Exploring
Non-Qualified and Unallocated Equity

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Distribution of Profits in a Cooperative

- 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

Net Income
  - Patronage-sourced
    - Non-Patronage Sourced
  - Unallocated (retained savings or earnings)
    - Allocated
      - Qualified
      - Non-Qualified
        - Cash Patronage Refunds
        - Qualified Retained Patronage Refunds
        - Non-Qualified Retained Patronage Refunds

Patronage Refunds (reverting)
Qualified Distribution

- 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

- 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

- 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)

- 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

<table>
<thead>
<tr>
<th>Year</th>
<th>All Cooperatives</th>
<th>Grain and Farm Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>32%</td>
<td>33%</td>
</tr>
<tr>
<td>2009</td>
<td>32%</td>
<td>40%</td>
</tr>
<tr>
<td>2010</td>
<td>32%</td>
<td>56%</td>
</tr>
<tr>
<td>2011</td>
<td>36%</td>
<td>56%</td>
</tr>
<tr>
<td>2012</td>
<td>36%</td>
<td>63%</td>
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</table>
Qualified Distributions are the Historical Choice

- 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

- 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?

- 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

<table>
<thead>
<tr>
<th>Category</th>
<th>IRR</th>
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<tbody>
<tr>
<td>Qualified</td>
<td>8%</td>
</tr>
<tr>
<td>Nonqualified</td>
<td>14%</td>
</tr>
<tr>
<td>Unallocated</td>
<td>6%</td>
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</tbody>
</table>
Member's IRR
Cooperative Retaining 199

- Qualified
- Nonqualified
- Unallocated
## Calculator for Determining Cash Neutral Non-qualified Distribution

Developed by Phil Kenkel, Bill Fitzwater Cooperative Chair, CO

<table>
<thead>
<tr>
<th></th>
<th>Qualified</th>
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</thead>
<tbody>
<tr>
<td>Net income before taxes and patronage</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>patronage</td>
<td>Cooperative</td>
<td>Patron</td>
</tr>
<tr>
<td>Cash</td>
<td>$45.00</td>
<td>$45.00</td>
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<tr>
<td>Stock</td>
<td>$55.00</td>
<td>$55.00</td>
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<tr>
<td>Taxable Income</td>
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<tr>
<td>Tax</td>
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<td>$45.00</td>
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<tr>
<td>After Tax Income</td>
<td>$0.00</td>
<td>$55.00</td>
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<tr>
<td>Cashflow</td>
<td>$55.00</td>
<td>$0.00</td>
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</table>

- **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

- 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