Impact of Tax Reform On Cooperatives and Members

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Tax reform is still a work in progress as of this writing. While the final analysis cannot be completed until the dust settles I have been using my cooperative simulation program to determine the impact of tax reform on a typical grain and farm supply cooperative. I won't go into the details of the simulation but it is based on financial data from a case study cooperative and considers the members return over a life time of use including complete modeling of equity retirement. Tax reform is eliminating the Section 199 deduction, creating new deduction for qualified patronage and reducing the corporate tax rate. I analyzed three scenarios: the cooperative and its members prior of the availability of Section 199, the cooperative and members when the cooperative retained Section 199 and the cooperative and its members after tax reform.

Since every tweak of the tax reform proposals changes the exact numbers it is most appropriate to describe the general finding. Prior to Section 199 our hypothetical cooperative was distributing member profits as 50% cash patronage and 50% qualified stock. That distribution resulted in a 26% rate of return for the member. If the cooperative wanted to maintain the same cash flow the next best choices were 15% cash/85% nonqualified stock which yielded a 22% rate of return and distributing 15% cash/85% unallocated retained earnings was the worse choice at 19%.

Section 199 allowed the cooperative to retain the same amount of cash without creating taxable income for either the member or the cooperative. Under Section 199 the cooperative could maintain the identical cash flow while increasing the member's after tax patronage. With Section 199 the 50% cash/50% nonqualified stock distribution becomes the best choice increasing member return to a whopping 42%. Retaining 50% of the profits as unallocated equity and distributed the rest in cash was the next best choice and was close behind with a 41% member return. Section 199 had no impact on the 50% cash/50% qualified stock choice the member return remained at 26%.

The projections with tax reform are in between the pre-Section 199 situation and the situation when the cooperative fully utilized Section 199. Under tax reform the optimal choice, in terms of member return is 37% cash/63% nonqualified stock. That yields a 37% member return and gives the cooperative the same cash flow as a 50% cash/50% qualified stock which only yields a 33% member return. A distribution of 37% cash/63% unallocated retained earnings is also equivalent in terms of the cooperative cash flow and yields a member return lower than the nonqualified choice but above the qualified choice.

There appear to be a couple of take home messages from tax reform as it currently stands. First it is an improvement of the pre-Section 199 situation and not as beneficial as full Section 199 utilization. Second, there continues to be an advantage of issuing nonqualified stock even when then the cash patronage percentage is adjusted to hold the cooperative's cash flow harmless. Because of the lower tax rate the reduction in the cash patronage rate to keep the cooperative's cash flow constant when issuing nonqualified stock is not as great. Finally, tax reform should give the CEO and board one more chance to consider their equity structure. I'll discuss the impact of profit distribution choices on the cooperative balance sheet in my next newsletter.

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