**Distributing Returns**

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**Introduction**

Chapter 12 laid the foundation of understanding and measuring cooperative returns. It acknowledged the fact that a cooperative can provide returns at both the farm level and cooperative level and even generate a value simply through existence. It also discussed the challenges in measuring the return on investment in a cooperative due to the multiple categories of returns and the fact that patrons can acquire equity without out-of-pocket investment. This chapter takes a closer look at cooperative level returns and how those returns flow to the member. Just as a cooperatives performance cannot be measuring entirely by profit, a member’s return from a cooperative cannot be entirely measured by the funds distributed. While non-monetary value is acknowledged, most members will judge their return from a cooperative on the basis of the amount and timing of the profits distributed. That makes it important to understand a cooperative’s alternatives in distributing profits and how those decisions affect the member and the firm.

Cooperatives invest in long-term assets such as buildings and equipment as well as short term assets such as inventory and accounts receivable. They then use those assets to provide goods and services to their customer members that involves both fixed and variable costs. If the cooperative is successful in all of those processes and operates efficiently it generates a profit. Generating a profit is not automatic and in fact it can be very difficult. While not minimizing the challenges in creating a profit, we are now going to assume that the cooperative has a profit, also termed “net income” and discuss the alternatives for using those funds.

After generating a profit, the next set of critical financial decisions becomes how to distribute that profit back to the patrons. The cooperative also needs to retain a portion of the profit to fund re-investment in plant and equipment and to fund equity retirement. The process of profit distribution is therefore intertwined with profit retention. The cooperative board of directors has the authority and responsibility to decide how to distribute profits. The board often receives advice from the manager and chief financial officer, but the final decision rests with the board. The board would also need to consider any loan covenants, priorities specified in the bylaws or any restrictions specific by state or federal tax law.

**Key Terms**

Patronage Refund

In order to avoid confusion it is useful to define a few terms. The term “patronage refund” refers to a distribution of cooperative profits made on the basis of business volume. That volume can be measured in either dollar amounts or physical units and the patronage calculation can be separated by department or product (separate patronage pools) or combined across the cooperative. The IRS uses the term “patronage dividends” but most cooperative scholars prefer the term “patronage refund” to avoid confusion with dividends based on stock ownership. Patronage refunds can be paid in cash or in two forms of stock: qualified stock and nonqualified stock. Stock patronage is also called retained patronage refund.

Dividend Paid on Stock

The term “dividend” refers to a payment based on the amount of stock owned. If a cooperative paid dividends on membership stock or revolving equity those dividends would go to members, but would be based on the amount of stock owned and not the business volume. Cooperatives can also issue preferred stock which can be held by both members and non-members. In that case a portion of the profits distributed as dividends do not go to members. In some cases, dividends in a cooperative are limited to 8% by law. Most cooperatives do not pay dividends on membership stock or revolving equity. In recent years, a few cooperatives have experimented with paying dividends on revolving stock after it has been held for a set number of years (example 10 years). In most cases, those cooperatives had very long equity revolving periods which were unpopular with younger members. The possibility of earning dividends after a given number of years reduces the negative reaction to the long revolving period. A few cooperative issue preferred stock (which can also be held by non-members) which does pay dividends, usually subject to an 8% maximum. In most cases, that preferred stock is used as a vehicle to generate additional investment from non-members. Dividend payments reduce the potential amount that can be distributed as patronage and therefore create an obvious tradeoff.

Net Income

The term “net income” and “net profit” are typically used synonymously and refer to the residual income after all expenses have been paid (net of all expenses). A cooperative’s decisions on distributing net income also impacts taxation at both the cooperative level and patron level. So, in discussing the distribution of net income we are typically discussing the net income before patronage distribution and taxes. A cooperative’s taxable income reflects the income before patronage and taxes less any tax deduction. Some forms of patronage are tax deductible to the cooperative so a cooperative with a positive net income before patronage and taxes could have zero taxable income.

Cash Flow

A cooperative’s “cash flow” reflects the amount of cash available to the cooperative. The annual cash flow comes from the current year’s operation while the cumulative cash flow includes the cash balance coming into the year. Cash flow differs from after tax net income for several reasons. Depreciation is a non-cash expense. It reflects the reduction in value of a long-term asset so as to give an accurate picture of the income for the current year. However, the cooperative does not make any payment for depreciation so depreciation is essentially added back to net income in calculating cash flow. Loan principal payments are just the opposite. They are a cash outlay but not considered an expense under accounting standards. Loan principal payments function to make cash flow lower than after tax net income.

Some of the cooperative’s options for profit distribution involve distributing profits in the form of equity. Since the cooperative is distributing stock and not cash, equity patronage improves the cooperative’s cash flow. We usually discuss cash flow in relation to after tax net income where taxes are already accounted for. In practice, the cooperative’s decisions on profit distribution impact taxes so the cash flow is impacted by the distribution decision. For example, if a cooperative distributes equity patronage in a form that is tax deductible it pays no taxes on the distributed amount and retains the full amount. If it distributes equity patronage in a form that is not deductible it must pay taxes on that portion of income and actually ends up retaining the after tax portion.

**The Decisions in Distributing Returns**

A number of intertwined decisions are involved in distributing net income and they be approached in different order. For the sake of simplicity we will order the choices and work through the decision process.

Separating Member and Non-Member Profits

Member profits in a cooperative are taxed under Sub Chapter T which is the cooperative specific section of the IRS tax code. Non-member profits are typically taxed differently and are basically taxed at the standard corporate tax rate. We will see in a later chapter that there is one special form of cooperative (Section 521 cooperatives) that can basically treat member and non-member profits in a similar fashion. The first step in distributing returns would really be to separate member and non-member profits. Because we are discussing the board of director’s decisions in distributing returns, and those decisions only relate to member-based profits, we typically skip the initial step of separating member-based profits and just discuss the decisions related to distributing those profits.

**Decision 1: Patronage refunds, dividends on equity or retain funds as unallocated retained earnings**

The first step is to decide what portion of (member-based) profits to distribute as patronage refunds, what portion to distribute as dividends on stock. Any portion not distributed in those channels will end up being retained as unallocated reserves, also called unallocated retained earnings.

Patronage Refund

Patronage refunds are the distribution of profits in proportion to use or business volume. Most cooperatives distribute the majority of their member-based profits in form of patronage refunds. Many cooperatives also do a portion of business with non-members. Some cooperatives pay patronage refunds to non-members. However, the tax treatment of non-member profits is different for most cooperatives. Most categories of cooperatives are taxed on non-member profits at the standard corporate tax rate. For that reason, the most common treatment of non-member profits is to pay taxes at the corporate rate and retain the after tax portion of the profits as unallocated retained earnings.

In determining patronage refunds the board must determine the unit (physical or monetary) and number of categories. The best guideline is to use the unit and number of categories that best reflect the usage. Physical units are preferred when costs and benefits are related to volume. For example, most grain marketing cooperatives calculate patronage on a per bushel basis. The cooperatives cost are related to volume, not price and most grain handlers price grain to maintain a constant per bushel profit margin. Monetary units are preferable when the costs and risks relate to the dollar amount (for example a credit cooperative) or when physical units are not easily distinguishable. For example, a farm supply store carries hundreds of items so it would be difficult to define volume in physical units. Patronage can be calculated separately for products or department or combined. In determining the number of patronage pools there is a tradeoff between fairness and complexity. A single pool can result in one product or service being subsidized by other areas. On the other hand, multiple pools require more record keeping and can be confusing to the member. There are some overhead costs, such as the salary of the general manager or the office expense that are related to all business areas. Those overhead costs must be allocated or apportioned across the various department and activities. The calculations of profits and patronage in sub-categories can therefore never be perfect but is rather impacted by how overhead costs are allocated. The major rationale for separate patronage pools is when some products or departments are only used by a portion of the membership. If all of the patrons used all departments and products the issue of patronage pools is of less importance.

Dividends

Dividends on stock reward ownership rather than use. Historically, dividends has been a very minor aspect of profit distribution for U.S. cooperatives. As you might recall, Rochdale principles stated that dividend payments should be limited to no more than 8%. That level has made its way into several laws affecting cooperatives. In practice, most cooperatives do not pay any dividends on stock. Perhaps the U.S. cooperative industry has over reacted to the Rochdale pioneers caution of not over emphasizing the return on ownership. It is true that distributing and profits as dividends reduces the potential amount of patronage refunds.

Unallocated Retained Earnings

Unallocated retained earnings, also called unallocated reserves, functions as a general reserve account. The cooperative members have a collective claim on unallocated retained earnings but, as the name implies, it is not allocated to particular members and it is never revolved or redeemed to the member. In terms of profit distribution unallocated retained earnings is somewhat the residual account. Any profits not distributed to the members in patronage or stock dividends end up as increasing unallocated retained earnings. Cooperatives need an adequate amount of unallocated retained earnings as a “cushion fund”. If a cooperative experiences a loss some category of equity must be reduced. In the absence of unallocated retained earnings the member’s stock would have to be written down in value in any year with a loss. Unallocated reserves provide the cushion that can be reduced in a loss year without writing down stock. Profits retained as unallocated are never returned to the member so channeling profits to unallocated retained earnings reduces the member’s return from the cooperative. Most cooperatives retain the after tax portion of non-member profits as unallocated retained earnings. There is no tradeoff in that decision since tax regulations do not allow non-member profits to be included in patronage refunds.

**Decision #2 Dividing Patronage Refunds into Cash and Stock**

The second decision is what portion of the patronage refund to pay in stock and what portion to pay as retained patronage (stock patronage).

Cash Patronage

Cash patronage provides an immediate benefit to the members. In terms of the choices of return distribution, cash patronage increases the member’s return more than any other alternative. Cash patronage is taxable to the member, so the member is actually gaining the after tax portion. It is still much more beneficial relative to some forms of retained patronage (stock patronage) which are also taxable. It is easy to see why a member would prefer receiving cash even if they had to use some of it to pay the tax obligation, relative to receiving equity where they had to use cash from other sources to pay the tax and then wait years for it to be revolved. Members would obviously prefer a cooperative to distribute 100% of profits as cash patronage. The problem from the cooperative’s standpoint is that the cooperative needs to retain some profits to fund infrastructure reinvestment and to fund equity revolving payments. If we were ranking choices in terms of the cooperative’s cash flow, cash patronage is the least desirable. If a cooperative issues a portion of the refund in the form of qualified stock, IRS regulations require it to pay at least 20% cash patronage. The logic is that the member should receive enough cash to pay the taxes on the qualified stock patronage. In practice, many members face tax rates higher than 20% and most board feel that they should pay 30-40% cash patronage if they are issuing qualified stock patronage.

Stock Patronage

Cooperatives can also make patronage refunds in the form of retained patronage also called stock patronage. Retained patronage is allocated because it is issued to individual members in specific amounts. So a member’s allocated patronage can be in a combination of cash and retained patronage. Years ago, cooperatives actually issued patronage in the form of stock certificates creating the term “stock patronage”. Today, most cooperatives simply track equity patronage in their accounting system. The equity is described as retained patronage because the cooperative is retaining the profits by distributring equity instead of cash. Describing a cooperative as distributing retained patronage sounds like a contradiction. For that reason, it is less confusing to describe retained patronage as stock patronage.

**Decision #3 Issuing Stock Patronage as Qualified or Non-qualified**

Stock patronage can be in the form of qualified stock or non-qualified stock. The term “qualified” refers to whether the retained patronage amount can be deducted from the cooperative’s taxable income in the year issued. Qualified stock is deductible when issued. Non-qualified stock patronage is tax deductible to the cooperative and taxable to the patron when it is redeemed into cash. In either case, the cooperative eventually gets the tax deduction and the member eventually pays the tax. When the cooperative distributes qualified stock, they get the tax deduction immediately in the year the stock patronage is issued. Retaining profits by issuing qualified stock is therefore the most beneficial option for increasing the cooperative’s cash flow. The cooperative retains all of the profits associated with the qualified stock portion since it has no tax liability on them. From the member’s perspective it ranks near the bottom in terms of improving member return since the member has to immediately pay the taxes on profits they are receiving in the form of stock.

There a number of IRS requirements for a stock patronage distribution to be qualified. The cooperative has to pay at least 20% cash, the patron has to receive written notice of the allocation and the patron has to have agreed to accept the tax liability (which is typically part of the membership application). If the stock patronage does not meet those requirements or the cooperative does not choose to treat the stock patronage as qualified it is automatically non-qualified.

Ranking the Alternatives

The cooperative board of directors faces a balancing act in protecting the cash flow and financial stability of the cooperative on the one hand and providing benefit to the members on the other hand. In the long run we would hope that there is not a conflict. Protecting the cooperative ensures that it will be there to provide patronage in the future. Profit distribution highlights the inherent balancing act. In terms of member benefits the alternative ranks (from most to least desirable) cash, nonqualified stock, qualified stock, unallocated equity). Members benefit from getting cash and from getting cash sooner and by deferring taxes when possible. In terms of the cooperative’s cash flow, the cooperative benefits from unallocated equity, qualified stock, nonqualified stock and cash. The cooperative would prefer unallocated equity because they keep the cash and never return it. Next would be qualified stock because they retain the entire portion of profits not issues in cash. The patron pays the taxes on the qualified portion. Next, the cooperative would prefer non-qualified stock. Because nonqualified is not deductible when issued the cooperative has to pay the tax and retains the after tax portion. They will get the tax deduction in a later year when it is redeemed. Finally, cash patronage that is most desirable for the member’s return is least desirable for the cooperative’s cash flow.

How Should the Board Make the Decision?

The cooperative board needs to consider both the cooperative balance sheet and its cashflow needs and of course consider the member’s need for a return. Unallocated retained earnings serves as a cushion fund that can be used to absorb a loss without writing down the value of the revolving equity. A common recommendation is for boards to build enough unallocated equity to absorb one or two years of foreseeable loss. The board should also consider what percent of the total equity they feel should be allocated to members to maintain a sense of ownership by the members. Historically, many cooperatives indicated they never wanted to exceed 50% of their equity being unallocated. In recent years the percentage of unallocated equity has been increasing. Hopefully that has been a well thought out decision and not a byproduct of cooperatives having available tax credits which makes it easier to retain funds as unallocated retained earnings. The decisions of the cash and stock portion and whether the stock portion should be qualified or nonqualified should be evaluated based on the cooperative’s need for cash flow. The board must maintain an adequate cashflow but should be focused on maximizing the member’s long term return from the cooperative as their over all goal.

Allocating Losses

Despite the best intentions and planning, cooperatives like other firms can experience a loss. The alternatives for handling losses are somewhat different in cooperatives versus investor owned businesses. IRS regulations and cooperative principles influence how losses are handled. Cooperatives can net losses across departments and products. That creates a tradeoff for the practice of multiple patronage pools. Multiple pools are generally more fair but increase the chance that a loss will occur in some area.

Reduce the Value of Unallocated Retained Earnings

A common alternative for allocating a loss is to reduce the value of unallocated equity. That alternative does not require any specific action of the member and does not decrease the value of their stock. In fact, having the ability to absorb a loss without a stock write down is the primary rationale for holding unallocated retained earnings.

Write Down the Value of Member Stock

Another alternative for allocating a loss is to reduce the value of the member stock. That requires a decision of which members to allocate the loss to. In an investor owned firm losses are allocated in proportion to ownership. Investor owned firms do not have to reduce the value of stock when a loss occurs since the stock trades on the market. The effect on stock value comes through the market price. The stock price decline effects on owners in proportion to their ownership. In a cooperative, losses are allocated in proportion to past business volume using some sort of a “look back” period. Typically, the cooperative defines a look back periods which is typically 6 to 10 years and allocates the loss in proportion to the business the member did during that look back period. The goal is to distribute the loss to the members that used the products and services associated with the loss. The cooperative structure tends to allocate the loss to active members rather than to inactive members who only have an ownership stake.

Since cooperatives have historically issued qualified stock, the members have already paid tax on the profits reflected by their revolving equity. Writing down the value of qualified stock gives the member a taxable loss that they can use to offset other taxable income. A stock write down is therefore more beneficial from a tax standpoint relative to reducing unallocated retained earnings. The disadvantage of a stock write down is the publicity and member relations. Qualified stock has never been popular with members since they are paying tax on stock that is not yet cash. Some cooperatives have long revolving periods which adds further to the negative imagine of cooperative equity. It is easy to see why a board would like to avoid the publicity of writing down stock value. A stock write down also creates recordkeeping challenges. The member would have a portfolio of stock shares earned in different years. When the write down occurs some of the stock shares must be adjusted to partial value. When additional stock patronage is issues those share are not re-adjusted to full face value, rather additional shares are added. If a member held stock for 20 years until it began to revolve and the several write downs occurred it is easy to imagine the members confusion over the actual amount of stock owned.

As an aside, cooperative bylaws often specify that a member must hold one share of membership stock to have a voting write. For that reason, the value of membership shares (which represent a small fraction of total investment in an open membership cooperative) is generally not reduced in a stock write down. Preferred stock is also generated from direct investment and not created out of the profit stream. The value of preferred stock would also not be subject to a stock write down. Of course, dividends on preferred stock are subject to the board’s discretion and would generally not be paid when the cooperative is experiencing a loss. The board can suspend dividends on preferred stock and that is what distinguishes it from debt. If the board issued the preferred stock with a stated dividend, it can suspend the dividend when required by financial conditions but it cannot pay patronage if tt did not pay the dividend. That preference for the order of profit distribution relates to the term “preferred”.

Summary

One of the important decisions made by the cooperative board of directors is how to distribute the firm’s net income. The board must decide whether to distribute any profits as dividends on stock and whether to retain any member based profits as unallocated retained earnings. Most cooperatives retain all non-member profits as unallocated retained earnings since those cannot be distributed as patronage. The second decision is determining what portion of the profits allocated to members to pay in cash and what portion is stock. The final decision is whether to structure the stock patronage as qualified or non-qualifies (or some combination). The decision involves a tradeoff between the cooperative’s need for cash and the member’s return. The ranking in terms of member return are: Cash, nonqualified, qualified and unallocated reserves while the ranking in terms of cooperative cashflow are just the opposite.

Cooperatives can net losses across departments and products. When a loss occurs at the overall cooperative level the cooperative can either asorb the loss by writing down the value of unallocated equity (assuming there is sufficient unallocated equity) or by writing down the value of member stock. In a cooperative, a stock write down involves allocating the loss to members in proportion to business volume during some “look back period:. The effect is to allocate the loss to members in proportion to use of the cooperative during the years relating to the loss or assets involved in the loss and not in proportion to overall ownership. In terms of allocating losses, cooperatives are different from investor owned firms because they allocate losses in proportion to past use and not in proportion to stock ownership.