Understanding Nonqualified Distributions

Phil Kenkel, Mike Boland and David Barton

*working copy: A later version of this manuscript is published in the “Cooperative Accountant, Summer 2014*

Under the cooperative business model there are many ways to distribute net income or net margins. Most cooperatives first distribute income to two primary pools, patronage income and non-patronage income. Our primary focus is on the patronage income pool. Some cooperative use the “pooling” form of income accounting but most cooperatives use the “non-pooling” form of income accounting which includes the use of patronage refunds. Patronage income may be distributed as (1) allocated patronage refunds to patrons, (2) unallocated retained earnings, (3) dividends on selected equity classes to owners, and (4) income taxes based on the taxability of the first three distribution choices. The types of patronage refunds allocated and distributed to patrons and the nature and components of the total distribution are important as are many other financial factors.

Specifically our objective is to look at the choice between using qualified versus nonqualified distributions. We have begun to see many agricultural farm supply and grain and oilseed marketing cooperatives, especially those with $300 million or more of sales moving to

1 Phil Kenkel is Regents Professor and Bill Fitzwater Cooperative Chair in the Department of Agricultural Economics at Oklahoma State University. He is editor of the Journal of Cooperatives and is currently the chair of the Cooperatives Community of Practice on eXtension. His contact information is Department of Agricultural Economics, Oklahoma State University, 4050744-9818 phil.kenkel@okstate.edu

Michael Boland is E. Fred Koller endowed professor in agribusiness management and information technology. The Koller Professorship was funded by agricultural cooperatives (CHS, Land O’Lakes, CoBank, and Country Financial); Koller friends, family, and colleagues; and University of Minnesota Foundation. His contact information is Department of Applied Economics, University of Minnesota, 612.625.3103, boland@umn.edu.

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 can be contacted at 785-565-2426 or davidgbarton45@gmail.com.

Senior authorship is not assigned.
nonqualified distributions. We conducted a webinar with more than 130 participants on this topic with a case study of Key Cooperative in March 2014 and those materials are available at http://www.extension.org/cooperatives. Those materials include an extensive case study, a set of frequently asked questions and answers, and other materials. This article provides a more in-depth discussion of the financial implications of nonqualified retained patronage.

Since the board of directors makes the decision on how to distribute the net earnings of the cooperative this choice is a critical policy decision. We recognize that the board uses the input and recommendation of auditors and management who tend to look at this decision through the prism of the cooperative as a firm. Our motivation as academics working with cooperatives is to look at this decision through the lens of a director who is a producer that is vertically integrated through the cooperative. This decision has a major impact on the after-tax cash flow of the cooperative and the after-tax cash flow of the patrons. The following information should be very helpful to boards of directors, executives and advisors to cooperatives on income distribution choices.

**Introduction**

Cooperatives distribute their member-based income to their patrons in the form of patronage refunds. Patronage refunds may be distributed in qualified or nonqualified form with the difference being whether the refund is qualified as a deduction from the taxable income of the cooperative or not. There are two categories of qualified patronage, cash patronage and qualified retained patronage. There is only one category of nonqualified patronage which is nonqualified retained patronage. In summary, a cooperative’s profit distribution decision has many dimensions including the choice of whether to retain funds in the cooperative or distribute cash
to the patron and whether retained funds are allocated to individual members or held as unallocated reserves. The method by which the cooperative distributes its net margins also impacts the allowable tax deductions for the cooperative and the taxable income attributed to the member. The board’s decisions on the distribution of the cooperative’s income determine the tax obligations of the members and timing of those tax obligations. It also impacts the tax obligations and cash flow of the cooperative.

The tax treatment of farmer cooperatives is described in Subchapter T of the Internal Revenue code which was enacted in 1962. Subchapter T specifies the tax treatment of patronage refund allocations by cooperative firms. Patronage refunds distributions, which are based on how much business the member conducted with the cooperative during the fiscal year, may be either cash refunds or non-cash funds (allocated retained refunds). Subchapter T also specifies that patronage refunds may be either “qualified” or “nonqualified”. Qualified allocations are given to the patron with a documentation that complies with the Subchapter T code. The patron agrees to include the entire amount of the qualified distribution in the taxable income for the current fiscal year. The cooperative can then exclude that amount from their taxable income.

Cash patronage refunds are one type of qualified refunds since the cooperative excludes the cash patronage from its taxable earnings and the patron agrees to include the cash patronage in their taxable income. The distinction between qualified and nonqualified refunds is most relevant in discussing retained patronage distributions. In a retained patronage distribution, the patronage earnings are placed in a patron’s equity account and the funds are retained by the cooperative to fund assets, such as fixed asset infrastructure and working capital for operations. The equity accounts are eventually refunded to the patron through an equity redemption program.
Historically, agricultural cooperatives favored the use of qualified retained patronage distributions over nonqualified distributions. In addition to the requirement that the patron agrees to include the qualified retained distribution in their taxable income, a cooperative making a qualified retained patronage distribution is required to pay at least 20% of the total qualified patronage distribution in cash.

Under Subchapter T cooperatives also have the opportunity to make a second type of retained patronage allocation, a nonqualified distribution. Under a nonqualified retained distribution the patron does not include the distribution in their taxable income and the cooperative does not exclude the distributed earnings from its taxable income. This decision results in the cooperative paying taxes on the earnings distributed in nonqualified form in the current year. Nonqualified retained patronage refunds are credited to patron equity accounts just like qualified retained distributions and are redeemed through the equity redemption program. At the time the equity is redeemed the cooperative receives an income tax deduction and the patron must include the redeemed amount as taxable income. A nonqualified retained distribution therefore maintains the principle of pass through or single taxation at the patron’s tax rate but the timing of the taxation for the patron is shifted to the time at which the equity is redeemed. There is no minimum cash requirement with a nonqualified distribution.

**Potential Advantages of Nonqualified Distributions**

Nonqualified distributions have several advantages for the cooperative and the patron. A very basic advantage is that of patron perception. Because of the tax effects, patrons may perceive and experience a negative after-tax cash flow with qualified distributions depending on the percentage of the distribution which was paid in cash and the patron’s tax rate. Nonqualified
distributions are more positively received because the timing of the tax obligation matches the
timing of the cash receipts. The cooperative can construct a strategy in which patrons only pay
taxes on cash received, first as a qualified 100% cash patronage refund and then as a
nonqualified retained patronage refund redeemed at a later time. Distributing patronage in this
combination of cash and nonqualified stock provides a positive after tax cash flow in both the
year of distribution and the year the equity is redeemed.

Another advantage of nonqualified distributions is that they may be more compatible
with balance sheet management. Decisions regarding profit distribution, equity management or
asset investments impact the cooperative’s balance sheet. 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. Qualified distributions are less compatible with balance sheet
management since there are mandatory (SubChapter T) and practical (patron cash flow) lower
limits on cash patronage. In addition, because patrons have already paid taxes on qualified
equity, they may expect the equity to be redeemed at a predetermined schedule, such as within
10 years, but sooner instead of later, since the patrons have already paid the taxes on the retained
portion. All of these factors lead to the profit distribution and equity management system driving
the balance sheet. A cooperative making nonqualified distributions faces no restrictions on the
proportion of cash patronage and may perceive more flexibility in matching equity redemption
payments with the desired redemption budget.

At a more technical level the choice between qualified and nonqualified distributions can
be evaluated on the basis of the member’s after tax cash flows or returns, adjusted for the time
value of money, or on a present value basis. This links with the idea that the member has
vertically integrated himself through the cooperative. A qualified retained patronage refund places the income in the cooperative at the patron’s tax rate and a nonqualified retained patronage refund places the income in the cooperative at the cooperative’s tax rate until redemption. Since a cooperative can be viewed as an extension of the patron’s business, such as a farmer’s business, intuitively, qualified distributions would appear to be favored when the patron’s tax rate is lower than that of the cooperative’s. When the cooperative has a higher tax rate it does not make sense to “park” the tax burden at the cooperative for the period of time between when the distribution is made and the equity is redeemed, all else equal. The cooperative and member unit is sending more money to the IRS than would be the case if the cooperative distributed qualified stock which was taxed at the member’s rate. However, all else is not always equal, such as when the cooperative may want to take advantage of certain tax benefits such as bonus depreciation and Section 199 (DPAD) by using a nonqualified distribution to create taxable income at the co-op level.

The tax rate differential may have been one of the justifications for the historical preference of cooperatives toward qualified distributions. At the time many agricultural cooperatives were formed the cooperative’s tax rate was higher than the effective tax rate for most cooperative members. Over time, corporate tax rates have been reduced and farmer’s total effective tax rates (primarily due to increases in self-employment taxes) have increased. Prior to the Tax Reform Act of 1986, the top corporate tax rate was 50%. The top corporate rate was 35% in 2013. Farmer-patron tax rates are more complex but the self-employment portion (social security and Medicare) has clearly increased. The self-employment tax rate was 5.4% in 1965 and was 15.35% in 2013. If cooperative members have a higher tax rate relative to the
cooperative firm then nonqualified distributions are not only more preferred by producers because of patron perception but are also more tax efficient as noted by Junge and Ginder

**Simulation Model Results**

In order to rigorously compare the impact of qualified or nonqualified distributions on the member’s return, the future cash patronage and equity redemption stream must be modeled. Royer (1987) used a simulation model to project returns to the member over a fifty year time horizon. His simulation assumed a 20% cash patronage rate and a 25% marginal tax rate for the patron. Royer modeled the cooperative taxes in accordance with the current tax codes and the investment tax credit provisions. The equity redemption period was a function of available funds. Royer concluded that the net present value of the patron’s cash flows from the cooperative were 7.5% higher with nonqualified distributions relative to qualified distributions. Royer noted that the simulation was designed to be reasonably representative but the results for a particular cooperative would depend on the parameters for the specific firm. It should be noted that Royer’s simulation assumed a higher tax rate for the cooperative relative to the patron. The advantage of the nonqualified distribution was likely due to the presence of the investment tax credit.

A cooperative simulation program developed at Oklahoma State University was used to revisit the qualified versus nonqualified comparison. The simulation used actual financial data from an Oklahoma grain and farm supply cooperative including grain and farm supply volumes, margins, expenses and fixed asset growth. The simulation used a 40% tax rate for the cooperative (35% corporate federal and 5% state) and considered scenarios with the patron’s tax rate lower than the cooperative (35%) and higher than the cooperative (45%). In accordance
with the case study cooperative, the baseline scenario included a 55% cash patronage, 45% qualified retained distribution and an 18 year revolving period. This was compared with a nonqualified distribution which was cash neutral to the cooperative (25% cash and 75% nonqualified retained) with an identical redemption period. The simulation calculated the internal rate of return (IRR) to the patrons over a 30 year time horizon. The IRR calculations assumed that the member’s investment was the current equity in the cooperative and the financial inflows were future cash patronage and redeemed equity. As was the case in the Royer study, the simulation was designed to be representative but results for an individual cooperative would depend on the parameters of the cooperative and members.

The results are summarized in figure 1. The first comparison illustrates the members’ IRR assuming a 45% member tax rate which is higher than the cooperative’s tax rate of 40%. This likely reflects the current situation for most cooperative. Under this assumption the member has a slightly higher IRR (13.7%) for nonqualified distributions relative to qualified distributions (11.8% IRR). The second comparison provides the same comparison when the member’s tax rate is 35% which is lower than the cooperative. Not surprisingly, the member’s IRR is higher with the assumption of a lower tax rate. The more important point is that, under the assumption of a lower patron tax rate, the member’s IRR is higher for a qualified distribution (14.4%) relative to a nonqualified distribution (14.1%).

The simulation also examined the impact of retaining the Section 199 Deduction as a third comparison. This deduction (which is described in an endnote) could allow a cooperative to offset the tax liability and distribute the same percentage of income (45%) through a nonqualified retained distribution as it did with a qualified distribution. This distribution would be cash neutral to the cooperative only if the Section 199 Deduction is available to offset the
taxation. The scenario assumed the original 45% patron tax rate. Utilizing the Section 199 Deduction to provide a 45% nonqualified distribution provides a dramatic increase in the owner’s IRR to 16.9% from the baseline of 11.8%. This effect is similar to the results of Royer’s study although in that study it was the investment tax credit rather than the DPAD that contributed to the advantage of nonqualified distributions.

The final comparison in Figure 1 illustrates the impact of retaining 10% of the income as unallocated equity, again at the original 45% patron tax rate. This strategy is cash positive to the cooperative so it is in some sense not a fair comparison. Since the time period that the DPAD became available some cooperatives have increased the percentage of income retained as unallocated reserves. The purpose of this scenario was to highlight the impact of that strategy on the member’s return. Not surprisingly, retaining funds as unallocated reserves decreases the members’ IRR (from 11.8% baseline to 10.2%, using the qualified distribution baseline.) Because unallocated reserves are never redeemed, the members never receive the financial benefit of the profits retained as unallocated reserves. However, in a strict balance sheet management situation where total assets and total equity are constant, new unallocated equity makes it possible to redeem more allocated equity which could have some offsetting effect in the present value of the member returns.
Determining a Cash Neutral Level of Nonqualified Distribution

The simulation results illustrate the rationale for cooperatives to consider transitioning to nonqualified distributions. As described in the simulation scenarios, a nonqualified distribution can generally be structured to be cash neutral to the cooperative. The percentage of a nonqualified distribution which creates the same cash flow relative to a qualified distribution can be determined by the formula:

\[ NQ = Q + \frac{Q \times T}{1 - T} \]
Where NQ is the percentage of nonqualified distribution, Q is the percentage of qualified distribution and T is the cooperative’s tax rate. The cash neutral distribution is possible only when the retained qualified distribution is greater than the cooperative’s tax rate, otherwise the equation yields a percentage in excess of 100%. Recalling the simulation example where the cooperative was in the 40% tax rate, a 25% cash and 75% nonqualified distribution is cash neutral with a 55% cash and 45% qualified distribution. This assumes the way to achieve a cash flow neutral transition is through adjusting cash patronage refunds. Another strategy is to adjust equity redemption cash outflow to achieve cash flow neutral. The simulator did not evaluate that alternative. A decision aid that calculates cash neutral qualified and nonqualified distributions is available at Oklahoma State University at this link.

http://agecon.okstate.edu/coops/index.asp?type=resources&subtype=software

Because there is generally no secondary market for cooperative equity, retained equity has value to the member only if it is eventually redeemed by the cooperative. In a local cooperative, nonqualified equity should be redeemed just like qualified equity consistent with the equity management system in place and subject to board approval. The cooperative can use the same equity retirement system or transition to another system. 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 that is being redeemed as cash. The cooperative board would want to consider this tax deduction in managing equity retirement as they would want to time the redemptions during years where the cooperative had taxable income. A cooperative that had transitioned to nonqualified distributions would generally have taxable income since they are not generating a tax deduction for allocated retained funds. Once the old qualified equity is
redeemed, the cooperative would be creating new nonqualified equity, which is taxable, and redeeming old nonqualified which provides a tax deduction that may be close to offsetting the tax obligation.

Some regional cooperatives (for example, CoBank) have issued nonqualified equities with a stated intention of not retiring those equities as noted by Houser. This has led to some misconceptions that nonqualified equity is not redeemed. These regional cooperatives needed to increase permanent capital due to regulatory requirements. They elected to create permanent allocated equity by issuing nonqualified equity rather than increasing unallocated reserves. This provided their patrons with a greater sense of ownership of the cooperative. It also avoids the incentive for their members to dissolve the cooperative in order to capture the value of the unallocated equity. Because the patrons of these cooperatives are cooperative corporations which have an infinite life, there is less of an argument for the necessity of equity redemption.

**Transitioning to Nonqualified Distributions**

There are a number of strategies in transitioning to nonqualified distributions. As in any decision involving cooperative income distribution and equity management, the cooperative should use balance sheet management to maintain the desired financial structure of the organization. The basic challenge with the transition to nonqualified distributions is that the timing of the cooperative’s tax deduction for allocated retained equity is moved from the year the equity is created to the year that the equity is retained. This leaves the cooperative with a higher tax burden and lower cash flow for the period of time between when the first nonqualified is issued and the time it is redeemed. This effect can be managed by utilizing an available tax deduction, such as the DPAD, reducing the amount of cash patronage to make the nonqualified distribution
cash neutral to the cooperative, reducing the equity retirement budget (which increases the revolving period) or some combination of these tactics.

**Communication with the Patron**

The transition also requires a communication effort to assist the patrons in understanding the rationale and tax ramifications of the nonqualified distributions as well as the reporting procedures. In most cases, the transition to nonqualified reduces the percentage of income distributed as cash patronage. However, since there is no tax burden from qualified retained distributions, the patron’s after tax cash flow is similar, or at times, higher than with a qualified distribution. In our experience, cooperatives transitioning to nonqualified have found that the change was well received by the patrons.

The patrons will need information on how the distribution will be reported. When a cooperative distributes nonqualified retained patronage, the patrons still receive a 1099-PATR which reflects their cash patronage in Box 1. The nonqualified distribution would not be reported on the 1099-PATR form but the cooperative would provide a separate written notice of allocation. At the point in time when the nonqualified equity is redeemed, the redemption is reported in box 5 on the 1099-PATR form. Cooperatives that are structuring payments for commodities as PURPIMs to capture the Section 199 Deduction would continue to reflect that payment in box 3 of the 1099-PATR. That reporting is not impacted by the decision to distribute qualified or nonqualified retained patronage.

**Summary**
Distributing patronage in the form of a nonqualified retained distribution is another alternative for agricultural cooperatives. Nonqualified distributions match the patron’s tax liability with the cash received and is therefore usually favorably perceived by the patron. Nonqualified distributions are more tax efficient when the patron’s tax rate is higher than that of the cooperative. This result can be easily illustrated with simulation analysis. The simulation results also show that strategies using the Section 199 Deduction and nonqualified distributions can substantially increase the patron’s financial return while retaining patron profits as unallocated reserves reduces the member’s return. Even in the absence of tax deductions, cooperatives can often structure nonqualified distributions to be cash neutral to the cooperative. Local cooperatives can, and should redeem nonqualified equity. A cooperative can use the same equity management system as it used for qualified equity or it can transition to an another system. The largest challenge in transitioning to nonqualified distributions occur during the period of time when qualified equity is no longer being issued but the initial nonqualified equity is not yet being redeemed. Transitioning to nonqualified also requires a communication effort, but the change is generally well received by patrons.

Endnote: Section 199 Domestic Production Activity Deduction
The availability of tax deductions at the cooperative level increase the attractiveness of nonqualified distributions but are not the only rationale. The availability of investment tax credits contributed to the advantages of nonqualified distributions in the previously study by Royer. The most recently available tax deduction is the Section 199 Deduction, also known as the Domestic Production Activities Deduction (DPAD). The tax issues involved with the Section 199
Deduction are quite complex and cooperative leaders should consult their auditor or tax advisor in regard to specific issues. The following description provides a general overview.

The Domestic Production Activity Deduction (DPAD), also commonly referred to as the Section 199 Deduction, was introduced into US tax law as part of the American Jobs Creation Act of 2004. In addition to traditional manufacturing activities the DPAD applies to producers who manufacture, produce, grow or extract agricultural or horticultural products. Cooperatives that market agricultural or horticultural products for their patrons can elect to show the deduction at the cooperative level. The DPAD is generally limited to the lower of the qualified production activities income (QPAI) or 9% of its taxable income or 50% of the production W-2 wages paid during the year. A cooperative’s taxable income and QPAI are computed without taking into account any deductions for patronage dividends, per-unit retain allocations, and non-patronage distributions under I.R.C. § 1382(b) and (c).

The structure by which the cooperative characterizes its payments to members for commodities impacts the QPAI. After reviewing numerous cooperative member agreements, the IRS has issued private letter rulings that conclude that a cooperative’s payment to a member for commodities is advance per unit retains payment in money (PURPIM). The result is cooperatives do not need to deduct these payments from their domestic production gross revenue to arrive at QPAI, which in turn increases the potential DPAD available to the cooperative and its members. This can provide the cooperative with a tax deduction in the current year which can be used to offset the tax liability which would otherwise result from a nonqualified retained patronage distribution. This could allow the cooperative to allocate the same percentage of income as a nonqualified retained distribution as it was previously distributing as qualified distribution. As
the simulation results highlight, this substantially increases the member’s financial return since they are not pre-paying the tax liability associated with the eventual redemption.

References

