

# **Some Aspects of the Taxation of Canadian Co-operatives**

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## I. INTRODUCTION

Co-operatives have traditionally been regarded as economic organizations differing somewhat from the ordinary business corporation, but there is no authoritative definition of a co-operative that is universally accepted. One Canadian writer has attempted to define a co-operative as

...a voluntary democratically controlled association of persons who operate an enterprise for the purpose of supplying themselves with commodities or services, on the basis that they share any surplus created in carrying on the enterprise substantially in proportion to the use they make of the association.<sup>1</sup>

Co-operatives are incorporated under provincial<sup>2</sup> or federal<sup>3</sup> legislation in much the same way as are other corporations and they possess many of the characteristics common to all corporations. However, there are a number of important differences which are traditional features of co-operatives and which are reflected in the incorporating statutes. Co-operatives have been characterized, in contrast to ordinary business corporations, as lacking the speculative or profit making element. The main objective of the common business corporation is to reap a return to investors based on the amount of capital invested in the corporation by the shareholder, while the co-operative de-emphasizes the role of the member as investor and stresses his role as patron. The aims of a co-operative have recently been succinctly stated to be:

...to socialize the interests of the members by eliminating or minimizing the role of the member qua investor and maximizing the role of the member qua patron, restricting the return on invested capital to a nominal rate, requiring that the surplus of the co-operative be distributed to the members according to their patronage rather than their investment and by substituting for the capitalist principle of "one vote per share" the co-operative principle of "one vote per member" regardless of the number of shares.<sup>4</sup>

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<sup>1</sup> W.B. Francis, *Canadian Co-operative Law* (1959), 1.

<sup>2</sup> Each province in Canada has specific legislation relating to the incorporation of co-operatives. All provinces have a separate co-operative statute except Ontario and Manitoba, which have special parts of the general companies legislation devoted to co-operatives; see *The Corporations Act*, R.S.O. 1970, c.89, Part V and *The Companies Act*, R.S.M. 1970, c.160, Part X.

<sup>3</sup> *Canada Co-operative Associations Act*, S.C. 1970-71-72, c.6.

<sup>4</sup> *Report on Co-operatives* (Select Committee on Company Law, Ont. 1971), 2; most co-operative incorporating legislation enshrines these basic co-operative precepts. See *Canada Co-operative Associations Act*, *ibid.*, which allows an association organized on a co-operative basis to seek incorporation (s.5); "co-operative basis" is defined in s.3(1)(d) as meaning "the carrying on of an

Co-operatives have become "big business" in Canada<sup>5</sup> and important questions arise as to the treatment they have received and are receiving under Canada's income tax laws. An attempt here is made to analyse and evaluate the position of co-operatives from an income tax point of view.

## II. THE NATURE OF CO-OPERATIVE INCOME

### A. The Problem Stated

Co-operatives in Canada fall into two general categories for the purposes of taxation: the non-income co-operative and the income-earning co-operative.<sup>6</sup> The income-earning co-operative is the type of main concern for income tax purposes as the problem of taxation clearly does not arise if the particular co-operative enterprise is deemed to have no income. However, the distinction is more than

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enterprise organized, operated and administered in accordance with the following principles and methods:

- (i) except in the case of an association the charter by-laws of which otherwise provide, each member or delegate has only one vote,
- (ii) no member or delegate may vote by proxy except that a member of an association may vote by proxy for the election of directors if the charter by-laws of the association so provide,
- (iii) interest or dividends on share or loan capital is limited to the percentage fixed in the articles of incorporation or application for continuation, or by-laws of the organization, and
- (iv) the enterprise is operated as nearly as possible at cost after providing for reasonable reserves and the payment or crediting of interest or dividends on share or loan capital; and any surplus funds arising from the business of the organization, after providing for such reasonable reserves and interest or dividends, unless used to maintain or improve services of the organization for its members or donated for community welfare or the propagation of co-operative principles, are distributed in whole or in part among the members or the members and patrons of the organization in proportion to the volume of business they have done with or through the organization."

<sup>5</sup> See *Co-operation in Canada* (Dept. of Agriculture, Can. 1972), 7, where it is stated that the gross volume of marketing and purchasing co-operatives in Canada exceeded \$2.6 billion in 1972. Marketing and purchasing co-operatives compose the bulk of co-operative business in Canada; the former include the large marketing co-operatives which are formed for the purpose of marketing their members' products and the latter include the typical consumer co-operative.

<sup>6</sup> Formerly there existed a third category for tax purposes: newly organized co-operatives could claim complete exemption under s.73(1) of the *Income Tax Act*, R.S.C. 1952, c.148; see *infra*, Part III.

of academic interest as several co-operatives have been found to come within the former category with the result that surplus retained or earned by the enterprise was not taxable in its hands. The deductions allowed co-operatives<sup>7</sup> only become relevant once sums are brought within the taxing statute. If an amount is not income within the meaning of the *Income Tax Act*, the question of exemptions or deductions never arises.

In Canada an incorporated co-operative, like an ordinary business corporation, is a "person"<sup>8</sup> within the meaning of the *Income Tax Act* and is liable for income tax on what it receives in the nature of a profit or gain. If at the end of a given accounting period the co-operative is in possession of more than in the beginning of the period, the question arises as to the taxability of the surplus. However, if it can be shown that the surplus does not belong to the co-operative, that is, the co-operative does not own or have a right to the surplus, then it is arguable that it cannot be taxed on the amount. Hence, the co-operative may then be deemed to be a non-income co-operative.

If the co-operative as a separate entity has not earned the surplus or does not have a right to it, who does have the right? The obvious answer is that the right belongs to the members or shareholders. It is thus essential to determine the circumstances which must exist before that co-operative will be deemed to be of the non-income type and therefore not taxable on surplus which it may possess. This determination depends upon the nature of the relationship that exists between the member and the co-operative. If it is such that the member has a right to the surplus or, conversely, that the co-operative has no right to the surplus, it can be said that the amount is not taxable in the hands of the co-operative. The courts have found the relationship between member and co-operative to be one of agency, trust or some contractual relationship less than a legal agency or trust in holding that a particular co-operative did not possess sufficient ownership in the surplus to be taxable on it. What must be ascertained, then, is the relationship which must exist between the co-operative and member to bring about this result.

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<sup>7</sup> *Income Tax Act*, S.C. 1970-71-72, c.63, s.135 allows for deduction of patronage dividends in the computation of taxable income; see *infra*, Part III.

<sup>8</sup> *Ibid.*, s.248(1) defines "person" as including "any body corporate and politic, and the heirs, executors, administrators or other legal representatives of such person, according to the law of that part of Canada to which the context extends".

## B. The Co-operative — Member Relationship in Non-Income Co-operatives

To determine whether or not a co-operative as an entity separate and apart from its members earns an income in its own right, the relationship between the co-operative and the member must be analysed. The issue first arose in two cases which came before the Supreme Court of Canada within a year of each other.

In *M.N.R. v. The Saskatchewan Co-operative Wheat Producers Ltd.*<sup>9</sup> the Supreme Court of Canada had to decide whether certain deductions from sale proceeds which were placed in a reserve fund were taxable in the hands of the co-operative as income. The respondent, commonly known as the Saskatchewan Wheat Pool, had been incorporated for the purpose of enabling its members to market their grain co-operatively. Shares in the co-operative were issued only to Saskatchewan grain growers who entered into an agreement with the company for the marketing of grain.

The memorandum of association stated that the objects were, *inter alia*, to buy, sell, market, and export grain either as principal or agent and to act as agent or broker for its shareholders. The articles of association provided that no profit was to be made by the co-operative on the marketing of grain. The memorandum of association also contained a provision prohibiting the declaration or payment of a dividend to the shareholders. In addition to being subject to the memorandum and articles of association, each member entered into a marketing agreement with the co-operative, the terms of which were very important in the ultimate determination of the case. The agreement contained a clause under which the member-grower appointed the co-operative as his sole agent for the purposes of marketing the grain. The agent's powers included borrowing on its own account on the security of the member's grain and exercising all rights of ownership without limitation in respect of the grain.

The marketing agreement also allowed certain deductions to be made by the co-operative from the gross returns upon sale of the wheat. The first deduction was an amount necessary to cover all operating costs; the second allowable deduction was a commercial reserve "to be used for any of the purposes or activities of the association".<sup>10</sup> A maximum of one per cent of the gross selling price of the grain could be deducted as a commercial reserve. In

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<sup>9</sup> [1930] S.C.R. 402, [1928-34] C.T.C. 47.

<sup>10</sup> *Ibid.*, 405 and 50.

addition, the co-operative could deduct a third amount, known as the elevator reserve, to be used for future capital expenditures. The amount reserved was not to exceed two cents per bushel calculated on the quantity of the grain sold. The amounts deducted by the Saskatchewan Wheat Pool in the years 1925 and 1926 as commercial and elevator reserves totalled over \$3 million. It was this amount that was in question for income tax purposes.

A further provision stated that the amounts deducted were to be credited on the books of the co-operative to the member. However, the member had no absolute right to realize upon the amounts credited to him: this was a matter within the discretion of the directors and, according to the evidence before the Court, such a distribution was made only in exceptional circumstances.<sup>11</sup>

On the basis of the terms of the marketing agreement, the Court held the co-operative association to be the agent of its shareholders. The reserves were merely advances made by the growers to their agent, the co-operative, to enable it to carry out marketing operations. The Court stated that the co-operative was "merely machinery for collecting contributions from the growers [members], not as shareholders of the Association but as subscribers to the fund, and for using those moneys for the benefits of the growers and handing them back in some form or other when no longer required...".<sup>12</sup> The sums therefore were found not to be "profits or gains" of the co-operative and thus not taxable under the *Income War Tax Act*.<sup>13</sup>

The Supreme Court of Canada arrived at this conclusion notwithstanding the fact that the property in the grain and the proceeds therefrom vested in the co-operative and did not remain with the member. Lamont J., who delivered the judgment of the Court, stated:

... the marketing agreement and the confirming Act do more than simply create the relationship of principal and agent, or mercantile agent, in the ordinary sense, between the growers and the Association. That relationship the agreement, without doubt, creates, but, in addition thereto, the property in the grain and in the proceeds is vested in the Association and all rights of ownership thereto without limitation are exercisable by it, for all or any of the purposes set out in the agreement.<sup>14</sup>

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<sup>11</sup> *Ibid.*, 408 and 53, where the Court stated: "The only distribution that has been made of the principal moneys of the two reserves has been in cases where the grower [member] died, leaving his family in not very affluent circumstances".

<sup>12</sup> *Ibid.*, 416 and 59.

<sup>13</sup> R.S.C. 1927, c.97.

<sup>14</sup> *Supra*, f.n.9, 409 and 53.

Without expressly referring to it, Lamont J. here is perhaps finding the relationship between the co-operative and member-grower to be one more akin to a trust relationship than an agency relationship,<sup>15</sup> In either case, however, the co-operative would be considered to be the non-income type as the surplus retained by it is held for the benefit of its members.

However, it must be noted that in the *Saskatchewan Wheat Pool* case there was no obligation upon the co-operative to distribute the reserves among the members. Notwithstanding the fact that it was in the absolute discretion of the directors to make such a distribution, the surplus placed in reserve was held not to be a profit of the co-operative. The Court met this point by stating:

... there is no necessity for any contractual or statutory obligation. As the growers who contribute the reserves have, in their capacity as shareholders who elect the directors, the absolute control and management of the Association, it must be amenable to their will without any express provision to that effect.<sup>16</sup>

This statement, it is submitted, does not recognize the separation of ownership and control which exists in large corporations whether they be co-operatives or ordinary business corporations.<sup>17</sup> It seems to be a sanguine expectation which bears little relevance to the practicalities of the situation. Although ultimate authority may exist with the member qua shareholder, is it reasonable to suggest that the corporate entity, although a co-operative in form, should not be taxable on funds used for expansion purposes, especially where the members have no right to receive or claim the amounts that are ostensibly held on their behalf? The question may be asked whether co-operatives in reality are in a different position from ordinary business corporations in this respect.

The *Saskatchewan Wheat Pool* case recognizes that co-operatives can arrange their affairs so that all of the surplus from operations will belong to the members. However, as was indicated by the

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<sup>15</sup> Although agents and trustees are both fiduciaries, there are certain usual differences, e.g., the trustee usually has legal title to the property with which he is dealing whereas the agent usually does not have title; see further for a comparison of the two relationships S.J. Stoljar, *The Law of Agency* (1961), 10; R.H. Maudsley, *Hanbury's Modern Equity* (1969), 87; G.H.L. Fridman, *The Law of Agency* (1971), 15.

<sup>16</sup> *Supra*, f.n.9, 415 and 59.

<sup>17</sup> See generally, A.A. Berle, *Property, Production and Revolution* (1965) 65 Colum.L.Rev. 1; E. Rostow, "To Whom and For What Ends is Corporate Management Responsible?", in E.S. Mason (ed.), *The Corporation in Modern Society* (1970), ch. 3; A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (1933).

Supreme Court of Canada, "each case must depend upon its particular facts".<sup>18</sup> In this case three factors deprived the surplus of its character as income in the hands of the co-operative: (1) the articles provided that no profit would be taken by the co-operative and no dividend would be paid on the shares; (2) the reserve funds were credited on the books of the corporation to the members; (3) the marketing agreement that each member had with the co-operative created a principal—agent relationship between member and co-operative.

It is interesting that the same Court one year earlier reached an opposite conclusion on similar facts. In *Fraser Valley Milk Producers' Association v. M.N.R.*<sup>19</sup> reserves retained by the co-operative were also in question. Here, however, the amounts had been returned to the members, yet were held to be taxable. The agency argument was put forth by the co-operative but with no success. The dividends were not paid on the basis of patronage but on the basis of paid-up capital and therefore the Court refused to treat the co-operative any differently than an ordinary business corporation. Herein lies the distinction between the two decisions: in the *Saskatchewan Wheat Pool* case the amounts credited to the shareholders were in proportion to business contracted with the co-operative, whereas in the *Fraser Milk* case the dividend was simply a return on capital.<sup>20</sup> If the surplus is credited or paid to the member in his capacity as shareholder, the amounts are considered income of the co-operative and are therefore taxable as such. However, if the surplus is credited or paid to the member in his capacity as patron, then the amounts may never be considered as income of the co-operative; this is contingent upon a finding in each particular case that the member has a legal right to the surplus. As we have seen, the Court referred to this relationship as one of agency in the *Saskatchewan Wheat Pool* case. The agency was based on the particular marketing contract in that case, but perhaps the same type of relationship could be created by statute or by the corporate constitution.

In the *Fraser Milk* case the Court appeared to place reliance on certain provisions of the *British Columbia Co-operative Associations Act* under which the co-operative had been incorporated.<sup>21</sup> The statute used the word "profit" in describing the surplus of the association and the Court concluded that a "profit-making concern",

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<sup>18</sup> *Supra*, f.n.9, 415 and 59.

<sup>19</sup> [1929] S.C.R. 435, [1928-34] C.T.C. 22.

<sup>20</sup> *Ibid.*, 438 and 25.

<sup>21</sup> *Ibid.*, 439 and 27.

was contemplated, apparently placing some reliance upon this terminology in holding the surplus to be taxable. It is interesting to note that the British Columbia statute now avoids the use of the word "profit", simply using the neutral word "surplus".<sup>22</sup>

The agency principle enunciated in the *Saskatchewan Wheat Pool* case has been followed often in cases involving marketing co-operatives. The Tax Appeal Board in 1952 held that a Manitoba dairy co-operative was exempt from taxation under the *Income War Tax Act* on the basis that the co-operative was acting as a mere "conduit pipe" of the members for the profits from the creamery operations.<sup>23</sup> The Board felt that the case was clearly governed by the *Saskatchewan Wheat Pool* case although the reasons for finding the agency relationship were not as compelling. There was no contract existing between the member and the corporation which expressly created the agency relationship. The by-laws, however, provided for the surplus to be paid on the basis of patronage. This appeared to be the salient feature rendering the surplus non-assessable. The Board concluded:

On the facts of this case . . . it is governed by the decision of the Supreme Court of Canada in *The Minister of National Revenue v. The Saskatchewan Co-operative Wheat Producers Ltd.* . . . In the present instance, the appellant company is merely acting as the agent for its patrons in the purchase from them of their cream . . . with any profit that may be made on the transaction being credited in the books of the company to the individuals who supplied the cream, such credit being computed according to the butter fat content of that cream. Therefore the appellant is not deriving profit for itself, but is merely acting, on behalf of its patrons, as a conduit pipe for the profits from the conduct of the creamery operations.<sup>24</sup>

Later decisions articulated more accurately the relationship that must exist between the potential taxpayer and the surplus. In *Canadian Fruit Distributors Ltd. v. M.N.R.*<sup>25</sup> Thorson P. adopted for the second time a "quality of income" test to determine the income tax status of reserves deducted by a co-operative. The test, which was originally formulated by Brandeis J. of the United States Supreme Court in 1933,<sup>26</sup> was said to be as follows:

Is his right to it absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment? To put it another way, can an amount in a tax-payer's hands be regarded as an item of profit or gain from his business, as long as he holds it subject to specific and

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<sup>22</sup> R.S.B.C. 1960, c.77, s.1.

<sup>23</sup> *Vita Co-operative Limited v. M.N.R.* (1952) 6 D.T.C. 43, 5 Tax A.B.C. 351.

<sup>24</sup> *Ibid.*, 45 and 355-6.

<sup>25</sup> [1954] Ex. C.R. 551, [1954] C.T.C. 284.

<sup>26</sup> *Brown v. Helvering* 291 U.S. 193, 199 (1933).

unfulfilled conditions and his right to retain it and apply it to his own use has not yet accrued, and may never accrue?<sup>27</sup>

The taxpayer, of course, is the co-operative; thus, if it does not have an absolute right to the surplus retained, then the surplus lacks the "quality of income" that is necessary to bring it within the taxing statute.

The most complete review of the principles involved in determining the quality of income was made by the President of the Exchequer Court in 1956. In the *Horse Co-operative Marketing Association Ltd. v. M.N.R.*<sup>28</sup> Thorson P., again applying the Brandeis formula,<sup>29</sup> found that the surplus in question did not meet the test and thus was not subject to taxation. In applying the test as to the right of the co-operative to the funds, several illuminating statements were made:

... the presence or absence of an intention to make a profit is not conclusive of taxability or otherwise, the absence of an intention to make a profit is a factor to be taken into account. Nor does the mere fact that the word "Co-operative" is part of the appellant's name indicate absence of tax liability in respect of its activities. The important thing to determine is the true character of the amounts in dispute.<sup>30</sup>

In determining the true character of the amounts in dispute, the Court looked to several factors, making the following observations:

The provisions of the *Income War Tax Act* relating to patronage dividends have no bearing in this case. And the corporate set-up of the appellant did not permit any declaration of dividends in respect of its transactions with its members.

... They were entitled to the amounts credited to them in their own individual rights under the conditions subject to which they had delivered their horses to the appellant for co-operative marketing or processing by it.

... [T]he fact that the moneys to which the members were entitled were not actually paid to them is immaterial. The effect of what the appellant did was exactly the same as if it had paid the members the amounts to which they were severally entitled and then borrowed such amounts from them.<sup>31</sup>

Then, referring again to the agency relationship, Thorson P. went on to state:

When the appellant received the horses it did so as agent for the members and was accountable to them for the net proceeds from their marketing or the sale of the processed products. The initial payments to the

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<sup>27</sup> *Robertson Limited v. M.N.R.* [1944] Ex. C.R. 170, 182-3, [1944] C.T.C. 75, 91.

<sup>28</sup> [1956] Ex. C.R. 393, [1956] C.T.C. 115.

<sup>29</sup> *Supra*, f.n.26.

<sup>30</sup> *Supra*, f.n.28, 411 and 133.

<sup>31</sup> *Ibid.*, 412 and 134.

members were really advances to them on account of the total to which they were severally entitled. Thus, the surplus of the appellant's receipts over its expenditures did not belong to the appellant as its profits or gains but belonged to the members in their own individual rights and was held by it on their own behalf.<sup>32</sup>

Therefore, the quality of income test is failed if it can be shown that the sums held by the co-operative do not in fact belong to it. If it can be shown that the co-operative is the agent of the members ("agent" perhaps not always used in its strict legal sense), then the surplus is not taxable because the co-operative's right to it is not "unrestricted". Factors which are looked at in determining whether the necessary relationship exists include the intention, or absence of the same, to make a profit on behalf of the co-operative in its own right, and a corporate set-up prohibiting the declaration of dividends otherwise than on a patronage basis. It is unimportant that the surplus is retained by the co-operative and is never actually paid to the member; all that is necessary is the credit entry in the books of the co-operative.

It will be recalled that in the *Saskatchewan Wheat Pool* case<sup>33</sup> a similar result was reached on similar principles. However, in that case the agency relationship was based largely on a marketing agreement which each member had with the co-operative, while in the *Horse Marketing* case no such contract existed. After finding the relationship between member and co-operative to be one of agency, the Court stated:

The correctness of this conclusion is not affected by the fact that there were no individual contracts between the appellant and its members on which they could sue the appellant for the amounts to which they were so entitled. They did not need contracts in order to become so entitled.<sup>34</sup>

The Court then cited section 10 of *The Co-operative Marketing Associations Act* of Saskatchewan, under which the appellant had been incorporated, which had the effect of rendering the memorandum of association and by-laws of the co-operative a binding contract between the members *inter se* and the co-operative. The by-laws provided for the deduction of certain amounts from the gross surplus, with a contractual effect identical to individual contracts with each member. Therefore, the agency relationship may be created by a combination of the incorporating statute and the by-laws of the particular association. Most jurisdictions now have a provision

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<sup>32</sup> *Ibid.*, 414 and 135.

<sup>33</sup> *Supra*, f.n.19.

<sup>34</sup> *Supra*, f.n.28, 412 and 134.

similar to section 10 of *The Co-operative Marketing Associations Act* of Saskatchewan.<sup>35</sup>

These principles were applied in several other cases involving marketing co-operatives, with similar results.<sup>36</sup> It is possible, however, for a marketing co-operative to earn income on its own account. In a 1957 decision<sup>37</sup> the Exchequer Court held that reserves deducted from the gross earnings of milk shippers by the marketing association were taxable. The method of operation of the association varied slightly from those cases referred to above: there was a marketing agreement signed by the co-operative with each member which enabled the co-operative to deduct certain amounts as a "commission"; the deductions were not credited to the members on the co-operative's books. The Court felt that the quality of income test as applied in the *Horse Marketing* case had been met. It held that the co-operative possessed a sufficient property interest in the surplus for it to be taxable in its hands, notwithstanding the fact that the co-operative lacked the intent to earn a profit but was a mere service organization. On this point Kearney J. stated:

...I do not think that the lack of intent to make a profit is a sufficiently weighty factor to enable the appellant to escape the incidence of income tax.<sup>38</sup>

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<sup>35</sup> *E.g.*, R.S.B.C. 1960, c.77, s.21(3) which states:

The memorandum and rules bind the association and its members to the same extent as if they had been respectively signed and sealed by each member and contained covenants on the part of each member, his heirs, executors, and administrators, to observe all the provisions of the memorandum and rules, subject to the provisions of this Act.

See also R.S.S. 1965, c.246, s.13 and the *Canada Co-operative Associations Act*, S.C. 1970, c.17, s.39(6). Jurisdictions which incorporate by issuance of letters patent also contain similar provisions in their Acts with respect to co-operatives; see R.S.O. 1970, c.89, s.156(2) and R.S.M. 1970, c.160, s.413(4): these provisions in the letters patent jurisdictions only apply to co-operatives incorporated under the respective Acts and not to ordinary business corporations. For a general discussion of the binding effect of by-laws in a letters patent jurisdiction, see: S. Beck, "An Analysis of *Foss v. Harbottle*", in J. Ziegel (ed.), *Studies in Canadian Company Law* (1967), 545, 581.

<sup>36</sup> See *M.N.R. v. La Société Coopérative Agricole de la Vallée d'Yamaska* [1957] Ex. C.R. 65, [1957] C.T.C. 132; *Manitoba Dairy and Poultry Co-operative Ltd. v. M.N.R.* (1957) 11 D.T.C. 1278, [1957] C.T.C. 401 (Exch.); *Saskatchewan Approved Flock Co-operative Hatchery Marketing Association Limited v. M.N.R.* (1955) 9 D.T.C. 586, 14 Tax A.B.C. 65.

<sup>37</sup> *Montreal Milk Producers' Co-operative Agricultural Association v. M.N.R.* [1958] Ex. C.R. 19, 12 D.T.C. 1010.

<sup>38</sup> *Ibid.*, 27 and 1014.

It must also be noted that nowhere in the corporate constitution was the association prohibited from declaring a dividend,<sup>39</sup> unlike the situation in the *Saskatchewan Wheat Pool* and *Horse Marketing* cases. This again was a factor in arriving at a conclusion contrary to the results in those two cases.<sup>40</sup>

All the cases which have held that the co-operative has had no income have involved marketing co-operatives. The marketing co-operative lends itself readily to the agency type of relationship. If it receives the member's product, sells it, and transfers the proceeds, it is clearly arguable that the co-operative itself has no income. Although the transaction is rarely this simple, the courts have been ready to find the relationship of principal and agent. No Canadian decision is reported in which a purchasing co-operative, as opposed to a marketing co-operative, has escaped the incidence of taxation because it operated on an agency basis. The issue arose in *M.N.R. v. Davidson Co-operative Association Limited*<sup>41</sup> where it was found that the nature of the co-operative's business was not substantially different than that of any other businessman in a similar trade. The co-operative purchased goods on its own account and not simply to fulfill previous orders. As well, it sold at regular retail prices. Although the surplus or profit earned after expenses was credited as a patronage dividend, it was held to be taxable in the hands of the co-operative. The co-operative was not merely the agent of the members, although that possibility was not excluded outright by the Exchequer Court. Fournier J. stated:

There is no evidence before the Court that there exists any agency contract between the respondent and its individual members to act as their purchasing agent. Furthermore, the respondent is not the agent of a number of persons who have joined together to further a common purpose of protection and have contributed to a common fund to that end.<sup>42</sup>

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<sup>39</sup> *Ibid.*, 23 and 1012.

<sup>40</sup> It has been held that even though a part of a co-operative's income was obtained as a result of its own activities, the whole of the operation must be considered as one business and no part of its "income" was taxable. The fact that the co-operative's expenses were paid from profits from an activity outside its marketing activities did not render the surplus taxable: see *The Vernon Fruit Union v. M.N.R.* (1956) 10 D.T.C. 43, 14 Tax A.B.C. 209; see also *Associated Growers of British Columbia Limited v. M.N.R.* (1956) 10 D.T.C. 10, 14 Tax A.B.C. 199.

<sup>41</sup> [1956] Ex. C.R. 138, [1956] C.T.C. 26.

<sup>42</sup> *Ibid.*, 156-7 and 43-44.

The possibility of agency contracts is therefore implied but the facts of the case did not support the conclusion of an agency relationship.<sup>43</sup>

Also, the Court emphasized the fact that the co-operative was a separate entity earning a profit in its own right, separate and apart from its members.<sup>44</sup> This raises the question of whether there was a piercing of the corporate veil<sup>45</sup> in all the cases where the agency relationship was upheld. It seems arguable that, in the cases where no separate contract existed between the members and the corporate body, any finding that the co-operative was a mere "conduit pipe"<sup>46</sup> or mere "machinery"<sup>47</sup> for the purposes of the members amounts to a finding that there has been a lifting of the corporate veil. However, it appears that a distinction can be drawn between these cases and those where individual marketing contracts existed, such as the *Saskatchewan Wheat Pool* case. It is submitted that there would be no infringement of the basic principles of company law in allowing a principal—agent relationship to exist between a company and its shareholders if the same is expressly provided for.<sup>48</sup>

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<sup>43</sup> The decision of the Tax Appeal Board being appealed from found in favour of the agency relationship: (1954) 8 D.T.C. 19, 20. The Board stated: "The situation may be summed up briefly by saying that the appellant claims to have nothing of its own and that everything it possesses is owned by the numerous patrons collectively, whose agent it is in carrying on the business mentioned".

<sup>44</sup> *Supra*, f.n.41, 145 and 33; see also, e.g., *The Fraser Valley Milk Producers Association v. M.N.R.*, *supra*, f.n.19, 435 and 22:

The sums acquired by the company and distributed as dividend, or otherwise dealt with, are in their nature undistinguishable from the profits and gains of ordinary traders and are therefore a fit subject for taxation. The company is an independent entity in itself and has realized excess profits over expenditures which are identical with all other traders' profits. The profit distributed is the difference between the cost of production and the price realized.

<sup>45</sup> See generally, M. Woods, *Lifting the Corporate Veil in Canada* (1957) 35 Can. Bar Rev. 1176; I. Feltham, *Lifting the Corporate Veil* (Law Society of Upper Canada Special Lectures, 1968), 305.

<sup>46</sup> *Supra*, f.n.24.

<sup>47</sup> *Supra*, f.n.28, 415 and 136, where Thorson P. states: "The conclusion that the members established the appellant as the means or machinery for accomplishing their purpose of disposing of their surplus horses is not affected by the fact that it is a corporation...".

<sup>48</sup> See *Rainham Chemical Works, Limited v. Belvedere Fish Guano Company, Limited* [1921] 2 A.C. 465, 90 L.J.K.B. 1252. It has been argued that in each of these cases the courts have ignored the corporate entity to a greater or lesser extent; see M. Woods, *Federal Taxation of Income of Cooperative Trading Corporations in the United States and Canada* (1962), 54. However, it is submitted that where a separate marketing contract exists, it is not a

The Canadian courts have tended to ignore any hinderances in connection with the lifting of the corporate veil.<sup>49</sup> The following indicates the philosophy that has been adopted:

It is essential in a case such as this that regard should be had to the substance of the transaction under consideration rather than its form. . . . Thus, it is the true nature of the appellant association that falls to be determined.<sup>50</sup>

The cases indicate that the courts will not allow the corporate veil to frustrate a decision as to the true ownership of funds which are sought to be taxed.

To summarize briefly, the courts often regard the co-operative as being in a representative or fiduciary capacity<sup>51</sup> *vis-à-vis* the member and thus accountable to the member for the proceeds or surplus of its operation.<sup>52</sup> Where such a relationship is found the co-operative is deemed to be of the non-income type and operates outside the

piercing of the corporate veil if the contract sets up the principal-agent relationship between member and co-operative.

<sup>49</sup> The problem of the corporate veil has caused Canadian courts little consternation in tax matters, e.g., *William Slater v. M.N.R.* (1964) 18 D.T.C. 513 (Tax. App. Bd.).

<sup>50</sup> *Manitoba Dairy and Poultry Co-operative Ltd. v. M.N.R.*, *supra*, f.n.36, 1285 and 414.

<sup>51</sup> The courts have not always used the terms "agency" and "trust" in this respect as words of art: *supra*, text at f.n.14. No Canadian court has relied solely on the trust relationship in defining the relationship between member and co-operative, but some cases in the United States have relied solely on the trust concept: see I. Packel, *The Organization and Operation of Co-operatives* 3d ed. (1970), 142. Also see Woods, *supra*, f.n.48, 41, where it is stated that the Exchequer Court in *M.N.R. v. La Société Coopérative Agricole de la Vallée d'Yamaska*, *supra*, f.n.36, referred to a co-operative as "trustee or agent".

This interpretation is based on a translation of the French judgment of Fournier J. at 76 where he stated: "... recevait livraison de leur produit comme consignataire, elle procédait, comme mandataire ou agent, aux opérations nécessaires...". Woods translates these words as follows: "... received delivery of their products as consignee, it proceeded as trustee or agent, to conclude the operations...". It is submitted that the word "mandataire" does not denote a "trustee" in the Anglo-Canadian common law sense but is used by Fournier J. as being nearly synonymous with "agent". In Quebec civil law the trust concept is less developed than in common law; however, the word "fiduciaire" would denote something closer to a "trustee" as opposed to "mandataire". Indeed, often the trust concept is simply translated into French as "un trust" with the word "mandataire" meaning simply an agent.

<sup>52</sup> A "price adjustment" theory of the operations of co-operatives has also been alluded to in Canadian jurisdictions. This theory is based on the premise that a true co-operative is intended only to provide goods and services to members at cost rather than to produce a profit. Patronage dividends paid out

relevant sections of the *Income Tax Act*. If a co-operative is deemed to have an income, then it is taxable as is any other taxpayer. However, certain sections of the *Income Tax Act* come to the co-operative's aid in reducing that income.

### III. TAXATION OF CO-OPERATIVE INCOME

If it is accepted that a co-operative is capable of earning an income in its own right, the question of the taxation of that income then arises where the particular co-operative is deemed not to be of the non-income type. The characteristics that must exist to make this determination have been analysed above. Taxation of co-operatives having income will now be considered.

#### A. Background: The Income War Tax Act, 1917-1946

The *Income War Tax Act* of 1917, which introduced the first taxation of income in Canada, contained an obscure provision exempting from taxation

... the incomes of mutual corporations not having a capital represented by shares, no part of the income of which inures to the profit of any member thereof...<sup>53</sup>

It was unclear whether a co-operative was a "mutual corporation" within the meaning of the Act, although the exemption clearly seemed inapplicable to such a corporation with share capital. In the decade following 1917, no serious effort appears to have been made to levy tax upon co-operatives with or without share capital. However, certain factors may have contributed to this lack of interest by the taxing authorities. Co-operatives were of relatively recent vintage as

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of surplus are deemed to be merely a price adjustment in arriving at this fundamental objective. See *Manitoba Dairy and Poultry Co-operative Ltd. v. M.N.R. supra*, f.n.36, 1286 and 316, where it is stated:

In the alternative... if it should be considered that the member's delivery of his produce to the association constituted a sale of it by him to it, it is manifest that it was a condition of such sale that the amount paid on the delivery of the produce was only a first payment on account and that the balance was to be paid after the close of the year's operations... In that view of the transaction between the members and the association the amounts credited to the members... would be part of the cost of the produce to the appellant association and there would not be anything left to constitute profit to it or taxable income in its hands.

See also *Saskatchewan Approved Flock Co-operative Hatchery Marketing Association Limited v. M.N.R., supra*, f.n.36, 588 and 69. This is the theory that direct charge co-operatives operate on: see *supra*, f.n.4, 89.

<sup>53</sup> S.C. 1917, c.28, s.5(f).

a type of business enterprise in Canada and generated a small amount of business activity<sup>54</sup> in these early years; thus, the actual loss of revenue to the government was minimal. This was especially so when one considers that the corporate rate of taxation prescribed by the Act was initially only four per cent on earnings over \$3,000.<sup>55</sup>

Also, a common view at the time was that a "true co-operative" by its very nature and mode of operation had no income of its own. This view was based on a number of theories, one being that the co-operative acted as an agent for its members. Another, not totally distinct from the first, was that a co-operative was intended only to provide goods and services to members at cost rather than to produce a profit. Thus, any surplus resulting from its operations was merely an adjustment in arriving at this fundamental object and was not income as such.<sup>56</sup>

Co-operatives, especially the grain marketing co-operatives of Western Canada, began expanding economically in the latter part of the 1920's.<sup>57</sup> This precipitated a change of attitude in the Department of National Revenue, which sought to assess the "income" of some of the more prosperous co-operatives. This resulted in two cases ultimately being determined by the Supreme Court of Canada in 1929 and 1930.<sup>58</sup> Both the *Saskatchewan Wheat Pool* case and the *Fraser Milk* case, discussed above, involved co-operatives with share capital but, as already seen, the Court came to different conclusions regarding the taxability of the co-operatives' surplus under the *Income War Tax Act*.

Although these two early decisions can be distinguished on the facts, Parliament shortly thereafter attempted to clear up any confusion that may have existed. Section 4(p) was added to the *Income War Tax Act*, which removed from tax liability:

The income of farmers', dairymen's, livestockmen's, fruit growers', poultrymen's, fishermen's and other like co-operative companies and associations, whether with or without share capital, organized and operated on a co-operative basis, which organizations

(a) market the products of the members or shareholders of such co-operative organizations under an obligation to pay to them the proceeds from the sales on the basis of quantity and quality, less necessary expenses and reserves;

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<sup>54</sup> See *Report of the Royal Commission on Co-operatives* (McDougall Commission, Can. 1945), 134 *et seq.*

<sup>55</sup> *Supra*, f.n.53, ss.4(1)(a), 4(2).

<sup>56</sup> *Supra*, f.n.52.

<sup>57</sup> *Supra*, f.n.54.

<sup>58</sup> *Fraser Valley Milk Producers' Association v. M.N.R.*, *supra*, f.n.19; *M.N.R. v. The Saskatchewan Co-operative Wheat Producers Ltd.*, *supra*, f.n.9.

(b) purchase supplies and equipment for the use of such members under an obligation to turn such supplies and equipment over to them at cost, plus necessary expenses and reserves.

Such companies and associations may market the produce of, or purchase supplies and equipment for non-members of the company or association provided the value thereof does not exceed twenty per centum of the value of produce, supplies or equipment marketed or purchased for the members or shareholders.<sup>59</sup>

The new section was of little improvement. The ambiguous wording caused problems of application. No definition of "co-operative" or "co-operative basis" was included in the provision.<sup>60</sup> What was the meaning of "like co-operative companies or associations"?

The confusion led to the establishment of a Royal Commission on Co-operatives<sup>61</sup> to study the taxation of co-operatives prior to the resolution of the various problems in the courts.<sup>62</sup> The Royal Commission (McDougall Commission) had a broad mandate to determine what was the most just and equitable means of taxing co-operatives.<sup>63</sup> One important finding of the Commission was that co-operatives could indeed earn income and thus become liable to pay tax on the same.<sup>64</sup> A co-operative was an entity unto itself, which of course is the necessary consequence of incorporation, and not merely a "price adjustment" agency.<sup>65</sup> However, it was recognized that dividends which were paid to members by a co-operative could not be treated in the same way as profits of an ordinary business corporation. The Commission stated:

In a competitive situation... most of the economies which ordinary companies secure tend to be passed on to their customers in the form of lower prices. The taxable income of the companies, however, depends on the prices actually charged. Similarly, if a co-operative association effects economies and passes these on to its customers, we are of the

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<sup>59</sup> *An Act to amend the Income War Tax Act*, S.C. 1930, c.24, s.2.

<sup>60</sup> See *supra*, f.n.4.

<sup>61</sup> The Royal Commission was established by Order in Council on November 16, 1944. The Honourable Mr Justice McDougall, Court of King's Bench, Quebec, was named chairman of the Commission; *supra*, f.n.54.

<sup>62</sup> See R.C. McIvor, *The Post-War Taxation of Canadian Co-operatives* (1959, Can. Tax Papers #17, Can. Tax Foundation), 11.

<sup>63</sup> *Supra*, f.n.54, 3. The Order in Council empowered the Commission to inquire into and report on "all facts which appear to them to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the *Income War Tax Act* ... and to make such recommendations for the amendment of existing laws as they consider to be justified in the public interest".

<sup>64</sup> *Ibid.*, 31-32.

<sup>65</sup> *Supra*, f.n.52; but note that this finding does not prevent a co-operative from being the agent of its members: see *supra*, Part II, esp. text at f.n.48.

opinion that it should not be taxed as though it did not adopt this practice.<sup>66</sup>

The main recommendation of the Commission was that the then existing provision of the *Income War Tax Act*, which ostensibly exempted co-operatives from taxation, be repealed and the Act be amended to provide for the taxation of co-operatives on the same basis as other taxpayers.<sup>67</sup> However, it was further recommended that all taxpayers be allowed to deduct patronage dividends "which are paid or credited to their customers in proportion to the quantity, quality or value of goods acquired, marketed, or sold or services rendered".<sup>68</sup> Then certain provisos were set out which were to be complied with before patronage dividends could be deducted. It is important to note that no attempt was made to place co-operatives in a privileged position in this respect; the deductions were available to all taxpayers, including partnerships and ordinary business corporations.<sup>69</sup> The one overt major concession made to co-operatives was that newly formed co-operatives in their first three years of operation would obtain a complete exemption from taxation. The rationale behind this proposal was that it was in the public interest to favour fledgling co-operatives, whose mortality rate had been high in the early years of operation because of their inherent inability to attract capital.<sup>70</sup>

In 1946 Parliament enacted most of the McDougall Commission recommendations.<sup>71</sup> The treatment of co-operatives for taxation pur-

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<sup>66</sup> *Supra*, f.n.54, 34.

<sup>67</sup> *Ibid.*, 41-45.

<sup>68</sup> *Ibid.*, 44.

<sup>69</sup> *Ibid.*, 43, where it is stated:

We are also of the opinion that where ordinary companies, partnerships or individual business enterprises hold forth, to their customers, that they will distribute among them on a patronage basis a portion of the surplus earnings, they should be allowed to deduct such payments before arriving at taxable income.

<sup>70</sup> *Ibid.*, 43, where it is stated:

It has been pointed out to us on numerous occasions that co-operative associations are difficult to organize and that their rate of mortality is high, especially in their earlier years. They are not in a position to attract capital for investment purposes, except in small amounts. Moreover, they are apt to find it difficult to finance the employment of the necessary managerial personnel. In addition, there is a pronounced tendency to organize co-operatives in times of economic stress. We are, therefore, of the opinion that in the public interest, co-operative associations, upon consent of the Minister, should be exempt entirely from income tax during the first few years of their operations.

<sup>71</sup> *An Act to amend the Income War Tax Act*, S.C. 1946, c.55, s.3(3).

poses has remained substantially the same since that time.<sup>72</sup> The existing provisions will now be discussed in detail.

## B. The Present Income Tax Act

### 1. Deduction of Patronage Dividends

The question of deductibility of patronage dividends only arises if the co-operative has failed to show that the sums in question are not income belonging to it.<sup>73</sup> If it has failed in this respect, it will seek to deduct patronage dividends from income.

The *Income Tax Act*<sup>74</sup> provides that any taxpayer may deduct in computing income "the aggregate of the payments made, pursuant to allocations in proportion to patronage...".<sup>75</sup> As recommended by the McDougall Commission, this provision is not limited to co-operatives but applies to any taxpayer.<sup>76</sup> However, in order that a taxpayer be allowed to make this deduction, the Act sets out certain requirements that must be met.

The first requirement is that any payments must be made (or credited)<sup>77</sup> within the taxation year or within twelve months thereafter.<sup>78</sup> Secondly, the "allocation in proportion to patronage"<sup>79</sup> referred to in the principal deduction section

...means an amount credited by a taxpayer to a customer of that year on terms that the customer is entitled to or will receive payment thereof,

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<sup>72</sup> The 1946 amendments to the *Income War Tax Act*, *ibid.*, pertaining to co-operatives were included in the *Income Tax Act*, S.C. 1948, c.52, ss.66, 68, and were continued in the statutory revisions, *i.e.*, R.S.C. 1952, c.148, ss.73, 75 and R.S.C. 1970, c.148, ss.85, 87; however, by S.C. 1970-71-72, c.43 the *Income Tax Act*, R.S.C. 1970, c.148, is deemed not to be in effect and the Act contained in R.S.C. 1952 is to continue in effect subject to amendments; in S.C. 1970-71-72, c.63, some changes were made. Although the provisions remain substantially the same, the changes include (1) removal of the 3 years exemption for new co-operatives, (2) removal of the capital employed provisions, (3) enacting a 15% withholding tax on patronage dividends. These changes are discussed in more detail below.

<sup>73</sup> See *supra*, Part II.

<sup>74</sup> S.C. 1970-71-72, c.63.

<sup>75</sup> *Ibid.*, s.135(1).

<sup>76</sup> *Supra*, f.n.69.

<sup>77</sup> See *infra*, text, regarding meaning of "payment".

<sup>78</sup> *Supra*, f.n.74, ss.135(1), 135(4)(a)(i)(A); the McDougall Commission recommended that patronage dividends be paid in cash or credited to each customer within six months after the annual meeting of the relevant fiscal period, but the 1946 enactment contained the twelve month provision: S.C. 1946, c.55, s.4(13).

<sup>79</sup> *Supra*, f.n.75.

computed at a rate in relation to the quantity, quality or value of the goods or products acquired, marketed, handled, dealt in or sold, or services rendered by the taxpayer from, on behalf of or to the customer, whether as principal or agent of the customer or otherwise, with appropriate differences in the rate for different classes, grades or qualities thereof . . . .<sup>80</sup>

Thus some flexibility is allowed in the computation of the patronage dividend; that is, differences in classes, grades or qualities of the goods or products dealt with may be taken into account. Also it may be noted that the Act contemplates a possible principal—agent relationship, yet allows for the deduction to apply.

However, three provisos are included in the definition of “allocation in proportion to patronage”. As already seen, the amount must be credited within the taxation year or within twelve months thereafter.<sup>81</sup> Also (allowing for the appropriate differences in classes, grades or qualities), all customers, whether members<sup>82</sup> or non-members, must be credited at the same rate.<sup>83</sup> If allocations are not made to all customers at an equal rate, the Act imposes a limitation on the amount that may be deducted. The deduction is limited to the lesser of: (1) all deductions and; (2) income for business done with members and allocations to non-members for the taxation year.<sup>84</sup> This, in effect, prevents a co-operative from paying out all of its surplus to its members by way of deductible patronage dividends unless the surplus was earned as a result of business done only with those members. Thus, a co-operative’s taxable surplus will never be less than the surplus earned from non-member transactions that is not distributed to those non-members.

In addition, in order for the patronage dividends to be deductible, the taxpayer must have held forth to customers the prospect that amounts would be credited according to patronage.<sup>85</sup> Such prospect is deemed to have been held forth if:

(a) throughout the year the statute under which the taxpayer was incorporated or registered, its charter, articles of association, or by-laws or its contract with the customer held forth the prospect that amounts would be so credited to customers who are members or non-member customers, as the case may be, or

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<sup>80</sup> *Supra*, f.n.74, s.135(4)(a).

<sup>81</sup> *Supra*, f.n.78.

<sup>82</sup> *Supra*, f.n.74, s.135(4)(e) defines “member” as “a person who is entitled as a member or shareholder to full voting rights in the conduct of the affairs of the taxpayer (being a corporation) . . .”.

<sup>83</sup> *Ibid.*, s.135(4)(a)(i)(B).

<sup>84</sup> *Ibid.*, s.135(2).

<sup>85</sup> *Ibid.*, s.135(4)(a)(ii).

(b) prior to the commencement of the year or prior to such other day as may be prescribed for the class of business in which the taxpayer is engaged, the taxpayer has published an advertisement in prescribed form in a newspaper or newspapers of general circulation throughout the greater part of the area in which the taxpayer carried on business holding forth that prospect to customers who are members or non-member customers, as the case may be, and has filed copies of the newspapers with the Minister before the end of the 30th day of the taxation year or within 30 days from the prescribed day, as the case may be.<sup>86</sup>

The allowing of the holding forth of the prospect by advertising in a newspaper permits ordinary business corporations to qualify for the deductions without having to alter their corporate documents or to enter into individual contracts with customers.<sup>87</sup>

Payments must be made within twelve months after the taxation year but some flexibility is given as to what constitutes a payment. "Payment" includes the issuing of a certificate of indebtedness or shares of the co-operative. This allows the co-operative to deduct patronage dividends which are in effect retained by the co-operative under a revolving fund plan.<sup>88</sup> However, the Act provides that payment may be made by this means only if:

...the taxpayer... has in the year or 12 months thereafter disbursed an amount of money equal to the aggregate face value of all certificates or shares so issued in the course of redeeming or purchasing certificates of indebtedness or shares of the taxpayer... previously issued...<sup>89</sup>

Payment also includes:

...the application by the taxpayer of an amount to a member's liability to the taxpayer (including, without restricting the generality of the foregoing, an amount applied in fulfilment of an obligation of the member to make a loan to the taxpayer and an amount applied on account of payment for shares issued to a member) pursuant to a by-law of the taxpayer, pursuant to statutory authority or at the request of the member...<sup>90</sup>

This allows for a set-off of a member's liability to the co-operative. This liability arises by statute, the corporate constitution or individual agreement with members imposing an obligation on the members to lend patronage dividends to the co-operative or to apply them toward the purchase of shares.

In addition to the limitation on the extent to which income can be reduced by payment of patronage dividends,<sup>91</sup> there exists

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<sup>86</sup> *Ibid.*, s.135(5).

<sup>87</sup> See Woods, *supra*, f.n.48, 278.

<sup>88</sup> See, for a description of a revolving fund plan, *Report on Co-operatives, supra*, f.n.4, 65.

<sup>89</sup> *Supra*, f.n.74, s.135(4)(g)(i).

<sup>90</sup> *Ibid.*, s.135(4)(g)(ii).

<sup>91</sup> *Supra*, f.n.84.

another limitation. Certain provincial incorporating statutes require that co-operatives set aside each year a percentage of their surplus as a reserve.<sup>92</sup> This unallocated reserve becomes subject to taxation; thus, the provincial statutes which require a mandatory reserve effectively impose a minimum upon which income tax must be paid.

There formerly existed a third limitation or restriction which prevented a co-operative from reducing its taxable income below a minimum amount by payment of patronage dividends. The *Income Tax Act* provided that the taxpayer's (co-operative's) taxable income could not be reduced below an amount equal to "3% of the capital employed in the business at the commencement of the year"<sup>93</sup> less "the interest, if any, paid on borrowed moneys . . . and deductible in computing his income for the year".<sup>94</sup> The effect of this limitation was to prevent a co-operative from escaping taxation completely by paying out its entire surplus by way of patronage dividends.<sup>95</sup> However, it also had the obvious effect of forcing co-operatives to pay income tax even though no surplus may have accrued throughout the year. This limitation no longer exists in the Act.<sup>96</sup>

Co-operatives therefore must pay tax under the *Income Tax Act* on whichever is the greater of: (1) total unallocated surplus, even

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<sup>92</sup> E.g., R.S.B.C. 1960, c.77, s.12; R.S.Q. 1964, c.292, s.82.

<sup>93</sup> R.S.C. 1952, c.148, s.75(3)(a).

<sup>94</sup> *Ibid.*

<sup>95</sup> The "capital employed" provision first appeared in the 1946 amendments to the *Income War Tax Act*, S.C. 1946, c.55, although the McDougall Commission contained no recommendations to that effect; see McIvor, *supra*, f.n.62, 16, where, referring to the "capital employed" provision, he states:

This provision was nowhere recommended in the Commission's report and it appears to have been enacted, following representations from the competitors of the co-operatives, as a sort of compromise measure characteristic of the democratic political process . . . . The choice of the "three per cent" figure presumably reflects what was considered to be a fair rate of return on capital during the war years when one major objective of government monetary policy was to maintain interest at relatively low levels. However, when viewed within the overall context of the Commission's report, the rationale of section 75(3) is by no means clear.

<sup>96</sup> It is interesting to note that in Bill C-259, *An Act to Amend the Income Tax Act*, the 3% minimum on capital employed was raised to 5%: s.135(3); however, in the Act that was passed by Parliament, S.C. 1970-71-72, c.63, the entire section had been dropped. In the interim much pressure was exerted on the government by the co-operative movement to have the provision repealed; see, e.g., *Joint Submission to the Minister of Finance by the Co-operative Union of Canada and Le Conseil Canadien de la Coopération in the matter of Co-operatives and in the matter of Sections 135 and 136 of Bill C-259* (August 1971).

though this surplus might be in the form of a mandatory reserve as required by provincial legislation;<sup>97</sup> and (2) the surplus that arises from non-member business that is not distributed to non-members.<sup>98</sup>

The deduction of patronage dividends to reduce taxable income is open to ordinary business corporations as well as co-operatives; however, as a practical matter it is clear that co-operatives are the principal beneficiaries of such provisions because of the coincidence of ownership and patronage. Because of the investment role that capital plays in co-operatives, large scale use of dividends accrues directly to the owners of the business, whereas in ordinary business corporations, payment of patronage dividends in effect reduces the equity of the owners. Therefore, although on the surface of the legislation there appears to be no discrimination between the two types of enterprise, a closer look reveals a discrimination in fact.

## 2. *Exempt Co-operatives*

Another possibility exists for co-operatives which can be brought within certain exemptive provisions of the *Income Tax Act*. Section 149(1) of the Act states:

No tax is payable... upon the taxable income of a person for a period when that person was...

(e) an agricultural organization, a board of trade or a chamber of commerce, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof: ...

(1) a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof...

Attempts have been made by commercial co-operatives to come within these provisions although it appears that the exemptions are intended to apply to associations of a non-commercial nature. Thus, co-operatives which are organized to promote educational or charitable purposes would clearly be exempt from paying taxes on any profits that might accrue.<sup>99</sup>

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<sup>97</sup> *Supra*, f.n.92.

<sup>98</sup> *Supra*, f.n.84.

<sup>99</sup> See Francis, *supra*, f.n.1, 208-9, where a precedent of a by-law is reproduced, approved by the Department of National Revenue, which will allow co-operatives of the non-profit or charitable type to obtain exempt status under the Act. The by-law states:

The net income of the association shall be retained as a reserve and used only for educational or charitable purposes and no part of the income

The exemption provisions were applied by the Tax Appeal Board in a case involving a co-operative organized to market agricultural products of its members. In *Edmonton District Milk and Cream Producers Association Limited v. M.N.R.*<sup>100</sup> the memorandum of association empowered the co-operative to "carry on all kinds of businesses or operations connected with marketing, selling . . . of any agricultural product, produced or delivered to it by its members . . .".<sup>101</sup> In fact the co-operative did no buying or selling of products but merely bargained on behalf of its members to get the best prices for milk. The dairies to which the members delivered the milk deducted a certain percentage on a volume basis, turning this amount over to the co-operative association. Expenses were paid out of this sum, 10% placed in a reserve, and the balance was credited to members. The Board held the co-operative to be a service organization and bargaining agency, and thus exempt under the provisions of the existing Act.<sup>102</sup>

Counsel for the Minister argued that since the memorandum of association stated the objects of the co-operative to be of a business nature, the association was more than a service organization and bargaining agency for its members. However, the Board indicated that substance rather than form was the important consideration and quoted from English authority to the following effect:

...the question is not what business does the taxpayer *profess* to carry on, but what business does he *actually* carry on.<sup>103</sup>

This de-emphasis on the professed objects as stated in the corporate constitution was not adhered to in a later decision of the Supreme

or reserve shall be payable to or otherwise available for the personal benefit of any member. The association shall not declare any dividend or distribute any of its property among its members during the existence of the association or upon its winding up or dissolution. On the winding up of the association the surplus, if any, shall be used for charitable or educational purposes as the members may determine by resolution and not for the personal benefit of any member.

<sup>100</sup> (1953) 7 D.T.C. 282, 8 Tax A.B.C. 432.

<sup>101</sup> *Ibid.*, 283 and 434.

<sup>102</sup> Because the taxation years in question were 1948, 1949 and 1950, the provisions of the *Income War Tax Act* and the *Income Tax Act*, 1948 both had to be considered. The relevant section in the latter Act was identical to s.149(1)(1) of the present Act. The relevant section in the former Act read:

The following incomes shall not be liable to taxation . . . income of clubs, societies and associations organized and operated solely for social welfare . . . or other non-profitable purposes, no part of the income of which inures to the benefit of any stockholder or member.

<sup>103</sup> *Inland Revenue Commissioners v. The Hyndland Investment Company, Limited* (1929) 14 T.C. 694, 699.

Court of Canada. In *M.N.R. v. St. Catherines Flying Training School Limited*<sup>104</sup> the Court was called upon to determine whether profits of a company incorporated with share capital under the *Companies Act*<sup>104a</sup> were exempt from taxation on the ground that the corporation was being operated for non-profitable purposes. Locke J., delivering the judgment of the Court, stated:

The question of the liability of the respondent to taxation depends, not upon the intention of the promoters or the shareholders as to the disposition to be made of the profits but rather upon consideration of the terms of the letters patent, the nature of the business authorized to be carried on and of the business which was carried on which resulted in the earning of the income . . . . If the company had succeeded in obtaining letters patent which prohibited the payment of dividends completely and, in addition, the retention of any earned income by the company, different considerations, which need not here be considered, would arise.<sup>105</sup>

This part of the judgment indicates that the provisions of the corporate constitution, that is, the letters patent, memorandum of association or by-laws, rather than the actual operations of the company, determine whether a company, be it a co-operative or otherwise, will get tax exempt status. In this respect, then, the decision of the Tax Appeal Board in the *Edmonton Milk*<sup>106</sup> case can no longer be considered good authority.

These cases must be distinguished from those previously discussed where it has been held that the co-operative had no income whatever in its own right. In the cases presently under discussion, the co-operative or association does have an income, but that income may be exempt from taxation because the association is not organized and operated for profit. To speak of the organizations seeking exemption under section 149(1) of the *Income Tax Act* as non-profit organizations is somewhat misleading. The position has been summarized as follows:

Thus, it is essential to distinguish between *purposes* which are non-profit in nature and the *results* of carrying out these non-profitable purposes. That is, it may be that the results of carrying out the non-profitable purposes are that profit is made; however, so long as the club, society or association is organized and operated exclusively for purposes except profit the fact that profit or income may result will not affect the status of the organization.<sup>107</sup>

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<sup>104</sup> (1955) 9 D.T.C. 1145, [1955] C.T.C. 185 (S.C.C.), [1955] S.C.R. 738.

<sup>104a</sup> 24-25 George V, R.S.C. 1934, c.27.

<sup>105</sup> *Supra*, f.n.104, 1148, 190 and 743.

<sup>106</sup> *Supra*, f.n.100.

<sup>107</sup> V. Peters and F. Zaid, *The Present and Proposed Taxation of Non-Profit Organizations* (1971) 9 Osgoode Hall L.J. 359, 366.

The distinction between the non-income co-operative and the exempt co-operative was made clear by the Exchequer Court in *Montreal Milk Producers' Co-operative Agricultural Association v. M.N.R.*,<sup>108</sup> where a claim for exemption was made under section 4(h) of the *Income War Tax Act*.<sup>109</sup> The Court held that, to accord with the words of the statute, an organization had to be *organized and operated solely* for non-profitable purpose to obtain the exemption. It was pointed out that the objects of the co-operative were of a commercial nature with no provision excluding the objective of pecuniary gain; nor was the declaring of dividends or the distributing of profits prohibited. The Court went on to state:

Even if it be true, as claimed by the appellant, that it did not pursue some of its stated objects of a commercial and gainful nature... nevertheless because it had declared objects of such nature, the Association cannot... qualify as a company organized exclusively for purposes other than profit... [T]he facts of the case, and particularly the evidence concerning the profits made... prove beyond question that the Association was not *operated exclusively* for purposes other than profit.<sup>110</sup>

Again the corporate constitution was determinative of the issue, unlike the *Edmonton Milk* case. It seems, therefore, safe to say that in order to come within the exemptive provisions of section 149(1) of the Act, merely operating as a "non-profit" organization<sup>111</sup> is not sufficient. The co-operative must also be organized so that "no part of the income . . . [is] payable to, or [is] otherwise available for the personal benefit of, any proprietor, member or shareholder thereof . . .".<sup>112</sup>

If a co-operative is organized and operated as a non-profit organization, it may fall clearly within section 149(1) and be tax exempt, depending on its objects. The section enumerates various types of organizations, but the broadest provision is in section 149(1)(1), referring to "any other purpose except profit". Co-operatives subject to the proper organization and operation may thus seek the benefit of this provision.<sup>113</sup> Also section 149(1)(e), referring to

<sup>108</sup> [1958] Ex. C.R. 19, 24, 58 D.T.C. 1010, 1012.

<sup>109</sup> See the similar provision *supra*, f.n.102.

<sup>110</sup> *Supra*, f.n.108, 24 and 1012.

<sup>111</sup> It is recognized that to speak of the taxation of the income of non-profit entities is in itself a contradiction in terms; hence, the term non-profit organization is used in this qualified sense; see *supra*, f.n.107, 359.

<sup>112</sup> *Supra*, f.n.74, s.149(1)(1).

<sup>113</sup> If a co-operative is organized for some purpose contemplated by the other subsections of s.149(1), nothing of course prevents it from qualifying for the exemption on that ground, *e.g.*, a co-operative may come within s.149(1)(i) regarding low cost housing for the aged; see *Campus Co-operative Residence, Incorporated v. M.N.R.* (1963) 17 D.T.C. 857, 33 Tax A.B.C. 305,

agricultural organizations, is of importance to co-operatives.<sup>114</sup> However, as seen above, organizations seeking the benefit of the exemption, whether they be co-operatives or otherwise, must be *bona fide* non-profit organizations. Therefore, the application of the exemption provisions is rightfully quite restricted and will not apply to the ordinary trading co-operative.

Until recently there existed provisions exempting co-operatives from taxation during their first three years of operation.<sup>115</sup> The exemption was broad in application, encompassing nearly all fledgling co-operatives. This exemption was recommended by the McDougall Commission<sup>116</sup> and enacted shortly thereafter by Parliament.<sup>117</sup> The need for such an exemption was questionable. If a co-operative in its first few years was having financial difficulty, no surplus presumably would accrue and the question of taxation would never arise. If the new co-operative did earn an income, it could be argued that tax should be paid on that income as this would *prima facie* be evidence of some financial stability, rendering the policy considerations behind the exemption meaningless. The only function the exemption provisions may have performed was to prevent new co-operatives not earning an income from having to pay a tax under the "capital employed" provisions that existed at the same time.<sup>118</sup> However, since the latter provisions have been removed from the Act, the removal of the three year exemption was a logical step.

### C. Taxation of the Co-operative Customer on Patronage Dividends

The *Income Tax Act* provides that patronage dividends shall be included in the income of the recipient in the year in which the payment was received.<sup>119</sup> An exception is made with regard to allo-

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where it was argued unsuccessfully that a student housing co-operative should qualify under s.62(1)(e) of the Act, now s.149(1)(f), as a charitable organization.

<sup>114</sup> In *Ontario Hog Producers' Co-operative v. M.N.R.* (1962) D.T.C. 322, 29 Tax A.B.C. 266, an agricultural co-operative was exempted from tax under s.62(1)(d) of the Act, now s.149(1)(e); however, the Tax Appeal Board seems to have followed reasoning similar to that in the *Edmonton Milk* case rather than the *Montreal Milk* case, for it does not appear that the co-operative here was organized on a non-profit basis though perhaps *operated* that way.

<sup>115</sup> R.S.C. 1952, c.148, s.73; repealed by S.C. 1970-71-72, c.63.

<sup>116</sup> *Supra*, f.n.70.

<sup>117</sup> S.C. 1946, c.55

<sup>118</sup> *Supra*, f.n.93.

<sup>119</sup> *Supra*, f.n.74, s.135(7).

cations in respect of consumer goods or services and these are defined as follows:

... goods or services the cost of which was not deductible by the taxpayer in computing the income from business or property.<sup>120</sup>

Thus, if patronage dividends are received by a taxpayer from a marketing or purchasing co-operative as a result of trading in his business, they must be included in his income. In the marketing co-operative the patronage dividend is essentially a belated payment for his product, therefore amounting to an increased price received for his product. In the purchasing co-operative the patronage dividend represents a decrease in operating costs, which will be reflected in the operations of the business. Amounts deducted from income must be included in income when collected or recovered later by way of patronage dividend.<sup>121</sup> However, if the goods or services are of the consumer type so that the cost is not deductible by the taxpayer in computing income from his business, the patronage dividends received by him can be ignored for income tax purposes.

If the payment of the patronage dividend is not in cash but by issuing a certificate of indebtedness or shares,<sup>122</sup> the amount of the payment by virtue of such issue must be included in computing the recipient's income.<sup>123</sup> The payment of the dividend by this means does not have the effect of granting a tax deferral to the recipient. It may also be noted that all patrons, whether members or non-members, are treated similarly with regard to the taxability of patronage dividends.

The recent amendments to the Act now require the co-operative which pays the patronage dividend to withhold an amount equal to 15% of such payment exceeding \$100.<sup>124</sup> The withholding tax is credited toward the recipient's personal tax. If the recipient is not

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<sup>120</sup> *Ibid.*, s.135(4)(b).

<sup>121</sup> See *Pope v. Beaumont* [1941] 2 K.B. 321, [1941] 3 All E.R. 9, where a dividend from a co-operative on trade purchases was held to be a trade receipt. There appear to be no reported Canadian cases interpreting these provisions, but perhaps an analogy can be drawn between patronage dividends representing a price adjustment and foreign exchange profits, the latter having been held to be a revenue receipt and therefore taxable: see *M.N.R. v. Tip Top Tailors Limited* [1957] S.C.R. 703, 11 D.T.C. 1232; *Eli Lilly and Company (Canada) Limited v. M.N.R.* [1953] Ex. C.R. 269, 7 D.T.C. 1252. The U.S. position seems to be similar to that of Canada: see Packal, *supra*, f.n.51, 268; also see Woods, *supra*, f.n.48, 290.

<sup>122</sup> *Supra*, f.n.74, s.135(4)(g)(i).

<sup>123</sup> *Ibid.*, s.135(7).

<sup>124</sup> *Ibid.*, s.135(3).

taxable, presumably the tax would be returned to him upon filing the usual tax return.<sup>125</sup>

#### IV. OBSERVATIONS AND PROPOSALS

As we have seen, co-operatives can be broadly divided into two categories for tax treatment, that is, the non-income co-operative and co-operatives with income. A third category of lesser import was also discussed, that is, the non-profit or exempt co-operative. Some observations must now be made regarding the tax position of these various types of co-operatives as compared to other corporate taxpayers. The issues must be evaluated to determine whether the present system of taxation is fair or, to use the terminology of the Carter Commission, whether equity and neutrality are achieved.<sup>126</sup> If it cannot be said that the system treats co-operatives and their competitors equally, are there justified policy reasons for this discrimination? There are numerous examples in our present tax system of preferential treatment based on policy considerations;<sup>127</sup> are co-operatives treated preferentially and, if so, what are the policy reasons for so doing?

##### A. The Non-profit Co-operative

The exemption that obtains under section 149 of the *Income Tax Act* to certain non-profit organizations applies equally to co-operatives which fall within one of the various categories set out therein. The exemptions apply to organizations of a charitable nature or organizations which perform a function which is deemed to be in the public interest. The reason for exempting co-operatives from paying income tax, if they fall within one of the categories of section 149, is not because of their co-operativeness *per se* but because of the function they perform in society. The rationale of the exemptive provisions lies on the broad base of social policy.

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<sup>125</sup> The withholding tax was proposed by the co-operative movement as a compromise for repealing the capital employed provisions in the Act; see *Joint Submission, supra*, f.n.96, 6. The withholding tax was not included in Bill C-259 but appeared in the Act as passed, and the capital employed provisions were removed. Originally the 15% withholding tax had been proposed by the Carter Commission: see *Report of the Royal Commission on Taxation* (Carter Commission, Can. 1966, v.4), 105.

<sup>126</sup> *Ibid.*, 3.

<sup>127</sup> See, e.g., *supra*, f.n.74, s.149(1) exempting certain charitable type organizations and s.125 allowing special deductions for Canadian controlled private corporations.

The present taxation status of non-profit organizations has been criticized on the ground that certain entities, although of doubtful public benefit, in effect receive a public subsidy and an unfair competitive advantage by reason of their qualifying for exempt status.<sup>128</sup> Co-operatives should also be required to meet a "public benefit" test to be exempt. It seems completely untenable that the provisions of section 149 should apply to co-operatives of a commercial nature.<sup>129</sup> If no profits of the organization are received by the members, they should not be taxed on them, but this does not justify exempting the organization itself.<sup>130</sup> The only justifiable reason for awarding exempt status to any organization is that of public benefit. No policy reasons exist to exempt from taxation entities which are organized and operated on a non-profit basis but perform services of a non-charitable nature for a select few individuals.<sup>131</sup> Surely only organizations of a charitable nature, interpreted quite broadly, should benefit from this preferred treatment under our tax system. Other entities which earn an income should be taxed as any other taxpayer.

## B. The Non-income Co-operative

One argument used successfully by co-operatives to support non-payment of taxes is that they are agents of their patron-members and have no taxable income. The result is that funds received by co-operatives in the course of operation are not deemed to be income of the co-operative at all.

There appears to be a legal inconsistency in treating the member—co-operative relationship as one of principal and agent on the one hand, while recognizing the separate legal entity of the co-operative on the other. It has been noted earlier that nothing prevents an incorporated body from entering into an agency agreement with its shareholders.<sup>132</sup> However, allowing the agency relationship to arise in circumstances short of an express agreement to that effect seems to be giving co-operative members the best of both worlds. They claim that income or surplus received by the

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<sup>128</sup> See, e.g., *Peters and Zaid*, *supra*, f.n.107, 379.

<sup>129</sup> *Edmonton District Milk and Cream Producers Association Limited v. M.N.R.*, *supra*, f.n.100; *Ontario Hog Producers' Co-operative v. M.N.R.*, *supra*, f.n.114.

<sup>130</sup> *Peters and Zaid*, *supra*, f.n.107, 380.

<sup>131</sup> E.g., *Edmonton Milk case*, *supra*, f.n.100.

<sup>132</sup> *Supra*, f.n.48; see also, *Apthorpe v. Peter Schoenhofen Brewing Co.* (1899) 4 T.C. 41, 80 L.T. 395 (C.A.); *Southern v. Watson* [1940] 3 All E.R. 439, 85 S.J. 8 (C.A.).

co-operative entity is not taxable in its hands because it does not truly belong to the co-operative, yet they are protected by the principle of limited liability which is obtained with incorporation. The nature of the agency relationship is such that the agent is in a position of acting so as to affect the principal's legal position with regard to third parties;<sup>133</sup> but because virtually all co-operatives are incorporated for these precise reasons, the member (principal) is shielded from liability to third parties. Thus the inconsistency: the benefits of the principal—agent relationship accrue without the detriment that might ordinarily arise because of the usual power of an agent to bind his principal.

Agents are subject to the control of their principal<sup>134</sup> and are under a duty to pay over to the principal all money received on the principal's behalf.<sup>135</sup> When applied to the co-operative—member situation, perhaps these two principles of agency suffer some erosion. Although the payment is made to the member, it is not usually in cash but is a mere journal entry in the books of the co-operative.<sup>136</sup> But more significant is the fact that the member has no control over how or when the actual payment to him will be made. This is a matter usually reserved for the discretion of the board of directors of the co-operative.<sup>137</sup> The direct control that a principal usually has over his agent is absent. The courts have overcome this hurdle by finding that ultimate control rests with the members by reason of their power to elect the board of directors;<sup>138</sup> this allows the principal to exert control over his agent only by means of a two step process. Although ultimate control over the agent (co-operative) lies in theory with the prin-

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<sup>133</sup> Agency has been defined as:

... the relationship that exists between two persons when one, called the agent, is considered in law to represent the other, called the principal, in such a way as to be able to affect the principal's legal position in respect of strangers to the relationship by the making of contracts or the disposition of property.

(G.H.L. Fridman, *The Law of Agency* 3d ed. (1971), 8).

<sup>134</sup> *Restatement of the Law of Agency* 2d (1958), 7, defines agency as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and *subject to his control*..." (italics added); see also *Bowstead on Agency* (1968), 1.

<sup>135</sup> Fridman, *supra*, f.n.133, 132.

<sup>136</sup> E.g., *The Horse Co-operative Marketing Association, Limited v. M.N.R.*, *supra*, f.n.28.

<sup>137</sup> *Ibid.*, 406 and 126.

<sup>138</sup> *M.N.R. v. The Saskatchewan Co-operative Wheat Producers Ltd.*, *supra*, f.n.133, 415, [1928-34] C.T.C. 47, 59.

cipal (member), it is perhaps too remote to meet the requirements of a strict legal agency relationship. Also, this ultimate power or control does not arise by reason of the principal—agent relationship but by reason of the shareholder status of the member. The following observation has been made on this point by an American writer:

While the patrons could change the distribution policies of the co-operative by electing a new board of directors, the new policy would result from the patrons' ownership capacity, not from a principal-agent relationship.<sup>139</sup>

Further considerations which indicate the absence of a true agency is that the co-operative usually conducts business in its own name, holds title to property and employs its own people. These factors all must be considered in characterizing the relationship; although none of these factors individually is sufficient to be determining, it has been held that the cumulative effect is a strong indication of the absence of an agency relationship.<sup>140</sup>

Although it has often been held that co-operatives did not earn income because they were acting as agents for the members, the actual impact of these decisions has been minimal. One commentator in 1959 wrote:

It is not unreasonable to assume the recent court decisions may encourage a substantial shift toward the establishment of many more agency-type "non-income" co-operatives. If such is the case, the social interest may be significantly affected by the adverse repercussions on the national treasury, a circumstance which could conceivably necessitate a reconsideration of their tax position.<sup>141</sup>

The decisions referred to did not have the effect contemplated. In fact, the point appears not to have arisen in any reported Canadian case since that time,<sup>142</sup> and no legislation has been passed that affects the findings in the "non-income" co-operative cases.

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<sup>139</sup> M.M. Caplin, *Taxing the Net Margins of Cooperatives* (1969) 58 *Geo. L.J.* 6, 26.

<sup>140</sup> *Firestone Tire and Rubber Co. Ltd. v. Commissioner of Income Tax* [1942] S.C.R. 476, [1942] 4 D.L.R. 433.

<sup>141</sup> McIvor, *supra*, f.n.62, 68.

<sup>142</sup> The agency argument has not arisen in any recent cases. There were several cases involving the issue in the mid-1950s: see *supra*, Part II. The last decision in which it was argued (unsuccessfully) was *Montreal Milk Producers' Co-operative Agricultural Association v. M.N.R.*, *supra*, f.n.37.

### C. The Income Earning Co-operative

Most co-operatives operate not as non-profit organizations nor as agents of their members but are of the income earning type. The provisions in the *Income Tax Act* which allow deduction of patronage dividends from taxable income have caused the most controversy in the area of co-operative taxation. Although, as previously indicated, the provisions do not only apply to co-operatives, it is they that benefit primarily from them. The main objection of the private sector is that while patronage dividends are deductible, corporate dividends are not.<sup>143</sup> Secondly, the form of payment has given rise to objections since the effect of paying patronage dividends in a form other than cash (such as the issuing of new shares and a setting off against a member's obligation to loan money to the co-operative) is to allow co-operatives to generate internally a major source of capital upon which tax has not been paid. The private sector has vigorously opposed this obvious advantage bestowed on co-operatives and has pointed to this preferred tax treatment as a main reason for rapid co-operative expansion.<sup>144</sup> The net result of the present treatment of patronage dividends as deductible is in fact to favor the co-operative form over the ordinary business corporation.

The effect of allowing co-operatives to reduce their taxation while not truly awarding the same benefit to other taxpayers is, in essence, to subsidize them at the expense of other taxpayers. The co-operative does not have the additional expense of paying tax on the amounts deducted and the loss of revenue resulting must be made up by requiring other taxpayers to pay more. Also, the preferred treatment of co-operatives gives them an unfair advantage over their competitors, which results in providing more tax free dollars to the co-operative than to the ordinary business corporation.

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<sup>143</sup> Non-co-operative competitors of co-operatives have always argued that co-operatives were treated preferentially in the *Income Tax Act*. The controversy has thrived for many years; see, e.g., *Report of the Royal Commission on Co-operatives*, *supra*, f.n.54, 37 *et seq.* and submissions to the McDougall Commission; Carter Commission, *supra*, f.n.125, 108, and submissions thereto, esp. submission of The Equitable Income Tax Foundation; I.H. Asper, *The Carter Report: Taxation of Co-operatives* (The Equitable Income Tax Foundation). The United States has had similar activity in this area: see *Tax Treatment of Earnings of Co-operatives*, Hearings Before the Committee on Ways and Means (House of Representatives, U.S. 1960); Caplin, *supra*, f.n.139.

<sup>144</sup> Carter Commission, *ibid.*; *Mutual and Tax-Exempt Organizations* (Report of Proceedings of the 19th Tax Conference, 1967), 137, 148.

If it is accepted that discrimination exists in the present tax system in favor of co-operatives,<sup>145</sup> the question that must then be asked is whether such discrimination is justified. Are there public policy reasons which indicate co-operatives should be treated differently from ordinary business corporations? Co-operatives today are big business; in 1972 the gross business volume of marketing and purchasing co-operatives in Canada exceeded \$2 billion.<sup>146</sup> The earlier arguments favouring a special treatment for co-operatives on the ground of encouraging agriculturalists to organize have lost some of their validity. On the whole, co-operatives perform the same function in Canadian society as ordinary businesses do; there appears to be no reason to grant them tax advantages *en blanc* that do not apply, for whatever reasons, to the ordinary business corporation. However, certain exceptions may be made for particular co-operatives which perform a service to society that is recognized to be beneficial. In this category may fall most consumer co-operatives. Consumer co-operatives which supply goods and services could justifiably be allowed to reduce taxable income by the amounts of savings (patronage dividends) which are passed on to members.<sup>147</sup> The same considerations do not apply to co-operatives which are mere vehicles to aid in the carrying on of the members' business; these deserve no special treatment.

Several possibilities present themselves in considering what course should be followed in taxing co-operatives. The ideal would be to tax co-operative earnings at the same rate and on the same basis as the earnings of ordinary business corporations<sup>148</sup> with exceptions made for consumer co-operatives. Patronage dividends, under this proposal, would not be deductible by any taxpayer save the excepted co-operatives. Thus, there would be no discrimination between the two business forms in fact as well as in law. The

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<sup>145</sup> The co-operative movement does not accept that discrimination exists in their favor. It is argued that the deduction of patronage dividends is available to all corporations. This is formally correct but does not accurately reflect the true position; see *supra*, text following f.n.98; see also R.C. McIvor, *Recent Growth in Canadian Co-operatives* (1962, Can. Tax Papers #28, Can. Tax Foundation), 27.

<sup>146</sup> *Supra*, f.n.5; the statistics for 1972 are the latest available.

<sup>147</sup> A recent report indicated that a Canadian food co-operative in one city has returned by way of patronage dividends 4% of sales. It is thought that co-operatives play a role in the consumer's fight against inflation; see *Financial Post*, May 26, 1973, p.5.

<sup>148</sup> This has always been proposed by the private sector, e.g., Asper, *supra*, f.n.143, 13.

privilege granted to consumer co-operatives would be strictly on a policy basis, since a recognized benefit to society accrues as a result of the passing on of savings to consumers. Organizations qualifying for the deductions would have to be strictly defined.

The Carter Commission recognized the fact that co-operatives obtained an advantage under the present system.<sup>149</sup> Referring to deduction of patronage dividends, the Commission stated:

...co-operatives have had a distinct advantage over corporations, because the equivalent treatment of a corporation would be the allowance of the deduction of interest *and* dividends in the determination of income.<sup>150</sup>

Again referring to the "forced loan" effect of non-cash dividends, the Commission said:

...the ordinary corporation is at a significant disadvantage because of the immediate withdrawal by the government of one half of the income before any distributions to shareholders...<sup>151</sup>

Consistent with its view that "if the economic position of the members is improved as a result of the activity, the economic gain is a proper subject for taxation",<sup>152</sup> the Commission recommended that co-operatives be treated like ordinary business corporations. The effect of the recommendations would be to give no preference to co-operatives and to provide for full integration of shareholder and corporation income taxes and member and co-operative income taxes. However, none of the Carter Commission recommendations has been implemented with respect to co-operatives, and there is little likelihood of change at this time.

Since much of the controversy surrounds the method of payment, it would seem that a compromise position could be reached. If only dividends that were paid in cash would be allowable deductions, the objection to co-operatives utilizing tax free dollars for capital expenditures would be met. The McDougall Commission made a similar recommendation in 1945, suggesting that payment be made in cash within six months after the relevant business period, or that patronage dividends be

...credited within the same period to each customer and exigible by him on giving such notice as may be deemed reasonable.<sup>153</sup>

However, such requirements were never included in the legislation and "forced loans" resulted.

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<sup>149</sup> Although the Carter Commission proposals were aimed at the tax system as it existed in 1966, it has not changed substantially since that time regarding co-operatives.

<sup>150</sup> *Supra*, f.n.125, vol. 4, 102.

<sup>151</sup> *Ibid.*, 113.

<sup>152</sup> *Ibid.*, 109.

<sup>153</sup> *Supra*, f.n.54, 44.

One final possibility would be to set a minimum limit to control business conducted with non-members. It could be required that 90% of a co-operative's business must be with members before patronage dividends would be deductible. This would limit the ability of co-operatives to conduct business on a par with ordinary business corporations as regards members of the general public. This would require co-operatives to truly become service organizations for the owners of the co-operative.

#### **D. Conclusion**

It is clear that co-operatives do earn an income and thus should be taxable on the same basis as are other intermediaries under our tax system. A further evaluation of the present system should be made and changes introduced to equalize the treatment received by co-operative and non-co-operative taxpayers.

Co-operatives today are large business ventures permeating virtually all possible markets. Preferential tax treatment that effectively amounts to a public subsidy of co-operatives allows them an unfair competitive advantage over non-co-operative taxpayers in similar businesses. Such differential tax treatment of business forms performing similar functions cannot be said to be equitable and neutral and should not subsist.

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