Quantifying the Tradeoffs

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As part of my work analyzing Section 199A, I developed representative farm supply and grain marketing cooperatives. Simulations of the representative wheat cooperative indicated that member return is improved by retaining profits as nonqualified stock, even when the cash portion was adjusted to keep the cooperative's cash flow constant. The results also indicate that the "typical" wheat cooperative needs to pass up to 50% of the Section 199A deduction to keep the "typical" producer equivalent with a producer marketing with a non-cooperative firm. That same representative cooperative can also be used bring insight into the tradeoffs in other decisions. Putting numbers to those tradeoffs might help both the board and the membership understand the nature of the cooperative balancing act.

The representative wheat cooperative in my simulation model distributed profits as 32% cash and 68% non-qualified stock. That provided the same cash flow as 50% cash and 50% qualified. It revolved equity on a 20-year cycle. The representative cooperative provided the member an internal rate of return of 11% and the cooperative could grow its asset base by around 4.5% per year, net of depreciation. That is a healthy growth rate but some members tell us that they are more interested in the cooperative building assets than they are in cash patronage. Increasing the cooperative's growth rate to 5% per year would require a 50% reduction in the cash patronage percentage (down to 15% cash and 85% nonqualified). The representative cooperative example illustrates the challenge in building infrastructure and the balancing act between building assets and offering cash patronage.

Many young producers indicate that retained equity is not meaningful to them unless the revolving period is 10 years or less. The representative cooperative can also provide some insights into that balancing act. In order to keep the cooperative's growth rate constant, the funds needed to accelerate the revolving period have to come from reducing cash patronage. Reducing the equity revolving period from 20 years to 10 years would necessitate cutting cash patronage percentage by around 25% (from 32% cash to 25% cash). Young producers (just like older producers) prefer a shorter equity revolving period. The key question is whether they would consider a 25% reduction in cash patronage as an acceptable price to get there.

To look at one last trade off, tax reform has made non-qualified stock the most logical vehicle for retaining funds. While the producer eventually pays the tax they are able to "park the taxes" at the cooperative's corporate rate which is generally lower than their rate. Many boards continue to retain profits as qualified equity since "that's the way we have always done it". The cost of that inertia is either a 15% reduction in the member's return from the cooperative or a 10% reduction in the cooperative's growth rate. In this case, the tradeoff is the effort to make and communicate a change versus leaving 15% on the table.

I hate for cooperatives to leave value on the table. How about you?