

Implications for the Use of a Co-operative Structure for Business Activity in NSW

Tracie Arkley-Smith

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INTRODUCTION

This paper attempts to address the question:

"What are the taxation, legal and other implications of the use of a co-operative structure for business activity in NSW?"

The first section of this paper discusses the nature of a co-operative and its guiding principles. Section 2 outlines the principal taxation provisions affecting co-operatives and section 3 considers the issues of competition and anti-competitive behaviour. Finally, sections 4 and 5 provide a comparison of a number of different business structures, including co-operatives, on the issues of ownership, formation, management, wealth distribution, flexibility and taxation.

WHAT IS A CO-OPERATIVE?

While there is no statutory definition of a co-operative, the NSW Department of Fair Trading have broadly defined a co-operative is a "democratic organization owned and controlled by the people it serves who join together for a common benefit" (Dept of Fair Trading, 2001). There are currently approximately 1,300 co-operative type organizations in NSW, of which 800 are general co-operatives and the remainder are predominantly financial co-operatives such as credit unions and building societies (Dept of Fair Trading, 2001). Some of the better-known Australian co-operatives include Australian Co-operatives Foods Ltd, Norco Co-operative Ltd and Golden Circle Ltd.

The relative importance of co-operatives can be evidenced by the extent of their contribution to the Australian economy. The annual combined turnover for general co-operatives in Australia is estimated at around \$4.5 billion, with NSW co-operatives accounting for approximately 80% of this figure. This figure represents approximately 20% of the total turnover of the broader social economy in Australia. The majority of this contribution is sourced from large agricultural co-operatives involved in the marketing, processing, storing, handling and supply of products such as dairy, cotton, rice, sugar and grain¹.

The activities of co-operatives are not however restricted to large agricultural operations. General co-operatives operate in a wide range of industries, vary considerably in size and can be involved in business or non-business activities. Examples of other activities which have been conducted through a co-operative include housing co-operatives which provide low-cost housing to low-income earners and taxi services which provide a common booking system for individual taxi-plate holders.

¹ This information was provided by Peter Boland

Legal Recognition as a Co-operative

In terms of legal recognition, the courts² have considered adherence to a set of fundamental principles to be the distinguishing factor between a co-operative and any other form of business structure. While the exact description of the fundamental principles has altered over time, the essence of the principles remains unchanged, with a continuing focus on democratic control, open membership, distribution of surplus based on member dealings and limited return on capital³.

The current legislation governing co-operatives in NSW; the Co-operatives Act, 1992, describes these fundamental principles as follows:

1. Voluntary and open membership
2. Democratic member control, including the principles of one member, one vote and board representation weighted towards active members;
3. Member economic participation, including contribution of member capital to the co-operative with limited compensation and active membership requirements;
4. Autonomy and independence;
5. Education training and information;
6. Co-operation among co-operatives; and
7. Concern for the community. (Co-operatives Act, 1992 (NSW), International Co-operative Information Centre, 2001)

These seven principles are common to co-operatives legislation in all States and Territories of Australia and the International Co-operatives Alliance and are often referred to as the "core principles".

² See for example *Shelly v FCT* (1929) 43 CLR, 208 and *A & S Ruffy Pty Ltd v FCT* (1956) 98 CLR, 637, *Shears V Chisholm* (1992) 9 ACSR, 691 & *Re Namoi Cotton Co-operative Ltd* (1998) 26 ACSR 694

³ The Rochdale Society of Equitable Pioneers first developed these principles in 1844. In 1937 seven principles were adopted by the International Co-operative Alliance (ICA) based on the Rochdale principles. These principles were subsequently amended and modified in 1966 and 1994. The seven principles currently adopted by legislation in all States and Territories in Australia are the same as those adopted by the ICA in 1994.

Perhaps the most important of these principles in terms of ensuring democratic control of co-operatives and highlighting the difference between a co-operative and any other business structure is the principle of "active membership".

Active Membership

Active membership is defined in terms of the primary activity of a co-operative. The primary activity can be an object of a co-operative, or an activity that falls within an object or objects of the co-operative, for example the supply of produce to the co-operative. Each co-operative is required to have an "activity test" within its rules that determines whether a member is active or not. For example, in the case of an agricultural co-operative the activity test may be determined by the member supplying a certain percentage of his or her produce, or purchasing goods to a specified value.

The activity test is usually measured over a twelve-month period, but it can be a longer or shorter period depending on the nature of the co-operative's activities and the approval of the Registrar of Co-operatives. Once admitted to membership an active member will exercise one vote irrespective of the number of shares held or the member's capital contributions to the co-operative⁴. Failure to remain active results in the member losing the right to vote and, after a period of 3 years, leads to the cancellation of membership and to the forfeiture of the member's shares⁵.

The active membership requirement can be contrasted to other forms of business structure such as companies, partnerships, unincorporated joint ventures or associations and trusts, which allow for "silent" partners or participants, passive shareholdings and varying rights to vote in the management of the organization.

⁴ Natural persons who are less than 18 years of age are not permitted to vote under the Core Consistent Legislation.

⁵ The 3-year period can be reduced under the rules of a co-operative, although in most cases it will be 2 years for co-operatives incorporated under the Co-operatives Act before December 1997

Similarly, other forms of organisation are not restricted in their ability to limit membership and vary entitlements to dividends or other compensation for the use of their capital.

In the remainder of this paper, discussion is focussed on trading co-operatives; given this is the more common structure for business activities operating under the Co-operatives Act. First, however we need to understand what a trading co-operative is.

Trading & Non-trading Co-operatives

Despite the name, classification of a co-operative as a trading or non-trading co-operative is not dependent on the extent of business activities carried on by the co-operative. Instead, classification is dependent on whether or not the co-operative is permitted under its rules to make distributions of surpluses to members. The ability to distribute surplus to members is restricted to trading co-operatives under S14 of the Co-operatives Act, hence the reason why trading co-operatives are more popular for business activities than non-trading co-operatives.

A trading co-operative is defined in S 14 of the Co-operatives Act, 1992 as a co-operative with the following features:

- Share capital
- Gives returns or distributions on surplus or share capital
- A membership of 5 or more active members or such lesser number as the Registrar may approve.

A “non-trading co-operative” is defined as a co-operative which is precluded under its rules from giving returns or distributions on surplus or share capital to members other than the nominal value of shares (if any) on liquidation. Unlike a trading co-operative, a non-trading co-operative may be formed with or without share capital.

We now turn to the implications of adopting a co-operative structure, by firstly considering taxation, then the application of the Trade Practices Act (1974) to co-operative activities.

TAXATION OF CO-OPERATIVES

This section considers the principles affecting the taxation of co-operatives. Section 5 of this paper contains an illustration of the application of these principles to a fictional trading co-operative.

The first issue of relevance is that a co-operative is not a definitive business structure under the Income Tax Assessment Act (1936) & (1997) ("ITAA") to which a particular rate of taxation applies or a particular type of tax return is required, in the same way trusts, partnerships, individuals or companies are uniquely identified and taxed. As a trading co-operative is required to have share capital, it would be considered to be a company for taxation purposes under S 6 of ITAA. For a number of co-operatives the items which would be considered assessable income and allowable deductions would not vary simply because the business is conducted through a co-operative structure.

In a number of cases however, a co-operative may meet the definition of a co-operative company contained in sections 117-120 of ITAA (1936)⁶ and receive more generous taxation treatment as a result of additional items being allowed as deductions from the co-operative's income.

Specific ITAA Provisions for Co-operatives Companies

Section 117: Definition of a Co-operative Company: Section 117 contains the definition of a co-operative company and is replicated below:

"a company ... the rules of which limit the number of shares which may be held by , or by and on behalf of, any one shareholder and prohibit the quotation of the shares for sale or purchase at any stock exchange or in any other public manner... and includes a company ... which has no share capital and which in either case is established for the purpose of ...

⁶ ITAA (1997) sections 10-5 and 12-5 refers readers to sections 117-121 of ITAA (1936)

- a) the acquisition of commodities or animals for disposal or distribution among its shareholders;
- b) the acquisition of commodities or animals from its shareholders for disposal or distribution;
- c) the storage, marketing, packing or processing of commodities of its shareholders;
- d) the rendering of services to its shareholders;
- e) the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business"⁷

The key parts to the definition as described in *A&S Ruffy Pty Limited v FCT*, 1956, 98, CLR, 637-664 are as follows:

- the co-operative must be a company under section 6 of ITAA;
- the rules of the entity must limit share membership by, or on behalf of, any one shareholder,
- the shares must not be available by public offer; and
- the primary object of the co-operative must be one of the objects specified in section 117.

Co-operative Must be a Company

Section 6 of the ITAA 1936 defines a company to include all bodies or associations corporate or unincorporated, but does not include partnerships or non-entity joint ventures.

Co-operative Must Limit Shareholding

While there is a requirement under s.117 for the rules to limit a member's shareholding, the maximum number of shares that may be held by a member is a matter for each individual co-operative to determine, subject to restrictions under the

⁷ Note Section 117 includes within its definition co-operatives with no share capital. Under the Co-operatives Act 1992 such co-operatives can only be non-trading co-operatives. Taxation of non-trading co-operatives is not considered in this paper.

Co-operatives Act. Under the Co-operatives Act no member may hold a relevant interest in more than 20% of the issued shares without member approval by way of a special postal ballot, and without the approval of the Co-operatives Council. Co-operative Council approval is not required where the shareholder is another co-operative.

Co-operative Must Not Have Shares Quoted on Stock Exchange

In most cases co-operatives registered under the Co-operatives Act will have a rule that precludes the public listing of shares on a stock exchange. However, as share ownership under the Co-operatives Act is restricted to active members, i.e. those members who satisfy the activity test specified in the rules of a co-operative, it is unlikely that co-operatives could list shares on the stock exchange. Moreover, the current provisions of the Act require the directors of a co-operative to have reasonable grounds to believe that a person will be an active member if the person is admitted to membership.

Such restrictions would not be acceptable to the listing and business rules of the ASX, or satisfy the requirements under the Corporations Act 2001 or the Security Clearing House rules relating to the electronic transfer of securities. Nevertheless, to comply with s.117 a co-operative would be obliged to insert a provision excluding the quotation of shares in a stock exchange or by other public means.

Primary Object of the Business Activities

Where the purpose of an entity's business activities has one or more objectives, some of which may not fall within the objectives stated in s.117, the primary objective is to be determined by reference to the sole or dominant purpose of the company in the income year (*Brookton Co-operative Society Ltd v FC of T* 81 ATC 4346).

To determine whether the business activities have one or more of the stated objects it is not sufficient merely to review the objects contained in the constitution. Consideration must be given to the business activities of the entity during the year of income for which deductions are sought under Part 9 of ITAA as a co-operative company. As a result of this requirement, co-operative company status may alter

annually depending on the primary activity of the co-operative and the amount of income derived from the activity through the co-operative's business dealings with its members.

Section 118: Ninety Percent Of Dealings Must Be With Members: Section 118 indicates that a company is deemed not to be a co-operative if less than 90% of its business is with members. Ninety percent is determined by reference to the type of business conducted by the co-operative, thus a co-operative whose primary object is to acquire commodities or animals for disposal or distribution among its shareholders must have 90% of sales to members, while an entity whose primary object is to acquire commodities or animals from its shareholders for disposal or distribution must purchase 90% of its product from members. It is not necessary that 90% of both sales and purchases be with members unless that is the primary object or business of the co-operative.

The main implication of co-operative company status for taxation purposes is that a co-operative company is allowed deductions for items that other business structures are not. These additional deductions can provide significant advantages to co-operatives.

Sections 119-120 Assessable Income and Allowable Deductions of Co-operative Companies: Sections 119 and 120 of ITAA identify the assessable income and allowable deductions of a co-operative respectively. Section 119 indicates the assessable income of the co-operative includes all sums received by it whether from shareholders or others in respect of its business activity and Section 120 allows deductions for distributions to shareholders or members in the form of interest or dividends and rebates or bonuses based on business transacted and loan repayments in limited circumstances. A detailed discussion of the loan repayment deduction is contained section 2.1.4.

The effect of Sections 119 and 120 is that a co-operative that distributes all of its assessable income to its shareholders in any one year would have a zero taxable

income. A co-operative company cannot have a tax loss as a result of distributions in excess of assessable income. This treatment is more generous than that allowed to other companies which are not allowed a deduction for dividends.

To be eligible for a deduction the dividend must be either paid or credited to the shareholder. A dividend will be credited if it has been declared and the member's account with the co-operative is credited in a manner that permits the shareholder to draw upon the amount when desired.

Allowing a deduction for dividends does however have a disadvantage, in that a co-operative is unlikely to have any franking credits available for distribution. Depending on the tax position of the co-operative's members this may place a co-operative at a considerable disadvantage over a company structure as distributions from the co-operative would be taxed at the rate of tax applicable to the member and would not receive the benefit of an imputation tax credit. To alleviate concerns over this anomaly the Federal Government have announced changes to ITAA effective 1 July 2002 which will allow co-operatives the option of franking dividend payments instead of claiming a deduction for dividend payments (Kemp, 2001).

Rebates or bonuses received by shareholders based on purchases made by the shareholder from the co-operative are not included in the assessable income of the shareholder except as an adjustment to cost of goods sold if such is an allowable deduction to the shareholder (section 120 (2)). Interest, dividends or other forms of distribution are assessable in the hands of the shareholder. Section 5 of this paper contains an illustration of the impact of these provisions on the total tax paid by a co-operative and its members. All calculations are based on the current tax law and do not take into account the proposed changes referred to in the previous paragraph.

Loan Repayment Deduction: The loan repayment deduction for a co-operative relates to loans from a State or Commonwealth government. Section 120 (1)(c) indicates that for co-operative companies which have as their primary object the acquisition of commodities or animals from its shareholders for disposal or distribution, so much of the assessable income which is applied for the repayment of

any moneys loaned to the company by a State or Commonwealth government to enable the company to acquire assets in order to carry on the business or to pay the government for assets required which the company has taken over from the business is an allowable deduction, provided that shares representing not less than 90% of the value of the company are held by members who supply the company with commodities or animals.

While this section has a narrow application, i.e. agricultural companies where not less than 90% of business is with members and not less than 90% of shares are held by member-suppliers, it would provide significant benefits to these entities, as both the principal and interest repayments on the loan would be an allowable deduction. In the majority of other cases ITAA would only allow the interest as a deduction. For those considering using this section to their advantage there are some important points to remember.

1. The repayment must be sourced from assessable income of the co-operative. Assessable income includes receipts from the business activity only. This means members or others could not lend money to the co-operative and then use this money to make repayments on a co-operative loan in order to receive a tax deduction for the full repayment, which they could not have received if they had taken the loan out as an individual.
2. The loan must be used to acquire assets for the purpose of carrying on the business or to pay the government for assets in a privatisation sale. This means the loan could not be used as a general fund or overdraft, it must be used to acquire assets specific to the commodity or animal disposal or distribution operation.
3. The loan must be sourced through a State or Commonwealth Government. This does not include a Commonwealth or State owned corporation or a municipal council. Rather, it covers any Commonwealth or State instrumentality, which is an emanation of the Crown in the right of the Commonwealth or of a State (any instrumentality which is controlled by a Minister of the Crown and whose revenues form part of consolidated revenue).

4. Not less than 90% of purchases must be from members and supplier-members must hold not less than 90% of shares. Thus, a co-operative with 5 equal shareholders, 4 of whom supply 100% of the commodities would not be able to take advantage of this section as only 80% (4/5) of shares are held by supplier-members.

To illustrate the application of this section, consider five individuals who form a co-operative for the purpose of slaughtering their livestock. The co-operative purchases an abattoir for \$1million. Repayments are \$120,000 pa of which \$60,000 is interest. In the first year of operation each of the members make a loan to the co-operative to enable it to fund operations in the start up phase. Total assessable income of the co-operative for the first year is \$80,000. This money is applied to loan repayments and the remaining loan repayments and working capital requirements are drawn from the members' loans. Assuming the co-operative meets the 90% business rule and 90% shareholding rule, the co-operative would have an allowable deduction of \$80,000 being the total loan repayments made from assessable income. Note the full \$120,000 is not tax deductible, as the repayment is not sourced from assessable income.

In a later year the co-operative's assessable income is \$250,000. The co-operative may use this as \$120,000 repayment, \$60,000 other income-producing expenses and \$50,000 distribution to members. As all of these items would be allowable deductions to the co-operative, the co-operative would have a zero taxable income.

The provisions of Sections 119-121 do not apply to mutual insurance associations or credit unions which are dealt with elsewhere in ITAA to ensure the effects of the principle of mutuality are negated. (See later for a discussion on mutual income).

Case Law relating to Sections 117-120: The two principle common law cases concerning the application of ss117-120 and its predecessors are *Shelley v FCT* (1929) 43 CLR 208 and *A & S Ruffly Pty Ltd v FCT* (1956) 98 CLR, 637⁸. Details of these cases and their implications follow.

Shelley v FCT (1929) 43 CLR 208

The key issue in this case concerned the nature of a co-operative and the need for a co-operative to have a "co-operative" purpose as its primary object. The findings of this case are reflected in the list of "allowable activities" in Section 117. In *Shelley's* case, Shelley was a member of a company which acquired product and then sold it to members who later on-sold the materials to the end consumers. Shelley argued that the distribution from the company was non-taxable as it was a distribution from a co-operative company. The court held the distribution was taxable as the company was not a co-operative "but a company formed for the sole purpose of benefiting middlemen who are neither producers or consumers, and whose benefit is only attainable at the expense of either the producer or the consumer" (p. 221).

A & S Ruffly Pty Ltd v FCT (1956) 98 CLR, 637

This case again turned on whether the primary purpose of a business was a co-operative purpose. In this case, the share structure of Ruffly was such that three classes of shares existed, two classes were held by a majority shareholder and associates and a third class were held by suppliers to the company. The company distributed a dividend to all three classes in varying amounts such that the first two classes received 12,800 pounds and suppliers of raw materials of the company's product received 38 pounds. Ruffly then sought a deduction for the whole of the dividend on the basis that the company was a co-operative company.

⁸ Other cases dealing with the application of S117 or co-operatives generally include: *Employers Mutual Indemnity Association v FCT* (1943) 68 CLR 165, *Revesby Credit Union Co-operative Ltd v Comr of Taxation* (1964-65) 112 CLR 564, *FCT v Cooke and Scherdon* (1980) 80 ATC 4140, *Shears v Phosphate Co-op Co of Aust* (1988) 14 ACLR, 747. All of these cases reinforced the general principles established in *Shelley's* case.

The court held the deduction was not allowable as the primary purpose of the company was to "earn profits for the A and B class shareholders" (p. 638) rather than a valid co-operative purpose. Of interest also were the findings that a number of classes of shareholders did not preclude co-operative status and that it was not necessary that all shareholders are suppliers rather than 90% of the value of supplies are sourced from the shareholders as a group.

Mutual Income

For those entities that do not meet the definition of a co-operative company, it may still be possible to gain relief from taxation if the activities of the co-operatives are considered mutual. Mutuality recognises that a person's income consists only of moneys derived from external sources. Where a number of persons contribute to a common fund for a common purpose, the use of that fund for the common purpose is not income in the hands of the fund or its members, nor is any surplus arising from the activities a profit of the fund (Grbich, Bradbrook & Pose, 1990).

ITAA recognises the mutuality principle by categorising the income of certain types of bodies as exempt bodies. Section 11-5 of ITAA (1997)⁹ identifies the following entities as exempt, no matter what kind of ordinary or statutory income they have:

- Charitable, religious, education or scientific societies or funds;
- Societies or associations for the promotion of agriculture, viticulture, aviation, horticulture, tourism, industrial, manufacturing or pastoral societies;
- Community service societies; and
- Societies or associations for the promotion of sports, culture or recreation

In each case the relevant society or association must not be carried-on for the purposes of profit or gain to individual members thereof (section 50-40, 50-45 and 50-70).

⁹ replaces S23 g & h of ITAA 1936

While many co-operative groups may fall within this definition, business co-operatives, would be unlikely to meet the no profit or gain requirement of Section 11-5 and these co-operatives must look elsewhere for taxation relief. Case law may provide some respite if the transactions of the co-operative are considered individually.

Case law in the area of mutuality suggests that the test for mutuality is not related to the nature of the association but the nature of the transactions themselves:

"it is not membership or non-membership which determines immunity from or liability to tax; it is the nature of the transactions" (Inland Revenue Commissioners v. Ayrshire Employers Mutual Insurance Association Ltd, 1946 1 All ER 637)

In determining whether a transaction, and thus the income deriving from that transaction is mutual CDS 10148 indicates four main characteristics are needed for a dealing to be mutual. They are:

- "a common purpose;
- contributions to a common fund to give effect to that purpose;
- control of the common fund by the contributors;
- all contributors to the common fund are entitled to participate in any surplus and all participators in the surplus are contributors to the common fund" (CDS 10148, 1998)

Without reference to entities which fall within the ambit of Section 11-5 of ITAA, transactions which have been considered to comprise mutual income in common law have included receipts for the sale of clothing made to a specific design for an incorporated club (ATO ID 2001/231), membership fees to a company established to provide services to members and develop policies for the benefit of a region (ATO CDS 10148) and membership fees to an unincorporated social club (Bohemians Club v Acting FCT, 1918, 24 CLR 92).

Transactions which have been considered to fall outside the scope of mutuality include interest on loans from credit unions (Sydney Water Board Employees' Credit Union Ltd V FCT (1973) 4 ATR 157), commissions earned by a motoring group from sales to members and non-members (RACV v FCT, 1974, VR 651) and stall fees for an association meeting (FCT v Australian Music Traders Association 90 ATC 4536; 21 ATR 471).

A co-operative falling outside the scope of Section 117-120 or Section 11-52 should therefore consider the nature of each of their transactions in order to determine their liability to taxation. Receipts from members paid in to achieve a common purpose, such as membership fees or levies are unlikely to be considered assessable income, whereas receipts from trading activities, with members or non-members are more likely to be considered to be assessable income.

Taxation of Co-Operatives Under State Legislation

In general, co-operatives are subject to the same State taxes duties and imposts as other incorporated entities. However, there are some stamp duty and land tax exemptions which apply exclusively to co-operatives.

Exemption from Stamp Duty: Under s. 437 of the Co-operatives Act there is an exemption from the payment of stamp duty relating to:

- the issue of the certificate of registration of a co-operative
- a share certificate or any other instrument issued or executed in connection with the capital of a co-operative.

Instruments issued or executed in connection with the issue of a Co-operative Capital Unit are excluded from the stamp duty exemption under s.437. Also, there is no exemption from the payment of stamp duty on transfer documents relating to shares or debentures.

Exemption from the Payment of Land Tax: Under s10 (1)(t) of the Land Tax Management Act 1956 (NSW), land owned by a co-operative registered under the Co-operatives Act that has as its objects any of the objects listed in s.7 of the Co-operation Act, will be exempted from taxation.

Section 10(1)(g)(iii) of the Land Tax Management Act exempts land which has a building owned and solely occupied by a society and not carried on for pecuniary profit. The building, or any part of the building, must not be used for the purpose of a commercial activity that is open to members of the public.

Case Law Concerning the Application of ITAA or State Taxation Laws to Co-operatives

The following material reviews relevant case law and its implications for cases concerning the application of ITAA (other than Ss 117-120) and State taxation laws.

McLennan v Federal Commissioner of Taxation (1989)

This case questioned whether a levy paid to a co-operative is deductible under S 51(1) as a cost of production. McLennan and others paid a levy to the Haughton Weir Co-operative Association Ltd; a body formed for the sole purpose of constructing water storage for use in Sugarcane farming. McLennan claimed a tax deduction for the levy and the Commissioner sought to deny this deduction on the basis that it was a capital investment by McLennan similar to the purchase of shares.

Hill J, looked at the nature of the co-operative, its rules of formation and activities and adopted a substance over form argument in allowing the deduction. In making his decision Hill J indicated "the shares in the Co-operative were not acquired for the purpose of thereafter deriving any dividend or for that matter liquidation distribution that might be received from them". The findings in this case suggest that in limited circumstances membership fees or levies to a co-operative may be considered a cost of production for taxation purposes.

Federal Commissioner of Taxation v Murry (1996)

In the case the Commissioner argued that shares in a co-operative had been sold for capital gain, when a taxi-plate holder sold his license. The court found that instead the payment was not for a capital gain but "goodwill" associated with the taxi licence. due to its connection

with particular geographic locations. The obiter in this decision discusses the nature of the co-operative structure in the taxi industry and expectations of the co-operative, suggesting the co-operative shares are not purchased for dividend or capital gain.

Common Equity Housing Limited v Commissioner of State Revenue (1996)

Common Equity Housing applied for a refund on stamp duty paid on the conveyances of property on the basis they were a corporation associated for charitable purposes as they were in the business of sub-letting houses at below market rental to low-income households. The case considered the nature of the co-operative structure, its rules and activities and allowed for a refund.

In each of these cases the court has considered the nature of the co-operative structure in making its decision and appears willing to take the co-operatives' purpose into account in their decision-making. This is particularly relevant in *McLennan v FCT* in which a payment for shares was treated as an allowable deduction given the shares were in the nature of a contribution to a co-operative which had one purpose only and that purpose would have been an allowable deduction had it been undertaken as a levy to a regulatory body.

CO-OPERATIVES AND THE TRADE PRACTICES ACT

The co-operative business structure encourages dealing and collaboration between members to achieve a common purpose. In many cases, this common purpose involves achieving the optimum price or lowest cost for members' product or maximising return to members for their individual operations. Given this intended purpose, it is not surprising the Australian Competition and Consumer Commission (ACCC) have made specific mention of the activities of co-operatives in their publication: *Rural Industry and the Trade Practices Act* (ACCC, 1998) and in speeches made to farmers and small businesses (Martin, 2000, Fels 1998). Much of the following material is sourced from the *Rural Industries Guidelines* and readers are referred to that publication and the *Trade Practices Act* (1974) for more detail on specific provisions and cases.

In terms of the activities of co-operatives which may raise issues of anti-competitive behaviour, the relevant sections of the *Trade Practices Act* (1974) are as follows:¹⁰.

- Section 45: arrangements, agreements and understanding which give effect to:
 - Substantially lessening competition in a market (S 45)
 - Exclusive dealing provisions which exclude or limit dealings with a particular supplier or class of supplier or customer (S 45)
 - Fixing, controlling or maintaining prices (S 45A)
 - Hindering the activities of a third person from supply, acquisition or conducting business (45D)
- Section 46: misuse of market power to eliminate, damage, prevent entry or deter competitive conduct in the market
- Section 47: prevents one party imposing conditions on a second party as to whom they can and cannot trade with, broadly described as exclusive dealing provisions.
- Section 51 provides a statutory exemption from some prohibitions where the act is specifically authorised by a Commonwealth, State or Territory Act where that legislation specifically refers to the *Trade Practices Act*. Section 43 of the Co-

¹⁰ A detailed discussion of the *Trade Practices Act* (1974) is outside the scope of this paper.

operatives Act has recently been amended to remove a provision that specifically allowed co-operatives to engage in exclusive dealing as defined under Section 47 of the Trade Practices Act, thus co-operatives no longer have this protection available to them.

Breach of the above provisions is, however, subject to a public benefit test. Where the public benefit of the behaviour exceeds the detriment from the "anti-competitive" behaviour the ACCC may authorise such activities in advance under the authorisation provisions. Authorisation cannot be obtained for misuse of market power (section 46) and cannot be sought after a contract is entered into unless the contract is conditional on authorisation and application for authorisation is lodged within 14 days of entering into the contract.

Authorisation is generally limited to a specified time period to allow for a specific purpose such as transition to deregulation and may be revoked where the ACCC believes the competitive detriment outweighs the public benefit. Unfortunately, there is no clear definition of public benefit or detriment under the Trade Practices Act to assist parties in assessing whether their activity may be in breach of the Act.

In a case brought before the Australian Competition Tribunal, the Tribunal provided the following broad definition of public detriment:

".. any impairment to the community generally, any harm or damage to the aims pursued by the society including as one of its principal elements the achievement of the goal of economic efficiency"
(Victorian Newsagency, (1994) ATPR 41-357 at 42,677)

Public benefit has also been defined widely with the Commission indicating it will look at each case on its own merits:

".. anything of value to the community generally, any contribution to the aims pursued by the society including ... the achievement of the economic goals of efficiency and progress ... the best use of society's

resources.." (Queensland Co-operative Milling Association (1976)
ATPR 40-012 and 17242)

Co-operative activities which have been found to be in breach of the Trade Practices Act (1974) include:

- exit barriers established by a co-operative which had the effect of preventing members from leaving and establishing a rival business (Darwin Radio Taxi Co-operative Limited cited in ACCC, 1998).
- a rule limiting the use of mobile telephones by taxi cab drivers (DeLuxe Red & Yellow Cabs Co-operative Trading Society Ltd, 1994)
- a pricing scheme which substantially replicated a scheme in place prior to deregulation which was argued to be a means of adjusting to deregulation (Australian Tobacco Leaf Corporation Ltd, 1998).
- a market sharing arrangement between milk treatment companies (Re Southern Farmers Co-operative Ltd, 1986)

Activities that have been found to pass the public benefit test include:

- an indicative price scheme for Winegrowers in the transition period following deregulation (Winegrape Growers' Council of Australia Inc);
- marketing and research facility provided by the Victorian Egg Industry Co-operative as a means of easing the transition period to deregulation (Victorian Egg Industry Co-operative);
- collective negotiation of growers contracts in the case where the purchasers were large processing companies and growers were generally small individual farmers (South Australian chicken growers' contracts);
- industry organizations which enforce activities of public benefit such as safe storage of chemicals by preventing dealing with members who are not accredited (Agsafe Ltd and Avcare Ltd); and
- restriction of supply to farmers not paying in a levy where the purpose of the levy was export development and was of benefit to the industry as a whole and individual farmers (Tasmanian Oyster Research Council Ltd) (ACCC, 1998)

In summary, co-operatives must carefully consider the nature of their co-operative activities during the formation process. Where such activities may breach the Trade Practices Act, authorisation should be sought to ensure the activities are either not considered anti-competitive by virtue of the public benefit test or can be restructured in such a way as to avoid penalty under the Trade Practices Act. The penalties for breach of the Act are severe and include injunctions, damages, divestiture of illegally acquired shares or assets and monetary penalties of up to \$10 million per breach for companies and \$500,000 for individuals.

COMPARISON OF ALTERNATIVE BUSINESS STRUCTURES

Table 1 in this section compares the co-operative business structure to other alternatives on the issues of ownership, formation, management and flexibility based on the laws affecting co-operatives registered under the Co-operatives Act (1992) (NSW). This table is similar to that contained in Lawless, Cropp and Harris (1996), which compared co-operative ownership with other business arrangements for multi-family dairy operations in Wisconsin, United States.

Table 1: Comparison of Alternative Business Structures

Issue	Unincorporated Association	Partnership	Joint Venture	Company	Co-operative registered under Co-operatives Act
Ownership Issues					
Ownership	Members	Partners	Joint Venturers OR Shareholders where there is an incorporated joint venture.	Shareholders OR Members in the case of a company limited by guarantee	Dependent on structure Trading co-ops must have shareholders
Term for owner	Dependent on rules of association	Dependent on partnership agreement	Dependent on the terms of the joint venture agreement	Generally no limitation	Dependent on rules of co-operative
No of members	Unlimited	Unlimited	Usually 2 joint venturers, but can be more, depending on the nature of the activity or project undertaken.	Proprietary companies limited to 50 non-employee members. Public companies unlimited	Must have a minimum of 5 members, unless the Registrar approves of a lesser number
Active membership required	No	No	No	No	Yes
Voting rights	Dependent on the rules of the association, but generally one person one vote.	Dependent on partnership rules	Dependent on terms of joint venture agreement.	Dependent on class of share and rights conferred by memo and articles of association. However regulated by Corps Law also	1 vote per active member
Limited Liability	No	No. Partners are jointly and severally liable.	No, if unincorporated Yes, if incorporated	Yes	Yes

Issue	Unincorporated Association	Partnership	Joint Venture	Company	Co-operative registered under Co-operatives Act
Formation Issues					
Legal and administrative costs	No mandatory costs. Depends on advice sought	Cost of establishing partnership agreement.	Cost of establishing joint venture agreement Where incorporated, must include purchase of company and associated administration costs.	Purchase of Company and associated administration costs.	Must apply for registration as a co-operative and prepare rules for the co-operative. Refer Dept of Fair Trading Formation rules and instructions.
Familiarity	Common	Common	Common in certain industries such as mining and manufacturing.	Common	Less common.
Decision making and administration issues					
Decision making	Dependent on rules of association. Can be a downfall of this form of organization if no "agreed" rules	Dependent on partnership rules.	Dependent on joint venture agreement Where incorporated, board of directors elected by joint venture shareholders. Certain Board decisions may need unanimous decision of directors to protect minority shareholder.	Board of directors elected by shareholders entitled to votes.	Board of directors. Directors must be active members, but if permitted by the rules the board may include employees of the co-operative and non-members. Non-members must not form a majority of the board members.

Issue	Unincorporated Association	Partnership	Joint Venture	Company	Co-operative registered under Co-operatives Act
External reporting requirements	None	None	None where the joint venture is unincorporated. Where incorporated, required to prepare financial statements if a "large" proprietary company, or if "small" proprietary company and directed by ASIC or 5% or shareholders. Annual return to ASIC required.	Required to prepare financial statements if a "large" proprietary company, or if "small" proprietary company and directed by ASIC or 5% or shareholders. Annual return to ASIC required.	Required to prepare financial statements in accordance with the Corporations Law requirements. Financial statements must be audited unless exemption granted Annual report to Registrar required.
Costs of administration	Dependent on complexity of activity	Dependent on complexity of activity	Dependent on the complexity of the joint venture and whether the joint venture is incorporated.	Dependent on complexity of activity and whether full financial report and audit required. Minimum requirement is ASIC return, tax return fees and accounting fees.	Dependent on complexity of activity, however for "small" non-complex activities likely to be more expensive than company structure due to the additional requirement that financial reports are audited.

Issue	Unincorporated Association	Partnership	Joint Venture	Company	Co-operative registered under Co-operatives Act
Wealth Distribution Issues					
Ability to distribute surplus	Dependent on rules of association	Dependent on the partnership agreement.	Dependent on the joint venture agreement, but can be based on the value of the assets that the joint venturers have contributed to the joint venture.	Returned as a dividend with franking credits if applicable. There is generally an expectation of dividend.	<p>Can be in the form of</p> <ul style="list-style-type: none"> -rebate or bonus on the basis of business conducted -interest or limited dividend for capital contribution <p>Dividend is limited to 20c in the \$1</p>
Flexibility of structure					
Withdrawal and transfer of ownership	Dependent on rules of association.	Dependent on rules of partnership. Can be very inflexible in admitting and removing new partners.	Dependent on the joint venture agreement, but usually not flexible because joint venturers bring to the arrangement specific assets that are used in production.	Dependent on the company's constitution. However, this is usually the most flexible structure, except in closely held corporations	Dependent on fulfilling the active membership requirements or not.
Stability for remaining owners	Can be very unstable after change of ownership.	No continuity of life can threaten long-term stability.	No continuity of life. A joint venture is usually formed for a specific project or activity.	No limitation on ability to continue dependent on impetus of remaining shareholders	No limitation on ability to continue dependent on impetus of remaining shareholders. Where co-operative is formed for a specific purpose, the co-operative is likely to disband after achieving the purpose

Issue	Unincorporated Association	Partnership	Joint Venture	Company	Co-operative registered under Co-operatives Act
Terminating the structure	No external rules	Dependent on partnership agreement. Can involve financial settlements between partners	Dependent on the joint venture agreement, but usually after the completion of a particular project or activity. Where a joint venture is incorporated it must be wound up in accordance the Corporations Act 2001.	Must be wound up in accordance with the Corporations Act 2001. In certain circumstances ASIC can de-register a company without the appointment of a liquidator and the winding up of the company.	Registrar's Certificate may be used in limited circumstances (s 324 Co-op Act). In all other cases the procedures under the Corporations Act 2001 apply. In certain circumstances Registrar can de-register co-operative without need for liquidation.
Taxation					
Entity taxed	Taxed in hands of members.	Partnership return required but taxed in hands of individual partners.	Each joint venturer assessable on the income derived from the venture. Allowed deductions for the share of outgoings incurred.	Company taxed as a separate entity	Dependent on whether the co-operative meets the ITAA rules for co-operative companies and the degree to which its income is considered mutual (see Sections 3 of this paper)

ILLUSTRATIVE EXAMPLE: TAXATION OF A CO-OPERATIVE

The following is an illustration of the taxation consequences of the co-operative business structure for a fictional trading co-operative operating in the agricultural industry under a variety of scenarios. All calculations are based on the author's understanding in the application of ITAA. The scenario is not intended to be commercially realistic, and has instead been created to illustrate the application of taxation laws to a co-operative company as compared to a non-co-operative company and the implications of surplus distribution decisions.

The Scenario

Five individuals operating in the agricultural sector have decided to form the "High-5" co-operative. Each of the members is a primary producer of a different type of livestock with some crossover. They have recently been reading about the value of manure as fertiliser to the organics area and believe they may be able to value-add to their respective operations by marketing a hybrid fertiliser made from the manure of each of the livestock groups (cattle, poultry, horses, sheep, goats).

The co-operative will be involved in mixing, analysing, packaging, marketing and selling the manure. To achieve these goals it will purchase capital equipment for mixing, quality control, analysis and packaging the manure, employ staff to operate the machinery and outsource the testing and analysis to a well-respected tester who will then be willing to certify the quality of the fertiliser.

Each of the members contributes an equal sum of money to establish the plant and finance the operations and agrees to supply the respective quantities of manure at a price and amount agreed between the members. They will then receive an annual distribution from the operation based on the surplus of the business activity. Additional capital contributions will be made by the members if required. The members will each be on the board of directors and will be jointly responsible for business decisions through the decision-making authority of the board of directors.

The product will be sold to retailers, nurseries and commercial horticultural operations. None of the members of High-5 are involved in this area, however they expect they will purchase a small portion back from the co-operative for general farm and household use as a marketing initiative.

In order to demonstrate the effects of taxation principles three scenarios are considered. In Scenario 1, the members provide their product free of charge and purchase 2% of total product, in scenario 2 they receive a payment for the raw materials as agreed between the members and the percentage of product taken by the members increases to 15%. For illustration purposes, in scenarios 1 & 2 the difference between classification as a co-operative and not meeting the definition is considered. Note however, High-5 would be likely to meet the section 117 & 118 definition if its primary object was acquisition of commodities from suppliers for distribution.

In scenario 2 the issue of mutual income and associated deductions is also considered. In each of scenarios 1 & 2 the distribution is in the form of a dividend from the co-operative. In scenario 3 the impact of receiving a co-operative distribution in the form of a rebate instead of a dividend is considered as a large proportion of sales are now also made to members.

Taxation of High-5

After a number of years of trading, results for the x1 year of income are shown in Table 2. For simplicity assume all stock produced is sold each year:

Table 2: Calculation of Tax Payable for Scenario 1

Sales	\$000 Scenario 1	Incl in TI Coy	Company	Incl in TI Co-op	Classified as a Co-operative
To external parties	980	Y		Y	
To members	20	Y		Y	
Total	1000	1000	1000	1000	1000
Expenditure					
Raw manure	0				
Depreciation of Plant	50	Y	(50)	Y	(50)
Wages and other materials & analysis	270	Y	(270)	Y	(270)
Selling costs	120	Y	(120)	Y	(120)
Admin costs	60	Y	(60)	Y	(60)
Total	500	500	(500)	500	(500)
Net Income	500	500	500	500	500
Tax paid by entity			150 ¹¹		0 ¹²
Available for dist			350		500
Distribution to owners		No	350	Y ¹³	500
Tax paid by each member 48.5% (assuming ff ¹⁴ div)			18.5 ¹⁵		48.5 ¹⁶
Total tax paid			242.5		242.5

Calculation of taxation for the company includes all income as taxable income regardless of the fact that a portion is sold to members. This is because common law looks to the nature of the transactions themselves not the recipient (see Section 2 of this paper) in determining mutual income. The transactions are clearly sales in the ordinary course of business. All of the expenses are incurred in the process of earning the assessable income and are therefore deductible. As a result of this treatment and the existence of 100% franking credits there is no difference in the total tax paid (members and entity) in the co-operative and company structure in this scenario. The effect of classifying a portion of the income as mutual income is considered in Scenario 2.

Scenario 2 considers the impact of income being classified as mutual and the co-operative paying for raw materials from its members. In scenario 2, each of the producers receive

¹¹ Calc is 30% of taxable income - note new tax rates used

¹² Distribution is deductible under S 120, therefore entity has zero assessable income

¹³ ibid footnote 13

¹⁴ fully franked

¹⁵ Calc is $70/70 = 100$ (grossed up div). Tax @ .485 = 48.5 Imputation credit = 30 Net tax = 18.5. After tax return = 51.5

¹⁶ Calc is $500 * 48.5\% / 5$ for each member.

\$40,000 for the supply of raw manure and the percentage of own supply bought increases to 15%.

Table 3 : Calculation of Tax Payable for Scenario 2 (Mutual Income)

Sales	\$000 Scenario 2	Included in Taxable Income -Company	Company Structure	Co-op Structure
To external parties	850	Y		
To members	150	No Mutual		
Total	1000	850	850	1000
Expenditure				
Raw manure	200	85% yes 15% Mutual		(200)
Wages, materials and analysis	270	As for manure		(270)
Depreciation of Plant	50	As for manure		(50)
Selling costs	120	100% No mutual ¹⁷		(120)
Admin costs	60	As for wage		(60)
Total	700	613	(613)	(700)
Net Income	300	237	237	300
Tax paid by entity			71 ¹⁸	0 ¹⁹
Available for dist			229 ²⁰	300
Distribution to owners		No	229	300
Tax paid by each member @ 48.5% (assuming ff div)			12 ²¹	29 ²²
Total tax paid			131	145

Each of the producers would however be required to include the \$40,000 received for their supplies in their own assessable income but may have deductions to offset the claim. The extent of deductions available and the structure used for their own individual operations will determine the amount of tax paid, however it is expected it will increase the total tax paid by each member.

As you will note the total tax paid under Scenario 2 appears considerably less than in Scenario 1. This is due to the entity receiving a deduction for the cost of goods sold rather than making a non-deductible distribution to members (in the case of the company) if suppliers receive no consideration for their goods. The differences between the co-operative and company

¹⁷ Assume no selling expenses are incurred in selling to members.

¹⁸ Calc is 30% of taxable income - note new tax rates used

¹⁹ Distribution is deductible under S 120, therefore the entity has zero taxable income

²⁰ Calc as 300 less tax paid

²¹ Calc is $45.8 * 100 / 70 = 65.4$ (grossed up div). Tax @ .485 = 31.7 Imputation credit = 19.6 Net tax = 12.1 After tax return = 34

²² Calc is $300 * 48.5\% / 5$ for each member.

structures are a result of mutual income in the co-operative. Classification as a co-operative precludes the use of mutuality provisions as S 119 includes income from all sources in assessable income, thus the mutual income becomes taxed in the hands of the members upon receipt.

In Scenario 3 the co-operative both buys and sells produce from itself and the distribution takes the form of a rebate or bonus to members. The calculations shown do not take into consideration the proposed changes to co-operatives taxation referred to in Section 2 which allow for the co-operative to choose between claiming a deduction for the dividend or distribution and paying a franked dividend.

Table 4 : Calculation of Tax Payable for Scenario 3 (Method of Surplus Distribution)

Sales	\$000 Scenario 3	Included in Taxable Income	Distribution to owners as dividend	Distribution to owners as rebate or bonus
To external parties	50	Yes S 119		
To members	950	Yes S 119		
Total	1000	1000		
Expenditure				
Raw manure	200	Yes S 51		
Wages, materials and analysis	270	Yes S 51		
Depreciation of Plant	50	Yes S 51		
Selling costs	120	Yes S 51		
Admin costs	60	Yes S 51		
Total	700	700		
Net Income	300	300		
Tax paid by co-op			0 ²³	
Available for dist			300	300
			Yes S 120	No S 120, Tax is only payable if the cost of goods sold is adjusted for shareholder by the rebate or bonus. Tax paid could equal zero.
Tax paid by each member @ 48.5% (assuming div not franked)			29 ²⁴	
Total tax paid			145	

²³ As distributions are an allowable deduction the co-operative has a zero taxable income

²⁴ Assuming the co-operative has always had a zero taxable income, there will be no franking credits available to provide a franking rebate - see however changes expected to take effect 1 July 2002 discussed in Section 2

In comparing the three scenarios the most efficient taxation outcome occurs when the entity is classified as a co-operative company and distributions occur as a rebate or bonus. In situations where the distribution is in the nature of dividend or interest, the most efficient outcome depends on whether the co-operative has mutual income. In situations where there is mutual income, not receiving classification as a co-operative is preferred. Where income is not mutual the tax position of each entity and its members is the same. Note however common law suggests trading receipts of co-operatives are unlikely to be considered mutual income regardless of the member status of the buyer (see section 2 of this paper for discussion of common law) and thus this is unlikely to be a major consideration in practice.

The above discussion and calculations are based on the author's understanding of ITAA at the date of writing. The changes discussed in Section 2 which allow for a co-operative company to frank dividends as an alternative to claiming a deduction for the distribution may alter the outcome depending on the tax position of each of the members of the co-operative. In addition, the calculations assume each of the co-operative members is a taxpayer on the highest tax bracket for illustrative purposes. In practice, however the structures employed by individual members and their tax positions may vary considerably and this should also be taken into account when determining the most tax effective structure for individuals and their combined business activities.

CONCLUSION

As is the case with many business decisions, the choice of which business structure is most appropriate for a business activity is dependent on the circumstances of each individual business's activity. There do not appear to be any significant legal, taxation or other impediments to the use of the co-operative structure over any other structure, nor do there appear to be benefits in the co-operative structure that would render it preferable in all situations. The key difference between co-operatives and any other structure appears to be legislated commitment to a set of organisational principles. Organisations and activities which wish to commit to these values are likely to find the greatest advantage in the co-operative structure as the Co-operatives Act ensures that these values cannot be "hijacked" as a business moves through its lifecycle.

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