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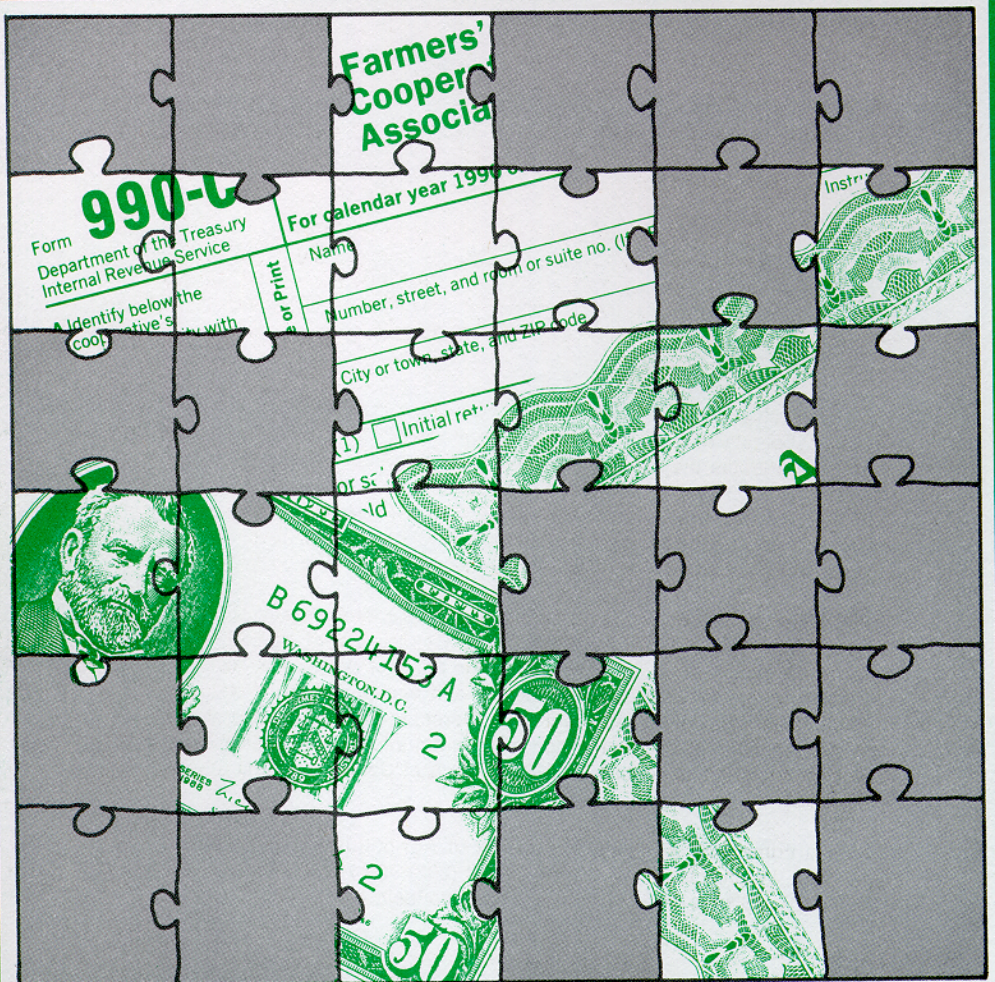
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Cooperative Financing and Taxation



FARMER COOPERATIVES IN THE UNITED STATES COOPERATIVE INFORMATION REPORT 1 SECTION 9

UNITED STATES DEPARTMENT OF AGRICULTURE
RURAL BUSINESS AND COOPERATIVE DEVELOPMENT SERVICE

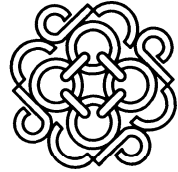


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Note: The material on cooperative taxation is presented only to provide information to persons interested in the tax treatment of cooperatives and does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other Government agency.

Cooperative Financing and Taxation



The field of cooperative finance is very specialized. The **fea-**tures of a cooperative make its **financial** characteristics and requirements unique and, consequently, **not well** understood by many in the financial community. Despite this, the general rules of finance apply equally to cooperatives as well as any other business enterprise. Specifically, a cooperative must have adequate equity capital and maintain sufficient cash flow to service its debt.

The most unique feature of a cooperative, compared with Investor Owned Firms (**IOFs**), is that a cooperative is organized by and for its member/patrons. Its members are both the owners and the primary users of the business. Members receive the benefits of the organization and provide the risk capital to operate the business. In an **IOF**, an investor is not necessarily a user of the firm's products or services.

Most farmer cooperatives begin as small businesses. Members supply most of the startup capital to minimize the initial need for borrowed capital. As the organization grows, however, the business usually expands faster than the ability of members to meet the additional demand for capital. At this point, cooperatives may begin to rely more heavily on debt to finance growth. As a cooperative's business grows, financial decisions become more and more important as a key factor in the success or failure of the organization.

Many cooperatives today are very large businesses, with millions and even billions of dollars of revenue. Their operations sometimes span large multi-State territories and may even involve buying and selling in international markets. Financing modern cooperatives can be a very complex undertaking.

This publication provides an overview of cooperative finance and the characteristics of cooperatives that make their financial requirements unique. It explores both the internal and external methods a cooperative uses to finance its business. Also, a section is included that highlights tax laws and regulations under which cooperatives operate.

Historical Perspective

Agricultural cooperatives have had a significant impact on the agricultural economy. The number of agricultural cooperatives in the United States peaked at more than 14,000 in 1922. Since then, the number has steadily declined to about 4,200 in 1993 and is expected to continue declining as cooperatives merge, consolidate, and dissolve.

Table 1 shows the number of agricultural cooperatives, by category, at the beginning of each decade during this century.

Despite cooperatives' declining numbers, the dollar business volume of those remaining has generally increased (figure 1).

Table 1-Numbers and types of cooperatives since 1990, by decade¹

Year	Type			Total
	Marketing	Purchasing	Service ²	
1900	1,167	56		1,223
1910	4,317	358		4,675
1920	11,269	1,943		13,212
1922 (Peak)	12,473	2,155		14,628
1930	11,272	2,288		13,560
1940	7,943	2,657		10,600
1950	6,519	3,283	262	10,064
1960	5,727	3,222	214	9,163
1970	5,097	2,731	167	7,995
1980	3,808	2,369	116	6,293
19903	2,519	1,717	427	4,663

¹ Sources: Prior to 1950, Cooperative Historical Statistics, CIR 1, Section 26, USDA, ACS, Washington, DC (revised October 1987). For years 1950 and after, Farmer Cooperative Statistics, 1993, CS Service Report 43, USDA, RDA/CS, Washington, DC (November 1994).

² Service cooperatives were reclassified from marketing to service cooperatives in 1989.

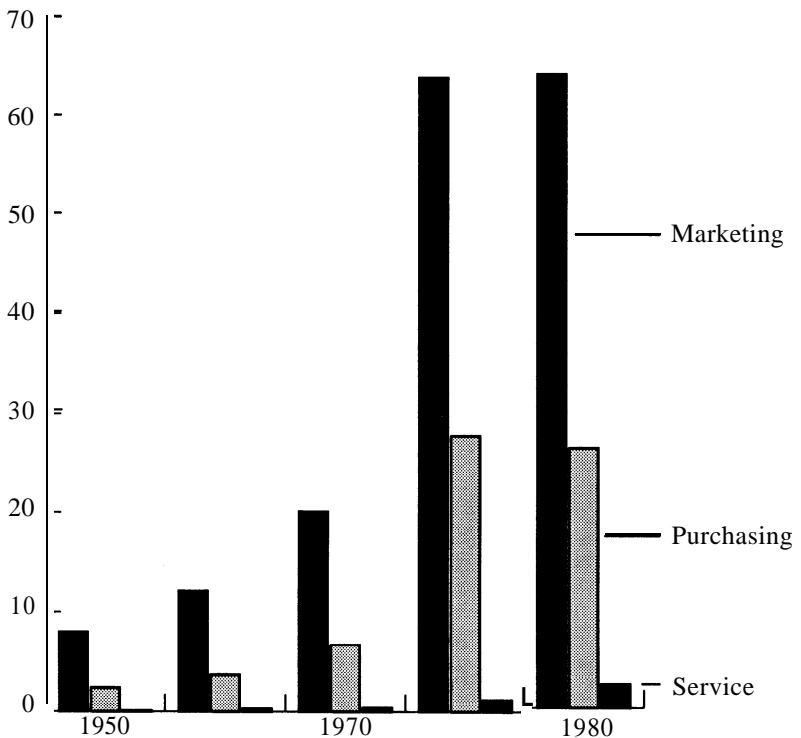
³ Cotton ginning cooperatives were reclassified from marketing to service cooperatives in 1989.

Significantly, the dollar volume nearly quadrupled during the 1970s, in part because of the inflationary growth in agriculture. By contrast, business volume during the 1980s decreased because of an economic retrenchment in the agricultural sector. By the first half of the 1990s, business volume returned to a steady growth pattern.

Total assets and net worth grew steadily through 1980, but then deteriorated somewhat in the relationship of net worth to total assets when cooperatives became more highly leveraged. In the late 1980s and early 1990s, net worth (member equity) positions strengthened, helping cooperatives to better withstand future economic downturns in agriculture. These trends are shown in table 2.

Figure 1 — **Gross Business Volume**

Billion dollars



¹ Farmer Cooperative Statistics, 1993, CS Service Report 43, USDA, RDA/CS, Washington, DC (November 1994).

² Gross business volume includes intercooperative transactions.

Table 2-Cooperative balance sheet data, selected years¹

Year	Total assets	Net worth	Net worth as a percentage of total assets
	— Million dollars —		<i>Percent</i>
1954	3,351	1,914	57
1962	5,323	3,057	57
1970	8,477	3,950	47
1976	18,554	7,727	42
1980	29,416	10,591	36
1985	27,779	12,053	43
1989	29,649	13,313	45
1993	33,446	14,812	44

¹ Farmer Cooperative Statistics, 1993, CS Service Report 43, USDA, RDA/CS, Washington, DC (November 1994).

Member Equity

Meeting Cooperatives' Capital Needs

All businesses need capital to finance assets and operations. Businesses, including cooperatives, derive capital from two primary sources: (1) accumulating net worth (ownership capital), and (2) borrowing (debt capital). The difference for a cooperative arises in the characteristics of the ownership capital. In a cooperative, net worth is often referred to as **member equity**.

Equity capital in a cooperative is money obtained for acquiring assets without assuming a legal obligation to repay it at a stated time, and under stated conditions. This factor differentiates equity from debt. Member equity is the risk capital of the organization, in that part or all can be lost if operating results are not profitable. Equity capital also provides the basis for membership control in the cooperative.

Several guiding beliefs affect the decisions a cooperative makes in determining its capital policy. The first addresses the sufficiency of capital. Cooperatives must maintain adequate levels of equity capital to ensure financial viability of operations. Each cooperative must determine its adequate level, but a rule of thumb is to have at least \$1 of equity capital for every \$2 of assets. Member equity should finance at least 50 percent of the operation.

Second, the membership must have control over the cooperative's future. Voting control, represented by equity ownership, must reside with the membership and not with outside interests.

Third, equity ownership should be held by the **current** membership of the cooperative, namely those who have patronized it recently, such as within the past 3 years.

If these beliefs are followed, then a cooperative has met the most important standards for ensuring that its capital program is being properly governed in accordance with time-honored cooperative principles.

Historically, cooperatives obtained the majority of their capital from **member-patrons**—individuals or firms that use the cooperative to market their products, purchase goods, or obtain various services. In today's **capital-intensive** agribusiness industry, however, agricultural cooperatives rely on **member** (equity) capital for slightly less than half of their financial resources.

Types of Member Equity

Equity capital in a cooperative occurs in two basic **forms**—allocated or unallocated. Each type has a number of variations, depending on how the capital is acquired.

Allocated

Allocated equity is capital recorded on the cooperative's books which is **assigned**—or allocated—on a proportional basis to each member. The proportional allocation is based on the amount of patronage or business the member does with the cooperative. Allocated equity is acquired by the cooperative in several different ways: (1) by direct member investment, **(2)** through a retained **patronage** refund, or (3) through the use of per-unit retains.

Unallocated

Unallocated equity is capital not assigned or designated to specific member accounts. It may originate from nonpatronage or nonmember business, result from patronage income not allocated to members, or be obtained from a special event such as a merger, acquisition, or the gain on the sale of an asset.

Unallocated equity provides several benefits to the cooperative: (1) a permanent capital base that allows greater flexibility in returning allocated equity to members in a more timely fashion; (2) a capital reserve that may be used in emergencies if regular capital

accumulation methods are hampered, and (3) a source against which operating losses may be charged. This last benefit provides an **alternative to charging losses against allocated equities and insulates member capital in poor operating years. Some State statutes require cooperatives to retain a specific capital reserve in an unallocated account.**

The disadvantage in unallocated equity lies in the same characteristics as its **advantages**—the removal of the direct link between an individual member’s ownership in the organization and the cooperative’s equity base. Unallocated equity is still owned by members as a group, but without the assignment of specific ownership stakes to individuals, members might become complacent regarding cooperative decisions.

Forms of Allocated Equity

The three basic forms of allocated equity a cooperative uses to establish its ownership capital (net worth) depend largely on historical, geographical, and commodity precedent.

Capital Stock Purchases

Many cooperatives require members to purchase a small initial amount of capital stock as proof of their membership. This becomes the qualifying share(s) of stock, usually classified as member’s voting stock. Under the one-member, one-vote rule, each member owns an equal amount of voting stock, having only one vote in the affairs of the organization, regardless of the amount of business conducted with the cooperative.

This democratic cooperative principle is very different from an **IOF** where the amount of stock owned translates into the number of votes a stockholder can cast. Some cooperatives require members to purchase additional capital stock so the member’s investment is maintained in proportion to the amount of business the member conducts with the organization.

As a general rule, stock in a cooperative may earn dividends at a rate not to exceed 8 percent. This limitation follows a long-time cooperative principle of limited returns on investment. The 8 percent is a historical level contained in many State laws. This limited rate of return is one reason why cooperatives are not viewed as an attractive investment for outside investors. It also keeps the focus of the cooperative’s operations on the objective of service to members rather than return on investment.

Retained Patronage Refunds

Cooperatives commonly use retained patronage refunds to acquire member equity. Patronage refunds are the net income allocated to members on the basis of the business they have conducted with the cooperative during the year. Net income is the earnings of the organization after operating expenses, taxes, and other deductions are subtracted from total revenue.

Patronage refunds are a flexible way to obtain equity capital. Net income may be held as capital retains or paid to members in cash. Certain rules apply, however, if a cooperative deducts these retains from earnings for income tax purposes. At least 20 percent of its patronage refunds must be paid in cash if the amount retained is to qualify for the deduction.

The amount of patronage refunds retained by the cooperative as equity capital must be allocated to the members on the basis of use. It is either retained as equity for an unspecified period or, at some future date, revolved back to members. The decision to retain or repay equity is always made by the cooperative's board of directors.

Retained patronage refunds, while a common source of equity, are not always the most reliable. The amount available is determined by the cooperative's business success each year. In good years, a cooperative may have a large amount of capital to retain. In poor years, little new capital is available. Retained patronage refunds are frequently used by supply or service cooperatives because their **earnings** are generally more stable from year to year. Many marketing cooperatives also use retained patronage refunds as their primary equity source.

Per-Unit Retains

A per-unit retain is based on the physical units handled by the cooperative, or established as a percentage of sales or market value of the product. Per-unit retains are typically used by marketing cooperatives, particularly those that use the pooling method of accounting for their product. Because per-unit retains don't depend on the level of cooperative earnings, they are considered a more stable source of equity capital. Like other retains, per-unit retains are periodically repaid or revolved to members as determined by the board of directors.

Base Capital Plan

A number of cooperatives have adopted a capital program that uses the features of the retained patronage and/or per-unit retain methods. But, because of the characteristics of a base capital plan, it provides more reliability in managing the capital needs of the cooperative.

Several characteristics distinguish base capital plans from other capital programs;

1. Periodically, a cooperative determines the base or minimum level of capital the business requires.
2. Each member's amount of required capital is determined by how much business was done during the base period. The base period usually ranges from 3 to 10 years, but varies among cooperatives depending on the type of commodity or service.
3. Members' current capital requirements are adjusted up or down at least annually to meet their proportional share of the current capital level established by the cooperative.
4. If members are underinvested, base capital plans provide a systematic way to increase their capital. Likewise, capital of overinvested members is returned, either in patronage refunds or retirement of per-unit retains, to bring their investment in balance. A base capital plan serves as a complete equity management tool because it acts as both an equity accumulation and redemption plan.

In calculating its required base capital, cooperatives use several different measurements. A member's investment requirement may be stated in terms of so much money per physical unit of product delivered, similar to the method used in establishing per-unit retains. Both this method and per-unit retains have drawbacks—a wide fluctuation in the volume of product handled each year creates instability. An alternative method measures the amount required based on the dollar value of the product or commodity. The benefit gained is that when volume is low, per-unit value can be set at a higher amount, and vice versa. This evens out the amount retained between high- and low-volume years when price variations may occur.

Each cooperative calculates its needs differently depending on the type of operation and the level of capital needed to support the business. Product cycle, investment in plant and equipment, and the pricing volatility of the product or service involved can all affect the cooperative's base capital requirement. A base capital system can be more complicated to design and administer than other types of

capital plans. However, its ability to provide the cooperative with flexibility and stability in meeting its capital needs far outweighs this disadvantage. **Most** importantly, a base capital plan contains an automatic mechanism for adjusting a cooperative's equity capital to keep ownership in the hands of current users.

Equity Redemption

A member's equity capital investment may be repaid after a number of years as an equity retirement or revolvment. The cooperative's board of directors establishes the capital retirement period or revolving cycle. Some cooperatives may retain member equity for an unspecified number of years.

The revolving cycle method of returning member capital is the most common system used by U.S. agricultural cooperatives. Although not legally obligated to repay member equity within a specified period, cooperatives often establish a target period or revolving cycle for returning capital. A reasonable target for most cooperatives is 5 to 10 years, depending on the type of capital acquired and the nature of the cooperative's operation and business cycle. The objective, regardless of the method used for acquiring capital, is to keep the ownership and control of the cooperative in the hands of current users.

Revolving Fund Considerations

Regardless of the method used to acquire equity capital, certain considerations affect how these equities are retired. It is important to include these considerations as part of the cooperative's overall financial plan.

A cooperative should attempt to keep its equity retirement or revolving cycle fairly short to assure members that their investment in the organization is worthwhile. If too long or the cooperative has no revolving cycle, members may feel that their investment has little or no value and may be less inclined to patronize the cooperative. A cooperative should have a specific plan and objective for retiring equities. This plan should be clearly communicated to all members and employees.

A cooperative must retain enough in its revolving funds to provide adequate equity financing for the business. This is **important** for two reasons. First, the equity level must be sufficient to keep operating expenses, including interest expense, low enough for the cooperative to be competitive. Second, lenders may establish specific equity levels to be maintained.

Members sometimes find it difficult to understand the various demands the cooperative has in maintaining adequate capital. The member's primary interest is to have equity funds returned as quickly as possible. Every cooperative must address this difficult balancing act. A cooperative needs to establish a realistic financial plan to accurately **estimate** its capital needs. The financial plan and the cooperative's need for capital should be regularly communicated to the membership.

The cooperative must determine how much of its patronage refund, or net income, to pay 'to members in cash. This becomes an important part of the financial planning process. A financial plan addresses the amount of capital to be revolved, plus other sources and uses of capital such as expenses for plant and equipment, and required debt repayment. Next, the cooperative's board, based on management's recommendation, can determine the amount of net income to be paid in cash and how much should be retained as capital.

One argument for paying out only the minimum amount of the patronage refunds in cash (20 percent) is to have the present membership carry the greatest responsibility for providing the cooperative with its current capital needs. This way, more of the oldest revolving retains can be retired. There is also a historical basis for setting the minimum amount of cash patronage at 20 percent. Members must pay taxes on the entire allocated patronage refund, and the 20 percent cash payment, as a minimum, provides money to help meet the tax liability.

Special Equity Redemption Programs

Special equity redemption plans are based on events that happen to a member, the most common being when a member dies. A board should have a specific policy dealing with this event. A cooperative may also have a policy dealing with equity retirement when a member reaches a certain age, such as 70, or retires from farming. The idea is to have an established method for more timely return of equities than under the regular redemption program. Because of the aging membership base of many cooperatives, such a practice provides several advantages. Estates can be settled more rapidly when a member dies. For an older member who has retired from farming, the investment can be returned so the individual can have use of the funds.

A cooperative that has formal plans for dealing with these situations is addressing a significant sociological condition in today's farm population. Early retirement of equities under these circumstances also helps keep the investment in the hands of current users.

Some cooperatives have policies for early equity retirement when a member's farming operation is liquidated by foreclosure or the operation is sold outright, regardless of the member's age. This keeps the investment in the hands of current members, and for the inactive member, provides the opportunity to have an out-of-the-ordinary transaction settled in a timely fashion.

While these special redemption programs have appeal, the cooperative must avoid weakening its capital position. In some cases, a cooperative may agree to retire equities early, but at a discount from their face or book value.

As an alternative to early retirement of equities, a cooperative may allow members to trade equities among themselves. This is usually limited to cooperatives operating on a pooling basis. Under most circumstances, it is permitted where member equity carries with it some type of delivery or purchase rights for product processed or sold by the cooperative. The advantage of permitting this type of trading is that the cooperative's total amount of equity is not reduced.

Measuring Equity Performance

In a competitive financial environment, the investor will seek the maximum return available consistent with the risk associated with the investment. In a cooperative, the same criteria do not necessarily apply. While members may expect a reasonable return on investment, it is difficult to determine the level of return received from the investment because of intangible benefits from membership that cannot be easily measured in financial terms. For instance, there is the more personal aspect of doing business with the cooperative. Cooperatives also provide a way to vertically access markets to improve the profitability of the members' operations. In addition, the cooperative may enhance the functioning of the entire marketplace. Another intangible is the member's equal vote in the affairs of the association. While these are clear benefits, they are hard to measure in terms of return on investment.

Regardless, the member should still attempt to measure the return provided by the investment in the cooperative. One measure may be the lower price paid on products or services purchased, or higher prices received for commodities marketed through the cooperative compared with noncooperative competitors. A member must evaluate the transaction price, plus the value of cash patronage refunds and the discounted value of retains to be received in the future, to arrive at the total return on investment.

Debt Capital

Debt capital is money borrowed with a legal liability to repay it under stated interest rates, terms, and conditions. The primary sources of debt capital are banks, insurance companies, bonds and notes, and specialty lenders such as government agencies and leasing companies. Cooperatives may also borrow money from their members and, under certain circumstances, from nonmembers.

Many cooperatives rely on equity for less than half of their capital requirements. Therefore, the majority of the assets are financed by debt capital. A recommended financial standard is a one-to-one relationship between equity and total debt. Between 1970 and 1990, cooperatives relied more heavily on debt capital to finance their operations. But the level improved in the 1980s and the trend has continued into the 1990s. As a result, cooperatives increased their equity holdings and reduced borrowings. Cooperatives recognized that a more conservatively financed organization could better weather tough economic times (table 2).

Debt capital is divided into two general categories—short-term and long-term debt. Short-term debt is repayable in 1 year or less. Repayment of long-term debt is scheduled over the life of the loan in periodic installments.

Short-Term Debt

Short-term debt and other current liabilities on the balance sheet include the common sources of short-term debt, as well as several other account items. Some are less formal types of debt, but provide important sources of financing. Current liabilities usually appear on the balance sheet in the order of payment priority based on due dates.

Accounts Payable

Although not generally considered debt, accounts payable (or bills due suppliers) are a form of short-term borrowing. These “trade” payables arise when a cooperative purchases supplies or services for use in its operations. Depending on terms negotiated at the time, this type of credit can be an alternative to short-term borrowings.

Notes Payable

Notes payable usually represent the operating loans or lines of credit that cooperatives obtain to supplement their working capital

during the operating year. Most cooperatives establish an annual **short-term** operating line of credit with a lending institution. This helps manage the day-to-day cash flow. The loan commitment is usually established as a revolving line of credit. This means the cooperative can borrow and repay amounts throughout the year up to the limit of the credit line. This helps the organization meet its obligations in a timely way. The money can be used to pay for supply purchases or make payments to members on their product deliveries in advance of when sales proceeds are received. When product sales are made, the cooperative uses those funds to repay its operating loan.

As an alternative to obtaining a short-term loan from a financial institution, some larger U.S. cooperatives issue commercial paper. This unsecured note is sold in the public debt market. Only a small number of cooperatives use this financing instrument because the money must be borrowed in large amounts and the commercial paper issuer must be strong financially.

Another alternative is an operating lease or short-term rental agreement for a seasonally used piece of equipment, such as a forklift. It can be a flexible option for financing day-to-day operations.

Current Portion, Long-Term Debt

Accounting practices require that a cooperative show, as a current liability on its balance sheet, the amount of long-term debt due in the current year. The remainder is shown as a long-term liability. Repayment terms and other debt conditions are explained in the notes to the financial statements. Terms and conditions of any short-term loans also may be explained.

Other Short-Term Liabilities

Cooperatives may have several other categories of short-term or current liabilities such as accrued expenses and taxes payable.

Patronage Refunds Payable

“Patronage refunds payable” is a current liability account unique to cooperatives. This amount is owed to members in cash, based on the amount of patronage or earnings the cooperative’s board of directors has decided to allocate.

In a marketing cooperative, which operates on a pooling basis, this category may be called “due members.” It reflects the amount owed for product delivered, if the amount earned exceeds the amount advanced.

Long-Term Debt

A cooperative acquires long-term debt primarily to finance the purchase of fixed assets. Long-term debt may also be used to increase working capital for general operating purposes. Repayment is often scheduled over the useful life of the asset being purchased—7 to 30 years. In today's competitive financial markets, many long-term financing instruments are available.

Long-Term Loans

Long-term loans obtained from banks and insurance companies can be structured in many different ways to serve the needs of the borrower and the lending institution. Generally, these loans will be granted in an amount equal to 60-70 percent of the cost or value of the asset being financed. The cooperative provides the rest from its equity capital. Repayment is usually scheduled in annual installments over the life of the loan. The repayment period depends on the type of asset being financed and its useful life. For example, equipment loans may be for 10 years while a loan to construct a building may be repaid over 30 years.

Depending on the financial strength of the cooperative, the lender may require certain conditions as part of the obligation. A financially stronger cooperative may encounter fewer conditions. Conditions may call for minimum levels of working capital, require certain minimum financial performance standards, limit expenditures for fixed assets, and require the lender's approval to revolve or pay equities. This protects the lender in case the cooperative's financial condition declines. Short-term debt may carry fewer conditions because it is renewed annually and permits a reevaluation of the cooperative's **creditworthiness**.

Leasing

Lease financing can be an attractive alternative to regular forms of long-term debt. The leasing company purchases the asset for the cooperative to use for a specific period of time. The cooperative pays the lease company "rent" in the form of lease payments. At the end of the lease term, the cooperative either returns the asset to the leasing company or purchases the asset for a price set at the beginning of the lease. Leases generally range from 3 to 7 years, depending on the type of asset involved. Financial leases can be used for such capital items as vehicles, computers, and processing equipment.

Many financial institutions offer lease financing in addition to normal long-term loans. Specialized leasing companies, however, deal exclusively in this type of financing. The advantage in leasing is that it does not require investing equity capital in the asset being purchased. This compares with the 30-40 percent investment of equity capital for a regular long-term loan. Another advantage is a lower effective interest rate because the lessor can pass on to the lessee the tax savings realized from depreciation and other expenses. Cooperatives that must invest in expensive limited-use assets may also find leasing advantageous because they are not left with an investment in equipment that may rapidly become obsolete.

In deciding how to finance the acquisition of an asset, a cooperative needs to analyze the relative advantages of using traditional debt financing versus some type of lease arrangement. This cost comparison must consider the impact each alternative will have on the financial return to the membership, and the long-term impact on the cooperative's finances.

Sources of Debt

Agricultural cooperatives use many of the same debt capital sources as other businesses. But, agricultural cooperatives have access to a unique source of financing not available to other businesses through the Banks for Cooperatives and the Farm Credit Leasing Services Corporation.

Other sources include commercial banks, insurance companies, leasing companies, and specialized financing organizations such as brokerage companies for unique types of financing requirements like private placements of debt and the sale of commercial paper.

Banks for Cooperatives

The Banks for Cooperatives (**BCs**), part of the nationwide Farm Credit System, have been financing agricultural cooperatives for more than **60** years and also provide substantial loans to rural utilities.

The two **BCs** are chartered to provide short- and long-term credit to agricultural cooperatives of all sizes throughout the United States.

The National Bank for Cooperatives, also known as **CoBank**, **ACB**, is headquartered in Denver, Colorado. It also has three regional Agribusiness Division offices located in Springfield, MA; St. Louis, MO; and Wichita, KS. As a result of merger with the Springfield (MA) Farm Credit Bank and Bank for Cooperatives,

CoBank now provides funding to the agricultural credit associations in the former Springfield district.

The St. Paul (MN) Bank for Cooperatives is the other BC. While primarily serving cooperatives in its geographic area, this BC is authorized to lend and provide other financial services to cooperatives throughout the country.

Through these two BCs, the nation's agricultural cooperatives obtain financing at variable and fixed interest rates. They also receive a wide range of other financial services, including cash investment services, letters of credit, and interest rate risk management. In addition, CoBank finances agricultural cooperatives' exports and provides international banking services. The banks also provide debt financing to the Farm Credit Leasing Services Corporation on property leased to cooperatives.

The BCs and other banks in the Farm Credit System obtain loan funds from the sale of securities to private, public, and institutional investors in the national and international markets. Farm Credit securities enjoy ready market acceptance and, as such, supply the banks with loan funds at attractive prices so they can provide members flexible terms at competitive interest rates.

Because the BCs are capitalized, owned, and controlled by their cooperative borrowers, activities are specifically tailored to respond to their needs. The BCs reduce members' borrowing cost through patronage refunds. The banks accept no deposits and depend entirely on the debt market and internal sources for loan funds.

Farm Credit Leasing Services Corporation

Farm Credit Leasing, a separate entity within the Farm Credit System, provides lease financing to agricultural producers (mostly for farm equipment and vehicles) and their cooperatives. The more complex leasing services for agricultural cooperatives involve both operating and financing leases. The size of leases may range from automobiles or forklifts, up to multimillion dollar pieces of processing equipment or facilities. Farm Credit Leasing, with headquarters in Minneapolis, has sales offices and representatives throughout the United States.

Farm Credit Leasing is organized as a cooperative, so its board of directors is elected by the member Farm Credit System institutions. Members invest capital in the leasing corporation and receive patronage refunds based on the amount of business conducted in each of the bank territories.

Commercial Banks

Banking laws differ from State to State, so the financial services available to cooperatives from commercial banks vary widely. Cooperatives use them primarily for short-term operating loans. A commercial bank generally doesn't make long-term loans because it obtains most of its money for lending from short-term deposit accounts and must keep its assets liquid. Banks also provide a number of other financial services for their cooperative customers, such as checking accounts, fund transfers, cash management and investments, and account collection services. Cooperatives may deal with local commercial banks or with larger regional or money center banks if their financial service requirements are more complex, such as international trade transactions.

Insurance Companies

Insurance companies deal primarily in long-term financing because they have a longer investment cycle for their assets than commercial banks. They provide cooperatives with debt capital to purchase or construct plants and equipment. They do not offer the variety of financial services like commercial banks, except for investment help with pension plans. They also provide insurance coverage for fixed assets and general liability.

Cooperative Taxation

Contrary to popular notion, cooperatives pay taxes. The misconception that they don't often leads to unjustified criticism of the cooperative method of doing business. In fact, cooperatives are taxed much like other businesses—a single tax is paid on earnings at the ownership level. Individual proprietorships, partnerships, and small investor-type firms also pay tax at the ownership level. With general investment corporations, such as General Motors and IBM, earnings are taxed at both the organizational and ownership levels. Cooperatives, like other businesses, also pay property, sales, employment, and fuel taxes.

Cooperatives use a unique method to distribute earnings so the tax is paid at the ownership level. Most States follow Federal rules in taxing cooperative net income, so this discussion will focus on cooperative income taxation at the Federal level.

Tax code rules for cooperatives refer to “patrons” rather than members. Some cooperatives conduct business only with members,

while others may do business with both members and nonmembers. The term “patrons” applies to both members and nonmembers who use the services of the cooperative on a cooperative basis. As long as the cooperative correctly refunds its net income to members and nonmembers, it can deduct these patronage refunds from income for tax purposes.

A cooperative’s net income on business conducted with or for patrons is not taxable to the cooperative if distributed or allocated to patrons on the basis of business done with the cooperative. This complies with rules and regulations of the Internal Revenue Code. These rules are based on the recognition of the cooperative operating principle of providing services at cost. Therefore, net income refunded to patrons on a patronage basis is taxable to the patron and not to the cooperative.

One important characteristic that distinguishes the **cooperative** way of doing business is that the distribution of net margins is made on the basis of the quantity or value of business conducted with or for patrons. If distributions to patrons are not made in this manner, they are not considered patronage refunds by the Internal Revenue Service (IRS). The cooperative may not deduct them for income tax purposes.

For example, dividends paid on capital stock are not considered patronage refunds. They are determined on a basis other than the amount of business done with the cooperative. Financial benefits must be distributed to patrons based on their use of the cooperative’s services, rather than on investment, as is the case in an **investor-owned firm (IOF)**.

Another important rule is that there must be a formal obligation by the cooperative to pay net income to patrons. This obligation must exist before patronage is distributed, it must be in writing, and the patron must have knowledge of it. Usually this obligation is found in a cooperative’s bylaws or marketing agreement.

Patronage refunds must result from business conducted with or for patrons. Therefore, any income the cooperative earns from other sources cannot be included as part of the patronage distribution.

How cooperatives distribute patronage refunds also affects their deductibility for income tax purposes. Several options qualify under tax code rules. A cooperative may either pay all of its patronage refunds in cash, or pay part in cash and keep the rest as allocated capital retains. Regardless of the option chosen, the cooperative must pay the patron a minimum of 20 percent of the patronage refund in cash for the refund to be deductible.

Patronage refunds are evidenced to the patron as written notices of allocation. The cooperative has 8 1/2 months from the end of its fiscal year to make this allocation. The cooperative deducts the allocated patronage refunds from its net income in the year they were earned. The refunds become part of the patron's taxable income in the year received.

If the cooperative uses per-unit retains, the tax treatment is similar to patronage refunds if the amount retained is taken from sale proceeds. In this case, there is no requirement to pay 20 percent in cash. The patron, however, agrees to include the amount of the retain as income for the year in which it was deducted.

Allocations are classified as either qualified or nonqualified. In a qualified allocation, the members agree to include the allocation as income for the tax year involved. Consent can also be obtained, through a statement on the check issued for the cash portion of the patronage refund, which says the patron consents by endorsing and cashing the check. The certificates issued to evidence a per-unit retain contain a qualification clause that achieves the same result.

Some cooperatives use nonqualified allocations. In this case, patrons do not include the allocation as part of their income at the time of the allocation. The cooperative pays tax on the amount being allocated. When the cooperative redeems the patronage refund or per-unit retain to members, it claims a refund for the amount of tax it paid when the nonqualified allocations were issued. Patrons must include this amount in their taxable income in the year received. This method gives the cooperative considerable flexibility in managing its tax obligations. For example, the cooperative may use **nonqualified** written notices to offset tax credits available to it.

Cooperative taxation issues can be very complex. Cooperatives must plan carefully to minimize their tax obligations because any taxes paid represent a decrease in member equity. This reduces the return to members and makes the cooperative less competitive. Cooperatives often use the services of accountants and attorneys, who specialize in cooperative taxation, to minimize this liability.

The Future of Cooperative Finance

Cooperatives continue to change the methods and resources used to finance operations. These changes are a result of increased competition in the financial markets, capitalization innovations, changes in the structure of the Farm Credit System (the Banks for Cooperatives in particular), and deregulation in the banking industry.

These factors will continue to play a very important role in cooperative finance. Changes in the tax laws will also continue to have an impact on cooperative operation and decisionmaking.

Competition, enhanced by further banking deregulation, should continue to intensify. Cooperatives are increasingly becoming large businesses and, thus, occupy an important segment of the middle market toward which many commercial banks target their services. In a more competitive environment, product and service innovation become major marketing tools. Commercial lending institutions are increasingly tailoring lending services to cooperatives. This has led the Banks for Cooperatives to expand their lending services and develop innovative products. The expertise and long history of lending to cooperatives will help the Banks for Cooperatives preserve their position as the major financing resource for cooperatives, but they cannot take this circumstance for granted.

The challenge to cooperatives is to continue strengthening their financial positions and to demand the best in service and product from their lenders. The cost of that service, in fees and interest rates charged, is a secondary consideration provided that the product and service are delivered in a consistent and timely fashion.

Innovations in cooperative finance will continue to occur. Cooperative leaders today bring a much broader perspective to the way cooperative operations are conducted. Younger members and potential members are less likely to embrace traditional cooperative principles. Instead, they will focus on a straightforward businesslike approach that rewards only results. Financial innovations in existence today challenge some of the traditional cooperative principles.

Examples of these innovations and how they have an impact on cooperative principles will illustrate the significance of the issue. For example, public stock offerings have been used in limited cases to provide additional equity capital. This financial tool threatens the principle of member control as do joint ventures with noncooperatives. There are a number of successful examples of this innovation, but it is imperative that such arrangements be structured to avoid the loss of member control.

Another financial innovation is the use of Employee Stock Ownership Plans (**ESOPs**). Member control is definitely threatened in this situation. More importantly, the employee ownership group's objective to realize a maximum return on its investment is contrary to the limited-return feature in cooperatives. The members realize their return through improved profits from the farming operation.

Employees have no such opportunity.

The future holds exciting challenges and opportunities for today's cooperatives. Professional and conservative fiscal management, prudent 'action by boards of directors, and timely, relevant, and straightforward communication with members will be the keys to success.

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Appendix A - Glossary of Terms

Allocated Equity	Equity assigned by amounts to a member's account.
Base Capital Plan	A method for providing equity where a member's capital obligation is determined by the member's share of total patronage over a prescribed period. Also known as an adjusted balances or adjusted capital plan.
Equity Capital	Member investment or ownership in the assets of the cooperative. Equal to total assets less total liabilities. Also known as member equity, patron equity, or net worth. It is the risk capital of the cooperative.
Investor Owned Firm(IOF)	A business operating as a profit-keeping enterprise. Capital is obtained by issuing shares of stock to investors who buy for the profit-making potential. An investor-oriented business versus a user-oriented business like a cooperative. A business firm other than a cooperative.
Member	A person or entity that has met the membership requirements of the cooperative and is entitled to voting privileges. An owner of the cooperative.
Member Equity	See equity capital.
Patron	Any person or entity with or for whom the cooperative does business. May or may not be a member.

**Patronage
Refund**

Net income of a cooperative allocated to a patron in proportion to the value or quantity of patronage (business) conducted with the cooperative.

**Per-Unit
Retain**

Equity invested in a cooperative by a patron based on the value or quantity of products marketed by or purchased for the patron.

**Unallocated
Equity**

Equity not assigned to a member's account. Tax-paid retained earnings or reserves.

**Working
Capital**

Current assets minus current liabilities. Measurement of a cooperative's ability to meet its daily operational expenses from its own cash flow.

Appendix B - Sample Financial Statements

For illustration, figures **B1** and **B2** depict a sample balance sheet and operating statement, respectively, for a fictitious agricultural cooperative. The purpose is to show the primary components of these documents, particularly as they relate to cooperative finance.

Figure B1 - Sample Balance Sheet

ABC Cooperative Association

December 31, 19XX

Current Assets

Cash	\$73,200
Accounts Receivable	123,700
Inventory	139,500
Prepaid Expenses	<u>42,900</u>

Total Current Assets **379,300**

Fixed Assets

Land	57,300
Buildings	177,200
Equipment	<u>92,100</u>

Total Fixed Assets **326,600**

Less Depreciation 102,500

Net Fixed Assets **224,100**

Other Assets

Investments in Other Cooperatives	57,300
Miscellaneous	<u>22,300</u>

Total Other Assets **79,600**

Total Assets **\$683,000**

Current Liabilities

Accounts Payable	\$56,400
Accrued Expenses	27,300
Notes Payable, Bank	75,000
Current Portion, Long-term Debt	30,000
Patronage Refunds Payable	<u>96,500</u>

**Total Current
Liabilities** **285,200**

**Long-term
Liabilities** **150,000**

Member Equity

Common Stock	30,000
Allocated Equity	159,500
Unallocated Reserves	<u>58,300</u>

**Total Member
Equity** **247,800**

**Total Liability and
Member Equity** **\$683,000**

Figure B2 - Sample Operating Statement

ABC Cooperative Association

Operating Statement, December 31, 19XX

Gross Sales Revenue	\$970,300
Less Cost of Goods Sold	<u>732,100</u>
Gross Margin	<u>238,200</u>
Operating Costs	
Salaries and Benefits	
Taxes	12,300
Utilities	11,400
Insurance	5,200
Depreciation	10,700
Legal and Auditing	7,600
Miscellaneous	<u>6,900</u>
Total Operating Costs	<u>203,600</u>
Net Operating Margin	<u>34,600</u>
Other Income and (Expense)	
Patronage Refunds, Other	
Cooperatives	27,500
Interest Income	6,300
Interest Expense	(18,700)
Other Expense	<u>(3,400)</u>
Total Other Income	<u>11,700</u>
Net Income	<u>\$46,300</u>
Distribution of Net Income	
Cash Patronage Payment	\$9,300
Allocated Retained Income	32,400
Unallocated Reserves	<u>4,600</u>
Net Income	<u><u>\$46,300</u></u>