TESTIMONY

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On behalf of Ag Processing Inc, a Cooperative
Before the
Finance Committee
United States Senate

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FSC/ETI REPEAL AND COOPERATIVES

Good morning. Thank you Chairman Grassley for holding this important hearing in Iowa. We in the cooperative world appreciate your continuing concern and effort on behalf of agriculture and agricultural cooperatives.

Ag Processing Inc (AGP) is a regionally federated cooperative. We are owned by approximately 260 local and regional cooperatives who are in turn owned by an estimated 260,000 individual farmers and ranchers. Our primary business is soybean processing and vegetable oil refining. We are proud to process more soybeans in the state of Iowa than any other entity – and – of course – soybeans are the number one value crop in Iowa.

We are also involved in renewable fuels production with a 50 million-gallon ethanol plant in Nebraska and Iowa's first soydiesel plant at Sergeant Bluff, Iowa.

BACKGROUND

Cooperatives

Farmers manufacture and market their products through cooperatives. Cooperatives are member-owned corporations formed under Subchapter T of the Code (sections 1381-1388). Cooperatives determine their taxable income at the entity level like any other corporate taxpayer,[1] but they are eligible to claim deductions from taxable income for certain distributions to their members in the form of qualified "patronage dividends," "per-unit retain allocations" and certain other items.[2] These deductions effectively make cooperatives passthrough entities for tax purposes.

[1] Code §1381(b).
[2] Code §1382(b)(1), (3).

A "patronage dividend" is an amount a cooperative distributes to a patron on the basis of quantity or value of business done with or for that patron.[3] A "per-unit retain allocation" represents part of the equity of members or patrons in the cooperative.[4]

A patron must include in income distributions received during the taxable year that constitute patronage dividends and per-unit retain allocations.[5]

FSC/ETI

The FSC Replacement and Extraterritorial Income Exclusion Act of 2000 (ETI Act), Pub. L. 106-519, provides that gross income for U.S. tax purposes does not include extraterritorial income (ETI). The exclusion is available for both corporate and individual taxpayers. ETI is eligible for the exclusion to the extent that it is "qualifying foreign trade income."

The ETI Act allows a cooperative to exclude 15% of its qualifying foreign trade income from gross income and to pass the ETI exclusion through to its members. This allows members of cooperatives to benefit directly, when portions of their crops are sold abroad by providing an individual-level exclusion from gross income. The ETI Act provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative that is allocable to qualifying foreign trade income of the cooperative is treated as qualifying foreign trade income of the member. In general, 15% of that amount is therefore excludable from a member's gross income under the ETI Act.

The World Trade Organization, in response to a request by the European Union, held in a decision in January 2002 that the ETI Act and the remainder of FSC violated the terms of various trade agreements. The WTO therefore directed the United States to eliminate FSC/ETI. A WTO arbitration panel in August 2002 approved a EU proposal for $4.043 billion in countermeasures, in the form of duties on U.S. goods imported into the EU, which might be applied if the U.S. fails to comply with the WTO directive.

FSC/ETI REPLACEMENT

Legislation has been introduced that would repeal FSC/ETI, despite the strong case made by the USTR that the WTO erred in its rulings. The purpose of FSC/ETI has always been

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[3] Code § 1388(a). A patronage dividend is defined as an amount distributed to patrons: (i) on the basis of quantity or value of business done with or for that patron, (ii) under an obligation of such organization to pay such amount (which obligation existed before the organization received the amount so paid), and (iii) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

[4] 744 T.M., *Taxation of Cooperatives*, A-32. "Per-unit retains" generally take the form of withholding of cash from proceeds of sales. The "per-unit" designation refers to cents or dollars per bushel of grain, per hundred-weight of milk, or some other unit of production.

[5] Code § 1385(a)(1), (3). These amounts are includible in income regardless of whether such distributions are paid in money, property, "qualified written notices of allocation," or "qualified per-unit retain certificates."

to offset tax advantages enjoyed by EU and other foreign producers, who compete directly with U.S. producers. Those EU tax advantages consist of lower corporate tax rates, rebates of VAT, territorial tax systems, and other subsidies. The effect of these foreign tax regimes is to provide a significant competitive advantage to foreign producers.

The tax advantages enjoyed by foreign producers would, of course, be increased by repeal of FSC/ETI. The effect of the increase in this imbalance would be further to place U.S. producers at a disadvantage in both domestic and international markets.

It is therefore imperative that any measure to repeal FSC/ETI offset the resulting tax increase on domestic producers by an equal or greater reduction in the tax on domestic producers. Otherwise, the effect of FSC/ETI repeal will be to further reduce the earnings of U.S. producers both absolutely and relative to their foreign competitors. That can only result in the further loss of business and jobs in the United States, for members of cooperatives, no less than for any other U.S. business.

The Job Protection Act of 2003 (H.R. 1769) (the "Crane-Rangel Bill"), introduced on April 11, 2003 by Representatives Philip Crane and Charles Rangel, would satisfy the necessary elements of a FSC/ETI replacement if – and only if – it is amended to apply to cooperatives and their members.

The Crane-Rangel Bill would repeal FSC/ETI and provide transition relief over a 5-year period for current FSC/ETI beneficiaries. It would also replace FSC/ETI with a new deduction for U.S. corporations engaged in U.S. production activities.

The legislation provides that the determination of the amount of transition relief available to agricultural and horticultural cooperatives is to be made at the cooperative level, and that such amounts should be excluded from the gross income of patrons when distributed.[6]

PROPOSAL

Cooperatives are essentially passthrough entities, and as such they generally have no taxable income. They are permitted a deduction from taxable income the amount of their distributions to members in the form of patronage dividends and per-unit retain allocations.

Consequently, the Crane-Rangel Bill or any similar legislation that creates a deduction or credit based on taxable income must provide special rules regarding the treatment of cooperatives.

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[6] H.R. 1769, Section 2(e)(6) ("Under regulations prescribed by the Secretary, determinations under this subsection with respect to an organization described in section 943(g)(1) of such Code, as in effect on the day before the date of the enactment of this Act, shall be made at the cooperative level and the purposes of this subsection shall be carried out by excluding amounts from the gross income of its patrons.").

For example, the Crane-Rangel Bill or any similar legislation should provide that, for purposes of calculating deduction with respect to domestic production, taxable income is not reduced by the amount of any patronage dividends or per-unit retain allocations of a cooperative.

In addition, the definition of manufacturing should look through to the patron producer. For cooperatives involved in grain operations it would be necessary for elevation, storage, handling, drying, cleaning or other typical grain activities be considered eligible "manufacturing or production activities as was the case for investment tax credits.

Furthermore, in order to provide a patron-level benefit similar to that provided under ETI, it is necessary that legislation like the Crane-Rangel Bill provide distributions received by a patron or member of a cooperative which is allocable to the cooperative's deduction for qualified U.S. production activities may also be treated as a deduction of the patron or member, and, thus, deductible against the gross income of the patron or member.

Finally, the transition provisions of the Crane-Rangel Bill should be amended to clarify that the amount of any patronage dividends or per-unit retain allocation received by a patron or member of an agricultural or horticultural cooperative and which is allocable to the cooperative's "transition amount," is treated as the "transition amount" of the patron or member, and, thus, is excludable from the gross income of the patron or member during the transition period.

Mr. Chairman, I would like to note that there is a coalition of cooperatives working on this issue. We have been ably assisted by Thomas A. Stout, Jr., Teree Castanias and Katherine Breaks of KPMG LLP. I am in debt to them for their assistance with this testimony.