Non-Qualified Regional Patronage

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Under the federated cooperative model, local cooperatives are both receiving patronage from regional cooperatives and issuing patronage to their producer members. Regional patronage has always created tax, cash flow and balance sheet issues for local cooperatives. In recent years, several regional cooperatives have issued patronage in the form of non-qualified equity. That has raised questions as to how non-qualified regional patronage effects the local cooperative. Many local cooperatives calculate patronage on a tax basis so I will concentrate on that situation.

The first question is should the nonqualified regional equity be reflected as an asset on the balance sheet. That is a question for your auditor but if the regional 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 would increase unless they pass it on in deductible form (cash or qualified local equity). If the regional cooperatives distributes cash and non-qualified equity, only the cash portion effects taxable income. The local cooperative would have to 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 the effect on the local cooperative's cash flow. If we assume the local cooperative set their cash patronage rate for their desired cash flow before receiving regional patronage they would want to adjust their cash patronage rate up when the regional's cash patronage rate was 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 if the regional cooperative issued 100% cash. If the local cooperative was satisfied with its locally generated cash flow, it would want to increase the cash percentage to reflect the regional pass through.

The final question with regional non-qualified patronage is how to allocate it to the member. The best choice for local cooperatives calculating patronage on a tax basis is to make a non-qualified distribution to the producer members. If you are already distributing patronage as cash and non-qualified equity, the regional pass through simply adjusts those percentages. If you are distributing cash and qualified stock you would need a supplemental non-qualified distribution reflecting the regional pass through. Another alternatives is to allocate it (distribute it) when it is redeemed. The disadvantage to that approach is that the member who receives the cash it likely not the one doing business when the regional patronage was earned. The final alternative is to not allocate the regional non-qualified and take it to retained earnings. That 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'll send a copy of my fact sheet "Understanding Regional Patronage".