Member Co-op Decisions on Handling Non-Qualified Patronage from Federated Cooperatives

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Under the federated cooperative model, local cooperatives receive patronage (cash and retained equity stock) from regional cooperatives. The patronage of a federated co-op and its member co-ops creates tax, cash flow and balance sheet considerations for its member cooperatives. Historically, federated cooperatives, commonly called regionals, have structured stock patronage in the form of qualified equity. Qualified regional equity becomes part of the local cooperative's taxable income in the year the equity is issued.

In recent years, several federated cooperatives have issued non-cash patronage in the form of non-qualified equity. Non-qualified regional equity is not taxable income for the member cooperative until it is redeemed into cash. That has raised questions as to how non-qualified regional patronage effects the local cooperative. Nationally, farm supply and grain marketing cooperatives are about evenly split as to whether they calculate patronage on a book or tax basis. In simple terms, book accounting is structured in accordance with generally accepted accounting principles (GAAP) while tax accounting is governed by the rules of the internal revenue service. A cooperative's net income and patronage calculated on a book basis can differ from the tax accounting net income and patronage. Non-qualified regional equity creates more issues for cooperatives with tax based patronage so this discussion is focused on those firms.

The first question is: "Should nonqualified regional equity be reflected as an asset on the member cooperative's balance sheet." That is a question for the co-op's auditor, but if the federated cooperative intends to redeem the non-qualified equity, I view it as an asset. There is nothing about non-qualified equity that makes it inherently less likely or more likely to be redeemed. Non-qualified regional equity can certainly represent future value (be an asset) for a local cooperative just as local non-qualified equity can provide future value to the producer member.

The second question is: "How does the regional patronage affect the local cooperative's taxable income?" When a local cooperative receives cash or qualified regional equity their taxable income increases unless they pass it on to members as patronage in deductible form (cash or qualified local equity). If the regional cooperative distributes cash and non-qualified equity, only the cash portion effects its taxable income. The local cooperative must pass on the cash portion as cash or qualified equity to avoid taxation. The non-qualified regional patronage is not taxable income for the local cooperative until it is redeemed. Until that time, it is essentially off the books for taxable income.

The next question is: "How does regional non-qualified patronage effect on the local cooperative's cash flow?" If we assume the local cooperative sets their cash patronage rate for their desired cash flow before receiving regional patronage, they should adjust their cash patronage rate up when the regional's cash patronage rate is above their rate and down when the regional issues a lower portion of cash. When a regional cooperative distributes cash and non-qualified stock, only the cash portion is relevant for tax basis patronage. From a tax and patronage basis, it is as if the regional cooperative issued 100% cash. If the local cooperative wants to maintain its locally generated cash flow, it would need to increase its cash percentage rate to be cash neutral.

The final question with regional non-qualified patronage is how to allocate it to the member. In terms of operating on a cooperative basis, the best choice for local cooperatives calculating patronage on a tax basis is to make a non-qualified distribution to the producer members. If a co-op is distributing patronage as cash and non-qualified equity, the regional pass-through of non-qualified patronage simply adjusts those percentages. If a cooperative is distributing cash and qualified stock, it must add a supplemental non-qualified distribution to members to reflect the regional pass-through. In either case, the regional non-qualified patronage is allocated and eventually redeemed by the members who helped create it. There can be differences in the timing of the equity redemption between the regional and local cooperative. If the local cooperative revolves equity more rapidly relative to the regional, there can be cash flow issues in the redemption year.

Another alternative is for the local cooperative to allocate it or distribute it to their members when it is redeemed by the regional. The disadvantage to this approach is that it does not match benefits with use. The members who receive the cash allocations are likely not the members doing business when the regional patronage was earned. The advantage of distributing the regional nonqualified at redemption is that it avoids the redemption year cash flow issues

The final alternative for the local cooperative is to not allocate the regional non-qualified and instead put it in their permanent equity, retained earnings. Cooperatives should be aware that this reduces the member's return since they never receive that portion of their member-based profits.

If you want more information, drop me a line at phil.kenkel@okstate.edu and I will send a copy of my fact sheet "Understanding Regional Patronage".