Tax Reform and the Cooperative Balance Sheet

Phil Kenkel
Bill Fitzwater Cooperative Chair

As I discussed in my last newsletter, tax reform eliminated the Section 199 deduction, changed the corporate tax rate and created new deductions for both the cooperative and the member. These changes have implications for profit distribution choices which in turn impact the cooperative balance sheet. Simulation modeling which held the cooperative's cash flow constant across choices found that member return was highest when profits were retained as nonqualified stock, followed by unallocated retained earnings and qualified stock. Tax return has reduced the differences between the effective tax rate of the cooperative and the member which results in less difference in member return across profit distribution choices. The choices do have drastically different impacts on the cooperative's balance sheet. A cooperative starting with 45% allocated equity would have less than 5% allocated equity in 10 years if it retained profits as unallocated equity. Retaining profits as nonqualified stock would increase the allocated percentage to 75% while qualified stock retention would result in 68% allocated equity. Clearly, one of the most important considerations for profit distribution under tax reform is the board's goals for the portion of allocated equity on the balance sheet.

Unallocated retained earnings, also called unallocated equity, are an interesting part of the cooperative business model. In an investor owned firms retained earnings is really just an accounting measure. The value of the firm is based on the stock price and the categories of stock and retained earnings have no impact on the stockholders return from investing in the firm. In the cooperative firm stock is issued to members are revolving equity and is held at face value. Unallocated retained earnings are never redeemed and individual members never receives the profits which are retained as unallocated retained earnings. While the member is active they have a collective claim on the unallocated retained earnings. However, once the member stop using the cooperative their claim on the unallocated retained earnings disappears. While some unallocated equity is necessary for a cushion fund, unallocated equity violates the cooperative principles of "profits distributes as patronage" and "ownership by users". At extreme levels, unallocated retained earnings provide the members and incentive to liquidate the cooperative. Tax reform provides a good opportunity to revisit our profit allocation choices. Maybe that would make a good new year's resolution!

More information the impact of tax reform on agricultural cooperatives is available in a new fact sheet which Dr, Brian Briggeman, KSU Arthur Capper Cooperative Center Director, and I have just published. Drop me an email at phik.kenkel@okstate,edu if you would like a copy.