2011Farmers Cooperative Conference

Meeting Competitive Challenges: Cooperative Structure and Finance for the Future

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Finance, Tax and Accounting Issues and Choices

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Agenda

- Recap of Section 199 rules and issues
- Discuss "Book" v. "Tax" v. "Modified Book or Tax" methods of allocating patronage
- Strategies for use of Section 199 deduction for coop and members
- Strategies for use of different equity allocation and redemption plans

Section 199 Recap

- Became law in 2005 as a result of repeal of "Foreign Sales Corporation" and "Extraterritorial Income Exclusion" rules
  - Ag Coops got special rules BECAUSE they were part of FSC and ETI rules!
- Issues for ag coops and their members
  - Farmers typically have low W-2 wages AND
  - Farmers typically are cash basis and have many tools to lower their taxable income
    - Deferral of income
    - Pre-paying expenses

Section 199 Recap – Coop Rules

- Issues for Ag Coops
  - May not be "manufacturing"
  - May not need the deduction because patronage income is distributed to members
- SO – since generally better to have a coop level due to wage limitation, you must have special rules for computing coop's deduction
  - Ag Marketing Coop – "Attribution Rule"
    - Coop is deemed to be "manufacturing" because its members are producers
  - Coops have option to pass-through the Sec 199 deduction to members or keep at coop level

Section 199 Recap – Coop Rules

- § 199(d)(3)(C) says that for purposes of this section, the taxable income of the coop is computed without regard to any deduction allowable under § § 1382(b) and (c).
  - All cash and qualified written notices of allocation – **per-unit retains** and patronage dividends
  - All nonpatronage distributions from § 521 coops
  - Regulations and recent private letter rulings make it very clear that any advances paid during the year are taken into account as amounts allowable under § § 1382(b) and (c) – **21 rulings issued to date holding that "grain check" is "per-unit retain paid in money" (PURPIM) – i.e. cash payment!!**

All payments to patrons meet this definition

Example Income Statements

Ag Marketing Pooling Coop

Gross Receipts Product	7,500
Royalty Income	500
Rental Income	100
Interest Income	50
Gross Income	8,150
Payments to Members	--
Payments to Non-Members	(600)
Processing Costs	(800)
Production Salary	(500)
Admin Salary Expense	(200)
Interest Expense	(300)
Other Cost	(300)
Net Proceeds & Non-Pat Inc	5,450
Per-Unit Retain Paid In Money	(3,000)
Patronage Dividend	(1,000)
Qualified Certificate	(780)
Net Income	670

Ag Marketing Non-Pooling Coop

Gross Receipts Product	7,500
Royalty Income	500
Rental Income	100
Interest Income	50
Gross Income	8,150
Payments to Members	(3,000)
Payments to Non-Members	(600)
Processing Costs	(800)
Production Salary	(500)
Admin Salary Expense	(200)
Interest Expense	(300)
Other Cost	(300)
Patronage Dividend	(1,000)
Qualified Certificate	(780)
Net Income	670

Section 199 Recap – Coop Rules

- Ag Marketing Coops
  - Same rules apply to pooling and non-pooling coops
  - Same rules apply to book and tax basis coops but impact will differ dramatically
  - The add-back for PURPIMs only applies to member (i.e. patronage) business
  - The add-back for the "grain check" does not apply to deliveries of grain to LLC that is owned by one or more coops
    - Grain needs to be "delivered" to the coop and title transferred immediately to LLC for "grain check" to be considered a PURPIM
  - NO DOUBLE COUNTING by lower-tier coop or farmer/member

Example Sec 199 Computation

Very simple example		Patronage	Non-Patronage	Total
Net Income		$0	$670	$670
Add Back:				
Payments to Members (PURPIM)	$3,000	$0		$3,000
Patronage Dividend		$1,000	$0	$1,000
Qualified Certificate		$ 780	$0	$ 780
Total		$4,780	$670	$5,450
Section 199 at 9%		$ 430	$ 60	$ 490
50% of W-2 Wages:				
Allocated based on pat/non-pat %	$ 280	$ 70		$ 350
LIMITATION		$ 280	$ 60	$ 340

Or is it not limited and you use the full $350?

These allocation issues and many others have not been fully explored with the IRS yet.

Board and management need to understand the filing positions being taken, and should NOT allocate Sec 199 amounts that are in the risky category

Section 199 Recap – Coop Rules

- Ag Supply Coops
  - No add-back for PURPIMs because members are buying FROM the coop, not selling TO the coop
  - The "manufacturing" requirement: farm supplies
    - In order for the sale of property to qualify for Section 199, the property must be "manufactured, produced, grown or extracted (MPGE) by the taxpayer in whole or in significant part within the United States." Section 199(c)(4)(i)(I).
    - This is referred to as the "MPGE requirement."
    - Generally, retailers and wholesalers <u>do not</u> meet the MPGE requirement if all they are doing is selling a product.
    - Is there a special rule for coops and the sale of farm supplies?

Supply Coops

- Is there a special rule for coops?
  - Some coops take the view that the coop attribution rule applies
  - Others rely on the "farm products" exception – ("for this purpose, agricultural … products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production")
  - Others take the position that they do enough to the products that they are selling to qualify as MPGE.

Supply Coops

- Analysis
  - How strong are the first two positions?
  - How much must be done to products to satisfy the MPGE requirement without the cooperative attribution rule or the farm products rule?
    - Safe-harbor if the direct labor and overhead of a taxpayer account for at least 20% of the taxpayer's cost of goods sold for a product. Treas. Reg. Section 1.199-3(g)(3).
  - What does the IRS think?
  - What should the supply coop's management and board do about this issue?

Paying Patronage Income

- How many know that coops use different methods for computing what the patronage dividend will be?
- How many understand why it can make a <u>huge</u> difference to the coop and the members which method the coop is on?
- The coop's Bylaws set the method for how the coop computes the patronage dividend
    - It is also the way the coop gets the tax deduction BECAUSE it sets the "pre-existing legal obligation"

Book, Tax or Modified Methods

- Historically there was not much difference between book income and tax income
  - Bylaws specified tax basis or were silent
- Over the years, more and more coops have migrated to paying on a book basis
  - Consider more fair and equitable to members
  - Easier to explain and quicker to finalize at year end
- Now more and more coops are looking at a "modified book" or "modified tax" basis
  - More equitable BUT not easier to explain

Book, Tax or Modified Methods

- Why should you care?
  - Timing of recognition of major items
    - Depreciation – new 100% expensing rules!!
    - Bad debts
    - Non-qualified deferred compensation
  - Arguably the wrong members bear the cost of certain items
  - Is that fair and equitable?
- What about other areas that you have not considered?

Book, Tax or Modified Methods

- New Business Combination Accounting Rules (Mergers)
  - Under "pooling method", income and asset adjustment issues did not come up
  - Now "acquiring coop" faces material write-up/ down of "acquired" assets, goodwill adjustments, etc. that generate current year and on-going effects on patronage income
  - This is a much more significant issue for coops computing patronage on a <u>book</u> basis

Book, Tax or Modified Methods

- Other considerations
  - How does the Section 199 deduction impact your current patronage calculation?
    - Tax basis – if <u>no modification in bylaws for it</u>, taxable income is reduced by Sec 199 deduction <u>before</u> patronage dividend is computed
  - Do hedging transactions cause unusual swings in income on either book or tax basis?
    - Perhaps a modification is prudent here too

"Unusual Income" and Bylaws

- Do your bylaws differentiate between how regular operating income v. unusual (e.g. gain on sale of a facility) income will be handled?
  - IRS requires special handling of "gains on sale" so your bylaws should mirror those requirements
  - It also gives the board better guidance in trying to determine who is entitled to these proceeds
  - Can you exclude former members in the "look-back" allocation of these gains?

Coop Payments and Bylaws

- Do your bylaws allow for the use of all types of coop payments and written notices?
  - Cash, property and written notices
  - Patronage Dividends
    - Cash and Qualified OR Non-Qualified Certificates
  - Per-Unit Retains
    - Cash (PURPIM) and Qualified OR Non-Qualified Certificates
- These are tools for management and the board to enhance coop's equity and balance it with member needs
  - CoBank example

Planning with Section 199

- Considerations
  - Are you using "book" or "tax" or "modified book" or "modified tax"basis for computing your patronage?
  - What are member expectations on distributions of patronage earnings?
  - Can you use non-qualified certificates in your planning?
  - Are you using the "ag products" rule to claim additional Sec 199 deductions? How risky is your position?

Planning with Section 199

- With "Tax" Basis Patronage Dividend
  - Section 199 deduction reduces the amount of the taxable income
  - Thus reducing the amount available for the patronage dividend
- Is this the result you want?
  - If PURPIMs were not added back in your Section 199 computation, this adjustment probably didn't matter much to you
  - But now, you may want to reconsider your patronage dividend computation

Planning with Section 199

- Changes to patronage dividend computation may require bylaw change
  - Still use tax basis but exclude Section 199 deduction
    - Coop may need to keep some/all of the Section 199 deduction to zero out patronage income
    - Example – in handouts
  - Change to book basis
    - Coop may need to keep some/all of the Section 199 deduction to zero out patronage income

Planning with Section 199

- With “Book” Basis Patronage Dividend
  - More options available here
    - Pass-through most or all of the Section 199 deduction and pay normal book basis patronage dividend
      - If book income is less than taxable income, coop may need to keep some of the Section 199 deduction to zero out patronage income
    - Issue non-qualified certificates for non-cash portion of patronage dividend or per-unit retain certificates and use some or all of the Section 199 deduction to zero out patronage income at the coop level

Planning with Section 199

- Retaining patronage income for reasonable reserves
  - If it is necessary for the coop to do this, the Section 199 deduction can reduce the amount needed
    - Coop will use it and also saves the tax it would have otherwise paid
    - Can be a win-win for the coop and the members

Planning with Section 199

- Netting Patronage Section 199 Deduction with Non-patronage Income
  - *Farm Services* decision – coop may not net patronage loss with non-patronage income
  - Can the coop retain the Section 199 deduction and use it against non-patronage income?
    - Clearly a risky proposition
    - Update on the IRS audits underway now where this issue is being raised

Planning with Section 199

- Supply Cooperatives Use of Ag Products Rule (Treas. Reg. 1.199-3)
  - If you have been using this rule to enhance your Section 199 deduction, consider carefully how much you pass through to members as this area is not fully developed yet
  - If you use this rule, disclose it on the tax return for tax penalty protection

Equity Plans and Redemption Strategies

- Sec 199 provides a great new tool for coops to enhance equity, BUT coop must still have good profits, balance sheet management, fixed asset investments and working capital too
- Members are Owners and Users
  - As Owners, must invest in the business
  - As Users, want the best deal possible
- Coop must balance these competing forces to meet their working capital needs
  - Allocated patronage income
    - Periodic redemption puts continuing pressure on coop's capital needs BUT satisfies owner's return on investment
  - Non-patronage income
  - Unallocated patronage income

Equity Planning and Redemption Strategies

- Why is it important to retain equity from members?
  - Differentiates coop from for-profit entity
  - Owner/user should have some "skin in the game" to feel a connection to the business
- Why is it important to redeem equity from members?
  - Keeps the financing of the coop's business in the hands of those using the coop currently

Equity Plans – Revolving Fund Plan

- Simple to do but works best where co-op is able to make annual redemptions of equity
  - Generally done with a retain from members' advances of set amount each year so that new year's retention repay prior year's retain
  - Term of revolving fund varies – 5 to 25 years – depending on coop's situation

Equity Plans – Base Capital Plan

- Much more complex but works best where patronage income fluctuates widely from year to year
  - Base capital is established by board each year and each member must fund his patronage share of the base capital
  - Money is withheld from the patronage dividend (or per-unit retain) to make required base capital contributions but 20% cash requirement is met
  - When base capital requirement is met, member receives 100% cash patronage dividend

Equity Plans – Base Capital Plan

- Issues to consider with these plans
  - If co-op wants to issue non-qualifieds, the base capital plan may restrict the coop's ability to time the payment of the non-qualifieds to its advantage.
  - What happens if the coop has an exceptionally good year and has not set the base capital requirement high enough, and therefore has to pay out a large amount of cash to members who have met their base capital requirement
  - Very difficult to anticipate all the possible issues when setting up plan
  - Hard for members to understand

Equity Plans

- Both plans tend to keep the burden of financing the coop on those currently using its services
  - Where a coop has fluctuating profitability, the use of per-unit retain certificates (e.g. $1/cwt) may be a better method of retaining equity from members on a consistent basis under either of these plans
  - Also gets money in hands of coop sooner AND co-op can issue the certificate without any cash up to 8 ½ months after the coop's year end (<u>great deferral for member</u>)

Redemption Strategies

- Revolving Fund
  - Generally based on set number of years or formula
  - Some use member age as basis for redemption
- Base Capital Plan
  - Member gets full or more significant cash payment of current patronage once he has met his "Base Capital"
  - When he leaves, Base Capital is revolved out as base capital reduces or as coop can pay
- Age based redemption policy can be problematic for coop and member
  - Most West Coast coops stay away from it
- All redemption programs must remain flexible to fit the working capital needs of the coop
  - Board has final say

Unallocated Patronage Equity Approach

- A method advocated by some coop advisors
  - Pay largest possible patronage refund in cash and small or no patronage certificate
    - Tax deduction for coop
    - Taxable income to members
  - All remaining patronage income is retained in the coop without any allocation to members
    - Tax paid at coop level
    - No ability to ever claim a tax deduction for payment to members of unallocated retained patronage income

Unallocated Patronage Equity Approach

- Justification
  - Many coops don’t redeem old equity on a timely basis, and some that do, shouldn’t.
    - This approach strengthens the balance sheet
  - Reduces member relations issues related to timing of redemption
    - This approach creates the impression that the member is not entitled to this income
  - Lenders prefer to see permanent equity on balance sheet
    - Many of them don’t understand coops

Unallocated Patronage Equity Approach

- BUT
  - Coop's relationship with members is weakened because the members don't have much, if any, equity interest in the coop
  - Single tax treatment is forfeited
  - Same result can be achieved by allocating non-qualified certificates for the portion the coop wants to retain "permanently"
    - Much better answer for coop and member
    - Risk of challenge to coop status is eliminated
    - "Cost" to educate board, members, lenders is not that great

Summary of Key Points

- Sec 199 rules have caused coops of all types to revisit fundamental coop principles and how their coop uses those principles
- Optimal use of Sec 199 and many other tax benefits for a coop requires a close look at methods of paying patronage and bylaws
  - The devil is in the details!
- Revisiting your equity planning periodically and considering all options available is beneficial to the coop, board and members

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