Impact of Tax Reform on Cooperative Profit Distribution

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The characteristics of the tax reform package and even its likelihood of passage are still in play as of this writing. Still, it is not too early to begin to think about how changes in tax regulations should impact how we distribute and retain profits in cooperatives. The tax treatment of cooperatives is one of the more interesting aspects of the cooperative business model. In general terms, Sub-Chapter T of the IRS code allows cooperative to deduct certain distribution of profits to patrons. The remaining member-based ncome as well as any profits from non-members are taxed at the regular corporate rate. The IRS is not famous for offering a free lunch so it is not surprising that the distributions that are deductible to the cooperative are taxable to the member. Cash patronage always creates a tax deduction for the cooperative and taxable income to the member in the year it is issued. As I have discussed in previous newsletters, cooperatives can distribute qualified stock patronage which is tax deductible to the cooperative and taxable to the member in the year it is issued or nonqualified stock patronage which is deductible to the cooperative and taxable to the member in the year that it is redeemed.

Agricultural cooperatives have historically distributed member profits in a combination of cash and qualified stock. One possible rationale for this historic decision was that producers were assumed to have lower tax rates relative to corporations. It was therefore logical to transfer the tax burden on the retained funds to the producer by issuing qualified stock rather than "park the taxation" at the cooperative at a higher rate until the equity was redeemed. The Section 199 Domestic Producers Activity Deduction (DPAD) threw another wrinkle into cooperative profit distribution. The available tax credit allowed cooperatives to retain funds as either unallocated retained earnings or as nonqualfied stock without creating taxable income. Many cooperatives choose to retain member-based profits as unallocated retained earnings. While retaining funds as unallocated equity implies that the profits will never be distributed to the members, it avoids creating revolving equity which much be managed by the board and CEO.

The proposed tax legislation has implications for our profit distribution and retention choices. First, the possible loss of the Section 199 tax credit eliminates the opportunity for cooperatives to retain funds without taxation at either the cooperative or member level. If enacted, that change will reduce cooperative cash flows, relative to post Section 199 levels and likely force cooperatives to retain funds by issuing allocated equity. Second, the proposed reduction in the corporate tax rate makes it less sensible to get the tax burden to the producer as quickly as possible. If the cooperative's tax rate is lower than the producers then the best alternative is to "park the taxes at the cooperative level" by retaining funds in the form of nonqualified, rather than qualified equity. There are a lot of moving parts in the cooperative model so a cooperative's choices could also involve changes in the level of cash patronage or the length of the equity revolving period.

I give some examples of the impact of possible tax changes on a typical cooperative in my next newsletter.

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