Virginia Cooperative Council

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WELCOME TO COOPERATIVES

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WELCOME TO COOPERATIVES

Congratulations on your opportunity to look at the world of cooperatives. You are entering an exciting business community, one that is growing in many directions.

This booklet will introduce you to the business principles and operating practices that distinguish a cooperative from other business forms. Its purpose is to help you understand what makes a cooperative unique. This, in turn, should help you gain the most from your experience with cooperatives as you go through life.

This booklet has a great deal of information to absorb. Keep it handy and review it from time to time as you may need to. Over time you will learn more about cooperatives and your experience working with them will be more rewarding and enjoyable.

WHAT IS A COOPERATIVE?

There is no generally accepted definition of a cooperative. For our purposes, **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. The members benefit from the cooperative, in proportion to the use they make of the cooperative, in two ways. 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 some 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 many 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.

To understand cooperatives, we need to look at their history.

A Bit of History

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. One example of early cooperation in America is the irrigation canals built in the Southwest, beginning about 800 A.D., by the Hohokam Indian tribe. These major systems, stretching for some 150 miles, were discovered and cleared by Mormon settlers in the 1870's and used for irrigating their fields.

Contemporary American cooperatives usually trace their origins from the Rochdale Equitable Pioneers' Society, organized in England in 1844. This was an urban, consumer cooperative. It was founded by 28 individuals, including 9 weavers, to sell consumer goods such as food and clothing because of dissatisfaction with the merchants in the community.

The Rochdale Society earned its place in history by studying earlier cooperative organizations and developing a written list of practices and policies that seemed consistent with success of such efforts. This list became the first set of cooperative principles, characteristics that distinguish cooperatives from non-cooperative businesses.

The Rochdale Policies and Practices were:

- 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

Legend suggests that the initial structured cooperative business in the United States was the Philadelphia Contributionship 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.

Founded in 1867, the Patrons of Husbandry, commonly called the Grange, 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 1870's, fewer Granges were organized and many cooperatives went out of business, but the impact of the Granger 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. 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.

Cooperation was an important part of President Franklin Roosevelt’s New Deal program to pull the United States out of the Great Depression of the 1930s. At the time, only 10 percent of rural homes had electricity. **Congress and the Roosevelt Administration created the Rural Electrification Administration to finance rural electric cooperatives**. **By 1953, more than 90 percent of U.S. farms had electricity**. Today about 99 percent of the nation’s farms have electric service.

The New Deal also brought stability to farm lending. The Federal Farm Loan Act of 1916 had established 12 Federal Land Banks and hundreds of cooperatively-owned National Farm Loan Associations to provide long-term credit to farmers. The Agricultural Credit Act of 1923 created 12 Federal Intermediate Credit Banks to assist other banks in funding short-term credit needs of farmers. However, the farm depression of the 1920s undercut these institutions and left farmers without needed credit.

The Farm Credit Act of 1933 established the Farm Credit System as a coordinated source of cooperative lending institutions to make loans for agricultural purposes. The Land Banks and Intermediate Credit Banks were supplemented by a third leg of 12 Banks for Cooperatives and a Central Bank for Cooperatives to provide credit for farmer cooperatives. By Executive Order, President Roosevelt placed all agricultural credit organizations under the supervision of a new agency, the Farm Credit Administration. This system has played a key role in maintaining a strong agricultural production and marketing industry in the United States.

Nonagricultural cooperatives recognized the value of a strong source of credit that they could own and control. In 1980, Congress created the National Cooperative Bank (now called NCB) to lend to these cooperatives.

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.

Today's 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 are the characteristics that 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-Owner Principle

The people who use a cooperative own it. As they own the assets, the members have the obligation to provide financing to keep the cooperative in business and allow it to grow. Accumulating adequate equity is a major challenge facing many cooperatives. The last portion of this report discusses how this task is accomplished

The User-Control Principle

As owners, cooperative members control the activities of their cooperative. This control is exercised through voting at annual and other membership meetings. Member-owners of a cooperative, 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.

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 available, in proportion to the use they make of them.

Members benefit in another way. They benefit by sharing in the earnings on business conducted on a cooperative basis. When cooper-actives generate margins from efficient operations and adding value to products, these earnings are returned to members in proportion to their use of the cooperative. Without the cooperative, these moneys would go to other middlemen or processors.

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 operating capital needs.

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, then Ms. Jones 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, informal networks -- they can pool their 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 revolution in the business world. They remain the foundation that supports the distinctive cooperative method of doing business.

COOPERATIVES AS A BUSINESS ORGANIZATION

In the United States, historically there are three basic categories of private business firms – sole proprietorships, partnerships and corporations. Cooperatives have traditionally been a type of corporation.

Today significant changes are taking place in the nature of business structures. In the late 1990s all states approved a new business structure, the limited liability company (LLC). And in the 2000s a hybrid structure, the limited cooperative association, has evolved that combines traits of traditional cooperatives and LLCs. This section explains the similarities and differences between cooperatives and the other business forms.

Sole Proprietorship

The sole proprietorship is the oldest and most common form of doing business. 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 and 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.

The individually owned business is more dominant in farming than in any other segment of the economy. Other examples of business commonly operated by an individual owner include service stations, food and hardware stores, restaurants, flower shops and dry cleaners.

Partnership

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. Each partner is personally liable, up to the value of much of the property he or she owns, 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.

Some farms are owned and operated on a partnership basis, often between a parent and child. One may furnish the land and buildings, another much of the physical labor, and each may own livestock and purchase supplies while sharing other operating expenses.

Other examples include law and accounting firms, insurance and real estate companies. Family members may form partnerships to operate an auto repair firm, store and other business.

General Business Corporation

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 stockholders. Most of the major corporations in America operate as general business corporations. General business corporation 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 corpora-action when earned and as income of the stockholders when distributed as dividends.

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

Cooperative Corporation

A cooperative corporation is also a state-chartered business, organized and operating under its laws. However, the purpose of a user-owner cooperative business is to provide economic benefits to its members as well as generate a return on investment. Characteristics of cooperative corporations include:

- **Control**. Management is controlled by a board of directors 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 make 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 conducted with members are taxed once, either as income of the corporation when earned or as income of the members when allocated to them.

Examples of businesses that operate as cooperatives include agricultural marketing, purchasing and service organizations; credit unions; utilities, grocery and hardware wholesalers, and multi-unit housing facilities.

Limited Liability Company

The limited liability company (LLC) has been used for many years in Europe and South America. However, until a change in IRS policy in the mid-1990s, tax rules made LLCs difficult to operate in the United States.

The LLC 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 determined by the amount of capital invested and the nature of the work performed by each member.
- **Taxes**. Earnings are taxed once, as income to the members.

The LLC has become a popular structure for smaller businesses, including single owner entities, as it is highly flexible, qualifies for single tax treatment, and provides protection for members' personal assets.

Limited Cooperative Association

In 2001, the Wyoming state legislature authorized a new business structure, **what is becoming known as the Limited Cooperative Association (LCA)**. Several other states, primarily in the Midwest, have followed suit. The LCA combines much of the flexibility of an LLC with some traits of a traditional cooperative. The most frequently cited benefit for the LCA is that it allows a cooperative to tap outside equity investors by offering them substantial control and financial interest in a cooperative.

In 2007, the National Conference of Commissioners on Uniform State Laws approved a model Uniform Limited Cooperative Association Act. This may well spur other states to consider enacting a law authorizing the creation of such entities. Characteristics of an LCA include:

- **Control**. An LCA can have two classes of voting members, patron members and investor members. While investor members can, under some State laws, have 85 percent or more of the membership voting power, safeguards in those laws provide patron members can elect at least half of the directors.

- **Capital**. Members usually provide the equity capital. The patron and investor members are free to determine how much capital each class of members and each individual member contributes
- **Earnings**. Profits (or losses) are shared between the two classes of members by mutual agreement, although patron members are usually guaranteed at least 15 percent of the earnings by law. The allocation to patron members is made on the basis of patronage. The allocation to investor members is usually made on the basis of investment.
- **Taxes**. The entity can choose to be taxed as a partnership or as a cooperative corporation.

Here is a note of caution about LCAs. While they are called cooperatives, they do not necessarily qualify for favorable treatment accorded most traditional cooperatives under other laws, such as antitrust and securities law. If another law requires, for example, that all members must be agricultural producers to be eligible for benefits the law provides, then an LCA with nonpatron investor members may well not qualify.

COOPERATIVES IN THE COMMUNITY

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 cooperatives directly serve 120 million members -- 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 community is credit unions. In 2006, the 8,600 credit unions in the United States have more than $730 billion in assets and 88 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.

The cooperative **Farm Credit System** 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. As of December 31, 2006, the Farm Credit System had 750,000 loans on its books and $123 billion in loans outstanding, 30 percent of all money loaned to U.S. agriculture.

One element of the Farm Credit System is **CoBank**. It provides 80 percent of the money farmer cooperatives borrow each year. It has $33 billion in outstanding loans and leases 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 telecommunications cooperatives. With $18 billion in assets and $18 billion in loan commitments, CFC supplements funding provided by USDA's Rural Utilities Service and provides business services to its borrowers.

Chartered by Congress in 1978 and private since 1982, **NCB** (formerly the **National Cooperative Bank)** has become an important financial institution for America's housing, business and consumer cooperatives. NCB has 2,600 customer-owners and nearly $2 billion in assets. 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 better medical care because of cooperatively organized **health care** entities. Hospitals and clinics hold down costs by obtaining supplies through VHA and similar purchasing cooperatives. In several major cities -- Minneapolis, Seattle, Memphis, Sacramento, Salt Lake City and Detroit -- companies have formed cooperative health alliances to purchase health care for their employees. Cooperative insurers, such as Wisconsin’s Co-op Care, are providing affordable health insurance coverage to farmers and other rural residents.

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

In the agricultural sector, USDA's Cooperative Programs survey of farmer cooperatives for calendar year 2005 reported 2,896 cooperatives in operation. Of these associations, 1,412 primarily marketed farm products; 1,128 handled primarily farm production supplies; and 356 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 2005, farmer cooperatives had 2.7 million members (some farmers belong to more than one cooperative) and a total gross business volume of $121 billion. Total net earnings (considering losses) were $2.5 billion. Combined assets of the group totaled $47 billion and liabilities were $27 billion, leaving member equity of $20 billion.

Utility Cooperatives

Forty million people in 47 states are served by America’s electric cooperatives, which provide at-cost electricity to their consumer-owners. There are two types of electric co-ops. Generation and transmission cooperatives produce and transmit electricity to distribution co-ops. Distribution cooperatives deliver electricity directly to consumers. Electric co-ops own and maintain some 2.4 million miles of electricity distribution lines, or 43 percent of the nation’s lines. The system generates $24 billion in retail revenues per year.

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 are the on-ramp for rural residents wishing to travel the information highway.

BENEFITS OF COOPERATION

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.

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.

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.

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.

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.

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.

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 to serve members.

Super local cooperatives operate over 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 virtually all 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, LLCs, and corporations) as members. 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 federates to undertake activities too complex and expensive for them to do individually, such as input manufacturing, 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. In a mixed cooperative, the cooperative members 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 produced. Most cooperative marketing activity involves either agricultural products or those of persons in related industries such as forestry, aquiculture and horticulture. New marketing ventures are developing in such diverse industries as handcrafts, 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 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 offer their branded products directly to consumers, including Land O'Lakes, Sunkist, Ace Hardware, REI (outdoor clothing and supplies), Touchstone Energy Cooperatives, Associated Press, and Carpet One.

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 non-farm 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 ServiceStar.

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.

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

PEOPLE MAKE A COOPERATIVE WORK

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 non-cooperative 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 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.

Member Responsibilities

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 non-cooperative 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 capitalize and patronize 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 re-examined.

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.

Director Responsibilities

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 regulations.
- Develop and adopt long-range business strategies.
- Require written monthly financial reports and operating statements for board meetings in order 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 on the part of 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** have these responsibilities:

- To act independently on matters that should be decided by the entire board. Individual directors have no authority outside of board meetings.
- Be a representative of special interests, factions or political entities. He/she was elected to direct the business activities of the cooperative, not serve as a representative 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 decision making 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 keeps watch over 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. For example, there may be a finance committee, a purchasing committee, a merchandising committee 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.

Manager Responsibilities

Success of a cooperative is in large part dependent on good board/manager relationships. The working relationship between board and general manager is one requiring respect and an understanding of each other's responsibilities.

In a cooperative, 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 replace those employees not meeting acceptable performance levels.
- Oversee the detailed operations of the cooperative, within the 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 are responsive 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.

Employee Responsibilities

In many ways, working for a cooperative is similar to doing the same job at a non-cooperative firm. But special features of a cooperative -- such as 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 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 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.

EQUITY FINANCING AND TAXATION

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, many smaller LLCs, and closely-held corporations all face similar problems acquiring equity. For these entities, equity capital usually is provided by the owners or acquired via retained earnings.

The single tax treatment accorded these entities tends 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 a second time at the ownership level if and when distributed as dividends. Owner(s) of a sole proprietorship, partnership, LLC, closely held corporation, 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 to reinvest in the business.

Sources of Equity Capital

The three primary ways members provide equity to their cooperative are direct investment, retained earnings and per-unit retains. Cooperatives may also acquire equity through direct investment by persons outside the membership and retained earnings on non-member, non-patronage 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 evidences 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 non-stock 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.

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 make capital available to the cooperative.

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. Section 521 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." This is the term used in cooperative literature and 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-source 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.

A special rule in the tax code states the amount of any patronage refund that is attributable to personal, living, or family items does not need to be reported as income by the recipient. Thus these refunds are totally tax free.

Per-Unit Retains

Cooperatives that market products produced by their members have a third means of acquiring equity capital, per-unit retains. Per-unit retains 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 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 per-unit retains into an unallocated reserve, thereby forfeiting access to single tax treatment.

People sometimes blur the distinction between patronage refunds and per-unit 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 retains.

Non-member/Non-patronage Earnings

Non-tax laws, such as the Capper Act (limited antitrust exemption for farmer cooperatives) 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 non-members on a non-cooperative 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 non-patronage income distributed to patrons on a patronage basis.

Financial Planning Options and Tax Treatment

As the flow chart on the following page illustrates, cooperatives have flexibility in designing an equity accumulation program to meet their individual needs. An understanding of the alternatives is especially important when allocating the 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.

Non-patronage 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, non-qualified retained patronage allocations and unallocated reserves.

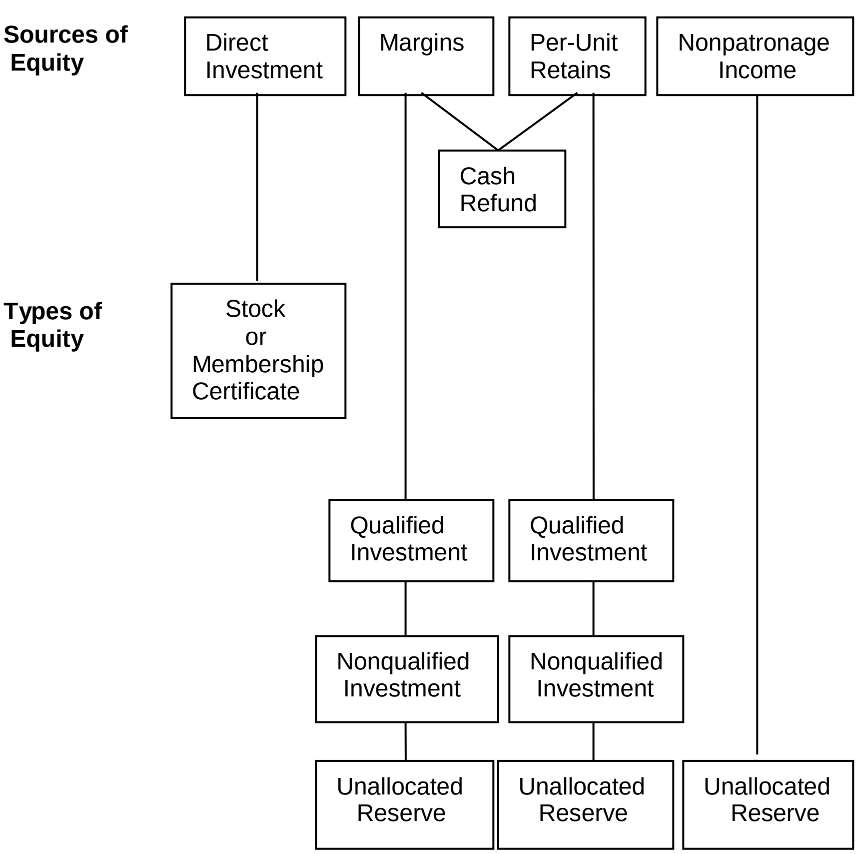
Cash Refunds

Cooperatives can distribute their margins and per-unit 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 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.

SOURCES AND TYPES OF EQUITY



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 marketing cooperative.

The cooperative pays the producer $600 for his crop at the time of delivery. It costs the cooperative $300 to market the crop. The cooperative sells the crop for $1000.

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	$1,000		
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 patronage allocation in 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 would have been 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.

Non-qualified Retains

Cooperatives have the option to delay the pass-through of the tax obligation from the cooperative to the patron. They can do this without forfeiting access to single tax treatment of those moneys.

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

TAX TREATMENT OF COOPERATIVE AND PATRON:
NON-QUALIFIED RETAINED EQUITY

Cooperative		Patron	
Expenses		**Income**	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1,000		
Margin	$100	Refund	$100
Taxable Income	$100	Taxable Income	$600

When non-qualified retained equity is redeemed, the cooperative receives a tax benefit based on the tax paid at the time of allocation. The patron is obligated to pay income tax on the funds received.

If the cooperative in the earlier example issues its patronage refunds as non-qualified 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 the non-qualified notice is redeemed*, the cooperative would deduct the $100 (or receive a credit under certain circumstances). The patron would report it as income in the year the cash payment was received

Thus the single tax treatment of cooperatives doing business with or for patrons 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.

Non-qualified 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 payout 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 non-qualified allocations, no tax is due from patrons until the allocation is redeemed. Also, there is no 20 percent cash payout rule for non-qualified allocations.

Unallocated Reserves

Cooperatives can treat margins just as a non-cooperative firm would treat earnings, put them into an unallocated reserve and pay 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 payout, unallocated reserves, and qualified and non-qualified allocations. This makes it possible for the leadership to develop a program that reflects the best interests of the membership.

Equity Redemption

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 redeeming patronage-based equities on a regular basis matches the responsibility of financing the cooperative to current use of its services.

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

Revolving Fund Plan

"Revolving fund financing" is a term used for systems in which patrons make capital contributions on an annual basis, 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 exists 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.

Base Capital Plan

"Base capital plan" is a general term given to a financing system that focuses more 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 - 7 years.

3. Each year the cooperative's equity requirements are reviewed 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 over-invested patrons generally are paid a cash rebate of current year's patronage refunds and per-unit retain allocations. Over-invested 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.

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 complication 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.

Special Tax Situations

The tax scheme described thus far in this section, featuring the single tax treatment for patronage refunds and per-unit retains, is commonly referred to as "Subchapter T" tax treatment because the rules are codified in Subchapter T of the Internal Revenue Code. While it is the basic tax treatment of cooperatives, the Code includes several unique provisions that benefit particular types of cooperatives.

Two of these were mentioned above:

- Farmer cooperatives that meet specific organizational and operational tests set out in Code sec. 521 can deduct nonpatronage income allocated to patrons on the basis of patronage and dividends on stock.
- The amount of any patronage refund that is attributable to personal, living, or family items does not need to be reported as income by the recipient. Thus these refunds are totally tax free.

Some types of cooperatives are truly tax exempt, at least on some of their operations, including:

- Electric, telecommunications, and water cooperatives, and like organizations; but only if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses. If these utility cooperatives can not comply with the 85-percent rule, they are still not technically covered by Subchapter T, but are taxed as if they were under common law principles.
- Credit unions without capital stock organized and operated for mutual purposes and without profit.
- Cooperative hospital service organizations organized and operated solely to purchase supplies and provide administrative services to their members.

Another special rule applies to housing co-ops. Tenant-shareholders of a cooperative housing corporation are allowed to deduct their proportionate share of amounts paid by the cooperative for real estate taxes on and interest on debt contracted to pay for their building and the land on which it is situated.

CONCLUSION

Learning about cooperatives can be a life-long process. As the world changes, so must cooperatives if they want to not only survive, but prosper. Members, directors, managers, employees and advisers must all seek out and take advantage of continuing educational opportunities. The **Virginia Cooperative Council**, which provided this booklet, encourages you to increase your understanding of cooperatives every time such an occasion presents itself.