Cooperative Information Report 55

Co-ops 101: An Introduction to Cooperatives

Abstract

This report provides a comprehensive summary of basic information on the cooperative way of organizing and operating a business. It covers the nature and extent of the use of cooperatives, compares cooperatives to other business structures, explains the roles various people play in a cooperative, and discusses equity accumulation and income taxation. The purpose is to make available, in a single report, the information someone would need to acquire a general understanding of how cooperatives function.

Keywords: Cooperative, Business, Finance, Structure, Tax

Co-ops 101: An Introduction to Cooperatives

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Preface

Welcome to the dynamic world of cooperation--people working together to solve common problems and seize exciting opportunities. Cooperatives are business entities that people use to provide themselves with goods and services.

This booklet introduces you to the attributes that distinguish a cooperative from other ways to organize and conduct a business. Its purpose is to help you understand what makes a cooperative unique. It contains a great deal of information to absorb. Use it as a reference and refer to it when specific problems arise. Over time, you will learn more about cooperatives and your experience with them should be more rewarding.

The author gratefully acknowledges the cooperation of the National Society of Accountants for Cooperatives (NSAC) in simplifying the preparation of this report. NSAC allowed me to base parts of this publication on material I had written earlier for *Welcome to Cooperatives*, an NSAC booklet designed to introduce accountants, financial, and tax professionals to cooperatives. This saved me the time and effort of reworking the

presentation of some basis concepts that everyone associated with cooperatives should understand. This is consistent with the concept of sharing knowledge freely that should be a cornerstone of cooperative education.

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Co-op 101
An Introduction to Cooperatives

<>There is no universally accepted definition of a cooperative. In general, a cooperative is a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use. The user-owners are called members. They benefit in two ways from the cooperative, in proportion to the use they make of it. First, the more they use the cooperative, the more service they receive. Second, earnings are allocated to members based on the amount of business they do with the cooperative.

<>In many ways, cooperatives resemble other businesses. They have similar physical facilities, perform similar functions and must follow sound business practices. They are usually incorporated- under state law by filing articles of incorporation, granting them the right to do business. The organizers draw up bylaws and other necessary legal papers. Members elect a board of directors. The board sets policy and hires a manager to run the day-to-day operations.

<>But in some ways, cooperatives are distinctly different from other businesses. These differences are found in the cooperative's purpose, its ownership and control, and how

benefits are distributed. They are reflected in cooperative principles that explain the unique aspects of doing business on a cooperative basis.

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Chapter 1. A Historical Perspective[(1)]

In one sense, cooperation is probably as old as civilization. Early people had to learn to work together to meet their common needs, or perish. The Pilgrims who settled at Plymouth, MA, jointly cleared fields abandoned by the Indians, broke up the soil, and planted and cared for their corn. After the harvest, celebrated with the Indians in 1621 with a Thanksgiving feast, the corn was shared equally among the settlers.

Legend suggests that the initial structured cooperative business in the United States was the Philadelphia Contribution-ship for the Insurance of Houses from Loss by Fire, a mutual fire insurance company established in 1752. This association's reputation is likely based on two factors. First, Benjamin Franklin was the organizer. Second, the business has been conducted so efficiently over the years that it is still operating today.

In the early 1800s, cooperative businesses appeared on several fronts. In Britain, cooperatives were formed as a tool to deal with the depressed economic and social conditions related to the struggles with Napoleon and industrialization. In the United States, farmers began to process their milk into cheese on a cooperative basis in diverse places such as Goshen, CT, and Lake Mills, WI.

Writers sometimes trace the origin of cooperatives from the Rochdale Equitable Pioneers' Society, an urban, consumer cooperative organized in England in 1844. It sold consumer goods such as food and clothing to persons unhappy with the merchants in the community.

While neither the first nor most successful early cooperative, the Rochdale Society developed an active outreach program, encouraging and assisting others to form cooperatives. It also prepared a written list of practices and policies that seemed consistent with success of such efforts. This list became one of the first sets of cooperative principles, characteristics that distinguish cooperatives from noncooperative businesses.

- Open membership
- One member, one vote
- Cash trading
- Membership education
- Political and religious neutrality
- No unusual risk assumption
- Limitation on the number of shares owned
- Limited interest on stock
- Goods sold at regular retail prices
- Net margins distributed according to patronage

The Grange, founded in 1867, quickly became the major thrust behind agricultural and rural cooperatives in America. In 1874, a Grange representative went to Europe to gather information about cooperatives. In 1875, the Grange published a set of rules for the organization of cooperative stores, based on the Rochdale principles.

Local granges organized stores to serve their rural members. They sold groceries and clothing as well as general farm supplies, hardware and agricultural implements. Granges in the South marketed cotton. Those in Iowa operated grain elevators. In

Kentucky, they sponsored warehouses for receiving and handling tobacco. California Granges exported wheat and marketed wool.

As the country recovered from the depression of the 1870s, fewer Granges were organized and many cooperatives went out of business, but the impact of the Grange cooperative movement survives. It demonstrated that the Rochdale type of cooperative, which handled goods at prevailing prices and distributed net savings according to use, offered a sound basis for cooperative efforts in America.

Cooperation flourished during the three decades from 1890 to 1920. As many as 14,000 farmer cooperatives were operating by the end of the period. Cooperative growth was fueled by the wave of other farmer movements and farm organizations sweeping the country, such as the American Society of Equity, National Farmers Union, and the American Farm Bureau Federation. They were engaged in marketing virtually every farm crop and furnishing supplies and services to their producer-members. Many of today's major farmer cooperatives were formed during this period.

The following decades have seen farmer cooperatives develop their own financial institutions through the Farm Credit System. Nonagricultural cooperatives likewise developed the National Cooperative Bank. With help from the Rural Electrification Administration, rural residents used cooperatives to bring electric and telephone services to their towns and farms. The rural electrics formed the National Rural Electric Cooperative Finance Corporation (CFC) as a supplemental source of financing.

Some cooperatives have become larger, partially in response to growing concentration among their competitors and the firms their members must deal with. They have adopted modern management techniques and sophisticated processing, distribution and marketing methods.

Today rural and urban residents use cooperatives to acquire consumer services such as housing, credit and other financial services (through credit unions), groceries, education and telecommunications. Franchisees, governmental units, hardware and grocery stores, florists and numerous other businesses use cooperatives to market their products and secure the supplies they need at competitive prices.

Cooperatives remain a major component of the food and agriculture industry, but now they are available to help people provide services for themselves in virtually all segments of the economy.

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Chapter 2. Cooperative Principles and Practices[2]

Cooperative Principles

Various writers over the past century have analyzed and observed the application of cooperative principles. Although slight differences in terminology appear on the various lists, three principles emerge as being widely recognized and practiced.

These principles are more than just good practices, policies or common sense. They distinguish a cooperative from other kinds of business. They are also recognized in state and federal statutes and regulations as criteria for a business to qualify as a cooperative.

The User-Benefits Principle

Members unite in a cooperative to get services otherwise not available, to get quality supplies at the right time, to have access to markets or for other mutually beneficial reasons. Acting together gives members the advantage of economies of size and bargaining power. They benefit from having these services avail-able, in proportion to the use they make of them.

Members also benefit by sharing the earnings on business conducted on a cooperative basis. When cooperatives generate margins from efficient operations and add value to products, these earnings are returned to members in proportion to their use of the cooperative. Without the cooperative, these funds would go to other middlemen or processors.

The User-Owner Principle

The people who use a cooperative own it. As they own the assets, the members have the obligation to provide financing in accordance with use to keep the cooperative in business and permit it to grow. Accumulating adequate equity is a major challenge facing many cooperatives. How this task is accomplished is discussed later.

The User-Control Principle

As owners, a cooperative's members control its activities. This control is exercised through voting at annual and other membership meetings, and indirectly through those members elected to the board of directors. Members, in most instances, have one vote regardless of the amount of equity they own or how much they patronize the organization.

In some instances, high-volume users may receive one or more additional votes based on their patronage. Equitable voting is assured, often by limiting the number of additional votes any one member can cast. This protects the democratic control of the membership as a whole.

Only members can vote to elect directors and to approve proposed major legal and structural changes to the organization. The member-users select leaders and have the authority to make sure the cooperative provides the services they want. This keeps the cooperative focused on serving the members, rather than earning profits for outside investors or other objectives.

Related Practices

Certain business practices have developed that implement and facilitate these basic principles. They further differentiate a cooperative from other forms of doing business.

The Patronage Refund System

While cooperatives strive to return earnings to members, this can't be done on a transaction-by-transaction basis. Rather, cooperatives usually charge market prices for supplies and services furnished to members and competitive prices for products delivered for further processing and marketing. Normally, this allows them to generate sufficient income to cover costs and meet continuing needs for operating capital.

After the fiscal year is over, a cooperative computes its earnings on business conducted on a cooperative basis. Those earnings are returned to the patrons--as cash and/or equity allocations--on the basis of how much business each patron did with the cooperative during the year. These distributions are called patronage refunds.

For example, if a cooperative has earnings from business conducted on a cooperative basis of $20,000 for the year, and Ms. Jones does 2 percent of the business with the cooperative, she receives a patronage refund of $400 ($20,000 x .02).

This allows the cooperative to return margins to members on an annual basis, consistent with standard accounting conventions and without regard to how much was earned on each transaction.

Limited Return on Equity Capital

Members form a cooperative to get a service--source of supplies, market for products or performance of specialized functions--not a monetary return on capital investment.

Many cooperatives don't pay any dividends on capital. Others pay a modest return, in line with state and federal statutes that bar substantial payments.

Limiting returns on equity supports the principle of distributing benefits proportional to use. It also discourages outsiders from trying to wrest control of a cooperative from its members and operate it as a profit-generating concern for the benefit of stockholders.

Cooperation Among Cooperatives

Many cooperatives, especially local associations, are too small to gather the resources needed to provide all the services their members want. By working with other cooperatives--through federated cooperatives, joint ventures, marketing agencies in common, and informal networks--they pool personnel and other assets to provide such services and programs on a collaborative basis at lower cost.

This permits members of local cooperatives to participate in owning and managing fertilizer plants, food manufacturing facilities, power plants, national financial institutions, wholesale grocery and hardware distribution programs, and so forth. Benefits flow back through the local cooperatives to the individual members.

These principles and practices have survived and flourished through 150 years of continuous evolution in the business world. They remain the foundation that supports the distinctive cooperative method of doing business.

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Chapter 3. Cooperatives in the Community[(3)]

While cooperatives are often most closely identified with agriculture, they are found working effectively to meet people's needs in all sectors of American life. The National Cooperative Business Association reports that in the United States a network of 47,000 cooperatives directly serve 100 million people -- nearly 40 percent of the population. Here are some examples and facts and figures about cooperatives in your community.

Financial Cooperatives

The largest single segment of the cooperative industry is **credit unions**. The roughly 12,600 credit unions in the United States have more than $280 billion is assets and almost 65 million members. Building on their base of member savings and consumer loans and home mortgages, credit unions now offer additional services to their members including credit cards, automated teller machines, tax-deferred retirement accounts and certificates of deposit.

Created in 1916, the cooperative **Farm Credit System** is the nation's oldest and largest financial cooperative. It provides real estate loans, operating loans, home mortgage loans, crop insurance and various other financial services to more than 500,000 farmer, small-town resident and cooperative borrowers. Annually it loans more than $50 billion to its members, 25 percent of all money loaned to U.S. agriculture.

One element of the Farm Credit System is **CoBank, ACB** and the **St. Paul Bank for Cooperatives**. They provide about 80 percent of the money farmer cooperatives borrow each year. They have about $11 billion in outstanding loans to farmer and rural utility cooperatives and water and waste disposal systems. CoBank has become an important financier of exports of U.S. farm products as it broadens its role of making credit available to enhance farm and rural income.

Since 1969, the National Rural Utilities Cooperative Finance Corporation (**CFC**) has been a valuable source of financing for rural electric and telephone cooperatives. With $5.7 billion in assets and almost $13 billion in loan commitments, CFC supplements funding provided by USDA's Rural Utilities Service and provides business services to its borrowers.

In a short period of time, the **National Cooperative Bank** (NCB) has become an important financial institution for America's housing, business and consumer cooperatives. Chartered by Congress in 1978 and private since 1982, NCB has originated more than $2.4 billion in loans to nearly 1,000 cooperatives throughout the country. NCB has become a leader in providing development funding for new, non-agricultural cooperatives and in devising methods of attracting outside capital to leverage its investments.

Consumer Service Cooperatives

America has about 1 million units of cooperative **housing**, nearly 600,000 of them in New York City. New units are being developed in many other areas including senior citizen communities, trailer parks, low-income complexes, and student housing near college campuses.

Millions of Americans receive basic medical care through cooperatively organized **health care** providers. Health maintenance organizations (HMO's) serve more than 1 million people coast-to-coast and will likely be an increasingly important part of the health care system in the years ahead. In several major cities--Seattle, Minneapolis, Memphis, Sacramento, Salt Lake City and Detroit--companies have formed cooperative health alliances to purchase health care for their employees.

Child care cooperatives are meeting the needs of families where the parent(s) are employed and want affordable, supportive care for their young children while working. These centers can be organized by parents on their own, by a single employer, or by a consortium of businesses providing a single center for the group. More than 50,000 families use cooperative day care centers daily.

Business Cooperatives

More than 15,000 independent grocery stores rely on cooperative **grocery wholesalers** for identity, brand names, and buying power they need to compete with the chains and the discounters. Members also receive training and financing. Several cooperative grocery wholesalers are multi-billion dollar firms rivaling the largest farmer cooperatives in sales and assets.

Restaurant supply purchasing cooperatives save money and provide quality products for franchisees of such noted fast-food chains as KFC (Kentucky Fried Chicken), Dunkin' Donuts, Arby's, Taco Bell, Burger King, Popeye's and Church's. Besides their bottom line impact, purchasing cooperatives also offer another, less tangible benefit; they help to build trust among franchisers and franchisees, particularly on pricing issues.

Cooperatively owned **hardware wholesalers** supply virtually all of the independent hardware stores in the United States. As huge warehouse chains spread across the nation, the independents are relying more and more on Cotter and Company (True Value), Ace Hardware and other cooperatives for products, promotions and education to remain viable businesses.

Cooperatives are leaders in other major industries including outdoor goods and services (Recreational Equipment Inc.), lodging (Best Western), carpeting (Carpet One), insurance, natural foods, hospital and pharmacy supply, and collegiate bookstores.

Farmer Cooperatives[(4)]

In the agricultural sector, USDA's Cooperative Services' survey of farmer cooperatives for calendar year 1995 reported 4,006 cooperatives in operation. Of these associations, 2,074 primarily marketed farm products; 1,458 handled primarily farm production supplies; and 474 provided services related to marketing or purchasing activities.

Marketing cooperatives handle, process and sell cotton, dairy products, fruits and vegetables, grains and oilseeds, livestock and poultry, nuts, rice, sugar and other agricultural commodities. Farm supply cooperatives provide farm chemicals, feed, fertilizer, petroleum products, seed and other input items to producers. Farm service cooperatives operate cotton gins, provide trucking and artificial insemination services and store and dry products.

In 1995, farmer cooperatives had more than 3.7 million members (many farmers belong to more than one cooperative) and a total gross business volume of $112.2 billion. Total net earnings (considering losses) were $2.36 billion. Combined assets of the group totaled $40.3 billion and liabilities were $23.6 billion, leaving member equity of $16.7 billion.

Another important cooperative activity in rural areas is furnishing electric power. Nearly 1,000 rural electric cooperatives operate more than half of the electrical lines in America, providing electricity to more than 25 million people in 46 States. Sixty of these are called generation and transmission cooperatives (G&Ts) because they generate and transmit electricity to meet the power needs of the other cooperatives that distribute electricity to the people.

Telecommunications services to rural areas are also provided by cooperatives. Telephone cooperatives serve 1.2 million people in 31 States. The National Rural Telecommunications Cooperative, owned by almost 800 rural electric and telephone systems, makes satellite television available to rural areas not served by cable companies. Cooperatives may be the on-ramp for rural residents wishing to travel the information highway.

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Chapter 4. Benefits of Cooperation (5)

People buy stock in a non-cooperative business to make money on their investment. The more of the company you own, the more benefits (stock appreciation and dividends) you will realize if the business succeeds.

The benefits of being a cooperative member differ in two ways. First, the advantages are more numerous. Second, they are distributed on the basis of how much use you make of the cooperative, rather than your equity stake. Here are some benefits of cooperative membership and how they relate to use.

1. Access to quality supplies and services at reasonable cost. By banding together and purchasing business supplies and services as a group, individuals offset the market power advantage of firms providing those supplies. You can gain access to volume discounts and negotiate from a position of greater strength for better delivery terms, credit terms, and other arrangements. Suppliers will be more willing to discuss customizing products and services to meet your specifications if the purchasing group

provides them sufficient volume to justify the extra time and expense.

The larger the group purchasing supplies and services through the cooperative, the greater the potential for savings. And the more each individual member uses the supply operation, the more he or she may save over doing business elsewhere.

Another option for cooperative members is to manufacture their own supplies and hire experts directly to provide essential services. This gives members even more reliable sources of supply and greater control over the types of products available, the cost, and the quality of the services received.

2. Increased clout in the marketplace. Marketing on a cooperative basis, like purchasing supplies and services, permits members to combine their strength while maintaining their status as independent business people. They can lower distribution costs, conduct joint product promotion, and develop the ability to deliver their products in the amounts and types that will attract better offers from purchasers.

A special Federal law, the Capper-Volstead Act, provides a limited exemption from antitrust liability for marketing agricultural products on a cooperative basis. Under this law, farmers can agree on the prices they will accept for their products and other terms of sale.

Through cooperative marketing, members can share information and negotiate with buyers from a position of greater strength and security. They can also develop processing facilities by themselves or as part of a joint venture with other cooperative or non-cooperative firms.

A cooperative can also serve as a vehicle for people selling goods and services to work with their customers to promote industry research, reduce regulatory burdens, and develop markets for their products. The cooperative can help create a "win-win" situation for the entire industry, a business environment where both producers and buyers have more income.

3. Share in the earnings. Some people talk about non-cooperative firms operating "for profit" while cooperatives operate "at cost." This isn't totally accurate. Most cooperatives generate earnings. They differ from non-cooperative firms in how they allocate and distribute their earnings.

A non-cooperative firm retains its earnings for its own account, or perhaps pays part of them out to shareholders as dividends, based on the amount of stock each investor owns. In a cooperative, earnings are usually allocated among the members on the basis of the amount of business each did with the cooperative during the year. Remember the example of a cooperative that has net earnings of $20,000 during the year and conducts 2 percent of its business with Ms. Jones. She is allocated $400 of those earnings ($20,000 x .02).

Typically, Ms. Jones would receive her allocation, called a patronage refund, partly in cash and the remainder as an addition to her equity account in the cooperative. Permitting their cooperative to accumulate retained patronage refunds is a relatively easy and painless way for members to help finance activities and growth. Also, if certain rules in the Internal Revenue Code are followed, the cooperative may deduct both the cash payouts and the retained patronage refunds from its taxable income. This makes cooperative earnings particularly valuable.

4. Political action. Growers, small business owners, and other rural residents have to realize that no one gives you a favorable law or regulatory ruling just because you think

you deserve it. You have to build your case and argue your point convincingly.

A cooperative gives people a means to organize for effective political action. They can meet to develop priorities and strategies. They can send representatives to meet with legislators and regulators. These persons will have more influence because they will be speaking for many, not just for themselves.

They can also form coalitions with other groups having similar views on issues. The larger the voice calling for a specific action, the more likely that the system will respond with the policy you desire.

5. Local economy enhanced and protected. Having its businesses owned and controlled on a cooperative basis helps your entire community. Cooperatives generate jobs and salaries for local residents. They pay taxes that help finance schools, hospitals, and other community services.

When a business is a cooperative, your town is less likely to lose those jobs and taxes. A business owned by one person, or a subsidiary of a big company, can easily be moved to another community. When many local people share the ownership of a cooperative, no individual or company can take it from your area or simply close it. Only the membership as a whole can make such decisions.

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Chapter 5. Business Organizations [6]

In the United States, historically there are three basic categories of private business firms--individually owned, partner-ships and corporations. Cooperatives are a type of corporation. Recently, most States have approved a new business structure, the limited liability company. This section explains the similarities and differences between cooperatives and the other business forms.

Individually Owned Businesses

The individually owned business is the oldest and most common form. One person owns, controls and conducts the business. Characteristics of individually owned businesses include:

- **Control**. The owner is responsible for management, makes all the major operational decisions an sets the business policies
- **Capital**. The owner supplies the equity and is responsible for all debts.
- **Earnings**. Profits belong to the owner.
- **Taxes**. Profits are taxed once, as income of the owner.
- **Life**. The life of the individually owned business is tied to the one owner. It continues until the owner sells the business, retires or dies. At that point the business is either taken over by a new owner or discontinued.

Many farms are operated as individually owned businesses. Other examples of business commonly operated by an individual owner include service stations, hardware stores, restaurants, flower shops and dry cleaners.

Partnerships

Partnerships consist of two or more people who jointly own, control and operate a business. The responsibilities of each are usually based on a partnership agreement. Characteristics of partnerships include:

- **Control**. Partners usually share management and make policy decisions by mutual agreement or majority vote. Some agreements provide for senior partners whose votes may carry greater degrees of weight.

- **Capital**. Partners provide the equity capital. Usually, each partner is personally liable, up to the value of all the property he or she owns (both within and outside the partnership), for the debts of the partnership. Some partnerships have "limited" partners, who relinquish any voice in managing the business in exchange for a limit on their personal liability.
- **Earnings**. Profits (or losses) are shared by the partners in accordance with the terms of the partnership agreement. This is usually determined by the amount of capital invested and the nature of the work performed by each partner.
- **Taxes**. Earnings are taxed once, as income of the partners.
- **Life**. The life of the partnership as a business is deter-mined by the partners, but if one dies or leaves the organization, it often must be dissolved and a new partnership formed.

Some farms are owned and operated on a partnership basis. Other examples include law and accounting firms, insurance and real estate companies. Partnerships may operate an auto repair firm, store and any other business.

General Business Corporations

Most businesses that have more than a small number of owners are organized as corporations. Corporations are legal entities, authorized by law to act much like an individual person. A corporation has the right to provide services, own property, borrow money, enter into contracts and is liable for its own debts.

A general business corporation operates as a profit-making enterprise for its investors, who are also referred to as stock-holders. Most of the major companies in America operate as general business corporations. Their characteristics include:

- **Control**. Management is controlled by a board of directors and officers who are elected by the stockholders. Each stockholder usually has as many votes as the number of shares of voting stock he/she owns. Business decisions and policy are made by the board and officers. The directors have no obligation to use the firm's products or services and may have no contact with the firm outside of board meetings.
- **Capital**. Equity is raised by selling shares of stock to investors for their profit-making potential. The corporation is responsible for its own debts. If the business fails, each owner of stock can lose only the amount invested.
- **Earnings**. Profits are distributed to stockholders as dividends according to the number of shares of stock owned or used to expand the business. The timing and amount of such dividend distributions are decided by the board of directors.
- **Taxes**. Earnings are taxed twice, as income of the corporation when earned and as income of the stockholders when distributed as dividends.
- **Life**. A corporation enjoys a continuing existence, regardless of changes that may occur in the ranks of its shareholder owners.

Examples of investor-oriented corporations are large department stores, chain grocery stores, regional banks, automobile manufacturers and much of the communications industry.

Limited Liability Company

A new form of business gaining widespread attention is the limited liability company (LLC). It combines the single-tax treatment of a partnership and the limited personal liability of owners of a corporation. Characteristics of an LLC include:

- **Control**. The owners, called members as in a cooperative, may share management and make policy decisions by mutual agreement or majority vote, or turn the management over to nonmembers. The operating agreement among the members determines voting rights of each member.
- **Capital**. Members usually provide the equity capital. Liability of the members is usually limited to their investment in the corporation.
- **Earnings**. Profits (or losses) are shared by the members in accordance with the terms of the operating agreement. This is usually based on the amount of capital invested and the nature of the work performed by each member.
- **Taxes**. The Treasury Department assumes an LLC wants to be taxed as a partnership. However, an LLC has the option to elect to be taxed as a general business corporation.
- **Life**. An LLC may have a perpetual existence, or the members may chose to be governed by the partnership rules.

The LLC is still developing as a business structure. It is already proving a useful vehicle for organizing joint ventures among established corporations, including those involving cooperative and noncooperative firms. Whether it can be used to organize a number of individuals, who may want the flexibility to join and leave the venture at will, is undetermined at this time.

Cooperative

A cooperative is also a state-chartered business, organized and operating as a corporation under applicable state laws. Cooperative attributes are:

- **Control**. Management is controlled by a board of directors who are elected by the members. One unique feature of a cooperative is that each member usually has only one vote in selecting directors, regardless of the amount of equity that member has in the cooperative. Another is that all or most of the directors must be members of the cooperative. Thus, the leaders are regular users of the firm's products or services.
- **Capital**. Equity comes from the members, rather than outside investors. It is obtained by direct contributions through membership fees or sale of stock, by agreement with members to withhold a portion of net income based on patronage, or through retention of a portion of sales proceeds for each unit of product marketed. If a cooperative fails, the liability of each member is limited to the amount he/she has invested.
- **Earnings**. Earnings (or losses) on business conducted on a cooperative basis, often called margins, are allocated to the members on the basis of the use they made of the cooperative during the year, not on the basis of equity held. The allocations may be distributed in cash or retained as additional equity. Members usually receive a combination of cash and an allocation of equity.
- **Taxes**. Earnings from business with members are taxed once, either as income of the corporation when earned or as income of the members when allocated to them.
- **Life**. A cooperative usually has a perpetual existence. Members can routinely join or resign without disrupting ongoing operations.

Examples of businesses that operate as cooperatives include agricultural marketing, purchasing and service organizations; credit unions; health care providers and multi-unit housing facilities.

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Chapter 6. Classifying Cooperatives by Structure

Cooperatives are regularly described by a number of classification schemes. The more important ways to categorize are by the geographical territory served, the governance system and the functions they perform.

Geographic Territory Served

One factor determining cooperative structure is the size of the area served. Cooperatives are loosely categorized as local, super local, regional, national and international.

Local cooperatives operate in a relatively small geographic area, typically a single county or an area within a radius of 10 to 30 miles. They usually have only one or two facilities, from which to serve members.

Super local cooperatives operate in two or more counties, often with several branch facilities.

Regional cooperatives serve an area comprising numerous counties, an entire State or a number of States.

National cooperatives serve a major portion or most of the United States.

International cooperatives operate in more than one country, with headquarters in the United States or another country.

Governance System

Cooperatives can also be classified based on membership structure, as centralized, federated or mixed.

Centralized cooperatives have individuals and business entities (including partnerships and family corporations) as members. Virtually all locals and super locals are centralized. Regional, national, and international cooperatives may also be centralized.

A centralized cooperative has one central office, one board of directors elected by its members, and a manager (chief executive officer) who supervises all operations. Business may be conducted through numerous branch stores or offices staffed by employees responsible to the central management team.

Federated cooperatives have other cooperatives as their members. Each member of a federated is a separate cooperative that owns a membership share entitling it to voting rights in the affairs of the federated. Local cooperatives commonly form federateds to perform activities too complex and expensive for them to do individually, such as manufacturing production supplies, tapping major financial markets, and marketing on a national or worldwide scale.

Each member of a federated typically has its own board of directors, manager, employees and facilities to serve its members. The federated has its own hired management and staff and a board of directors elected by and representing its member cooperatives.

Mixed cooperatives have both individuals and other cooperatives as members, who are usually given voting rights representative of their own membership.

Functions Performed

Cooperatives may perform one or more of three core functions: marketing products, purchasing supplies and providing services.

Marketing cooperatives assist members maximize the return they receive for goods they produce. Most cooperative marketing activity involves either agricultural products or those of producers in related industries such as forestry, aquaculture and horticulture.

New marketing ventures are developing in such diverse industries as handicrafts, professional services and information technology.

Some marketing cooperatives limit their activity to negotiating prices and terms of sale with buyers. Growers of fruits and vegetables for processing and dairy farmers are primary users of these cooperatives, called bargaining associations.

Other marketing associations assemble member production into large quantities for sale to further processors, wholesalers or retailers. This first-handler role is common for cooperatives of grain growers and producers of fruits and vegetables for the fresh produce market.

Other such associations add further value to member production by processing or manufacturing member products into other, more valuable products. These may serve as ingredients in further processed products or be sold to institutional buyers and restaurants for their direct use, to grocery chains for resale as private label products, or to brand-name companies for resale under their brand. Cooperatives that process dairy products, fruits, vegetables, grains, fish, and lumber exemplify these value-added processing activities.

Still others put member products right on the grocery store shelf under their own brand name. Land O'Lakes, Sunkist, Ocean Spray, Welch, Tree Top and Knouse Foods are examples of cooperatives with established brands.

Marketing cooperatives enable members to extend control of their products--and realize additional margins--through processing, distribution and sale.

Purchasing cooperatives were first used by farmers to gain access to affordable, quality production supplies such as feed, fuel, fertilizer and seed. These early efforts often became businesses having full-time managers and warehouses to handle other production supplies and services such as farm chemicals, animal health products, fencing, building supplies, construction contracting, automotive accessories, etc.

Many local purchasing cooperatives have affiliated with other such organizations, often through regional and national federated cooperatives. These efforts reduce member costs and strengthen their purchasing power through direct ownership of large-scale facilities such as petroleum refineries; phosphate, potash, and nitrogen manufacturing plants; feed mills; research facilities and laboratories.

Today many nonfarm businesses have developed supply purchasing cooperatives to gain access to the same volume discounts and quality control assurances long available to farmers. These include hardware stores, independent grocery stores and fast food restaurant franchisees. Many have developed private labels, such as Shurfine Foods, or recognized brand names such as Ace Hardware, True Value and Servistar.

Service cooperatives were also developed to serve farmers. Some of these services are farm-specific, such as recommending and applying fertilizer, lime, or pesticides; animal feed processing; and crop harvesting. Others are general in nature, such as credit through the Farm Credit System, electricity through rural electric cooperatives and communications service through rural telephone cooperatives.

Nonagricultural service cooperatives are also flourishing. Credit unions and the National Cooperative Bank provide credit on a cooperative basis to nonfarm individuals and cooperatives. School systems, health care providers, and insurance buyers are among the general public segments making use of service cooperatives.

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Chapter 7. People[7]

Because a cooperative is owned and controlled by the people who use its services, the various persons affiliated with a cooperative must work even more closely together than in a noncooperative firm. Customer service and satisfaction are the driving forces behind a cooperative, not maximizing bottom-line return to investors. These take on a highly personal tone when the owners and directors, in their role as users, have regular contact with management and staff.

Cooperatives depend on a coordinated team consisting of four elements -- members-owners, board of directors, the manager and other responsible employees. Each part of the team has its own distinctive duties. Success is based on intelligent and active cooperation and each group carrying its load.

Members

Members are the foundation of the cooperative. They organized it. Their needs are the reason for its existence. Their support, through patronage and capital investment, keeps it economically healthy. And their changing requirements shape the cooperative's future.

Statutory law and the basic legal documents of a cooperative --articles of incorporation, bylaws, and contracts between the cooperative and its members--give the members the tools to control the cooperative and the duty to use those tools for their mutual benefit. Legal rights and responsibilities of cooperative members normally include:

- To adopt and amend the articles of incorporation and bylaws.
- To elect and, if necessary, remove directors.
- To decide whether to dissolve, merge or consolidate the cooperative or form a joint venture with other cooperative or noncooperative firms.
- To make sure officers, directors and other agents comply with laws applicable to the cooperative and with its articles of incorporation, bylaws and membership contracts.

Members also have general responsibilities toward their cooperative. Unlike the passive investor in a general business corporation, the member-owner-user of a cooperative must patronize and guide the venture for it to succeed. Employees and advisers need to understand these member obligations and help members fulfill them.

1. **Patronize the cooperative.** Members must make a conscious decision to be committed to the cooperative, even when short-term prices or services may be better elsewhere. If members don't want to use the cooperative, the need for it must be reexamined.

2. **Be informed about the cooperative.** To carry out their other duties, members must know what the cooperative is about; what it can do for them; its purpose, objectives, policies; and the issues it faces. They can obtain information through annual meetings, reports and newsletters, and from talking to the manager, staff, directors and other members. To effectively exercise their right of ownership, a member needs a good understanding of the present situation and projected future operations.

3. **Be conscientious when selecting and evaluating directors.** Although the cooperative is a user-owner, democratically controlled form of business, members can't make all the decisions directly. They select from among their peers individuals with the best judgment and business management skills to represent them in management affairs as the cooperative's board of directors. Loyalty, integrity, the ability to make wise

business decisions and willingness to serve are necessary characteristics for board members.

4. **Provide necessary capital.** Members must provide the equity financing their cooperative needs for acquiring inventory, facilities, services and working capital. This is done initially through the purchase of stock or a membership. It continues by permitting the cooperative to retain a portion of the earnings allocated to each member and through the collection of per-unit retains from checks to members for the proceeds of sale from marketing member products.

If the cooperative loses money, members have the same obligation to share those losses as they do the earnings.

5. **Evaluate performance of the cooperative.** Members should examine the annual report and observe whether the cooperative is meeting their needs. If they are dissatisfied with cooperative performance, they should share their concerns with the directors. They should also express support for things the cooperative is doing well. Directors can't effectively represent the members if they don't know the members' true feelings.

Directors

Directors in a cooperative occupy a key position between members and hired management. They are both users of its services and representatives of other members who depend on those same services.

Acting as a group, directors set the objectives for the cooperative and make decisions that set the course the cooperative will follow in achieving those objectives. These broad managerial decisions include:

- Hire a competent manager, determine the salary, outline the duties and authority of the position and formally review his/her performance at least annually.

- Adopt broad, general policies to guide the manager. Topics covered might include credit limits to patrons, expenditures that need prior board approval and general personnel regulation.
- Develop and adopt long-range business strategies.
- Require written monthly financial reports and operating statements for board meetings to be informed of adverse as well as favorable operations.
- Direct the manager to prepare, before the close of each year, an operating budget for the next fiscal year for board approval. This budget should estimate the volume of sales and gross income of various items to be handled, the expenses by account classifications and the net income expected. This constitutes necessary forward planning by the board and management. The budget should be reviewed at intervals throughout the year to determine the trends of the business.
- Employ a qualified auditor to make an independent audit at least once each year to determine the accuracy of the financial records. An audit is the primary method the board uses to verify the financial condition of the cooperative. Many successful cooperatives also use the audit report to evaluate the effectiveness of the policies and budget, performance of the manager and gain insight into the effect of past decisions and the need for new ones.
- With the aid of the manager, plan and conduct the annual meeting to keep the membership informed about the status of their business, including operations, finances and policies.

- Determine the patronage refund allocation and per-unit retain level. Factors to consider include legal requirements, member needs and desires for cash refunds, the desirability of providing money to retire old equities, and current and future capital needs.
- Assure competent legal counsel is available.
- Keep a complete record of the board's actions.

A cooperative director should not expect to receive special favors from the manager or employees, and a director **does not**:

- Act independently on matters that should be decided by the entire board. Individual directors have no authority outside of board meetings.
- Represent special interests, factions or political entities. Directors are elected to oversee the business activities of the cooperative, not serve as an agent of these groups.

In carrying out their responsibilities, directors serve much like trustees, charged with a legal obligation to protect the assets of the members. Directors who act outside the parameters of the law or don't exercise due care in their decisionmaking can be personally liable for the harm they cause the members, the cooperative or third parties.

Officers

The board usually elects the cooperative's officers shortly after the annual membership meeting. Each officer has specific duties as detailed in the cooperative's bylaws.

- The president presides at all meetings and watches over the association's affairs, serving as the main communication link between hired management and the other directors and members.
- The vice president, in the absence or disability of the president, performs the duties of the president.
- The secretary keeps a complete record of all meetings of the board of directors and general membership and also is the official custodian of the cooperative's seal, bylaws, and membership records.
- The treasurer oversees the bookkeeping and accounts to ensure accuracy and proper handling and also is responsible for presenting periodic financial reports.

Board Committees

The board's work may be divided among special or permanent committees, each dealing with a phase of the association's operations, such as finance, purchasing, merchandising, and others.

Each committee studies the problems in its particular field and makes recommendations to the board of directors. In some instances, committees may be given certain powers to act for the board, subject to review by the entire board.

Large associations may select an executive committee to perform general management and oversight duties as authorized by the board.

Managers

Success of a cooperative largely depends on good board/ manager relationships. The working relationship between board and general manager requires respect and an understanding of each other's responsibilities.

The board of directors decides what the cooperative will do; the general manager and immediate staff decide how it can best be done--subject to board review--so as to achieve the basic objective of serving members effectively.

The manager is selected by the board and accountable to it for his/her actions. The manager should therefore not be a part of the board. The manager should, however, attend all board meetings and be an active, nonvoting participant.

The manager controls the ongoing activity of the cooperative. Responsibilities of the general manager include:

- Supervise and coordinate, under board direction, the business activities of the co-op by managing the people, capital, and physical resources.
- Hire, train, supervise, and set compensation for employees. The manager also needs to review their performance and train, reassign, or replace those employees not meeting acceptable performance levels.
- Oversee the detailed operations of the cooperative, within policies established by the board of directors, such as purchasing inventory and selling commodities, maintaining the general appearance of the co-op, and making sure employees respond to member needs.
- Maintain, and revise as necessary, an adequate bookkeeping and accounting system; develop for board approval a financial budget annually; prepare proper financial reports regularly for board review; and present a report of the cooperative's operational highlights to the membership at the annual meeting.
- Furnish information needed for long-range planning. This will bring matters, such as fixed asset additions or revisions, to the board's attention for review.
- Represent the cooperative and portray a positive image to members and others in the community.
- Encourage membership and active patronage.
- Communicate developments at the cooperative to members.
- Keep current on local, State, and Federal legislative and regulatory developments affecting cooperatives.

Employees

In many ways, working for a cooperative is similar to doing the same job at a noncooperative firm. But special features of a cooperative--the role of the member-owner as user and the emphasis on service over bottom-line numbers--place unique obligations on the employees.

1. **Understand the purpose and objectives of the cooperative.** Employees need to know how cooperatives are different from other methods of doing business. By understanding cooperative purposes, objectives, operations and their role as employees, they can help improve member relations, the cooperative's image and the general public's understanding of cooperatives.

2. **Fully perform duties.** In many cooperatives, like other business firms, the largest operating expense is for personnel. While the cooperative has responsibility for recruiting and providing training, the employee is responsible for using these opportunities to provide the best possible service to members.

3. **Understand the relationship to member-owners.** All employees have a responsibility to maintain a high level of customer satisfaction and good relations between the cooperative organization and its member-users. Immediate feedback from members should be encouraged to keep the manager informed of problems, needs and customer satisfaction.

The employee role is particularly important in larger cooperatives. The only cooperative employees that members may encounter regularly, from annual meeting to annual meeting, may be the individual pumping the gas, the cashier, the person answering the telephone, the truck driver picking up their milk or delivering a product. To the average member, they are the voice of the cooperative.

4. **Favorably represent the cooperative**. Employees help build the cooperative's image as they serve members and the community--both on and off the cooperative's premises. Employees should keep the premises clean and attractive; make sure equipment and service tools are operating; serve members pleasantly, promptly, and in the order promised and take an extra step to give members satisfactory service.

Employees, like their manager, can be community boosters by taking part in religious, school or community affairs. Their efforts can positively affect the cooperative image held by members, the general public and other businesses.

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Chapter 8. Sources of Equity [8]

One of the greatest challenges facing cooperatives is raising equity capital. Because cooperatives pass earnings through to users on a patronage basis, they cannot attract equity from outside sources to the same extent as investor-owned businesses.

Cooperatives are not alone. Sole proprietorships, partnerships and closely held corporations face similar problems acquiring equity. Their equity capital usually is provided by the owners or acquired via retained earnings.

Only a single tax is placed on their income, to help overcome the capital accumulation problem. Earnings of investor-owned corporations are subject to taxation twice, once at the corporate level when earned and again at the ownership level if and when distributed as dividends. Owner(s) of a sole proprietorship, partnership, limited liability company or cooperative can generally reduce tax liability at the firm level if they meet specific Internal Revenue Code (Code) requirements. A greater portion of income is therefore available for reinvestment in the business.

The three primary ways members provide equity to their cooperative are direct investment, retained margins, and per-unit capital retains. Cooperatives may also acquire equity by retaining earnings on nonmember, nonpatronage business. This section explains the nature of each source of equity.

Direct Investment

Direct investment refers to cash purchases of membership certificates, common and preferred stock or other forms of equity.

Most cooperatives require a member to make a direct payment when joining the cooperative. In return, the member receives a membership certificate in a nonstock cooperative or a share of common stock in a stock cooperative. The certificate or share of stock usually conveys to the owner the right to vote on matters submitted for decision to the cooperative membership and the owner is generally referred to as a member of the cooperative.

Direct investment by members is often a minor source of equity to a cooperative. Most cooperatives are trying to retain current members and attract more members and member business. And members generally prefer the cooperative to generate its own equity, rather than solicit checks from them. Thus the cost of a membership certificate or share of common stock is usually modest. Equity that evidences membership usually does not pay a dividend, if for no other reason than the administrative expense of issuing a large number of small checks.

Traditionally, direct investment can be a major source of equity in two instances. Direct investment is often the primary means for a new cooperative to acquire equity capital. Once the cooperative is functioning, it then can accumulate additional equity from operating funds in the form of retained earnings or per-unit retains.

Some cooperatives also acquire equity by selling nonvoting stock or equity certificates to members and nonmembers. This nonvoting equity usually pays a limited dividend as an inducement for persons to invest in the cooperative.

A resurgence in cooperative value-added processing of commodities is being fueled by a system of direct investment, called **transferable delivery rights**. Members who wish to share in the benefits from the value-added processing are required to provide necessary up-front capital by purchasing long-term delivery rights in the cooperative. These delivery rights entitle and obligate the member to deliver to the cooperative all of the production from specified acreage or specific quantities of product (so many tons or bushels). The purchase of delivery rights assures members of a long-term "home" for their production and provides an opportunity to share in the benefits of value-added processing based on their patronage.

Membership is generally limited to producers who purchase delivery rights and the cooperative only sells enough delivery rights to secure the quantity of product it can process efficiently and resell at a profit. The delivery rights are typically represented by non-dividend bearing, non-voting preferred stock. The preferred stock (and thus the right to deliver product to the cooperative) are transferable by the member to other producers, subject to approval by the cooperative's board of directors. If the cooperative is successful, the only way other producers can participate is to purchase delivery rights from current members. Thus, members may enjoy an additional benefit, a gain on the sale of their preferred stock tied to their delivery rights.

Generally, the tax treatment of direct investments in a cooperative follows the same rules as a direct investment in an investor-owned corporation. The payment to the cooperative is a nontaxable event. While the value of cooperative equity is usually constant, any gain or loss realized by the equity holder is generally a capital gain or loss.

Cooperative earnings used to pay dividends on equity are usually subject to taxation at both the cooperative and the recipient levels. An exception is dividends paid by farmer cooperatives that qualify for so-called "exempt" status under Code section 521. These cooperatives are allowed to deduct dividends paid on stock, so they are only taxed once, at the recipient level.

Retained Margins

While cooperatives are sometimes described as businesses that operate "at cost," few if any can do so on a day-to-day basis. Rather, cooperatives seek to generate income that exceeds expenses on an ongoing basis. Then, usually after the close of the fiscal year, they return earnings from business conducted on a cooperative basis to the persons responsible for the business generating those earnings, who are called patrons.

These returns, based on the amount of business each patron does with the cooperative during the year, are called "patronage dividends" in the Code. This report refers to them as "patronage refunds," the term used in cooperative literature. This reduces the likelihood such refunds will be confused with traditional dividends, which are based on stock ownership rather than the amount of business conducted with the firm.

The board usually determines how the earnings will be distributed. All of the earnings may be returned to the patrons as cash patronage refunds. Or the directors may decide to have the cooperative retain some or all of the patronage refunds as an equity investment in the cooperative. Single tax treatment is available only for patronage-sourced earnings that are returned to the patrons as cash or "other property," or retained under procedures set out in the Code.

Qualifying for the single tax treatment provided in the Code is discretionary, not mandatory. Earnings not allocated to patrons are treated just as profits of an investor-owned firm. They are taxable income to the cooperative when earned and taxed a second time to the recipients when distributed by the cooperative.

Per-Unit Capital Retains

Cooperatives that market products produced by their members have a third means of acquiring equity capital, per-unit capital retains. These are capital investments based on either the number of physical units handled by the cooperative or on a percentage of sales revenue. Per-unit retains are deducted from sales proceeds due the members from the cooperative.

As with patronage refunds, per-unit capital retains returned to patrons as cash or retained by the cooperative, under rules in the Code, are only subjected to a single income tax.

And again, single tax treatment is discretionary. A cooperative may place some or all of these retains into an unallocated reserve, thereby forfeiting access to single tax treatment.

People sometimes blur the distinction between patronage refunds and per-unit capital retains. Patronage refunds are based on the earnings of the cooperative; per-unit retains on the volume or value of business done with the cooperative. Thus, a cooperative can acquire capital, even in a year of limited margins or a loss, through the use of per-unit capital retains.

Nonmember/Nonpatronage Earnings

Non-tax laws, such as the Capper-Volstead Act and state cooperative incorporation statutes, frequently require affected cooperatives to do a majority of their business with members. This still leaves those associations free to do up to 49 percent of their business with nonmembers on a noncooperative basis.

Earnings on this business are usually not eligible for single tax treatment. But the after-tax earnings can be used to build the equity base of the cooperative to improve its balance sheet and finance services it provides to members. Again, an exception is made for section 521 cooperatives, which may deduct nonpatronage income distributed to patrons on a patronage basis.

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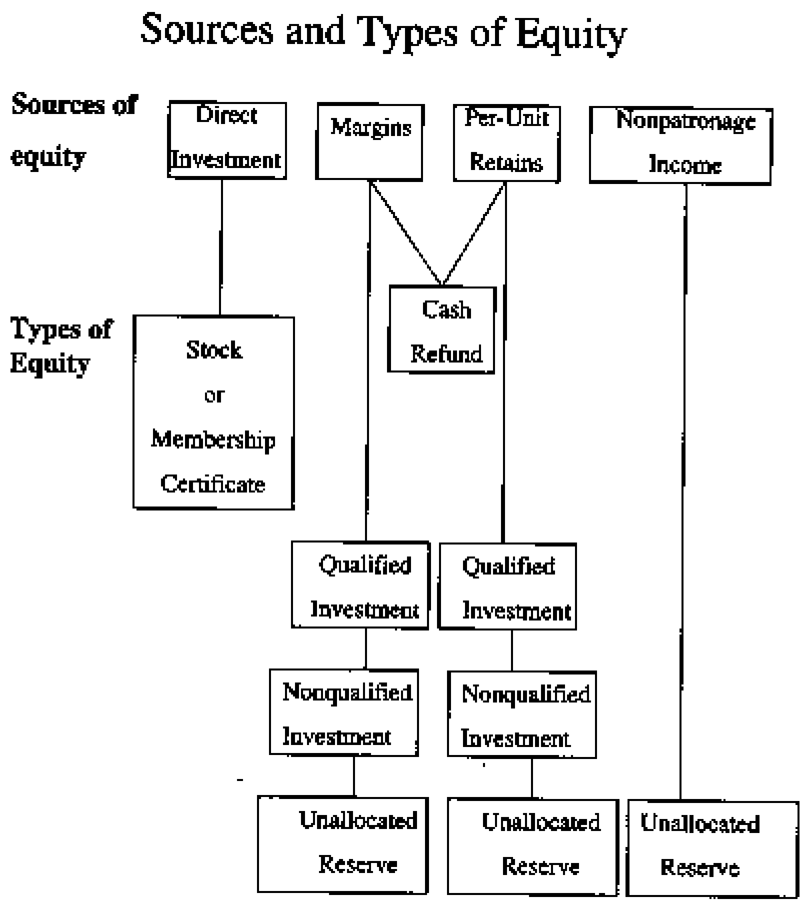
Chapter 9. Financial and Tax Planning

As the following flow chart illustrates, cooperatives have flexibility in designing an equity accumulation program to meet their individual needs. An understanding of the alternatives and their tax treatment is especially important when allocating patronage-based sources of equity, retained margins, and per-unit retains.



Direct investments usually are made to purchase membership equity, the membership certificate or a share of common voting stock.

Nonpatronage income is likewise usually placed into a single type of account, an unallocated reserve.

Patronage-based sources of equity can be used for at least four purposes: cash refunds, qualified retained patronage allocations, nonqualified retained patronage allocations and unallocated reserves.

Cash Refunds

Cooperatives can distribute their margins and per-unit capital retains as cash refunds to the patrons. Cash distributions are generally tax deductible by the cooperative in the year earned and taxable income to the recipient in the year of receipt. Cash refunds do not add to the equity of the cooperative, but provide an immediate additional return to the patron on his or her use of the cooperative.

Qualified Retains

Cooperatives can retain margins and per-unit capital retains and allocate the retained funds to equity accounts of the patrons, based on the amount of business each patron did with the cooperative during the year. If the cooperative follows the rules in the Code to "qualify" the equity, the cooperative deducts the amount of the allocations from its taxable income in the year the margins and retains were realized.

Patrons include the amount allocated in their taxable income in the year they receive a required written notice of the allocation. The retained funds become an equity investment by the patron in the cooperative. An example illustrates how this works for a typical agricultural marketing cooperative.

The cooperative pays the producer $600 for his/her crop at the time of delivery. It costs the cooperative $300 to market the crop. The cooperative sells the crop for $1,000.

The resulting margin of $100 is returned to the patron as a patronage refund. Thus the patron receives a total payment of $700 for the crop, a $600 advance at the time of delivery and a $100 patronage refund.

When the cooperative figures its taxable income, it is allowed to deduct the initial payment for the crop ($600), its other expenses of marketing the crop ($300), and the patronage refund ($100). Thus, it ends up with no taxable income. The patron includes both the initial payment ($600) and the patronage refund ($100) in taxable income, for a total of $700.

TAX TREATMENT OF COOPERATIVE AND PATRON
QUALIFIED RETAINED EQUITY

Cooperative		Patron	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin	$100	Refund	$100
Taxable Income	0	Taxable Income	$700

The Code requires at least 20 percent of a qualified patronage refund be paid in cash. But the cooperative can still retain up to 80 percent of its margins without having to pay a tax (at the co-op level) on any of the patronage refund. There is no 20-percent cash distribution requirement for qualified per-unit retains, so a cooperative can keep the entire amount free of tax liability at the co-op level.

The patron must report the entire $100 refund as taxable income, even though $20 or less may have been paid in cash.

The redemption of qualified equity is a tax-free event for both the cooperative and the patron, since the tax was paid by the member when the patronage refund was received.

The tax treatment of qualified retained equity is similar to the pass-through procedures that provide single tax treatment for partnerships and other single-tax corporations. But, cooperatives have additional flexibility not generally available to other pass-through entities.

Nonqualified Retains

Cooperatives may delay the pass-through of the tax obligation from the cooperative to the patron without jeopardizing single tax treatment of those moneys.

Any patronage-based allocation not meeting the requirements of the Code to be "qualified," has "nonqualified" status. When a nonqualified allocation is made, the cooperative pays corporate income taxes on the funds retained. The patron has no tax obligation on these funds in the year of allocation.

TAX TREATMENT OF COOPERATIVE AND PATRON NONQUALIFIED RETAINED EQUITY

Cooperative		Patron	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin	$100	Refund	$100
Taxable Income	$100	Taxable Income	$600

If the cooperative in the earlier example issues its patronage refunds as nonqualified written notices of allocation, it would have taxable income of $100, the amount of the margin. The patron's taxable income would have been $600, the payment for the crop.

At some later time, *when nonqualified retained equity is redeemed,* the cooperative receives a tax benefit based on the tax paid at the time of allocation. The patron is taxed on the funds received. In the example, the cooperative would deduct the $100 paid to the patron (or receive a credit under certain circumstances). The patron would report the $100 as income in the year the cash payment was received.

Thus the single tax treatment of cooperatives doing business with or for members is complete and consistent with that accorded other single-tax entities. Income is ultimately taxed once, at the level of the owner-user of the business.

Nonqualified allocations have particular appeal to cooperatives with member-patrons in high marginal tax brackets. If the cooperative uses qualified allocations, it must make substantial cash payouts or high income patrons may suffer a negative cash flow on the margins they generate. This occurs when the total tax owed on the allocation (Federal and State) exceeds the amount of cash paid out as part of the distribution.

By using nonqualified allocations, no tax is due from patrons until the allocation is redeemed. Also, there is no 20-percent cash payout rule for nonqualified allocations.

Unallocated Reserves

Cooperatives can treat margins just as noncooperative firms treat earnings, by putting them into an unallocated reserve and paying corporate income tax. Under this approach, single tax treatment is forfeited. If the funds are later distributed, the recipients must pay a second income tax.

Cooperatives are free to use a combination of cash payouts, unallocated reserves, and qualified and nonqualified allocations. This makes it possible for the leadership to develop a program that reflects the best interests of the membership.

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Chapter 10. Equity Management

Another practice unique to cooperatives is the regular redemption of outstanding equity. Capital contributions from continuing patrons build as time passes. But the level of patronage will fall for some members, and others will likely cease using the cooperative at all. A program of adjusting patronage-based equity requirements on a regular basis matches the responsibility of financing the cooperative to current use of its services.

Three methods of matching patronage and equity obligations have achieved general acceptance: revolving fund plans, special plans, and base capital plans. Although the systems are often viewed as unrelated, they may, in fact, operate together.

Revolving Fund Plan

"Revolving fund financing" refers to systems in which patrons make annual capital contributions, typically through retained patronage refunds or per-unit retain allocations. The cooperative, in turn, redeems earlier capital contributions on a regular basis. Redemption is usually on a first-in, first-out basis. The cooperative determines what its total capital requirements are and the excess is redeemed each year, the earliest or "oldest" equity being revolved out first.

A revolving fund plan is frequently described as "systematic" if older equities are retired on a regular basis, usually a given number of years after they were issued. In a systematic plan, member investment is related to recent and current use. Newer members usually add equity to their account during their early years in the cooperative.

The accounts of established members are adjusted each year to better reflect current patronage. They make new investments based on current year's patronage and have their earliest year's equity redeemed. The accounts of former members are commonly paid off during the life of the revolving cycle, usually beginning the year after they cease patronizing the cooperative.

Redemption is normally dependent on a board of directors determination that funds for revolvement are available. This insures that there is room for flexibility if the situation warrants it. For instance, if there is a shortfall in new equity or a need to increase the cooperative's total equity, equity requirements can be met by lengthening the revolving cycle (the cooperative keeps equity for a longer period of time).

This tactic should be used sparingly, as it deviates from the objective of having current users finance the cooperative. Also, it can create member relations problems if the members have the expectation that their oldest equities will be redeemed on a fixed schedule, sometimes without regard for the cooperative's financial condition.

Special Plans

A special plan is one in which a specific event or condition, such as a member's death, triggers equity redemption. The most common events covered are death, retirement or reaching a specified age. Once the condition is verified, the member's equity may be returned at once or over a prescribed number of years.

Special plans are often popular with members, who see redemption of their equity investments supplementing retirement income or their estates. But special plans can complicate financial planning for the cooperative. One problem is forecasting how much equity will be redeemed in a given year.

Another difficulty is dealing fairly with members who are partnerships or corporations and whose business activity or life may continue well beyond that of individual partners or shareholders. One approach is for the association to redeem that portion of the member firm's equity equal to the ownership interest in the firm of the person meeting the special redemption condition. Then the firm would be expected to make up the difference just as if it had been underinvested by the amount of the redemption.

Special plans are sometimes combined with revolving fund or base capital plans.

Base Capital Plan

A "base capital plan" is a special equity capital management plan. It focuses directly on the current proportion of capital a patron should have in the cooperative at a particular time, based on the degree of use. Development of the base capital plan involves several steps.

1. The cooperative determines its total equity capital needs.
2. The equity capital needs are allocated among patrons based on the proportion of the cooperative's business each patron did with the cooperative during a base period, typically the past 3 to 7 years.
3. Each year the cooperative's equity requirements are re-viewed and adjusted as the board of directors finds appropriate. Each patron's share of the equity requirement is also adjusted to reflect (a) any change in the total requirement of the cooperative and (b) any change in the patron's proportional share in the new base period.
4. Under invested patrons must add to their equity account, usually through the current year's retained patronage refunds or per-unit retains, or by direct contribution.
5. Fully invested and overinvested patrons generally are paid a cash rebate of current year's patronage refunds and per-unit retain allocations. Overinvested patrons may receive an additional payment in redemption of their excess share of the equity.

The proportional share of former patrons will fall each year, reaching zero at the end of the base period beginning the first year after they cease patronizing the cooperative.

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Conclusion

Cooperation is a very old concept, with the potential for a very bright future. That potential will only be realized if the people with an interest in cooperatives make the effort to make them work. Reading and studying this booklet, and others like it, is an important first step. But that alone won't make you an expert. Learning about cooperatives can be a life-long process.

As the world changes, so must cooperatives if they want to survive and prosper. Members, directors, managers, employees and advisers must all seek out and take advantage of continuing educational opportunities.

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ENDNOTES

1. This chapter is based primarily on chapters 1 and 2 of *Farmers, Cooperatives, and USDA: A History of Agricultural Cooperative Service,* Agricultural Information Bulletin 621 (USDA 1991).

2. This explanation of cooperative principles and practices was developed by the author for *Welcome to Cooperatives,* available from the National Society of Accountants for Cooperatives, Springfield, VA. *Welcome to Cooperatives* is particularly appropriate- for educating accounting, financial and tax professionals with limited knowledge of cooperatives.

3. Most of the material in this chapter is from *A Day in the Life of Cooperative America*, a fascinating collection of facts and figures on cooperatives, sponsored by the National Cooperative Bank, Washington, DC.
4. The first 3 paragraphs of this section are based on *Farmer Cooperative Statistics, 1995*, RBS Service Report 52 (USDA 1996).
5. This chapter was written originally for *Do Yourself a Favor: Join a Cooperative*, RBS Cooperative Information Report 54 (USDA 1996).
6. Much of this chapter was also prepared by the author for *Welcome to Cooperatives* (see note 2, above).
7. This chapter reflects material originally published in *Under-standing Cooperatives*, a series of circulars that can be used individually or collectively for teaching people about cooperatives. RBS Cooperative Information Report 45, sections 4-6 (USDA 1994).
8. Much of the last 3 chapters was first drafted for *Income Tax Treatment of Cooperatives: Background*, RBS Cooperative Information Report 44, part 1 (USDA 1993), the first in a technical series of reports on Federal income taxation of cooperatives.

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