

Exploring Non-Qualified and Unallocated Equity



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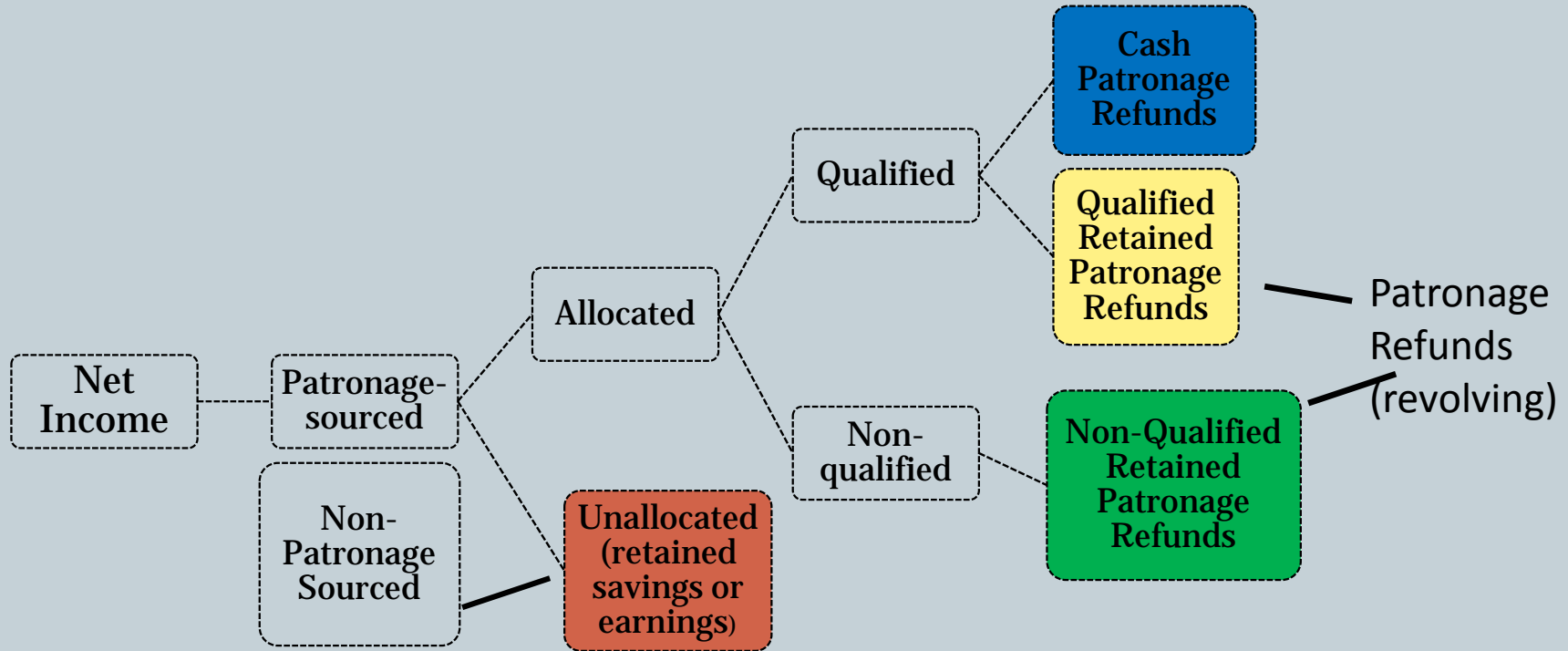
Distribution of Profits in a Cooperative

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- Board of directors decides on allocation to cash patronage, allocated retained patronage and retained earnings (unallocated reserves)
- Allocated retained patronage can be distributed in the form of a qualified or non-qualified distribution
- The board is responsible for decision of how much to allocate and the tax decision on the allocated retained equity

Simplified Representation of Income Distribution Choices in a Cooperative

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Qualified Distribution

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- Member receives equity which is taxable in the current year
- Cooperative is able to exclude the distribution from taxable income in the current year
- There is no tax effect at redemption since the tax has already been paid
- Cooperative must pay a minimum of 20% cash patronage

Non-qualified Distribution

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- Member receives equity which is not taxable in the current year
- Cooperative cannot deduct the distribution and thus pays corporate tax on the earnings
- At the time of redemption the payment is taxable to the member and creates a deduction for the cooperative
- No requirement for a minimum percentage of cash patronage

The Choice

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- The member ultimately pays the tax but the timing of the tax is impacted by the choice of distribution
- The choice of distribution impacts the timing of cash flows to the cooperative and to the member
- The cooperative can adjust the cash patronage rate to be cash neutral assuming the current cash patronage is equal to or higher than the cooperatives tax rate
- One criteria is which method maximizes the member's financial return

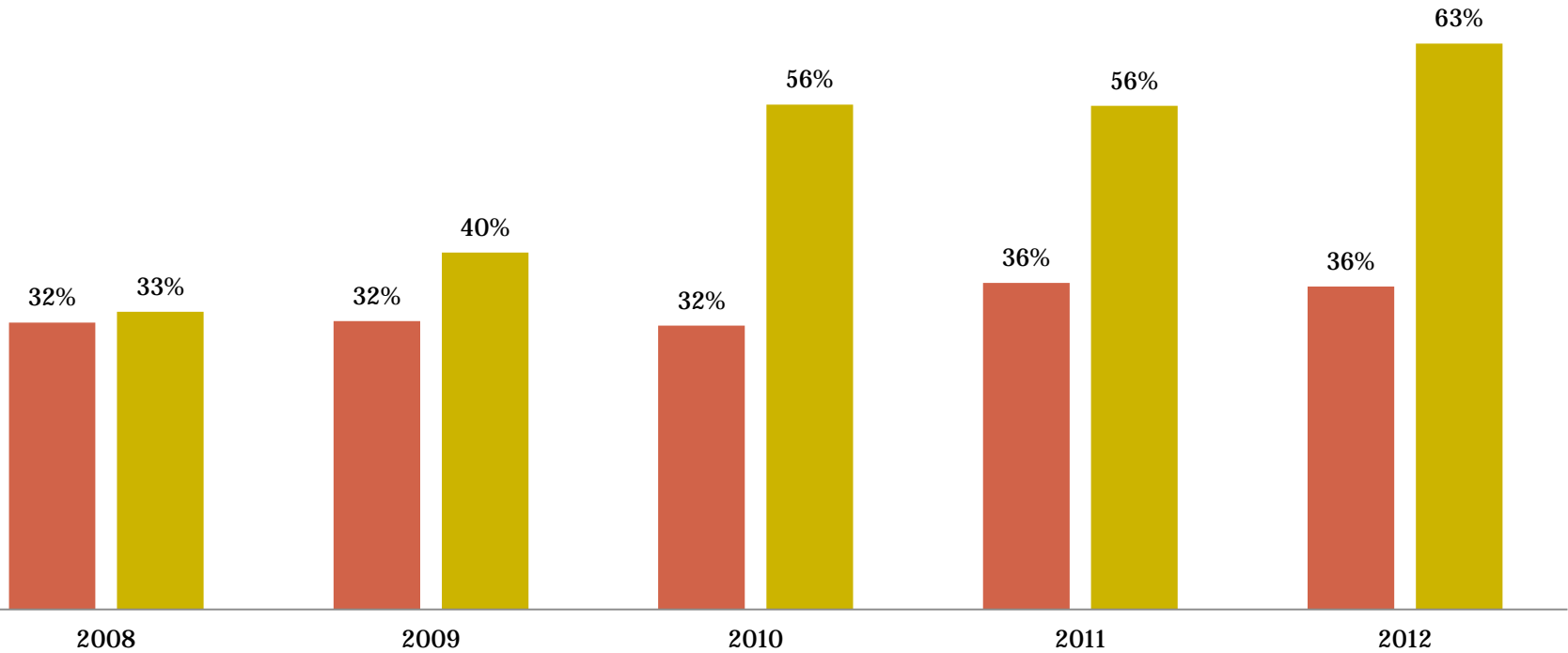
Unallocated Equity (Retained Earnings)

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- Cooperative retains the after tax portion of member and/or non-member profits
- Members have a “common and collective” claim on the unallocated equity
- Member has no individual claim on the unallocated equity and will never receive the profits retained as unallocated equity

Unallocated Equity as a Percent of Total Equity 2008-2012

■ All Cooperatives ■ Grain and Farm Supply



Qualified Distributions are the Historical Choice

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- Assumed producer had a lower marginal tax rate relative to the cooperative.
- Cash patronage barely covered the patron's tax obligation created
- Contributed to the perception that the patron had a right to see equity redeemed on a fixed schedule since the co-op forced the patrons to pay the taxes on the non-cash equity in the cooperative.

Why Are Some Cooperatives Transitioning to Non-Qualified

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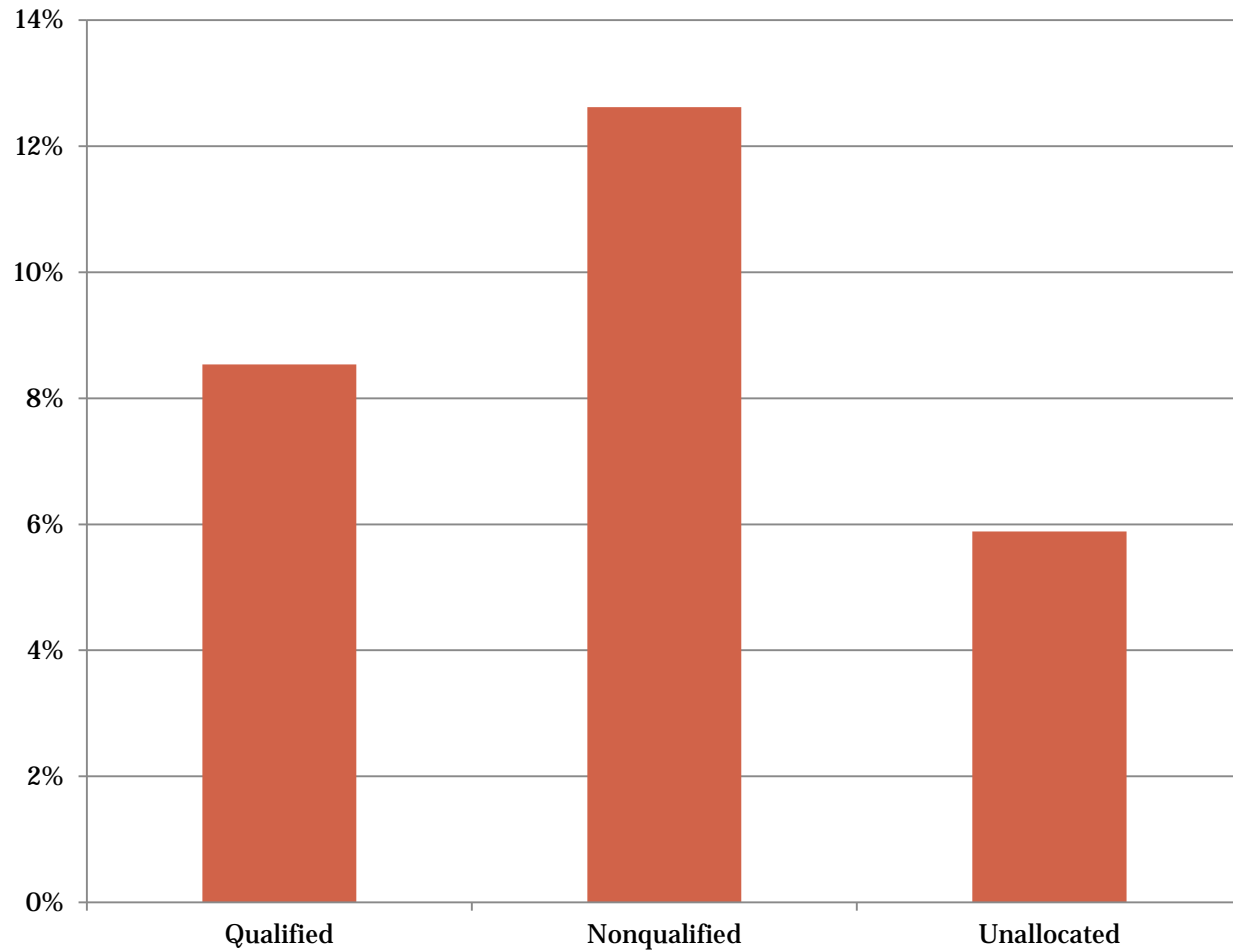
- Recognize that it is in the patron's interest
- More popular with patrons and easier to explain
- Tax matched with the cash distribution
- Tax deduction softens the cash flow impact at redemption
- Patron should be more receptive to the cooperative managing the redemption timing
- Eliminates the minimum cash percentage

Which Allocation is in the Best Interest of the Member?

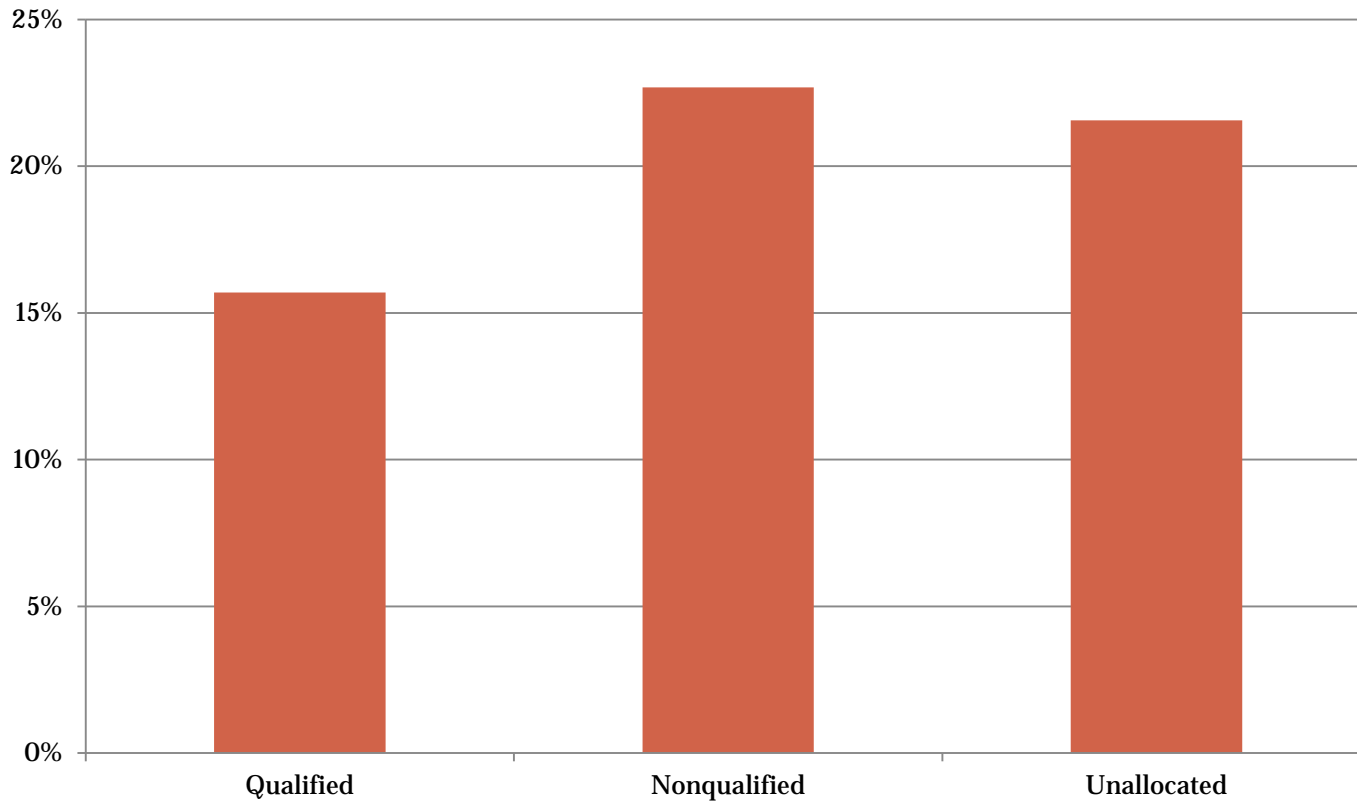
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- Data from 10 case study grain and farm supply cooperatives in Oklahoma
- Used historical financial and operations data in simulation program-simulated 30 years
- Projected the member's Internal Rate of Return (IRR) with and without use of the Section 199 deduction
- All patronage distributions adjusted to be cash neutral to the cooperative

Member's IRR without Section 199



Member's IRR Cooperative Retaining 199



Calculator for Determining Cash Neutral Non-qualified

Distribution

Developed by Phil Kenkel, Bill Fitzwater Cooperative Chair, O

	Qualified		
Net income before taxes and	100		
patronage	Cooperative	Patron	
Cash	\$45.00	\$45.00	
Stock	\$55.00	\$55.00	
Taxable Income	\$0.00	\$100.00	
Tax	\$0.00	\$45.00	
After Tax Income	\$0.00	\$55.00	
Cashflow	\$55.00	\$0.00	
Stock patronage rate	55.00%		
Cash patronage rate	45.00%		
Tax rate	40.00%	45.00%	
Cash patronage rate to keep coop's cash flow equivalent with non-qual			8.33%

Short Answers to Frequently Asked Questions

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- Is nonqualified equity redeemed: yes
- Does nonqualified equity reduce cash flow: no
- Does nonqualified equity complicate equity retirement: doesn't have to
- Does higher ratios of unallocated increase incentive to demutualize the cooperative: yes
- Is that a realistic threat: you tell me