Nonqualified Stock and the Time Value of Money

Phil Kenkel
Bill Fitzwater Cooperative Chair

Cooperatives can distribute profits as cash patronage or retain profits in the form of qualified stock, nonqualified stock or unallocated retained earnings. Members pay taxes on qualified stock when issued and pay taxes on nonqualified stock when redeemed. I sometimes hear managers and board members relating the benefit of nonqualified stock to the member's tax rate. They assume that the benefit of nonqualified stock is that the member will be a lower tax rate when the equity is redeemed relative to their rate when it was issued. I have never considered changes in the member's tax rate in my analysis of qualified versus nonqualified stock. The major benefit of nonqualified stock, from the member's standpoint, relates to the time value of money.

A dollar paid at a future date has less value than a dollar paid today. The difference between the present value and future value depends on the time and the interest rate. At 4% interest rate the present value of a dollar paid in 20 years is $.45. That reflects the fact that I could put forty five cents in the bank at 4% interest and in 20 years it would have compounded to be worth a dollar. At 6% interest, which is probably closer to the long-term interest rate, the present value of a $1 payment in 20 years is $.31. If a member of a cooperative with a 20 year revolving period had the choice of receiving $1 of qualified stock or $1 of nonqualified stock the choice comes down to whether they would rather pay $1 in taxes (qualified stock) or $.31 in tax (nonqualified stock). One clearly does not have to assume a difference in tax rates to presume that a member would prefer nonqualified stock.

The kicker of course is that the time value of money also affects cooperatives. The cooperative would much rather have the tax deduction from qualified stock today rather than wait to get the deduction when the stock is redeemed. Tax reform has shifted the tradeoffs since it reduced the corporate tax rate at the cooperative level. My analysis suggests that the typical cooperative member would be better off receiving nonqualified stock even when the cooperative reduces the cash patronage rate to keep the cooperative's cash flow constant. In essence, it makes more sense to "park" the taxes at the cooperative at their 21% tax rate rather than rush to get the taxation to the members.

Marketing cooperatives face a new decision of whether the cooperative will retain or pass on the Section 199A deduction. While your board is considering that decision, you might want to look at nonqualified stock. The potential advantage does not depend on tax brackets, it stems from the time value of money.

Now if I could just find a way to delay my federal income tax payments for 20 years…!