



EEC



Food and Agriculture Organization
of the United Nations

*EEC–FAO Seminar on Cooperatives in Post-Soviet Countries
Moscow, 25 September 2015*

Some issues of cooperative legislation in CIS and Georgia

Zvi Lerman

The Hebrew University of Jerusalem, Israel

Two-layer structure of cooperative legislation in the region

- **Civil Code:**
 - Cooperative as a legal body (commercial, non-commercial)
 - Limited list of cooperative types (production coop, consumer coop)
- **Specialized cooperative legislation:**
 - Laws on cooperatives of specific types (agricultural coops, credit unions, etc.)

Specialized law subordinate to Civil Code definitions

DISTINGUISHING FEATURES OF COOPERATIVES IN WESTERN PRACTICE

How to characterize a cooperative?

Attribute	Cooperative	Corporation
Owners	Members	Shareholders–investors
Owners' objective	Use of services provided by the cooperative	Earning income
Organization's objective	Maximize members' benefits from working with the cooperative	Maximize corporate profits
Voting rights	One member–one vote, regardless of share contribution	Number of votes proportional to number of shares (i.e., share contribution)
Income distribution rules	Income distributed to members in proportion to their participation in the activity of the cooperative	Income distributed to shareholders in proportion to the number of shares held

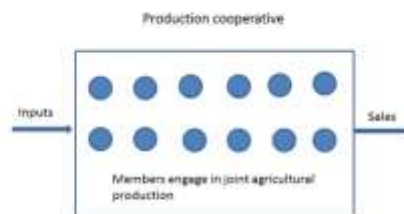
TYPES OF COOPERATIVES IN WESTERN PRACTICE

What is a service cooperative?

Service (“consumer”) cooperative



Production cooperative



What is a service cooperative?

Service cooperative

- **Independent production:** members produce independently on own land
- Joint services to members
 - Marketing
 - Input supply
 - Machinery and mechanized field works
 - Processing

Production cooperative

- **Joint production** based on common land, i.e., **collective farm**
- Joint services to joint production process

Distinguishing features of service and production cooperatives

	Service	Production
Objective of cooperative	Increase members' well-being by lowering input costs and raising sale prices	Increase members' wages by maximizing the profit of the cooperative as a legal body
Purpose of cooperation	Provide services supporting members' production activities	Implement joint large-scale commercial production
Owners	Legal and physical persons	Only physical persons
Work in the cooperative	Not applicable	Members must work in the cooperative
Participate in economic activity	Obligatory participation in economic activity of coop	Not applicable
Tax status	Non-profit	For profit

How is the Concept 'Cooperative' Perceived?

In Western countries

- Automatically perceived as *service* cooperative

In CIS countries

- Automatically perceived as *production* cooperative

The term “consumer cooperative” used for service cooperatives creates serious confusion

- Inherited from the Law of USSR (1988) “On cooperation in USSR”
- Direct link to Soviet rural policies (“Potrebsoyuz”)

Cooperatives counteract the “curse of smallness”

- *Traditional socialist approach*
 - Encourage farmers to join collective farms with their land – **production cooperatives** as a method of physical enlargement
- *Market approach*
 - Create **service cooperatives** as a method of effective enlargement – farmers retain independent production on own land and associate only for joint farm services (sales, input supply, farm machinery, processing)

**ESSENTIAL CHARACTERISTICS OF THE
COOPERATIVE SYSTEM: WHAT THE COOP LAW
SHOULD COVER?**

Essential characteristics of the cooperative system

- Law of cooperatives
- Adoption of ICA principles
- Cooperative objectives
- Clear distinction between production, service, and consumer coops
- Membership (physical and legal bodies)
- Participation in cooperative activity
- Income, “non-profit” status
- Income distribution to members
- Taxation
- Clientele: members, third parties,
- Multilevel structure
- Investment of land shares in coop capital

Countries that prohibit transfer of land ownership to cooperative

- Kyrgyzstan
- Tajikistan
- Moldova (allowed for production coops only)
- Ukraine (allowed for production coops only)

INCOME, NOT-FOR-PROFIT BEHAVIOR AND TAXATION OF COOPERATIVES

Income distribution and taxation Western accounting of a marketing cooperative

	Marketing service cooperative
1	Revenue (from sale of members' product to outsiders)
2	Expenses:
	(a) Payment of advances to members for products sold (based on preliminary estimates)
	(b) Operating expenses of the cooperative
3	Revenue – expenses = gross income/gross profit
	– (a) Allocation to reserve fund and other reserves
	– (b) Distribution proportional to members' <i>shares</i> (dividends)
4	= Residual for distribution to members in proportion to their volume of transactions (patronage refunds, cooperative payouts)

In the West, corporations pay tax on (3), cooperatives on (3a)

Some taxation practices in the West

- **USA:**
 - Only amounts retained by the cooperative in its equity are taxed (line (3a) in the income table)
- **Israel:**
 - Cooperatives have an option to be taxed like partnerships: all profits are allocated to members, who are then taxed individually. This provision does not require physical distribution of income

Taxation of cooperatives in CIS (1)

- **Tajikistan** (Coop Law 2013, art. 36)
 - Payments to coop members proportionally to their participation in coop activity are treated as expenses
- **Kyrgyzstan** (TC 2008-2015, art. 212, 239)
 - Profit of agricultural service coops is exempt from taxes
 - Deliveries to members by the coop and to the coop by members are exempt from VAT

Taxation of cooperatives in CIS (2)

- **Moldova:**
 - Non-commercial cooperatives are exempt from profit tax
 - Deliveries to members by the coop and to the coop by members are exempt from VAT (TC art. 103 (22))
- **Kazakhstan:**
 - Draft coop law in 2014 proposed exempting from tax all transactions with members; **proposal rejected** – 2015 final draft taxes coops like enterprises (although at a reduced rate)

Non-profit status: marketing coop

Revenue	100	100	100
Cash advance: first payout wave	50	80	90
Operating expenses	20	20	20
Surplus	30	0	-10
Allocated to fund	10	0	0
Decision about second wave payout (patronage refunds)	20		
Reimbursed by members	0	0	10
Taxed	10	0	0

Non-profit status: supply cooperatives

Cost of inputs	-100	-100	-100	-100
Advances from members	+130	+110	+90	+120
Operating expenses	-20	-20	-20	-20
Surplus	+10	-10	-30	0
Reimbursed by members	--	10	30	0
Distributed to members/retained	10	--	--	--
Income (taxed)	(10)	0	0	0

Non-profit status: production cooperative

Revenue	100	100	100
Payouts to members as wages	100	80	60
Operating expenses	20	20	20
Surplus	-20	0	20
Reimbursed by members	20		
Distributed to members			-20
Income	0	0	0

CONCLUSION

What types of cooperatives should be recognized in CIS?

- Adopt Western terminology:
 - Production coops
 - Service coops
 - Consumer coops – local rural shops
- Introduce appropriate amendments in the Civil Code
- Any other course will perpetrate the existing confusion

How the neighboring countries tackled similar issues?

- **Tajikistan:** Law “On cooperatives” (2013)
 - Commercial
 - Noncommercial
 - Civil Code amended
- **Kyrgyzstan:** Law “On cooperatives” (2005)
 - Agricultural cooperative (art. 5)
 - Production
 - Processing
 - Service
 - Civil Code amended
 - The legal status of cooperatives ... is determined by the Law “On cooperatives” (Civil Code, art. 152)

Tax distortions – an obstacle to membership in cooperatives

- *The share of income distributed to members as dividends and patronage refunds should be exempt from taxes at the level of the cooperative*
- Transactions with members – input supply, services – should be exempt from VAT
- These issues should be clearly formulated in cooperative laws *and in the Tax Code*