Key Cooperative Income Distribution and Equity Management Policy: Use of Non-Qualified Distributions

Section 1: Introduction

The income distribution and equity management policies of Key Cooperative are used to illustrate the possible use of a non-qualified distribution of patronage income as a non-qualified retained patronage refund to co-op patrons in an agricultural cooperative. It is part of a comprehensive financial strategy that also included use of a qualified 100% cash patronage refund. Therefore, the new strategy employed a mix of qualified and non-qualified distributions. This replaced its traditional strategy of using a qualified only distribution of patronage refunds, normally with a split of 40% cash and 60% retained.

For many years Key Cooperative and its predecessors used a very traditional income distribution policy for distributing patronage refunds, allocating them only in qualified form. Recently they changed their policy to include use of a non-qualified distribution. This case study explains their rationale for this change in policy. They are convinced the new policy benefits both the cooperative and their patrons.

The advantages and disadvantages of using a non-qualified distribution are best understood in the context of an overall financial strategy. The financial strategy chosen by Key Cooperative and its use of a non-qualified distribution are based on its unique situation, its choice of broad priorities or goals, and its choice of how best to achieve those goals.

This case study is not intended as a recommendation to other agricultural co-ops on what specific policies to follow in all situations. But the case study does apply broadly recommended approaches to making financial strategy decisions in a realistic economic and business context. Therefore, this case study should be very useful to other agricultural co-ops in formulating their own financial strategies related to income distribution, equity management and balance sheet management, if they apply this broad decision making framework and context to their own unique situations.

This case study assumes the reader has a basic understanding of cooperative finance and especially a basic understanding of cooperative income distribution alternatives in the context of balance sheet management and the sub-field of equity management unique to cooperatives. Numerous references are provided at the end of the case study for those interested in additional education on these topics.

---

1 Prepared by Dr. David Barton, Professor Emeritus and Director Emeritus, Arthur Capper Cooperative Center, Kansas State University, based on the information, answers and a review of this document provided by Jim Magnuson, CEO, and Mike Thomas, CFO, Key Cooperative. It is provided for distribution to registered participants following the eXtension webinar on March 13, 2014. It is not available for further distribution or citation without permission of Dr. David Barton and Key Cooperative. See Exhibit 1 for information about the presenters. See Exhibit 2 for the PowerPoint slides used by the presenters during the webinar.
Because the central focus is qualified and non-qualified patronage refunds we provide a brief review of patronage refunds and the meaning and requirements to be qualified and non-qualified. We should also note we are describing the “non-pooling” form of income distribution that utilizes patronage refunds, the predominant practice in cooperatives, including Key Cooperative. A small percentage of cooperatives use the “pooling” model of income accounting and distribution.

Patronage refunds that are a distribution of patronage income may be distributed in qualified or non-qualified form. Patronage refunds are a distribution of income or profits to patrons based on use or volume of business not based on equity ownership. But the way in which they are distributed determines whether they are qualified on non-qualified and therefore which party, the co-op or the patron has taxable income as a result. The underlying taxation rationale is single taxation of patronage income at any point in time.

In any case it is assumed the business is operating on a cooperative basis, whether it is legally a cooperative or not, and it has a pre-existing agreement with patrons to be able to distribute some or all of patronage income as a patronage refund. The patronage refund is a reduction in the cost or price paid in a previous business transaction purchase by the patron, such as purchasing fertilizer from the cooperative, or an increase in the revenue or price received in a previous business transaction sale by the patron, such as the sale of grain to the cooperative. The patronage refund may be paid in part or all in cash for the year of distribution.

The year of distribution represents the co-op’s fiscal year and tax year of business in which the income was earned by the business although the actual timing of the distribution occurs following the fiscal year end and physically occurs in the following year. Therefore, the patron’s receipt of the patronage refund, based on a notice of allocation, possible receipt of a cash patronage payment and/or cash redemption of a retained patronage refund, and possible receipt of a 1099PATR from the co-op, may be in a subsequent year.

Cash patronage refunds are always “qualified.” If the patronage refund is distributed or “paid” in the form of a retained patronage refund, a form of equity investment by the patron, the retained patronage refund may be qualified or non-qualified, depending on the way in which the cooperative chooses to distribute the patronage refund.

A qualified distribution of patronage refunds is one that meets the IRS requirements to “qualify” as a deduction from the taxable income of the cooperative (or other business) in the year of distribution. For a retained patronage refund to be qualified the cooperative must pay a minimum of 20% of the total qualified patronage refund in cash. The remaining retained patronage refund may then be declared as qualified by the cooperative. In this case the cooperative “qualifies” to reduce its taxable income by the qualified patronage refund, cash plus retained. The patron must include the qualified portion in taxable income, if the transaction with the co-op was a business taxable event or transaction (cost or revenue) not a consumer transaction. Both the cash and retained (“noncash” or “paper”) portion are qualified. In the year of redemption of the qualified retained patronage refund there are no income tax consequences for the patron or the co-op. In summary, the patron pays all the income taxes on a

---

2 An excellent description of qualified and non-qualified patronage refunds and the factors of importance in understanding the impact of using non-qualified patronage refunds is contained in work published by Dr. Jeffery Royer in the mid-1980s. See the references section at the end of this paper for complete citations.
qualified distribution in the year of distribution and the co-op pays none, even though the noncash portion may be retained by the co-op for many years.

A non-qualified distribution of patronage refunds is a retained patronage refund that does not qualify as a deduction from the taxable income of the cooperative. There is no minimum cash requirement component, meaning 100% of patronage refunds could be distributed as a non-qualified retained patronage refund by declaration of the co-op. However, if the co-op intended to distribute a qualified only patronage refund but failed to pay at least the minimum 20% in cash patronage the retained portion would become non-qualified by default. The cooperative includes the non-qualified retained patronage in taxable income and the patron does not, in the year of distribution. In the year of redemption the co-op receives a deduction from taxable income and the patron includes the redemption payment as taxable income, if the underlying transactions of cost and revenue were taxable events for the patron. In summary, the patron has taxable income only when it receives cash, as cash patronage or cash redemptions of non-qualified retained patronage refunds. The co-op has taxable income for a temporary period, starting in the year of distribution or retention and ending in the year of redemption.

The co-op finance terminology in this case study uses generally accepted generic terms, supported by academic co-op finance experts and corporate accounting and finance experts. The intent is to be as clear and consistent as possible for a broad audience of co-op leaders, professional advisors to cooperatives (accountants, lawyers, consultants, etc.), bankers, academics and students. Cooperatives use a wide variety of different but equivalent terms. In addition, the terminology used by co-ops in their internal management information system reports may be different than the terms used in their annual audit report. Exhibit 3 contains a list of generic terms and the equivalent term used by Key Cooperative on the balance sheet and operating statement in its annual audit report.

This case study was prepared as part of a summary report sent to registered participants of an eXtension webinar held on March 13, 2014. In the webinar Dr. David Barton interviewed Jim Magnuson, CEO, and Mike Thomas, CFO, of Key Cooperative. They responded to a series of extemporaneous questions prepared in advance and they used a series of slides to communicate some of the details of their answers to the audience. They also responded to several impromptu questions asked by participants at the end of the webinar. Readers can view the webinar presentation at: https://connect.extension.iastate.edu/p43gk4p0gvq/

Section 2: About Key Cooperative

What basic information should we know about Key Cooperative?

Key Cooperative is a large grain marketing and farm supply cooperative headquartered in Roland, Iowa. It serves customers primarily in the Central Iowa counties of Jasper, Mahaska, Marshall, Poweshiek, Story and Tama out of facilities in 12 separate communities. Customers include 1,600 voting farmer members (“Class A Members”) and 1,600 non-voting patrons (“Class B Members”). Voting member-patrons hold Common Stock A and non-voting patrons hold Common Stock B to indicate the voting status of patron-owners. It is governed by a board of 10 elected directors and 2 associate directors appointed by the board.
Key Cooperative was created in 2009 from the merger of Heart of Iowa Cooperative (HOIC) and Sully Cooperative Exchange (SCE). It employs over 220 permanent, full-time employees and offers products and services in seven business divisions: agronomy, grain, energy, feed, transportation logistics, lumber and construction services and NAPA auto care. In 2013 it had sales of $531 million and net after tax income of $10.6 million.

Additional information on Key Cooperative is available on their web page: http://www.keycoop.com/

Section 3: Policies Prior to 2009 Merger

What income distribution policy and related equity management policy did you use prior to shifting to the use of non-qualified retained patronage refund distributions?

Prior to the merger in 2009 HOIC and SCE each used a very traditional income distribution program that included the use of qualified distributions to cash patronage refunds at a rate of 40% and the remaining 60% as retained patronage refunds. Retained patronage refunds were split into a regional class and a local class, based on the source of the earnings. HOIC treated local and regional equity pools the same so they were effectively one pool. SCE treated local and regional pools differently. Both redeemed qualified retained patronage using a combination of estate settlement, revolving fund and age of patron redemption methods, depending on the particular unique equity pool. HOIC used an estate settlement and revolving fund on all pools but also used an age of patron at age 70 on one closed end sub-pool, equity retained in 1995 and prior. SCE used an estate settlement and revolving fund on both local and regional pools. However, SCE discounted the regional class redemptions when using a revolving fund by 50% of book value at the time of redemption. Estate settlement redemptions were made at 100% of book value. Also, SCE made a special one-time, pre-merger redemption of 100% of book value of local and regional classes of all equity held by those age 88 and older.

Section 4: Philosophy and Policy Change with Merger.

Your pre-merger discussions led to a change in your view of co-op financial policy for the surviving consolidated entity, going forward. What philosophy and policy views changed?

At the time of the merger in 2009 both co-ops agreed to simplify and improve their income distribution and equity management program in the merged entity. They eliminated the split between regional and local classes of equity on new retained patronage refunds, beginning in 2009, and decided to phase out the future use of age of patron redemptions. Both co-ops had been using estate settlement and revolving fund redemptions and those would continue. They implemented a balance sheet management approach that established a redemption budget for each year based on profitability (additions to working capital and equity), asset growth and financing priorities. This more disciplined balance sheet management approach was adopted to establish a redemption budget based on available working capital and cash flow. The actual redemption budgets selected are described later.

Pre-merger, the use of non-qualified distributions was discussed as an option but not implemented immediately following the merger. There were already a lot of moving parts and changes with the merger so it was decided to consider this change at a later time.

After redeeming estates settlements, as the first priority claim on the total redemption budget, the remaining redemption budget was split 43.59% to old HOIC equity and 56.41% to old SCE equity. The
split was based on the relative the amounts of allocated equity each predecessor co-op contributed to
the merged entity. All old HOIC and SCE allocated equity was then redeemed using their respective
rules on using additional redemption methods for each class of allocated equity.

HOIC had been redeeming local and regional equity in an identical manner so those two old equity
classes were combined at the time of the merger. Therefore the old HOIC equity in the closed end pool,
1995 and prior equity, was redeemed with an age of patron redemption at the existing age of 70 as the
first priority call on the HOIC redemption budget (after estates) and a revolving fund as second priority
to expend the remaining HOIC portion of the redemption budget. This oldest allocated HOIC equity sub-
pool, eligible for an age of patron redemptions, was relatively small and has been completely redeemed
as of April 2013 using this balance sheet management approach. The sub-pool, 1996-2009, is now being
redeemed using estate settlement and revolving fund methods.

SCE had been treating local and regional equity differently, as previously noted. These two classes were
maintained in the new entity as SCE-local and SCE-regional. The SCE share of the redemption budget,
56.41%, was divided into two parts with 71.8% applied to the SCE-local and 28.2% applied to the SCE-
regional. Both classes are being redeemed using the estate settlement and revolving fund methods.

New allocated, qualified retained patronage equity created after the merger, “Key” equity, was placed in
a separate class and is being redeemed using a combination of estate settlements and revolving fund.
However, the revolving fund method will not be applied to redeeming new allocated equity until all old
HOIC and SCE allocated equity is redeemed. This is expected to happen to the HOIC and SCE pools at
about the same time.

Therefore, Key Cooperative completed the transition in their equity redemption program to completely
phase out use of age of patron and use only an estate settlement and a revolving fund by April 2013.

The 2009 fiscal year, following the merger, was a short year of 8 months and ended before fall harvest
so had relatively low earnings. Only a 100% cash patronage refund was paid on the grounds that a cash
patronage refund check size should be meaningful and somewhat consistent with the size of cash
patronage refunds in previous years. It was believed that perception is reality for most patrons.

In 2010 patronage refunds were distributed in traditional qualified form on the basis of 40% cash and
60% retained. Key Cooperative’s predecessors, HOIC and SCE, used the tax benefits of the Section 199
Domestic Production Activities Deduction (DPAD) on their grain marketing business with patrons prior to
the merger, as early as 2007, and that continued in 2009 and after the merger. This benefit and other
perceived advantages of a non-qualified distribution motivated a review of this option. The added tax
benefit of bonus depreciation in 2011 added to the interest in a non-qualified distribution.

---

3 There are at least three alternative ways to calculate this split, each with advantages and disadvantages:
allocated equity, total equity, or expected cash flow to patrons over a selected future period if each entity
remained independent. Cash flows reflect different levels of expected profitability, leverage and relative
allocated/unallocated equity while equity balances do not.
Section 5: Last “Qualified Only” Distribution in 2010

2010 was a transition year, the first 12 month fiscal year after the merger, and the last year to use a “qualified only” patronage refund distribution. What happened in 2010?

Total income in 2010 was split as 67% patronage-sourced and 33% non-patronage sourced, similar to previous years. And patronage income was split 57% to qualified patronage refunds and 43% to unallocated retained earnings. Patronage refunds were qualified only, split 40% cash and 60% retained.

Key Cooperative continued to be concerned about the impact of regional earnings and the way regional co-ops distributed patronage and redeemed retained patronage. But instead of creating and distributing “regional” retained patronage to patrons, as in the past, a large share of patronage income was distributed to unallocated retained earnings, creating a larger “reserve” that would never be expected to be redeemed.

One reason for using non-qualified distributions in the future was to reduce the amount of patronage income being distributed to unallocated retained earnings, thereby slowing the growth to total unallocated equity on the balance sheet. At the end of 2010 the unallocated equity on the balance sheet totaled 63% of total equity.

Section 6: Adopted Non-qualified Distribution in 2011

When and why did you shift to using a non-qualified distribution and how did you implement it?

Following the close of the 2011 fiscal year the Key Cooperative Audit and Finance Committee made a recommendation to the board of directors to change its income distribution policy for 2011 from that used in 2010 and prior. This included a shift to using a non-qualified distribution for retained patronage refunds. It was decided that a non-qualified distribution had more advantages than disadvantages in Key Cooperative’s situation.

One of the primary motivations was the desire to retain at the co-op level the tax benefits of DPAD and bonus depreciation. Another was to slow down the growth of unallocated equity. But the principal driver was the after-tax cash flow benefits to the patron of a new program.

The patron perceives a positive after-tax cash flow in the year of the distribution, say 2011, of a qualified 100% cash patronage refund since only this cash is taxable income, if a business patron. And if the revolving fund is 12 years long the patron perceives a positive after-tax cash flow in 2023, the year of redemption, when 100% of the non-qualified retained patronage refund retained in 2011 is paid with a 100% cash payment, since this non-qualified equity investment is not taxable to the patron until cash is received. In essence, in this type of program, taxable patronage refunds to the patron end up being paid 100% in cash, part in the year of distribution and part in the year of redemption. Taxes are only due on cash payments by the co-op to the business patron, as noted in Section 1.

A mix of qualified and non-qualified patronage refunds replaced the 2010 and prior policy of having 100% of patronage refunds distributed as qualified, usually with 40% as cash patronage and 60% as retained patronage. The qualified and non-qualified split was flexible but expected to be similar to the
previous 40% cash, 60% retained split of qualified only, only now the qualified portion was a 100% cash patronage refund and the balance of the patronage refund was a non-qualified distribution.

The board policy continued to distribute a significant portion of the patronage income to unallocated equity as a proxy for the regional component of patronage income. A split of 40% to allocated patronage refunds and 60% to unallocated retained earnings was normal for 2011-2013.

This shift in policy was part of a more comprehensive view of financial policy that spanned income distribution, equity management and balance sheet management. This comprehensive policy view guided Key Cooperative as it implemented its new income distribution choices, including deciding how much patronage income to distribute as patronage refunds. It was based on a series of drivers or priorities.

Section 7: Comprehensive Financial Policy View

Your pre-merger discussions and immediate post-merger discussions and decisions led to the creation of a broader comprehensive financial policy view. What is that view?

First and foremost, the objective is to protect the financial position of the co-op by using two related philosophies or policies. Key Cooperative adopted these in 2009 at the time of the merger, more vigorously than had its predecessor co-ops, to protect the co-op’s financial position, regardless of the income distribution choices made. The policies were:

1. Balance sheet management to achieve liquidity (working capital), solvency (debt to equity) and equity structure (allocated relative to unallocated, etc.) goals
2. Cash flow management to support these goals

This helped fulfill the fiduciary duty of the board and management team to protect the co-op business so it could effectively continue to serve members. It also kept the lenders, including CoBank, comfortable.

Second, but also critical, was to improve the after-tax cash flow perception of the customers who were business patrons and were eligible to receive a patronage refund. This was especially true for the farmer patrons who were the biggest customers and the voting members (Class A members). Specifically, Key Cooperative wanted to take off the table the perception that patronage refunds to farmer patrons have a negative, or at best, a breakeven after-tax cash flow impact in the year of distribution. In other words it believed that positive cash flow now, the year of distribution of income, was more important than the promise of positive cash flow later, at the time of redemption. Using a traditional distribution of patronage refunds all in qualified form with a 40-60 split on cash-retained suffered from this negative perception.

Key Cooperative realized it could improve customer-patron perception by using a non-qualified distribution and still protect the co-op using balance sheet management. A shift to a mixture, with a part of the patronage refund as a 100% cash patronage refund in qualified form and the remaining part as a

---

4 This financial policy view applies primarily to income distribution management and equity management aspects of balance sheet management. In general, a comprehensive financial policy or strategy should include strategies for growth and profitability, and should be integrated into income distribution and balance sheet management components of financial strategy. Growth and profitability are the biggest drivers of financial outcomes or performance. In this context, we take those as given and proceed with the supporting strategies being discussed.
nonqualified retained patronage refund substantially improved the after-tax cash flow of the patron in the year of distribution. And the after-tax cash flow to the farmer patron in the year it redeemed the non-qualified retained portion was also positive. This ultimately would result in a simple outcome: patrons doing business as a taxable entity are only obligated to pay taxes on cash they receive from the co-op, as cash patronage refunds or cash redemptions of non-qualified equity.\(^5\)

Third, it wanted to more proactively manage the balance between the amount of allocated equity and the amount of unallocated equity, but still have the option to retain at the co-op level the tax benefits of bonus depreciation and DPAD. A non-qualified retained patronage refund gave it more flexibility to achieve that goal.

After the merger, in 2009 and 2010, the policy was to only distribute local or operating income in allocated form as patronage refunds. This meant regional and other income was distributed in unallocated form to retained earnings. This compensated for the fact both co-ops agreed to stop creating regional retained patronage refunds out of regional-sourced patronage income. The combination of a relatively high non-patronage rate and a relatively high level of regional earnings meant it was distributing a very high proportion of total income and patronage income to unallocated retained earnings. At the end of 2010 unallocated equity was 63% of total equity. It would continue to increase just due to a relatively high non-patronage rate, even though the rate decreased from 33% in 2009-2012 to 25% in 2013 due to some changes in sources of business. But the relative level of unallocated equity would increase even faster due to distributing additional patronage income from non-local sources to unallocated retained earnings. At the end of 2013, three years later, unallocated equity had increased to 70% of total equity, but would have been even higher without the use of non-qualified distributions.\(^6\)

Fourth, Key Cooperative wanted to add consistency to its income distribution and equity management program and its patron’s perception of what they can depend on from Key Cooperative. An example is its commitment to a 100% cash patronage refund as part of that program. Patrons have expected to get a cash patronage refund so it intends to provide one, in improved form, at a 100% rate.

CoBank is known for paying patronage of 1% or 100 basis points on patronage interest income rates to patrons like Key Cooperative with a cash patronage rate of 65%. It is not a legal obligation but is a historical pattern that has significant competitive advantages. If the interest expense paid to CoBank by the patron was 5%, the refund of 100 basis points or 1%, 20% of 5%, is a significant “rebate” and is often factored in by borrowers when deciding how much to borrow and from whom.

Key Cooperative is also looking for those kinds of competitive advantages. It believes if it makes a commitment to consistently use a 100% cash patronage refund, a non-qualified retained patronage refund and a revolving fund redemption instead of an age of patron redemption, that consistency in using superior policies, in the eyes of patrons, creates additional competitive advantages. However, Key

---

\(^5\) Key Cooperative assumes all patrons are doing business as a profit-making business and that patronage refunds are taxable to the patron. Therefore, all patrons receive a 1099PATR. There may be some patrons that do business as consumers or other non-taxable entities and can ignore the 1099PATR. No attempt is made to segregate patrons into taxable and non-taxable entities and adjust income distribution policy accordingly. The cash flow perception and reality for business patrons is different than that for consumer patrons.

\(^6\) Managing this mix of allocated and unallocated equity would be an interesting topic for a future webinar.
Cooperative has not committed to pay a patronage refund equivalent to a set percentage of patronage sales, such as 1%, similar to CoBank’s recent historical strategy.7

Section 8: Comparison of Qualified/Non-qualified Mix Policy versus Qualified Only Policy

The way you implemented the new policy in 2013 is instructive. How would you compare the policy you used in 2013, a mix of qualified and non-qualified distributions, to the traditional policy of a qualified only distribution?

The new non-qualified policy used by Key Cooperative in 2011-2013 can be compared to the traditional qualified policy used in 2010 and before in an “apples to apples” way. This clarifies the different impacts of the two policy alternatives and reveals some of the reasons Key Cooperative shifted to using a non-qualified distribution. To make the comparison we have constructed a set of simplified income distribution scenarios, based on the actual policy used in 2013. The first scenario uses a “mix of qualified and non-qualified” distributions and is labeled the “NQ policy.” The NQ policy is very similar to the policy followed in 2013. The second scenario uses a “qualified only” distribution policy and is labeled the “Q Policy.”

The two different scenarios are illustrated with the help of the “Cooperative Income Distribution Management Model” developed by Dr. David Barton to communicate different income distribution strategies to co-op leaders, students, educators and co-op advisors including bankers, accountants, lawyers and consultants8. The NQ policy is illustrated in Exhibit 4 and the Q policy is illustrated in Exhibit 5. The models are used as a “thought experiment” in this context.

---

7 REI is a cooperative retailer of recreational clothing and equipment that does promise to pay a 100% “cash” patronage refund equivalent to 10% of eligible sales, which would be similar to Key Cooperative promising to pay a patronage refund of 1% of patronage sales. However, REI encourages patrons to spend their refund on the purchase of additional products and services, a clever way to pay the patronage refund. Patrons can go to a store and request cash instead of a credit towards additional purchases but few do so.

8 The earliest version of the Cooperative Income Distribution Management Model was used in a class on cooperatives, AGEC 600, Bargaining and Cooperatives, taught by David Barton in 1984 and 1985, to explain cooperative income distribution alternatives to students. More complete versions were used in subsequent research and education programs on cooperative finance, including when he helped teach the Kansas Cooperative Council’s Director Development Program course on cooperative finance, starting in 1987. Initially a table form was used, supplemented with hand drawn diagrams. The “decision tree” or flowchart diagram form was consistently added to publications and presentations in about 2000. The current version of the model was first used in 2007 with the addition of a very rarely used option, distributing non-patronage income as a patronage refund, not just as dividends and/or unallocated retained earnings. This model has been and continues to be used as the basis for an algorithm in a financial planning simulator to calculate and compare the outcomes of alternative income distribution policies a cooperative may choose to use. The simulator, FINPLAN, has been used in research projects, financial planning projects for cooperatives and in related cooperative case studies beginning in 1987.

Note that the model uses a discipline similar to the balance sheet management discipline, the fundamental equation of accounting: assets = liabilities + equity. Income (in this case, book income before bonus depreciation, DPAD and income taxes) = cash payments (cash patronage + dividends on equity + income taxes) + retained equity (qualified retained patronage + non-qualified retained patronage + unallocated retained earnings).
Tax preparers will note that the way in which taxable income and income taxes are calculated in the Exhibits does not follow the standard calculation process represented in Form 1120-C but the outcomes are equivalent. Auditors will note they typically provide cooperative boards and management teams with information equivalent to that shown in the model’s diagram, but in table form. They normally provide maximum and/or minimum distributions to patronage refunds based on legal constraints in laws and corporate legal documents such as bylaws. For example, the bylaws may state that patronage refunds are based on taxable income not book income or they may state that the minimum distribution of patronage income to patronage refunds is at least 90%, thereby limiting the amount of patronage income that may be distributed to unallocated retained earnings. Auditors also provide other distribution policy choices between the maximum and minimum constraints that are of interest to the co-op. The model’s diagram can be used to illustrate these alternative policy choices in a clear and consistent way that is often easier for co-op leaders and others to understand than a presentation in table form.

The assumptions made by Key Cooperative about how to think about utilizing the tax benefits of bonus depreciation and DPAD are:

1. First, capture bonus depreciation at the co-op level by making sure there is sufficient taxable income from non-patronage income plus additional patronage income retained on an unallocated and/or an allocated non-qualified basis.
2. Second, capture a desirable proportion of DPAD at the co-op level by making sure there is sufficient taxable income from patronage income retained on an unallocated and/or an allocated non-qualified basis (non-patronage DPAD is insignificant).
3. Third, pass through remaining DPAD to patrons.

We used several simplified assumptions for both the NQ and Q policy scenarios including:

1. Total book income before bonus depreciation, DPAD and income taxes is $10,000,000 ($10.0M).
2. Patronage income is 75% of total income and non-patronage income is 25%.
3. The amount of the bonus depreciation deduction available is $4.0M and all will be captured or retained by offsetting it with taxable income. In this simple illustration we assume, as part of the thought experiment:
   a. We create taxable patronage income to absorb $3.0M
   b. Non-patronage income will absorb the remaining $1.0M
4. The amount of patronage based DPAD is $5.0M (non-patronage DPAD is insignificant) and it will be utilized as follows, as a thought experiment:
   a. We create taxable patronage income to absorb $3.5M
   b. We pass through to patrons the balance of $1.5M
5. The total taxable patronage income needs to be $6.5M to be able to offset the bonus depreciation deduction applied of $3.0M plus the DPAD deduction retained of $3.5M.
6. Any combination of nonqualified retained patronage refunds and retained earnings created from patronage income that totals $6.5M will work to create an “apples to apples” comparison between the NQ and Q policy scenarios.

---

9 These assignments of bonus depreciation deductions to taxable patronage income and taxable non-patronage income are arbitrary in the context of income tax calculations made on IRS Form 1120-C. This is a thought experiment approach.
7. These common assumptions for both the “NQ policy” and the “Q policy” mean that $1.0M is left of $7.5M in patronage income to distribute as a patronage refund. Any combination of qualified cash patronage, qualified retained patronage and non-qualified retained patronage will work. The splits chosen for the Q and NQ policy scenarios are very similar to the splits used by Key Cooperative in 2010 (Q policy) and 2013 (NQ policy) and facilitate an apples to apples comparison (“all else equal” comparison).

The comparison of the NQ and Q policies will use the simplified numbers above which are similar to the numbers for 2013. Since 2013 actually used the NQ policy it will be described first. Then the Q policy, last used in 2010, will be described and compared.

The NQ policy is represented in Exhibit 4. To achieve the objectives of utilizing the tax benefits of bonus depreciation and DPAD plus split patronage refunds into qualified and non-qualified components as desired the following splits were made:
   1. Patronage income of $7.5M is split so that 40% goes to patronage refunds, $3.0M, and 60%, $4.5M, goes to unallocated retained earnings.
   2. One-third of patronage refunds, $1.0M, is paid as a qualified 100% cash patronage refund.
   3. Two-thirds of patronage refunds, $2.0M, is distributed as a non-qualified retained patronage refund.

This creates $6.5M of taxable income to the cooperative and allows it to retain $3.0M of bonus depreciation and $3.5M of DPAD. As a comparative metric, cash patronage is 13% of patronage income and non-qualified retained patronage is 27% of patronage income. Therefore 60% of patronage income is distributed to unallocated retained earnings, which increases unallocated equity by $4.5M (net of taxes in our thought experiment), one of the metrics Key Cooperative wants to monitor.

Another metric of interest is cash outflow. Cash outflow is $1.625M before equity redemptions, the sum of cash patronage, $1.0M, and income taxes, $0.625M.

The traditional Q policy is represented in Exhibit 5. To utilize the same tax benefits and to use the qualified only policy with 40% cash, 60% retained the following splits are made:
   1. Patronage income of $7.5M is split so that 13.33%, $1.0M, goes to qualified patronage refunds and 86.67%, $6.5M, goes to unallocated retained earnings.
   2. Qualified patronage refunds are split so that 40%, $0.4M, is paid as cash and 60%, $0.6M, is retained.

As in the NQ policy, the Q policy creates $6.5M of taxable income to the cooperative and allows it to retain $3.0M of bonus depreciation and $3.5M of DPAD. As a comparative metric, cash patronage is about 5% of patronage income and non-qualified retained patronage is about 8% of patronage income. Therefore about 87% of patronage income is distributed to unallocated retained earnings, which increases unallocated equity by $6.5M (net of taxes in our thought experiment), one of the metrics Key Cooperative wants to monitor.

Each policy has advantages and disadvantages. Key Cooperative believes the NQ policy has more advantages than the Q policy. The comparisons are made using a strict balance sheet management approach, requiring the ending balance sheets of each scenario to be identical in terms of liquidity (working capital and ending cash) and solvency (equity to assets or debt to equity). This allows an apples
to apples comparison using a comprehensive financial accounting system expressing all the inherent interrelationships between the balance sheet and income statement.

Of course there are cash flow transition issues at the co-op level when switching from qualified to non-qualified. Creating non-qualified equity in place of qualified equity increases income taxes payable by the co-op and reduces taxes payable by the patron in the year of distribution. Key Cooperative thinks that is a good tradeoff, but it has consequences. The co-op has to cover that tax increase in its balance sheet management and cash flow management.

In the case of switching from the NQ policy back to the Q policy, cash outflow would decline from $1.625M to $1.025M. Perhaps a better way to think about it, from the point of view of Key Cooperative’s actual timeline or sequence of decision making, is to think of switching from the Q policy to the NQ policy. Key Cooperative has to cover the increased cash outflow of $0.6M. The way it would have to do so in this example is to reduce cash redemptions of qualified retained patronage refunds by the difference of $0.6M.

This example is realistic for Key Cooperative, given its objective of retaining $6.5 million in tax benefits through it income distribution policy. However, if retention of tax benefits at the co-op level is not the primary driver then the more general case of having to deal with the “transition problem” of switching from qualified to non-qualified comes into play.

The transition problem exists because Key Cooperative would normally be redeeming old qualified equity until it is all redeemed with no tax benefit while it replaces the qualified equity with non-qualified equity. Income tax cash outflow will increase during this transition, all else equal. Something has to give under its first priority, balance sheet and cash flow management. There is only so much cash available, and the level of net equity on the balance sheet would remain the same for either scenario. So one adjustment it can make, to be cash flow neutral when switching from the Q to the NQ policy, is reduce redemptions to offset the tax increase and keep equity financing at the same level in either scenario.

Essentially the new NQ policy is increasing after-tax cash flow to patrons on the front end, the year of distribution, and slowing it down on the back end, the year of redemption. Key Cooperative thinks that is a good tradeoff for patrons and it is cash flow neutral to the co-op, if it is strict on cash flow management.

But it should also be noted that having the tax benefits of bonus depreciation and DPAD means it can create taxable income by retaining patronage income in unallocated form or retaining in allocated form with a non-qualified distribution. Then taxable income is and offset with the tax benefits. In other words, it gets to book tax-free equity, which increases total equity. If those benefits go away it may want to adjust its use of non-qualified distributions to manage the balance sheet and cash flow. Otherwise it will be forced to reduce redemptions on the back side even more.

The components of the equity section will change but the total equity will remain constant (on a net basis, considering differential tax benefits to be claimed at some future time when non-qualified equity is redeemed). For example, the use of the NQ policy will add a non-qualified class of allocated retained patronage refunds equity to the balance sheet equity section and the balances in the different equity classes will be different between the Q and NQ policies.
The amount of cash out flow for income taxes and cash patronage refunds is shown in Exhibits 4 and 5, as is the amount of new equity created in income distribution, by class of equity. The corresponding beginning and ending balance sheets are not shown in this illustration.

The advantages and disadvantages of the Q and NQ policies are as follows:

1. Both protect the financial position of the co-op if you practice strict balance sheet and cash flow management.
2. A non-qualified distribution improves perceived and actual cash flow to the patron, especially if combined with a 100% cash patronage refund for a portion of the patronage refunds.
3. A qualified distribution improves (reduces) cash outflow of the co-op, all else equal, allowing a higher redemption budget under strict balance sheet management.
4. A non-qualified distribution requires a reduction in the redemption budget while the co-op is still redeeming old qualified equity.
5. A non-qualified distribution gives more flexibility to practice balance sheet management when trying to manage the balance between allocated and unallocated equity, especially in the context of tax benefits like bonus depreciation and DPAD.
6. A non-qualified distribution gives one more option to help maintain consistency in cash flow payments to patrons from cash patronage and cash redemptions.

**Section 9: New Income Distribution Policy and Equity Management Program**

How have you coordinated your new income distribution policy of using non-qualified distributions with your equity redemption program? More specifically, how do you plan to redeem non-qualified retained patronage refunds?

As noted earlier, Key Cooperative (and its predecessor co-ops) made a transition in its equity redemption program. It continues to use an equity redemption program that does estate settlement redemptions as first priority call on the redemption budget. But it stopped using an age of patron redemption as the second priority call. The current program uses a revolving fund as the second priority call. Of course, the board has full discretion, and can change programs and priorities at any time based on what it thinks is best for the co-op and the patrons, given the co-op’s unique circumstances.

At this point in time it intends to redeem non-qualified equity using these priorities just like it redeemed qualified equity. Since the tax benefits to the cooperative are different for redeeming qualified equity and non-qualified equity it is possible it may want to redeem some non-qualified equity ahead of the normal revolving fund order. Key Cooperative is keeping its options open and checking into what is possible.

But as a matter of fact Key Cooperative has already been redeeming both qualified and non-qualified equity through its estate settlement redemptions. Since it is now using a revolving fund that redeems the oldest equity first it is still redeeming old qualified equity with its revolving fund. Its next revolving fund redemption will be redeeming all or part of its oldest equity in three old qualified equity classes that have equity retained up through 2008. The class and the next year to be redeemed are: HOIC, 1996 (1986-1995 already redeemed), SCE-Local, 2000 (1996-1999 already redeemed), and SCE-Regional, 1982 (1976-1981 already redeemed). Eventually it expects to redeem each of these classes to zero using the
redemption budget allocation rules described previously. Then it will begin redeeming qualified Key equity for the 2010 year (none was retained in 2009). After that it will start on the first year of non-qualified equity, 2011.

The redemption budget was $1 million each year for the three years, 2010-2012, and was increased to $1.5 million for 2013. The redemption budget is set based on cash flow projections near the end of each fiscal year. Given current equity balances, if the future budget was $1 million indefinitely, it expects the revolving fund to be about 18.7 years in length. If the future budget was $1.5 million it expects the length to drop to about 12.5 years. The future rate of asset growth and profitability will be big drivers of the revolving fund length.

Allocated and qualified pre-merger equity was 63% of total allocated equity in 2010. Key Cooperative’s qualified equity created in 2010 (none in 2009 due to only distributing a 100% cash patronage) was 8% of total allocated equity. Its non-qualified equity created in 2011-2013 is 29% of 2013 total allocated equity. Its goal is to have 12-15 years of allocated equity outstanding at any one time.

Once all the qualified equity is redeemed, each year after that it will be creating new non-qualified equity and redeeming old non-qualified equity. The tax obligation and tax benefit will be somewhat offsetting. At that time it won’t have the transition problem of higher cash outflows for income taxes. But that could take many years, depending on how fast the old qualified equity is redeemed and how long the revolving fund goes back.

Section 10: Popularity with Patrons

How has this change in policy to use non-qualified distributions gone over with patrons?

Patrons have said they really like the new patronage refund policy. They like the positive cash flow in the year of distribution and like knowing they will eventually get more when the non-qualified retained patronage refund is redeemed. Key Cooperative no longer gets the comment that “patronage refunds cost me cash out of my pocket” in the current year, the year of distribution.

Section 11: Effectiveness in Achieving Goals

How has this change in policy worked, overall, in achieving your goals?

The new balance sheet and cash flow management policy has sent the message that if the co-op performs on a consistent basis, in terms of profitability, patrons can expect to receive cash, first as a 100% cash patronage refund, and then as a cash redemption with remaining available cash. These additional tools help it proactively manage the balance sheet instead of being managed by it through inflexible income distribution and equity redemption programs.
Section 12: Advice to Co-ops

What advice do you have for cooperatives considering changing their policy to include use of non-qualified distributions?

The most important advice, in addition to following the balance sheet management, income distribution management, and related policies discussed earlier, is to educate patrons and tax preparers.

Education of patrons is essential on the new income distribution program and its cash flow advantages. Patrons understand 100% cash patronage but they don’t understand non-qualified distributions or allocations as easily.

Education of tax preparers and accountants used by farmers is also essential. The amounts showing up on 1099PATRs change relative to the cash and retained amounts. Future tax planning also changes. Some preparers believe the co-op’s 1099s are incorrect and insist the cash and non-qualified retained patronage refunds should have been included on the 1099. Some say they intend to report both as current income because they don’t understand the difference between qualified and non-qualified.

The co-op has also had to educate tax preparers about the pass-through of DPAD and the inclusion of PURPIM on the 1099.

Section 13: Summary

To fully understand the advantages and disadvantages of the Q policy (qualified only) versus the NQ policy (mix of qualified and non-qualified) it is essential to have a basic understanding of the principles of cooperative finance, including balances sheet management and income distribution management strategies.

The advantages of using a non-qualified retained patronage refund are (1) the positive cash flow perception and reality for patron-customers (especially when combined with a 100% cash patronage refund), (2) the ability to retain at the co-op level the tax benefits of bonus depreciation and DPAD, and (3) the ability to increase the relative level of allocated to unallocated equity, compared to using a qualified only policy.

The disadvantages of using a non-qualified retained patronage refund are (1) the transition problem of higher cash outflows while retaining non-qualified patronage refunds and redeeming qualified patronage refunds, and (2) the belief by many in the myth that non-qualified retained patronage refunds are permanent equity and are not redeemed in the future, thereby creating resistance from patrons to non-qualified distributions replacing qualified retained patronage refunds.

Education of co-op leaders and patrons, as well as affiliated stakeholders, is the key to making effective choices that fit the unique circumstances of each co-op. It is essential to get informed, competent advice from co-op accounting and tax professionals.
Additional Resources

The following additional publications are available that address the distribution of income in qualified and non-qualified form or other related cooperative finance topics.


Exhibits
Exhibit 1. Biographical Sketches of Presenters

James "Jim" R. Magnuson

Jim Magnuson is the general manager and chief executive officer of Key Cooperative, an agricultural grain marketing and farm supply cooperative in Roland, Iowa. He was elected to the CoBank board in 2013 and is a member of the Governance Committee.

In addition, he is chairman of United Suppliers Inc. and serves as a director for ACES (Agricultural Cooperative Employment Services). He holds a bachelor’s degree and a master’s degree in agricultural economics from the University of Nebraska-Lincoln.

Mike Thomas

Mike Thomas is Chief Financial Officer of Key Cooperative in Roland, IA. He joined Key Cooperative (then Heart of Iowa Cooperative) in 1992 becoming CFO in 1998. He has a bachelor’s degree in Business Administration with an emphasis in Accounting from the University of South Dakota.

Dr. David G. Barton

David Barton is Professor Emeritus, Agribusiness Management, in the Department of Agricultural Economics at Kansas State University and President and CEO of ACES.

In addition, he is Director Emeritus of the Arthur Capper Cooperative Center. He served on the faculty of Kansas State University in a full-time position for 35 years, from August, 1976 through July, 2011, and as Director of the ACCC for 27 years, from 1984-2011.

Prior to joining the faculty at K-State, Dr. Barton completed his Ph.D. studies at Purdue University and was a faculty member in the Department of Agricultural Economics at Cornell University during 1973-76. He served as a director on the Kansas Cooperative Council (KCC) Board of Directors for 25 years, from 1985-2010, and as chair of the KCC Education Committee for 24 years, from 1986-2010.
Webinar: Non-Qualified Distributions

March 13, 2014
Co-sponsored by:
CoBank, State Cooperative Councils, USDA Cooperatives Community of Practice on eXtension
NCERA-210 Cooperative Research Committee
Panel Members

- Phil Kenkel: Moderator and Introduction
- Mike Boland: Myths and Misconceptions
- David Barton: Overview of Key Cooperative
- Jim Magnuson, CEO, Key Cooperative
- Mike Thomas, CFO
Webinar Overview

- Audio through your computer—there is no conference phone line
- You may type in questions at anytime
- We will be sending a summary of questions and answers to all pre-registered participants and to others by request
- Material available: slide deck, FAQ, white paper and previous literature.
Phil Kenkel

- Bill Fitzwater Cooperative Chair, Department of Agricultural Economics, Oklahoma State University
- Editor of Journal of Cooperatives
- Chair, Cooperatives Community of Practice on eXtension
  www.extension.org/cooperatives

- Cooperative financial simulator
- Qualified to Non-qualified Calculator
- Goodwin formula calculator
- www.agecon.okstate.edu/coops
- Phil.kenkel@okstate.edu
Distribution of Profits in a Cooperative

- Board of directors decides on allocation to cash patronage, allocated retained patronage and retained earnings (unallocated reserves)
- Allocated retained patronage can be distributed in the form of a qualified or non-qualified distribution
- The board is responsible for the tax decision on the allocated retained equity
Simplified Representation of Income Distribution Choices in a Cooperative

- **Net Income**
  - Patronage-sourced
    - Qualified
      - Qualified Retained Patronage Refunds
    - Non-Qualified
      - Non-Qualified Retained Patronage Refunds
  - Non-Patronage Sourced
    - Unallocated (retained savings or earnings)

Patronage Refunds (revolving)
Qualified Distribution

- Member receives equity which is taxable in the current year
- Cooperative is able to exclude the distribution from taxable income in the current year
- There is no tax effect at redemption since the tax has already been paid
- Cooperative must pay a minimum of 20% cash patronage
Non-qualified Distribution

- Member receives equity which is not taxable in the current year
- Cooperative cannot deduct the distribution and thus pays corporate tax on the earnings
- At the time of redemption the payment is taxable to the member and creates a deduction for the cooperative
- No requirement for a minimum percentage of cash patronage
The Choice

- The member ultimately pays the tax but the timing of the tax is impacted by the choice of distribution.
- The choice of distribution impacts the timing of cash flows to the cooperative and to the member.
- The cooperative can adjust the cash patronage rate to be cash neutral assuming the current cash patronage is equal to or higher than the cooperatives tax rate.
- One criteria is which method maximizes the member’s financial return.
Members IRR at Equivalent Coop Cash Flow

Based on data and projections
From Oklahoma Grain and
Farm supply cooperative

<table>
<thead>
<tr>
<th>Percent</th>
<th>Coop Higher Tax</th>
<th>Coop Lower Tax</th>
<th>199 Section</th>
<th>199 Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Qualified</td>
<td>Non-Qual</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

10
<table>
<thead>
<tr>
<th></th>
<th>Qualified</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net income before taxes and patronage</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>Cooperative</td>
<td>$45.00</td>
</tr>
<tr>
<td>Stock</td>
<td>Patron</td>
<td>$55.00</td>
</tr>
<tr>
<td>Taxable Income</td>
<td></td>
<td>$0.00</td>
</tr>
<tr>
<td>Tax</td>
<td></td>
<td>$0.00</td>
</tr>
<tr>
<td>After Tax Income</td>
<td></td>
<td>$0.00</td>
</tr>
<tr>
<td>Cashflow</td>
<td></td>
<td>$55.00</td>
</tr>
</tbody>
</table>

| Stock patronage rate   | 55.00% |
| Cash patronage rate    | 45.00% |
| Tax rate               | 40.00% | 45.00% |

Cash patronage rate to keep coop's cash flow equivalent with non-qual: **8.33%**
Michael Boland (Mike) holds the Koller endowed Professorship in agribusiness management at the University of Minnesota where he has teaching, research, and outreach responsibilities in agribusiness management, food marketing, and in particular, agricultural cooperatives.

- boland@umn.edu
- 612.625.3013
Qualified Distributions are the Historical Choice

- Assumed producer had a lower marginal tax rate relative to the cooperative.
- Cash patronage barely covered the patron’s tax obligation created.
- Contributed to the perception that the patron had a right to see equity redeemed on a fixed schedule since the co-op forced the patrons to pay the taxes on the non-cash equity in the cooperative.
Which Allocation is in the Best Interest of the Member?

- At current marginal tax rates, the after tax cash flows to the member has increased the benefits of non-qualified distributions.
- Section 199 Domestic Activity Production Deduction (DPAD) further increases the benefits.
- Shifting allocated distributions to retained earnings does not maximize the member’s financial return.
- Managing the cooperative balance sheet is also clearly in the member’s best interest.
What is the Impact on the Cooperative’s Cash Flow?

- If cash patronage is unchanged the cooperative’s cash flow is reduced because of higher taxes
- The largest impact is during the transition period before all the qualified equity is redeemed (no tax benefit) and replaced by non-qualified or unallocated equity
- There are a number of ways that cooperatives are using to make the transition cash flow neutral to offset this impact
  - Reduce the proportion of patronage being redeemed as cash
  - Use DPAD and Bonus Depreciation to offset the co-op’s income tax
  - Do not revolve equity redemptions from regional cooperatives
  - Increasing the equity redemption period
- The reality is that all of these are being used
Why Are Some Cooperatives Transitioning to Non-Qualified

- Recognize that it is in the patron’s interest
- More popular with patrons and easier to explain
- Tax matched with the cash distribution
- Tax deduction softens the cash flow impact at redemption
- Patron should be more receptive to the cooperative managing the redemption timing
- Eliminates the minimum cash percentage
Are Non-qualified Distributions Redeemed?

- Yes, local cooperatives can, and should, redeem non-qualified just like qualified equity
- Can use the same equity management system or move to a new system
- If not redeemed, it functions just like unallocated equity (retained earnings) except that it is harder to manage since your members die and their equity is not redeemed.
- CoBank issued non-qualified distributions to increase permanent equity and because of regulatory issues. These are not redeemed because corporations have an infinite life. The intent was to increase permanent equity with a patron’s name on it, in case of future dissolution.
Does Non-Qualified Complicate Equity Retirement Programs?

- Not necessarily as will be seen from the case study.
- If the non-qualified distribution is set up to be cash neutral or offset with Section 199 it has no impact on managing the equity retirement budget.
- If the co-op is committed to being profitable, the non-qualified tax benefit can be claimed in the future when the board decides to redeem non-qualified equity.
- Our Frequently Asked Questions handout addresses this and other issues.
David Barton is Professor Emeritus, Agribusiness Management, in the Department of Agricultural Economics at Kansas State University and President and CEO of ACES.

In addition, he is Director Emeritus of the Arthur Capper Cooperative Center. He served on the faculty of Kansas State University in a full-time position for 35 years, 1976-2011, and as Director of the ACCC for 27 years, 1984-2011.

davidgbarton45@gmail.com; 785-565-2426
Key Players at Key Cooperative

Jim Magnuson-CEO
- He was elected to the CoBank board in 2013 and is a member of the Governance Committee.
- In addition, he is chairman of United Suppliers Inc. and serves as a director for ACES (Agricultural Cooperative Employment Services). He holds a bachelor’s degree and a master’s degree in agricultural economics from the University of Nebraska-Lincoln.
- JIM.MAGNUSON@keycoop.com

Mike Thomas-CFO
- He joined Key Cooperative (then Heart of Iowa Cooperative) in 1992 becoming CFO in 1998. He has a bachelor’s degree in Business Administration with an emphasis in Accounting from the University of South Dakota.
- Mike.Thomas@keycoop.com
Key Cooperative

- Large grain marketing and farm supply cooperative headquartered in Roland Iowa
- 12 locations, 1600 voting members, 1600 non-voting patrons, 220 full time employees
- 2013 sales of $531M, net income of $10.6M
- Created in 2009 from merger
  - Heart of Iowa Cooperative (HOIC)
  - Sully Cooperative Exchange (SCE)
- Summary report will be sent to registered participants with more details
Prior to 2009 Merger: Traditional

- **Income Distribution**
  - HOIC and SCE patronage refunds were distributed 40% cash, 60% qualified retained so all allocated equity was qualified
  - Created negative cash flow perception with patron-customers
  - HOIC and SCE had relatively high non-patronage business and distributed a significant portion of patronage income to unallocated retained earnings

- **Equity Management**
  - HOIC had local and regional equity pools but redeemed them the same way – estates and revolving fund; and one sub-pool (1995 and before) used age of patron at 70
  - SCE had local and regional equity pools but redeemed differently – estates and revolving fund but discounted regional revolving fund redemption by 50%

- Age of patron system created cash flow inflexibility
- Patrons not invested proportional to use: age of patron and long revolving fund
- At the end of 2010 unallocated was 63% of total equity due to non-patronage business and distributing patronage income to unallocated
- Started using Section 199/DPAD in 2007
After the 2009 Merger: New Financial Philosophy

- Goal: simplify and improve
- Eliminated local-regional split on new Key Cooperative allocated equity; regional income “informally” to unallocated
- Used qualified 100% cash in 2009 (short transition year)
- Used qualified 40% cash, 60% retained in 2010 but not ready for non-qualified
- Used more disciplined balance sheet management: set an equity redemption budget of $1.0-$1.5M each year
- First call on budget is estate settlements on all equity pools
- Split remainder of budget to old HOIC and old SCE pools
- HOIC sub-pool using age of patron was redeemed by 2013
- Future: Revolving fund on all pools (14-22 years on old pools)
• Patronage and non-patronage split: 67% - 33%
• Patronage income split: 57% allocated, 43% unallocated
• Used qualified 40% cash, 60% retained in 2010 but not ready for non-qualified
• Unallocated equity on balance sheet: 63% of total
First Non-qualified Distribution in 2011

- Motivated by desire to retain the tax benefits of DPAD and bonus depreciation at the cooperative level but slow down increase in unallocated
- Shifted to income distribution policy with a patronage refund that had a mix of qualified and non-qualified
  - Qualified 100% cash patronage refund
  - Non-qualified retained patronage refund
  - Qualified and non-qualified split “flexible” but used 40%/60%
- Also continued to distribute significant portion of patronage income to unallocated, partly as a proxy for regional income component, such as 40% - 60% for 2011-2013
- Captured bonus depreciation tax benefit and DPAD tax benefit at co-op level with non-qualified and unallocated distribution
- All part of a more comprehensive financial policy view
Current Comprehensive Financial Policy

- First, protect the financial position of the co-op
  - Balance sheet management: liquidity, solvency, equity structure
  - Cash flow management
- Second, improve the cash flow perception and reality (after tax) for the customers who are patron-owners
- Third, proactively manage the equity structure part of the balance sheet: the relative mix of allocated and unallocated equity
- Fourth, add consistency and dependability to future patronage refund management, especially cash patronage but also cash redemptions
Key Cooperative had income of about $10.0M in 2013 (using simplified numbers)

Key used a qualified/non-qualified mix in 2013
- 100% cash patronage (qualified) – 13% of patronage income
- Non-qualified retained patronage – 27% of patronage income
- Balance of patronage income to unallocated – 60% of patronage income

What do you like or not like about this choice? (Q&A at end)

What if Key went back to a traditional “qualified only” distribution (apples to apples)?
- 40% cash patronage (qualified) – 5% of patronage income
- 60% retained patronage refund – 8% of patronage income
- Balance of patronage income to unallocated – 87% of patronage income

What do you like or not like about this choice? (Q&A at end)

Which choice is best, assuming we protect the co-op with a cash flow neutral program, so income taxes + cash patronage + cash redemption total the same in each case?
Which alternative would patrons prefer?

Let’s briefly look at some details about two possible choices, qualified/non-qualified mix versus qualified only to understand the differences and consequences in each choice

Using “Cooperative Income Distribution Management Model” (Barton, circa 1987)
- Similar to balance sheet management discipline: assets = liabilities + equity
- Income (book) before bonus depreciation, DPAD, taxes = cash payments (cash patronage, dividends on equity, taxes) + retained equity (qualified retained patronage, non-qualified retained patronage, unallocated retained)
The "Cooperative Income Distribution Management Model" can be used to communicate the consequences of alternative distribution strategies to the board and management team. Legal constraints due to laws and bylaws can be represented, including the rule that maximum patronage refunds are based on after tax net income not book income. Auditors typically provide various options in table form, including maximum or minimum distributions to patronage refunds.

Total Income is book net income before bonus depreciation, DPAD and income taxes.

Cash Patronage Refunds (P-Q) 100.00% $1,000,000
Retained Patronage Refunds (P-Q) 0.00% $0
Net Retained Patronage Refunds (P-NQ) 100.00% $2,000,000
Income Taxes (P-NQ) 0.00% $0
Dividends (P-NQ) 0.00% $0
Net Retained Earnings (P-NQ) 100.00% $4,500,000
Income Taxes (P-NQ) 0.00% $0
Cash Patronage Refunds (NP-NQ) 0.00% $0
Retained Patronage Refunds (NP-NQ) 60.00% $2,500,000
Income Taxes (NP-NQ) 40.00% $0
Dividends (NP-NQ) 0.00% $0
Net Retained Earnings (NP-NQ) 75.00% $1,875,000
Income Taxes (NP-NQ) 25.00% $625,000
Key Cooperative 2013 Income Distribution: Used Non-qualified

Source

Cash outflow = $1,625,000 before redemptions
Cash flow neutral versus qualified (Q): Reduce redemptions of Q equity by $600,000

Allocation

Allocated Patronage Refunds
40.00% $3,000,000

Allocated Patronage Refunds (P-Q)
100.00% $1,000,000

Patronage Income
75.00% $7,500,000

Tax Deductability

Qualified
33.33% $1,000,000

Retained Patronage Refunds (P-Q)
0.00% $0

Nonqualified
66.67% $2,000,000

Net Retained Patronage Refunds (P-NQ)
100.00% $2,000,000

Taxable Retained Patronage Income = $6.5M
Apply $3.0M bonus depreciation
Retain $3.5M DPAD  Taxes = $0

Distribution as:

Income Taxes (P-NQ)
0.00% $0

Unallocated Not Qualified Net Retained Earnings (P-NQ)
100.00% $4,500,000

Dividends (P-NQ)
0.00% $0

Not Qualified
$4,500,000

Income Taxes (P-NQ)
0.00% $0

Net Retained Earnings (P-NQ)
100.00% $4,500,000

Unallocated
60.00% $4,500,000

Cash Patronage Refunds (P-Q)
100.00% $1,000,000

Cash flow neutral versus qualified (Q): Reduce redemptions of Q equity by $600,000.
### Key Cooperative 2013 Income Distribution: If Used Qualified

<table>
<thead>
<tr>
<th>Source</th>
<th>Allocation</th>
<th>Tax Deductability</th>
<th>Distribution as:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash outflow = $1,025,000 before redemptions</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Cashflow neutral versus non-qualified (NQ):</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Increase redemptions of Q equity by $600,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Qualified</strong></td>
<td><strong>Cash Patronage Refunds (P-Q)</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>100.00% $1,000,000</td>
<td>40.00% $400,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Retained Patronage Refunds (P-Q)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>60.00% $600,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Net Retained Patronage Refunds (P-NQ)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>100.00% $0</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Income Taxes (P-NQ)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.00% $0</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Dividends (P-NQ)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.00% $0</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Net Retained Earnings (P-NQ)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>100.00% $6,500,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Income Taxes (P-NQ)</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.00% $0</td>
<td></td>
</tr>
</tbody>
</table>

#### Patronage Income
- **75.00% $7,500,000**
- **13.33% $1,000,000**
- **86.67% $6,500,000**

#### Taxable Retained Patronage Income = $6.5M
- Apply $3.0M bonus depreciation
- Retain $3.5M DPAD  Taxes = $0

- **Unallocated**
  - **86.67% $6,500,000**

- **Not Qualified**
  - **$6,500,000**
Why the Shift to Non-qualified?

- Concluded it was in the patron’s interest
- Compatible with balance sheet and cash flow management
- Patron perceives a positive cash flow in both year of distribution (2013) and year of redemption (2025?)
- Slowed the rate of growth of unallocated equity but still rose from 63% of total equity in 2010 to 70% in 2013
Coordination with Equity Redemption Program?

- Already transitioned out of age of patron to revolving fund
  - SCE did prior to merger
  - HOIC started prior to merger and finished in 2013
- First priority is estate settlements, all pools, so redeeming mix of Q and NQ
- Second priority is revolving fund, old qualified equity
  - Old HOIC and SCE qualified equity (2008 and prior with pro rata rules), then
  - New Key qualified equity (2009)
- Third priority is Key non-qualified equity (2011 and after)
- Intend to redeem non-qualified under the same system and priorities
- Goal is a 12-15 year revolving period
- Transition issue: Willing to slow down revolving fund redemptions of qualified equity (no tax benefit) while adding new non-qualified and unallocated (taxable) until all qualified is redeemed using strict cash flow management
- DPAD and bonus depreciation help with the transition
How has the change gone over?

- Patrons like the new policy and positive cash flow
- New balance sheet and cash flow management policy sent the message that available cash goes first to cash patronage and then to equity retirement
- Helps us manage the balance sheet rather than being driven by inflexible income distribution and equity retirement programs
What Advice Do You Have for Other Cooperatives?

- Follow balance sheet management and income distribution management strategies
- Education of patrons is essential
- Education of tax preparers and accountants used by farmers is essential
- Tax preparers and accountants need to understand difference between qualified and non-qualified as well as pass through of DPAD and inclusion of PURPIM on the 1099
- Retain professional advisors who understand all this
Summary

- Understand the basics: balance sheet management and income distribution management strategies
- Non-qualified advantages versus qualified
  - Positive cash flow perception and reality for patron-customers
  - Flexibility to manage tax benefits and equity structure (allocated/unallocated mix)
- Non-qualified disadvantages versus qualified
  - Transition problem: higher cash outflow while redeeming old qualified equity requiring adjustment down in cash patronage and/or cash redemptions
  - Myth that non-qualified equity is not redeemed to patrons
- Education is the key to making effective choices that fit the unique circumstances of each co-op
Future Webinar Topics?

- More depth on qualified versus non-qualified tied to
  - Tax benefits (bonus depreciation, DPAD, redemption program)
  - Cash flow management

- Allocated versus unallocated balance in equity management
  - Pure co-op that distributes all patronage income as patronage refund (100% allocation)
  - Co-op that distributes small part of patronage income (e.g., 10%) as a 100% cash patronage refund and balance as unallocated equity never to be redeemed
  - Some mix of above (such as Key Cooperative strategy)
Questions from Audience?

- Phil.kenkel@okstate.edu
- boland@umn.edu
- davidgbarton45@gmail.com
- JIM.MAGNUSON@keycoop.com
- Mike.Thomas@keycoop.com
Exhibit 3. Generic Co-op Finance Terms and Equivalent Terms for Key Cooperative

2. Operating income: operating savings
3. Total income (Income before income taxes): Savings before income taxes
4. Net income: Net savings
5. Patronage refunds: Patronage dividends
6. Retained patronage refunds: Deferred patronage dividends, allocated [retained] patronage refunds [held in “Members Equity” before distribution to individual patron equity accounts, qualified or non-qualified]
7. Qualified retained patronage refunds: Preferred stock
   a. Preferred Class A: Key Cooperative (2010)
   b. Preferred Class B: HOIC (1996-2008)
   c. Preferred Class C: SCE (2008 and before)
8. Non-qualified retained patronage refunds: Preferred Stock Class D (2011 and after)
9. Retained earnings: Retained savings
10. Equity: Members’ equity
Exhibit 4: Key Cooperative 2013 Simplified Cooperative Income Distribution Management Model: NQ Policy

Source

<table>
<thead>
<tr>
<th>Total Income</th>
<th>100.00%</th>
<th>$10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonpatronage Income</td>
<td>25.00%</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Patronage Income</td>
<td>75.00%</td>
<td>$7,500,000</td>
</tr>
</tbody>
</table>

Allocation

<table>
<thead>
<tr>
<th>Patonage Income</th>
<th>75.00%</th>
<th>$7,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocated Patronage Refunds</td>
<td>40.00%</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Nonqualified</td>
<td>66.67%</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

Taxable Retained Patronage Income = $6.5M

Apply $3.0M bonus depreciation
Retain $3.5M DPAD Taxes = $0

Tax Deductability

<table>
<thead>
<tr>
<th>Source</th>
<th>Allocation</th>
<th>Tax Deductability</th>
<th>Distribution as:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Income</td>
<td>100.00%</td>
<td>$10,000,000</td>
<td></td>
</tr>
<tr>
<td>Nonpatronage Income</td>
<td>25.00%</td>
<td>$2,500,000</td>
<td></td>
</tr>
<tr>
<td>Patronage Income</td>
<td>75.00%</td>
<td>$7,500,000</td>
<td></td>
</tr>
<tr>
<td>Allocated Patronage Refunds</td>
<td>40.00%</td>
<td>$3,000,000</td>
<td></td>
</tr>
<tr>
<td>Nonqualified</td>
<td>66.67%</td>
<td>$2,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Cash Patronage Refunds (P-Q) 100.00% $1,000,000
Retained Patronage Refunds (P-Q) 0.00% $0
Net Retained Patronage Refunds (P-NQ) 100.00% $2,000,000
Income Taxes (P-NQ) 0.00% $0
Dividends (P-NQ) 0.00% $0
Net Retained Earnings (P-NQ) 100.00% $4,500,000
Income Taxes (P-NQ) 0.00% $0
Cash Patronage Refunds (NP-NQ) 0.00% $0
Retained Patronage Refunds (NP-NQ) 60.00% $0
Income Taxes (NP-NQ) 40.00% $0
Dividends (NP-NQ) 0.00% $0
Net Retained Earnings (NP-NQ) 75.00% $1,875,000
Income Taxes (NP-NQ) 25.00% $625,000

Cash outflow = $1,625,000 before redemptions
Cash flow neutral versus qualified (Q): Reduce redemptions of Q equity by $600,000

Exhibit 4: Key Cooperative 2013 Simplified Cooperative Income Distribution Management Model: NQ Policy
Exhibit 5: Key Cooperative 2013 Simplified Cooperative Income Distribution Management Model: Q Policy

Source
Cash outflow = $1,025,000 before redemptions
Cashflow neutral versus non-qualified (NQ): Increase redemptions of Q equity by $600,000

Total Income
100.00% $10,000,000

Nonpatronage Income
25.00% $2,500,000

Patronage Income
75.00% $7,500,000

Allocation

Allocated Patronage Refunds
13.33% $1,000,000

Taxable Retained Patronage Income = $6.5M
Apply $3.0M bonus depreciation
Retain $3.5M DPAD Taxes = $0

Unallocated
86.67% $6,500,000

Net Retained Patronage Refunds (P-NQ)
100.00% $0

Nonqualified
0.00% $0

Income Taxes (P-NQ)
0.00% $0

Income Taxes (NP-NQ)
$625,000

Unallocated Not Qualified Net Retained Earnings (NP-NQ)
$10,000,000

Net Retained Earnings (P-NQ)
100.00% $6,500,000

Not Qualified
$6,500,000

Income Taxes (P-NQ)
0.00% $0

Allocated Patronage Refunds
0.00% $0

Retained Patronage Refunds (NP-NQ)
60.00% $1,875,000

Dividends (NP-NQ)
0.00% $0

Net Retained Earnings (NP-NQ)
75.00% $1,875,000

Income Taxes (NP-NQ)
25.00% $625,000

Tax Deductability

Qualified
100.00% $1,000,000

Retained Patronage Refunds (P-Q)
60.00% $600,000

Income Taxes (P-Q)
40.00% $400,000

Distribution as:

Cash Patronage Refunds (P-Q)

Cash Patronage Refunds (NP-NQ)

Cashflow neutral versus non-qualified (NQ):
Increase redemptions of Q equity by $600,000

Increase redemptions of Q equity by $600,000