Aug 26, 2003

"Refiner Co-op Tax Issues"

CHS appreciates the opportunity to speak today on tax issues affecting refiner co-ops. We know first hand based on many years of working with the Congress, in particular with the Senate Finance Committee and you, Mr. Chairman, that you do listen to co-ops, do appreciate co-op input, and do actually incorporate co-op input into many tax bills.

My name is Josh Blaisdell, Director of Tax at CHS. CHS is a regional cooperative owned by 325,000 members. We have over 3,800 local cooperatives and facilities primarily in 28 states from the Great Lakes to the Pacific and from the Canadian border to Texas. Iowa is our third largest state with 339 facilities. We are the second largest employer in Montana.

<u>Overview of refiner co-ops</u>

Few people outside rural America know the importance farmer owned petroleum refineries—called refiner co-ops –have in local communities.

Since the 1950's when the number of refiner co-ops reached their height of 20, the number of refiner co-ops has been decreasing and stands at 4 today.[1] They are Farmland in Kansas, CHS in Montana, National Cooperative Refinery Association in Kansas and Countrymark in Indiana.

Together these 4 refiner co-ops sell over 90 % of the petroleum products they make to farmers, and local cooperatives. Cumulatively, refiner co-ops sell through the cooperative system to over 1.1 million farmers.[2] That is over 60% of the farmers in the United States.[3]

Petroleum operations at the local cooperative level are an important source of income, sometimes making up to 40% of a local cooperative's revenue. [4]

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[1] The closure rate of refiner co-ops has been much faster than the petroleum industry in general. It has decreased from a high of about 350 down now to 152 refineries. USDA Rural and Cooperative Development Service report #143, "Petroleum Cooperatives, 1995".
[2] Although refiner co-ops sell most of what they produce to co-ops (88% of their gasoline, 94% of their diesel and other distillates fuels, and 95% propane), their production only meets about 40% of the demand from co-ops. Therefore they have to buy from other refiners, predominantly small refiners, the balance of their needs –about 60%. USDA Rural Business Cooperative Service report #149, "Local Petroleum Operations".
[3] According to USDA Economic Research Service report # 768, "Structural and Financial Characteristics of US Farms, 2001 Family Farm Report"
[4] USDA Rural Business Cooperative Service report #149, "Local Petroleum Operations".

Refiner Co-ops work with USDA and Congress

The value of refiner co-ops to rural America and agriculture is well understood at USDA especially by the office of Rural Development, lead by Undersecretary Tom Dorr and the Energy Office, lead by Roger Conway. These are the two offices with which CHS does much of its federal coordination on co-op issues.

The value of refiner co-ops is also well understood in the Congress especially in the Senate Finance Committee. For the past several years the Committee leaders have been promoting major tax assistance to all cooperatives. Today they continue to fight for needed help for cooperatives—we very much appreciate that.

Senate Tax help for Co-ops

Take for example three of the Committee's recent major efforts: (1) to advance the "Tax Empowerment and Relief for Farmers and Fishermen Act" -- called "TERFF"; (2) the elimination of the Dividend Allocation Rule (known as the DAR) and (3) tax provisions in the energy bill for agriculture and small petroleum refiners including refiner co-ops.

I would like to touch on these three bills and their role in helping co-ops.

What is TERFF? The TERFF Bill (Senate Bill number 665 or as we call it "S665") is a bill of 13 items keyed on reducing the burdens of our tax system on farmers and cooperatives. It would, for example, permit risk management accounts, include value added animal processing cooperatives as marketing cooperatives, exclude rental income from self employment tax, coordinate income averaging and the alternative minimum tax, to name a few. We see the bill as an important vehicle to address farmer issues and some cooperative issues.

What is the dividend allocation rule or DAR? The DAR is a tax rule that creates an additional tax for cooperatives that pay a dividend on their capital stock – like nonvoting preferred stock that some cooperatives issue to raise much needed equity for their operations. No other type of corporation pays this additional tax. Today, regular corporations pay a double tax on corporate earnings – once at the corporate level and again at the shareholder level when a dividend is paid on stock. Cooperatives pay this double tax on their nonpatronage business, but they also pay an additional tax under the DAR.

How does this work? Under the DAR, when a cooperative pays a dividend on its stock, the amount of the dividend is allocated between the cooperative's patronage and nonpatronage operations, and the portion allocated to the patronage operation reduces the amount of the patronage dividend tax deduction. By reducing the patronage dividend deduction in this way, an additional tax is generated on the cooperative's patronage earnings. The cooperative and its shareholders are already subject to a double tax on nonpatronage earnings; this additional tax created by the DAR is in essence a third tax on co-ops.

Senators Grassley and other Finance Committee members have argued for years that this rule is unfair and have tried repeatedly to get it repealed.[5] Their current bill, S. 785, is focused on helping large and small cooperatives. It would amend the DAR and eliminate the third level of tax. Cooperatives have historically had great difficulty raising equity capital, and the DAR has contributed to the current situation we see in agriculture where many of our cooperatives are debt heavy.

This past year, two of the largest agricultural cooperatives have gone into bankruptcy -- Farmland Industries, Inc. (a large agricultural marketing and supply cooperative, headquartered in Kansas City) and Agway, Inc. (one of the nation's largest supply cooperatives, headquartered in Syracuse, NY). Several other regional cooperatives are heading toward similarly difficult times.

We need to help cooperatives strengthen themselves financially by giving them greater access to equity capital and removing this unfair third tax that cooperatives pay under the DAR for having dividend bearing stock. We believe S. 785 could be very useful in strengthening the financial situation of agricultural and other cooperatives across the country.

I will give you an example how elimination of the DAR would impact CHS. Recently, CHS offered $88 million in preferred stock. When we pay dividends on this stock, the DAR requires us to allocate a large portion of that dividend to our patronage operation and then reduce the amount of our patronage dividend deduction by the amount so allocated. This produces an additional tax for CHS of almost $2 million per year. That reduces our patronage equity, affecting our ability to secure better

[5] Elimination of the DAR has broad and deep Congressional support. In fact it passed both Houses of Congress in 1999 as part of an overall budget bill only, to be vetoed by the President. It has since been introduced several times with broad bipartisan support but has never passed the Congress. Today, it is found both in S. 785 and S. 665 as well in the House HR 1671.

loans. It also significantly reduces the amount we pay our farmer members as a patronage dividend each year.

Elimination of the DAR by passage of S. 785 would allow us to increase our patronage distribution by the amount of dividends we currently allocate to our patronage pools and reduce our tax burden at the cooperative level. That is real money kept in the co-op system for our members.

Finally, a third example of tax help for cooperatives is found in both the Senate and House versions of the 2003 Energy Bill, now called "The Energy Policy Act of 2003" and HR 6. The bill is awaiting a conference between selected House and Senate members to work out compromises. Few people know that the Senate version of an energy bill has 10 tax items for agriculture and co-ops, three very specific for refiner co-ops. These tax provisions include for example, tax credits for (1) producing electricity from poultry, bovine and swine waste, (2) small ethanol producers, (3) biodiesel, (4) installation of alternative fueling stations, and (5) retail sale of alternative fuels for motor vehicles.

We are particularly interested in the tax help for all small refiners since this group includes refiner co-ops. The refining industry must remove over 95% of the sulfur from diesel fuel to make the new ultralow diesel fuel. The Energy Bill's small refiner tax provisions include an expensing provision that allows us to accelerate the write-off of most costs we incur to comply with the new diesel desulfurization rule. It also provides a 5-cent per gallon tax credit for producing the ultralow sulfur diesel.

Passage of these tax provisions is critical to refiner co-ops. Collectively, two refiner co-ops, CHS and the National Cooperative Refinery Association, face over $450 million in compliance costs between 2002 and 2005. The two tax provisions really help us ease the burden of complying with the new rules by reducing the costs to our member owners and permitting us to maintain our role as the dependable provider of petroleum products to keep agriculture strong.

Repeal of the dividend allocation rule and the credit and expensing provisions have significant impact on refiner co-ops. Repeal of the DAR will provide cooperatives access to new, untapped sources of capital as well as provide an opportunity for farmers and local cooperatives to reinvest in their systems. In order for refiner co-ops to maintain their production capacity under the ultra-low sulfur diesel rules

and take advantage of growth opportunities as they become available, access to new capital markets is necessary.

While repeal of the DAR rule provides refiner co-ops a new arena in which to find funding for the low sulfur diesel capital improvements, the credit and expensing provisions of the Energy Bill allow refiner co-ops the ability to recover the costs of those improvements. These provisions significantly reduce the cost of funding these improvements allowing refiner co-ops to return more cash to local cooperatives and farmers through increased patronage distributions. Together they provide much-needed help to a diminishing pool of refiner co-ops.

In summary, each of these tax bills—TERFF (S 665), DAR (S 785) and the energy bill (HR 6) with its tax provisions -- has some very good provisions to help co-operatives, in turn either reducing costs or returning money back to local cooperatives, their members and the communities we live in. We just need them to be passed by the Congress.

Thank you for your time today and most importantly thank you for helping cooperatives.

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