license or register depending upon the chosen structure of the business. A sole proprietorship is required to obtain a business license at the county level, while limited partnerships, limited liability partnerships, cooperatives, corporations and limited liability companies must be appropriately registered through the office of the Secretary of State.

# Tennessee Processing Cooperative Law

The idea of a processing cooperative law in Tennessee gained momentum during the development of a biodiesel feasibility study for Tennessee in 2002. A bill drafted by Mark Hanson was introduced in the 2003 General Assembly but was not brought up for a vote. In the summer of 2003, revisions to the original draft were developed under sponsorship by the Tennessee Farm Bureau Federation. Continued revisions were made to the bill in 2004 by the Farm Bureau, Department of Agriculture,

Department of Revenue and the Secretary of State's office. The third revised draft of the bill was available in March 2004. The bill was introduced in the Senate by Senator Mark Norris and others as Senate Bill 1161 and to the House by Representative Gene Davidson and others as House Bill 1675.

This bill was signed into law in April 2004 and is available as Public Act 2004, Chapter 534. A broad summary of the entire law, authored by Dan Elrod, is provided here, followed by a chapter-by-chapter description.

## Unique Provisions of the Law

by Dan Elrod

Some of the provisions in the law unique to the concept of a processing cooperative, include the following:

**Organization:** A cooperative may not file its organizational documents until the Commissioner of Agriculture determines that the cooperative will provide new or improved markets for Tennessee products or opportunities for partners to participate in the processing in Tennessee of agricultural products.

**Members:** The members of the cooperative are the owners. The owners are divided into two classes: (I) patron members and (II) non-patron members. Patron members have rights and obligations of delivery of the product to the cooperative, and non-patron members do not have product delivery obligations and are primarily "investment" members. Patron members also have the option of participating as investment members. The patron members have preference in both governance and financial rights. Neither patron members nor investment members have any personal liability for the debts of the cooperative.

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**The cooperative must provide new or improved markets for Tennessee products or opportunities for partners to process agricultural products in Tennessee**

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**Voting Rights:** The voting rights of the members are differentiated between patron and investment members. Patron members vote on a democratic basis of one vote per member subject to certain exceptions. The patron member vote, however, is counted collectively based on a majority of the patron members voting on an issue. Investment members' voting rights are prescribed in the bylaws of the cooperative. The articles and bylaws may restrict certain voting rights to patron members or investment members or a combination of the two based on their ownership class or series of ownership interests. The collective nature of the patron member's vote assures patron members maximum representation in cooperative voting. For example, if patron members have 65 percent of the cooperative's voting rights and the majority of the patron members vote in favor of a proposal, the entire 65 percent of the patron member's voting rights will be counted in favor of the proposal.

**Cooperative Governance:** The cooperative is governed by a board of at least three directors. At least one of the directors must be elected by the patron members. Directors elected by the patron members have at least 51 percent of the voting power of the board or voting power on an equal governance basis. The governance structure assumes that the patron members always have effective control in the governance of the cooperative.

*continued on p.26*

continued from p.25

**Financial Rights:** The financial rights of the owners of the cooperatives are further distinguished between patron members and investment members. The patron members are allocated financial rights; that is, profits, losses and distributions based on patronage or business financial rights based on capital contributions. Financial rights are allocated between patron members collectively and investment members based on capital contributions; provided, however, the patron members collectively must receive at least 15 percent of the profit allocations and distributions.

**Tax Treatment:** Cooperatives created pursuant to this Act shall be subject to the same fees and taxed in the same manner as nonprofit cooperative associations established pursuant to T.C.A. §§ 43-16-101, et seq.

**Restrictions, Redemptions and Mandatory Disclosures:** Restrictions on member control contributions, governance rights and financial rights must be stated in the bylaws or within separate member control agreements. Investment members have redemption rights if bylaw amendments alter governance or financial rights that affect their investment. To protect both patron members and investment members upon their entrance to the cooperative, the cooperative must disclose to any person or entity acquiring membership interests in the cooperative, the capital structure, business prospects and risks of the cooperative including the nature of governance and financial rights of the membership interests being acquired and of other classes of membership and membership interests.

*Mr. Elrod is an attorney with the Nashville, Tennessee branch of the Miller & Martin, PLLC law firm. Mr. Elrod has significant experience drafting and analyzing Tennessee law, particularly farm and rural issues, and has provided particular assistance in the drafting and explanation of the Tennessee Processing Cooperative Law.*



## Additional Considerations

by Phil Kenkel

The new Tennessee Processing Cooperative statute provides an exciting new avenue for the organization of a value-added business. The statute provides producer groups with much more flexibility in the design of their business structure. By accessing non-member capital, it might allow a group that is unable to raise sufficient equity capital to have a degree of ownership and control in a value-added business. The statute expands the types of business structures that can be classified as a cooperative. Issues could arise as whether new entities are inappropriate capitalizing upon the goodwill associated with the term "cooperative." Firms incorporated under the new act that are structured with non-producer member owners may find that they do not qualify for exemptions from anti-trust regulation and security exchange commission filing requirements.

# Chapter-by-Chapter Summary

The Tennessee Processing Cooperative Law allows cooperatives to be organized by both patron and non-patron members on a pass-through basis similar to limited liability companies. The law was modeled after Tennessee's existing LLC law, with some special provisions that are unique to the concept of cooperatives. The Act specifically amends Title 43 [Agriculture and Horticulture] of the Tennessee Code by adding new chapters 38 through 70. The Act is summarized below. A more detailed comparison of the shortcomings of the existing laws for value-added processing ventures and the advantages of the new processing cooperative law is presented in Table 3 (page 30).

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*Chapters 38 - 50 of the law address the articles of organization and bylaws of the cooperative. It provides for formation by one or more individuals, filing the initial articles of organization, amending and restating the articles of organization, adopting bylaws and the tax classification of a cooperative.*

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Chapter 38: Specifically names the act the "Tennessee Processing Cooperative Law."

Chapter 39: Defines 28 terms used in the act (chapters 38-70). Terms defined in the chapter include association, board, business entity, distribution, nonpatron, patron member, surviving entity and so on.

Chapter 40: Discusses various acceptable forms of notice of the new act.

Chapter 41: Describes the organizational purposes allowed for entities seeking legal status under this act.

- ... market, process or change the form or marketability of crops, livestock and other agricultural products, including manufacturing and further processing ...
- One or more people may organize
- Date of formation

Chapter 42: Describes 12 items that must be included in the organizational articles. Chapter 42 also describes some procedures for filing articles with the Secretary of State. Also mandates that the Commissioner of Agriculture must first approve articles of organization after determining that the cooperative will provide new or improved markets for agricultural products in Tennessee or that the cooperative will provide opportunities for patron members of the cooperative.

Chapter 43: Describes the bylaws of the organization (quorum, board, number of directors).

Chapter 44: Describes, in great detail, activities regarding the name of the cooperative.

Chapter 45: Describes requirements of a registered office for the cooperative in the state and the requirements of the cooperative's registered agent.

Chapter 46: Describes, in great detail, how the cooperative may amend its organizational articles.

Chapter 47: Specifically states: "Cooperatives created pursuant to this act shall be subject to the same fees and taxed in the same manner as nonprofit cooperative associations established pursuant to 43-16-101 et seq." NOTE: Regarding fees and taxes, Title 43-16-145 states: **Annual fee in lieu of other taxes – Exception.** *Each association organized hereunder shall pay an annual fee of ten dollars (\$10.00) only, in lieu of all franchise, license, corporation or other privilege taxes, or taxes or charges upon reserves held by it for members; provided, that if any association organized hereunder sells to persons other than its own members any product or merchandise other than unmanufactured tobacco, livestock, poultry products, dairy products or any other farm products, such association shall be liable for any privilege tax with respect to such transactions or method of doing business imposed under the laws of Tennessee, other than franchise and excise taxes and corporation filing fees or charges upon reserves held by it for members.*

Chapter 48: Describes the various procedures and requirements that the act allows the cooperative to function (unless otherwise addressed in the groups articles of organization). Such functions include the rights of other cooperatives, the right to perform business, the right to buy and sell and so on.

Chapter 49: Describes, in detail, the legal obligations between the cooperative and its patron members.

Chapter 50: Describes the cooperative's power and validity and how such may and may not be challenged.

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*Chapters 51 - 61 of the law provide for the members of the cooperative. The law limits liability of members, and establishes procedures for calling and holding meetings, providing notice to members, conducting meetings, voting, preemptive rights, membership interests, assignment of financial and/or governance rights, and records and reports.*

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Chapter 51: Describes the issuance of membership in the cooperative, overall membership make up and membership transfer.

Chapter 52: Describes membership termination.

Chapter 53: Describes limited liability and exemptions to personal liability and obligations.

Chapter 54: Describes the transferability of membership rights.

Chapter 55: Describes the rights of a member who dies or is judged incompetent.

Chapter 56: Discusses preemptive rights.

Chapter 57: Describes when, where and how notification for regular meetings shall be provided.

Chapter 58: Describes actions taken at meetings and voting on these actions.

Chapter 59: Defines a quorum, patron member voting, proxy and absentee ballots.

Chapter 60: Describes the 12 items that the cooperative must keep in its office (including a current list of officers, list of rights, copy of articles, bylaws all amendments and so on). Chapter 60 describes the rights and procedures for members to obtain information from the cooperative office. Chapter 60 also describes the information required to be delivered by the cooperative to the Secretary of State each year.

Chapter 61: Describes the functions of the cooperative's board of directors, officers and agents.

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*Chapter 62 of the law provides for the management of a cooperative by a board of directors and officers. Specifically, the Act provides for the election of directors, vacancies and the filling of vacancies, and for board action, including providing for quorum requirements, regular board meetings, special board meetings, the establishment of committees, the conduct of meetings, and actions that may be taken without a meeting. The Act also prohibits conflicts of interests and provides for their resolution. The Act provides for the appointment of officers and their powers and duties. It provides standards of conduct for a director or officer based upon a standard of good faith and reasonable prudence. The Act limits the personal liability of directors and officers, and provides for the indemnification of former directors, officers, employees and agents.*

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Chapter 62: Describes the governance of the cooperative by the board, election of directors, meetings of directors, functions of directors, committees and conflict of interest.

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*Chapters 63 - 64 of the law provide for the legal remedies and rights of members of the cooperative.*

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Chapter 63: Describes proceedings allowed and not allowed by the cooperative.

Chapter 64: Defines five specific terms used in the chapter and describes, in great detail, membership dissent proceedings.

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*Chapters 65 - 66 of the law provide for the capital structure of the cooperative. The law provides for the distribution and allocation of the cooperative's net earnings, as well as limitations on distributions.*

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Chapter 65: Describes parameters for allocation of the cooperative's profits and losses to patron and non-patron members. Unless otherwise described in the bylaws, profits are to be allocated on the basis of the value of contributions to capital made by patron members and others. The portion of profit allocated to patron members cannot be less than 15 percent of the total annual profits.

Chapter 66: Describes unlawful distributions.

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*Chapter 67 of the law provides for the indemnification of members and officers.*

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Chapter 67: Describes the cooperative's position of holding members and officers harmless from claims.

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*Chapters 68 - 69 of the law provide for the conversion, merger, sale and dissolution of the cooperative. The Act provides that a cooperative may merge or consolidate with other entities under the chapter. It provides that the cooperative may provide for the sale of a cooperative's assets or mortgage, pledge, encumber, sell, lease, exchange or otherwise dispose of its property.*

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Chapter 68: Describes allowed merger and consolidations involving the cooperative.

Chapter 69: Describes, in great detail, parameters for the dissolution of a cooperative.

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*Chapter 70 addresses the filing of documents with the Secretary of State, filing fees, etc.*

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Chapter 70: Describes filing fee requirements with the Secretary of State's office. Chapter 70 also establishes the effective date of the act as January 1, 2005.



**Table 3: Detailed Comparison of the Shortcomings of a Limited Liability Company and the Current Tennessee Marketing Cooperative Law with the Advantages of the New Processing Cooperative Law**

	<b>Shortcomings of Other Laws for Value-Added Agriculture Ventures</b>	<b>Advantages of the Processing Cooperative Law Compared to Existing Options</b>
<b>Limited Liability Company</b>	Not specific to processing cooperatives	Specific to processing /changing crops, livestock or other agricultural products
	Not specific to agriculture	
	Not exempt from state franchise and excise taxes	Explicitly exempt from state franchise, excise and state income taxes
	Not likely to be eligible for federal anti-trust protection	May be eligible for federal anti-trust protections
	May not be eligible for same federal IRS tax exemptions as true cooperatives	May be eligible for federal IRS tax exemptions for cooperatives
<b>Tennessee Marketing Cooperative Law [Title 43, Chapter 16]</b>	Primarily based on 80-year-old practices	Modernized terminology to accommodate significant start-up investment costs
	Not specific to modern commodity processing issues	
	Does not restrict the term cooperative-to-cooperative associations chartered under the current law	Restricts the term cooperative-to-cooperative association chartered under the new processing law
	Requires a minimum of 11 incorporators, a majority of which must be Tennesseans	Reduces the number of incorporators to one or more
	Does not allow non-patron members	Specifically accommodates non-patron investors and members
	Does not clearly allow for processing of by-products	Clarifies that processing of by-products is allowed
	Does not clarify that LLCs can be members of the cooperative	Allows an LLC to be a member
	Does not allow directors of the cooperative to be non-members of the cooperative	Allows members of the board that are not members of the cooperative
	Does not allow equity unit transfers to non-members	Allows equity unit transfers to non-members
	Restricts re-purchase of equity units by the cooperative at book value rather than market value	Allows re-purchase of equity units by the cooperative at market value
	Does not allow much organizational flexibility through the chartered bylaws	Provides some organizational flexibility through the chartered bylaws
	Does not clarify the cooperative's authorization to enter joint ventures	Clarifies the cooperative's ability to enter joint ventures

# Final Thoughts

The law allows some important organizational freedom and flexibility. However, some specific organizational details must be spelled out in the chartered bylaws. Due to the organizational flexibility offered to businesses organized under this law, it is difficult to generalize (in this commentary) that a cooperative organized under this law will or will not have the federal anti-trust protection under Capper-Volstead or whether it will or will not be subject to certain federal income tax situations that are offered to other cooperatives.

Some advantages of the Tennessee processing cooperative compared to existing legal forms of business organization are given below.

1. The primary purpose of the legislation is focused on processing agricultural products.
2. The legislation allows for profits to go to more than just member producers.
3. Reduces the minimum number of incorporators from 11 (a majority mandated from Tennessee) to one or more.
4. Clarifies that the cooperative can process and market by-products.
5. Allows payment of advances to non-members as well as members.

6. Allows the cooperative to exist as a non-producer cooperative (not mandated to be a 521 cooperative).
7. Clarifies that LLCs can be members of the cooperative.
8. Clarifies that “cooperatives” of other states can be members of a Tennessee processing cooperative.
9. Simplifies the “majority rule” to amend stock designations and bylaws.
10. Generally, the new law enhances the likelihood of loan financing by banks.
11. Allows for outside directors (directors do not have to be members of the cooperative).
12. Does not preclude directors from being a party of a for-profit contract with the cooperative.
13. Reduces the requirements for bonds for employees handling property.
14. Allows equity unit transfers to non-producers.
15. Does not restrict repurchase of equity units (by the cooperative) at book value rather than market value.
16. Does not allow one-third of the board to refer a matter to the entire membership.
17. Clarifies the cooperative’s ability to enter joint ventures.
18. Clarifies limitations of liability.
19. Specifically exempts the cooperative from state franchise, excise and income taxes.

## New Co-op Laws in Other States

by Mark Hanson

Despite the detail of comparisons provided in this commentary, significant confusion regarding the Tennessee Processing Cooperative Law and cooperative laws in other states still exists. The following comments address some of the confusion.

As of March 2004, the states of Minnesota and Wyoming are the only two states that have enacted a law that is parallel to the Tennessee Processing Cooperative Law. The legislation in all three states allows cooperatives to organize as “unincorporated associations.” This is unique to most all other cooperative formation laws that develop “corporate cooperatives” that allow corporate taxation and the corporate cooperative taxation under Subchapter T of IRS Code.

Some corporate cooperative laws allow nonmember/nonpatron investment as does Tennessee, but in many cases the state or federal tax law restricts distributions to 8 percent of the paid-in capital, which is marginal to unacceptable for an equity investor. The Tennessee law allows cooperatives to be formed as unincorporated associations similar to an LLC without the

restrictions of a traditional corporate cooperative, including non-patron members investing on an equity basis.

The Tennessee law may allow cooperatives to participate in ventures without paying tax as a nonpatronage-sourced business. In summary, a new Tennessee processing cooperative would have alternatives for capital structure and tax-efficient business ventures that would not be available to corporate cooperatives, in general, on the same basis as an LLC.

Iowa and Wisconsin have introduced a similar law in their legislatures. Indications are that the act will be passed in Wisconsin in 2004, while Iowa is hopeful the act will be passed next year. Missouri has a select study group reviewing a revised draft with the intent of introducing the draft this year.

*Contributed by Mark Hanson. Mr. Hanson is an attorney with the Minneapolis, Minnesota-based law firm of Lindquist & Vennum, PLLP. Mr. Hanson directs the agribusiness and cooperative efforts of the firm and has extensive experience in starting cooperatives. Mr. Hanson was instrumental in drafting the processing cooperative laws in Wyoming and Minnesota and drafted the first draft of the Tennessee processing cooperative law.*

# Summary Points

- The Tennessee Processing Cooperative Act became law in May 2004. The law is effective as of January 2005. The law creates a new legal form of business organization in Tennessee. The law sets forth business organizational requirements and guidelines that are different from other states.
- A Tennessee Processing Cooperative (formed under the new law) can have some characteristics of traditional cooperatives and some characteristics of a LLC. Therefore, many refer to this new business structure as a hybrid of Tennessee's traditional cooperative law and Tennessee's LLC law. The new law prescribes organizational rationale similar to traditional cooperatives but provides exemption from Tennessee franchise and excise taxes.
- The law provides a significant amount of organizational and operating flexibility. That is, rather than mandating every specific protocol, the law states that some organizational and operational procedures can be described in the cooperative's bylaws. Because of this flexibility, some cooperatives formed under the law will be subject to case-by-case rulings by some federal agencies for certain exemptions.
- A Tennessee Processing Cooperative may or may not be eligible for federal IRS tax status as a traditional cooperative under Section 521 of the IRS Code. (Each processing cooperative will be subject to a review by the IRS to determine whether the business meets all of the standards of Section 521).
- A Tennessee Processing Cooperative may or may not be eligible for federal anti-trust protection under the Capper-Volstead Act. (Each processing cooperative will be subject to a review by the IRS to determine whether the business meets all of the standards of Section 521).
- A Tennessee Processing Cooperative may or may not be eligible for exemption from federal SEC registration and filing requirements. This SEC exemption is based on the same Section 521 status from the IRS. (Each processing cooperative will be subject to a review by the IRS to determine whether the business meets all of the standards of Section 521).
- A Tennessee Processing Cooperative can have both patron members and non-patron members.
- A business organized under the new law can raise start-up capital from farmers (patrons) and investors (non-patrons) with both having membership rights in the cooperative.
- Patron members are those who "conduct business" with the cooperative by delivering a predefined quantity of raw input commodities to the business for processing. Patron members have potential benefits from selling commodities to the business, plus possible financial returns on investment in the business from the value of the processed product.
- Non-patron members do not have an obligation to deliver commodities for processing. Non-patron members seek to benefit from their capital investment by dividends and appreciated value of equity units.

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# Footnotes

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PB1748-750-11/04 R12-4010-18-002-05 05-0066

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