

**LAW OF COOPERATIVES**  
**—Renewable Energy:**  
**Trends in Finance and Business Structures—**

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This chapter provides an overview of alternative cooperative business models and trends in financing renewable energy projects. The three business models examined below and often used in renewable energy projects are (1) a cooperative with producer members qualified for certain preferred tax treatment pursuant to section 521 of the Internal Revenue Code (“section 521 cooperative”), (2) a cooperative with both producer and nonproducer members organized under Minnesota Statutes chapter 308B or equivalent state statute (“308B cooperative”), and (3) a joint venture or other combination of a section 521 cooperative and a limited liability company. Three key factors to consider in choosing a business structure for a renewable energy project are the desired relationship between the members and the entity, financing, and taxation.

## **I. Section 521 Cooperative**

### **A. Membership**

Cooperatives exempt under section 521 of the Internal Revenue Code (the “Code”) are formed by farmers, fruit growers, or similar producers organized and operated on a cooperative basis for the purpose of either (1) “marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them” or (2) “purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.” For renewable energy projects, the section 521 cooperative is composed of members that are producers of the feedstock to be converted to energy at the facility. Although nonproducers may invest in a section 521 cooperative, their investment must be through a separate, nonvoting class of stock with annual dividends limited to state-specific maximums usually ranging from 8 to 10 percent.

As a condition to a producer becoming a member of a section 521 cooperative, the producer must, in most instances, enter into a marketing agreement with the cooperative regarding the amount of the feedstock the producer is obligated to deliver to the cooperative on an annual basis. The return paid to each member is based on either the quantity or dollar value of the feedstock the member delivers to the cooperative each year, which is referred to as “patronage.” An advantage to the delivery requirement is that, for example, a cooperative organized to produce cellulosic ethanol may require members to deliver corn stover, guaranteeing the cooperative the feedstock needed to produce the ethanol at a predetermined price or under a predetermined pricing mechanism.

### **B. Tax Considerations**

All associations that operate on a cooperative basis can deduct earnings that are returned to members as dividends on the basis of business done by the cooperative with or for its member (“patronage dividends”). In addition, a section 521 cooperative is allowed to deduct a limited amount of the dividends it pays on capital stock and the earnings from nonpatronage sources that it distributes to its members on the basis of patronage (together, “nonpatronage dividends”). To qualify for a deduction of nonpatronage dividends, a cooperative must receive a favorable determination letter from the Internal Revenue Service that it is an exempt cooperative under section 521 of the Code. Whether a dividend is a patronage or nonpatronage dividend depends on “the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative.” Patronage and nonpatronage dividends are subject to state self-employment taxes, with limited exemptions for certain retired producers receiving nonpatronage dividends in certain states.

### **C. Financing**

Under section 3(a)(5) of the Securities Act of 1933, as amended (the “Securities Act”), securities issued by a section 521 cooperative are exempt from federal registration. Securities issued by a section 521 cooperative are considered federal covered securities, which means the states are preempted from regulating the registration of the securities. The benefits of this exemption include the ability to solicit a large number of prospective investors through public means, including radio and newspaper advertisements, which are not typically available to other entities issuing securities that are not registered with the Securities Exchange Commission (the “SEC”). However, to qualify as a section 521 cooperative, the securities can only be sold to producers who are able to and agree to enter into a patronage relationship for the delivery of commodities to the cooperative and nonproducers. Further, the states can regulate who can offer and sell the securities and under what circumstances.

## **II. 308B Cooperative**

### **A. Membership**

Iowa, Minnesota, Tennessee, and Wyoming have specific cooperative laws that apply to cooperatives with both producer and nonproducer members. For example, cooperatives organized under Minnesota Statutes chapter 308B permit producers and nonproducers to be members so long as certain protections are in place for the benefit of the producer members. The producer members must retain at least 50 percent of the voting power to elect members to the board of directors and at least 60 percent of the cooperative’s profit allocations and distributions unless the producer members vote to reduce their financial rights, but in no event can the financial rights of the producer members be reduced to lower than 15 percent, regardless of the ownership interest of the producer members.

The benefit of a 308B cooperative is that there can be nonproducer members and those nonproducer members can provide needed capital for the entity and enjoy voting rights and allocations and distributions based on ownership. Further, the combination of the equity from the nonproducer members and the feedstock from the producer members allows a renewable energy cooperative to obtain outside capital for the construction and operation of the renewable energy production facility while still having a guaranteed source of inputs needed to produce the renewable energy. For example, a 308B cooperative could require its producer members to deliver corn stover for a cellulosic ethanol facility, as a condition of investment, while the nonproducer members would provide additional capital necessary to purchase the land, equipment, and construction services for the facility.

Cooperatives in states other than Iowa, Minnesota, Tennessee, and Wyoming can take advantage of being a 308B cooperative by organizing in any of these states pursuant to the applicable statutes and qualifying to do business in the appropriate local jurisdiction. However, some states do not recognize 308B cooperatives as cooperatives for purposes of state law. In those states, the entity must qualify as a foreign corporation instead of a foreign cooperative. This can have adverse state tax and state securities law implications, which are discussed below. Because of the varying degrees of recognition of 308B cooperatives in states other than Iowa, Minnesota, Tennessee, and Wyoming, the applicable state laws must be considered before organizing as a 308B cooperative.

### **B. Tax Considerations**

308B cooperatives can be taxed as either a cooperative under Subchapter T or a partnership under Subchapter K. Under Subchapter T, the 308B cooperative is treated as a cooperative and all taxation occurs at the entity level, with the cooperative receiving a deduction from taxable income for any patronage dividends it pays to its

producer members. However, a 308B cooperative taxed under Subchapter T does not receive a deduction for nonpatronage dividends.

Under Subchapter K, the 308B cooperative is treated as a pass-through entity and all taxation occurs at the member level. Allocation of income, gain, deduction, loss, or credit as set forth in the cooperative's bylaws are subject to partnership tax accounting rules, and deductions of loss are limited to the extent of a member's investment and share of the cooperative's debt. One important item to note is that generally for all producer members and for any nonproducer members that are involved in the management or otherwise employed by the cooperative, all of the pass-through income is subject to self-employment tax, regardless of the amount of distributions received by the members from the 308B cooperative. The benefit of being taxed under Subchapter K for a 308B cooperative is that any income from nonpatronage business is passed through to the members instead of being subject to double taxation at both the entity and member levels.

### **C. Financing**

To raise equity, a 308B cooperative must offer and sell securities either after registering under the Securities Act or pursuant to an exemption from such registration. Registration requires the cooperative to prepare and file a detailed registration statement with the SEC for its review and approval. Once the registration statement is effective, the cooperative can offer its securities without any limitations on general advertising or the number or type of investors that can invest in the cooperative. Unless the securities are going to be traded on a national securities exchange, such as Nasdaq®, the securities must also be registered under the applicable state securities laws. However, some states have exemptions for cooperatives, regardless as to whether they are 308B cooperatives. Whether such an exemption is available to a 308B cooperative depends on if the 308B cooperative qualifies as a foreign cooperative or corporation and the text and interpretation of the applicable states' securities laws.

To avoid the time and expense of registration, securities can be sold pursuant to various exemptions from federal and state securities laws. One of the most common exemptions is pursuant to the federal safe harbor provided by Rule 506 of Regulation D of the Securities Act for transactions not involving a public offering. Similar to securities of a section 521 cooperative, securities sold in accordance with Rule 506 are considered federal covered securities and are exempt from state registration requirements. In general, sales can be made to an unlimited number of accredited investors (as defined in Regulation D) and up to 35 nonaccredited investors, there can be no general solicitation or general advertising, the securities cannot be resold unless registered or otherwise exempt, and the cooperative must satisfy certain disclosures requirements. The states can require notice filings be made for any offers or sales made in accordance with Rule 506.

Another potential exemption for transactions in securities is in compliance with section 3(a)(11) of the Securities Act and the Rule 147 safe harbor (the "intrastate exemption"). The intrastate exemption exempts from federal securities regulation offers and sales of securities that are offered and sold only to persons in one state. In general, to qualify for the Rule 147 safe harbor, the cooperative must be organized, doing business, and making offers and sales of its securities in the same state; the offers and sales can only be made in that state and cannot be made to any resident of another state within six months of the offering; and any transfers of the securities within nine months of the offering must be made only to residents of that state. The securities must be registered or exempt under the applicable state securities laws. As discussed above, some states have cooperative exemptions that apply to 308B cooperatives whereas other states require full registration.

### **III. Joint Venture Between Section 521 Cooperative and Limited Liability Company**

#### **A. Membership**

Another common model is a joint venture between a cooperative and a limited liability company to take advantage of the benefits of both types of entities in renewable energy projects. One particularly successful type of joint venture is when a cooperative is formed, obtains a favorable determination letter from the Internal Revenue Service for section 521 status, and enters into marketing agreements with its members for delivery obligations of feedstock for the renewable energy production facility (*i.e.*, corn stover for a cellulosic ethanol plant). Next, a separate limited liability company is formed to own and operate the renewable energy production facility (the “LLC”). The LLC is composed of investors that contribute the necessary capital to construct the facility. One of the members of the LLC is the section 521 cooperative. As part of its membership in the LLC, the cooperative agrees to deliver the feedstock it receives from its members in exchange for membership interests in the LLC and/or cash. Although it is unclear whether a favorable section 521 determination letter could be obtained for such a project, it is possible that members of the cooperative could provide some minimal level of equity investment and land rights, wind rights, development rights or other non-traditional cooperative rights and the other members of the LLC that are able to take advantage of the production tax credit (the “PTC”) could provide the significant additional equity capital needed for the project.

#### **B. Tax Considerations**

The section 521 cooperative can deduct patronage and nonpatronage dividends as described above in Section I.B. The LLC is a pass-through entity taxed pursuant to Subchapter K. The LLC can enter into an operating agreement with its members for the allocation of profits and losses. The members of the LLC, including the section 521 cooperative, would be required to pay taxes on the net income allocated to the members by the LLC. However, to the extent the LLC’s income is distributed to the members of the section 521 cooperative as exempt patronage or nonpatronage dividends, the section 521 cooperative receives a deduction from its income of such dividends and effectively does not have to pay any tax on that income. The other members of the LLC pay taxes on their income similar to all nonproducer members of a 308B cooperative that elects to be taxed as a pass-through entity pursuant to Subchapter K as described above in Section II.B.

#### **C. Financing**

Any sales of securities by the section 521 cooperative are exempt from registration at both the federal and state levels as described above in Section I.C. Any sales of securities by the LLC must either be registered or made pursuant to an applicable exemption, similar to the exemptions described above in Section II.C. However, the offers and sales of securities by the cooperative and the LLC must be two distinct offerings so they are not integrated into one offering for securities law purposes. A safe harbor exists if the LLC offers and sells its securities in reliance on Rule 506 and the offerings are more than six months apart. If the LLC and section 521 cooperative offerings occur within six months of each other, whether the LLC and section 521 cooperative are first integrated into a single offeree and then whether the two offerings are integrated into a single offering is determined based on the facts and circumstances. In general, two issuers are integrated if an investor able to invest in both companies would deem an investment in one enterprise as not being materially different from an investment in the other enterprise and/or the people in control of the entities are the same.

#### **IV. Conclusion**

There are distinct advantages and disadvantages to organizing a renewable energy production entity as a section 521 cooperative, a 308B cooperative, or some type of joint venture model between a cooperative and an LLC. One of the main benefits of forming any type of cooperative as part of a renewable energy project is the guaranteed delivery obligations of the members providing the feedstock for the facility.

Some of the benefits of forming a section 521 cooperative are that both patronage and nonpatronage dividends paid to members can be deducted from the section 521 cooperative's taxable income, thus preventing the section 521 cooperative and its members from double taxation at the entity and member levels, and sales of securities of a section 521 cooperative are exempt from federal and state securities laws. The main disadvantage to section 521 cooperatives is the limitation on raising capital because of producer membership requirements.

The benefits of a 308B cooperative are the pass-through treatment of all income, regardless of whether it is patronage or nonpatronage, and nonproducers can be members. The disadvantages of 308B cooperatives are that the securities are not exempt from registration under federal and some state securities laws just by virtue of the securities being issued by the 308B cooperative, and that some state regulators are unfamiliar with and dislike 308B cooperatives, which can make foreign qualification, state taxation, and compliance with state securities laws cumbersome.

Some of the benefits of a joint venture between a section 521 cooperative and an LLC are the section 521 cooperative can deduct the patronage and nonpatronage dividends it distributes to its members, including any of the income distributed to the section 521 cooperative by the LLC that is distributed to the section 521 cooperative members; pass-through treatment of all income to the members of the LLC; local landowners as well as large institutional investors may be able to benefit from the PTC and could develop a renewable energy production facility together; and sales of securities by the section 521 cooperative are exempt from federal and state registration so long as there is no integration between the offering of securities by the section 521 cooperative and the LLC. Disadvantages of the joint venture structure are that the section 521 cooperative members potentially have less control of the renewable energy production facility depending on the structure of the LLC and its operating agreement and that the complicated structure may not be as easily understood or trusted by producers.

Regardless of the type of cooperative or joint venture between a cooperative and another type of business entity, it is likely the advantages to having a consistent and reliable source of feedstock will make the cooperative structure important in the future of successful renewable energy projects.