Frequently Asked Questions and Answers on Use of Nonqualified Distributions
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Why are boards of directors responsible for the tax decision of allocated equity?
After ascertaining what portion of local savings is patronage income (done by an auditor), the board of directors decides what proportion of that patronage income is placed into retained savings as unallocated equity. The remainder is allocated in a patron’s name. The board decides what proportion will be paid out in cash in that year and the remainder is held in the patron’s name as equity (stock) in Allocated Equity (also called patron’s Ledger Account). This income or savings has a tax implication which is where the issue of qualified and nonqualified arises.

What is a qualified distribution of equity?
A qualified distribution of equity is one where the member receives equity which is taxable income in the current year and the cooperative is able to exclude the distribution from its earning calculations and does not pay corporate tax on the allocation. The board makes the decision to redeem the equity at a later date and, since the member has already paid taxes on the earnings, there is no tax effect at redemption.

What is a nonqualified distribution?
A non-qualified distribution of equity is one where the cooperative does not exclude the distribution from its earning calculation and the distribution is not reported to the IRS as income to the member. The cooperative pays the corporate tax on the earnings. At the time of redemption the cash payment is reported as income to the patron and creates a deduction for the cooperative. The decision to distribute in qualified versus non-qualified equity therefore changes the timing of the tax payment, but in either case the tax burden is ultimately transferred to the member as an extension of their farm business. The qualified versus non-qualified decision is somewhat inter-related with the decision on the portion of cash patronage. A cooperative issuing qualified equity must also pay 20% in cash. There is no cash requirement when issuing non-qualified equity. Because a non-qualified distribution increases the cooperative’s current year taxes, the cash flow impacts may require the cooperative to reduce the portion of cash patronage.

Why did cooperatives historically issue qualified distributions?
Historically, cooperatives have followed a practice of issuing qualified distributions because the producer was in a much lower marginal tax bracket than the cooperative and it made sense to issue a qualified distribution. Because a producer pays tax on the retained patronage, many

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directors consider this equity as debt like obligations that must be redeemed at a prescribed future date. A common phrase that is often heard is, “The cash patronage I received from the cooperative barely covered the taxes on the stock I received. I took on the tax burden from the stock and the cooperative owes it to me to redeem it on schedule.”

**Why have many cooperatives moved to the use of nonqualified distributions in recent years or simply put, each entity pays tax on what they get in cash? That is, the member gets a portion of their patronage income in cash and pays tax on what they receive in cash and the co-op pays tax on the portion of the patron’s patronage earned in that year that is kept as cash by the cooperative.**

In recent years, as more and more producers (principally crop farmers) face higher marginal tax rates similar to a cooperative’s marginal tax rate, boards of directors have begun to look at non-qualified distributions as a way to better align members with the cooperative. The members pay tax only on the cash patronage refunds and understand that the non-cash portion is being retained to invest in capital investments needed by the cooperative or to strengthen the balance sheet to provide working capital. Because the members have not pre-paid the tax on the stock patronage, they are more receptive to the concept that the future redemptions will only occur when the cooperative no longer needs that equity on its balance sheet. The use of non-qualified distributions is easier to communicate to members: each entity pays tax on what they receive (in the case of the patron) or retain (in the case of the cooperative) in cash.

**I thought only co-ops with a Section 199 deduction from the Domestic Activities Production Deduction (DPAD) could use nonqualified distributions.**

It is true that the use of nonqualified equity by local cooperatives began with this issue because, from a cash flow perspective, it makes sense that the cooperative issue nonqualified equity and apply this tax credit to the cooperatives taxes. However, any cooperative can use nonqualified retained patronage as a tool to manage equity.

**Isn’t it true that nonqualified distributions are never redeemed?**

No, this is not true. Nonqualified equity can be redeemed just like qualified equity subject to board approval. At the time of redemption, the cooperative gets a tax credit because it already paid taxes on the nonqualified distribution and the patron pays tax on the equity which is now being redeemed as cash. It is true that lenders such as CoBank and Farm Credit issue patronage as nonqualified distributions and do not redeem this equity. They do this because of regulatory requirements and because their members are corporations (non-individuals) who have an infinite life. The intent of these lenders is create retained savings or unallocated equity but with a patron’s name on the equity since their patrons have an infinite life.
If I use nonqualified distributions, my equity redemption program becomes more difficult because now I have to pay the tax as a cooperative.

It is true that the cooperative has additional income taxes to pay. However, this has no impact on the cooperative’s equity redemption program if the cooperative practices cash neutrality which is discussed in the next question. The equity redemption program remains as it did before.

How are cooperatives transitioning to a nonqualified distribution?

Education is a key component. Farm business management specialists who work with farmers on their taxes, patrons, auditors, and others will require documentation from the cooperative. This is often in the form of a letter explaining what the cooperative is doing and its tax implications. Most cooperatives that we are aware of make the transition in one year. Traditionally it has been difficult for a cooperative to transition from qualified to non-qualified distributions, unless they reduced the cash patronage rates because they lose the tax effect of qualified distributions and do not get the tax benefit of non-qualified redemptions until the first non-qualified issued reaches the revolving cycle. As we stated earlier, there is a unique opportunity to consider non-qualified distributions because a cooperative with excess Domestic Activities Production Deduction (DPAD) available can utilize the credit to eliminate the tax impact of a non-qualified distribution. And as an additional benefit, the tax deduction at the time of redemption will reduce the effective redemption budget. Other cooperatives have chosen to increase the amount of patronage income going into unallocated equity, thus reducing the overall amount of allocated equity available for redemption, in order to maintain current cash patronage rates because of competitive reasons. Others have stopped redeeming regional patronage and use those funds to help pay the tax to move to a nonqualified. Still others have lengthened their redemption period. The reality is that cooperatives are using all of these methods in one way or another.

How would you determine which allocation method is in the best interest of the member?

Member after-tax cash flow is the appropriate method to use. There are various ways to do this but one way is to use a simulation model to capture the cash flows of the cooperative. Dr. Phil Kenkel and Dr. Rodney Holcomb at Oklahoma State University have developed such a model that is publicly available to use. This model is used in various courses taught by faculty in cooperatives in the United States. It is available by contacting phil.kenkel@okstate.edu. In the example based on the Oklahoma grain and farm supply cooperative which was referenced in the webinar, there was a 2.5% advantage in the member’s internal rate of return when the cooperative’s tax rate was 5% higher than the member’s tax rate (cooperative 45%, member 40%) and a 2.7% advantage to non-qualified when the member’s tax rate was 5% higher (40% cooperative, 45% member). The member’s return was almost 14% higher if the cooperative used the Section 199 deduction to offset the taxes and increased the non-qualified distribution to the same percentage as the qualified distribution percentage.
**What is the impact on the cooperative’s cash flow?**
If the cooperative seeks to keep everything else the same; that is, they want to maintain the current redemption period and proportion of cash patronage, the impact on the cooperative’s cash flow will be negative while the members sees an increase in their cash flow. Obviously this is not an attractive reason to switch. However, most cooperatives are looking at ways to make the transition cash flow neutral and we have listed some ideas on how they have done so in our response to the question of how cooperatives are transitioning to nonqualifieds.

**What is balance sheet management?**
When the board of directors makes decisions regarding profit distribution, equity management or asset investments they are impacting the cooperative’s balance sheet. For example, leverage (debt/equity ratio), liquidity (the amount of working capital) and equity structure (ratio of permanent to revolving capital and ratio of allocated to unallocated equity) are all impacted by the previously described decisions. A cooperative using balance sheet management establishes goals for the structure of their balance sheet and then structures their decisions on profit distribution, equity management and asset investment consistent with their goals for the balance sheet.