Unit 4 - Finance and Taxation of Cooperatives

Objective

The objective of this unit is to teach the student how a cooperative is financed and taxed.

After completion, the student should:

1. Be able to explain the difference between the two forms of capital – debt and equity.

2. Be able to explain how equity capital is provided.

3. Be able to describe the various ways a cooperative can obtain borrowed capital.

4. Be able to explain the single tax principle and how it works for cooperatives.

5. Be able to trace the flow of cash through a cooperative business.

Instructor Directions

1. Become familiar with the information provided as well as the reference materials.

2. Lead the discussion using PowerPoint slides and/or selected references provided. The discussion guide serves as an outline.

3. Identify a cooperative in the area, and research its financing characteristics by interviewing the local manager and others.

4. Trace the cash flow through a cooperative business.

Unit 4 – Index and References

Teaching Tools

Instructor Discussion Guide
Quiz 4
Quiz 4 Answers
Unit 4 PowerPoint Slides
S 4.1 Who Finances the Business (Members)
S 4.2 Common Stock
S 4.3 Preferred Stock
S 4.3 Transferable Delivery Rights
S 4.5 Who Finances the Business (Owners)
S 4.6 Retained Patronage, Per-Unit Retains, Equity Redemption
S 4.7 Who Finances the Business (Creditors)
S 4.8 How Cooperatives are Taxed
S 4.9 Taxation Example
S 4.10 Single Tax Treatment
S 4.12 Flow of Funds to Finance a Business
S 4.13 Flow of Funds Exhibit

Teacher References

CIR 55: Co-ops 101
CIR 45, Section 7: Financing Cooperatives
CIR 45, Section 8: Income Tax Treatment of Cooperatives

Student References

CIR 5: Cooperatives in Agribusiness
CIR 45, Section 7: Financing Cooperatives
CIR 45, Section 8: Income Tax Treatment of Cooperatives

Unit 4 - Instructor Discussion Guide

Corresponding slides are in parenthesis with associated discussion points, denoted "S" for slide and by number.

I. Who finances the business – owners (S 4.1)

Members as owners—members of a cooperative must capitalize its business. Members meet this obligation by the purchase of:

a) Common Stock (S 4.2)
- 1) Common stock is the voting stock—usually one member one vote. However some cooperatives vote on a proportional basis.

b) Preferred Stock (S 4.3)
- 1) Preferred stock may be sold by the cooperative to provide additional capitalization.
  - (a) Has preference over common stock during liquidation.
  - (b) May be purchased by either members or nonmembers.
  - (c) May pay a limited dividend.
  - (d) Has no voting privileges.

c) Transferable Delivery Rights (S 4.4)
- 1) Purchase of long-term delivery rights.
  - (a) The right to deliver a specified quantity of production for value-added processing.
  - (b) The obligation to deliver a specified quantity of production for value-added processing.
- 2) The delivery right is usually tied to the purchase of shares of preferred stock (e.g., 1 share of stock provides the right and obligation to deliver 1,000 bushels of corn).
- 3) Sale of long-term deliver rights.
  - (a) Producer may sell the stock and its delivery rights to other qualified producers with board approval at whatever price they agree to accept, which can be more or less than the original price of the stock.

II. Who Finances the Business (Users) (S 4.5)

Members as users of the cooperative's services—it is the responsibility of members to capitalize the business. In addition to the purchase of stock or delivery rights, members supply additional equity by retained patronage and per-unit retains.

Members as financers also have their equity redeemed.

a) Retained Patronage (S 4.6)
- 1) Proceeds from net income generated by the business distributed as patronage.
  - (a) Usually 20 percent is paid in cash.
  - (b) 80 percent as allocated retained patronage—percentage of allocation is a board of director decision.

b) Per-Units Retains (S 4.6)
- 1) Based on the physical units handled by the cooperative for the members or dollar volume (examples):
  - (a) 10 cents per box,

(b) $1 per cwt/ $1 per $100 of sales.

c) Equity Redemption (S 4.6)

1) Oldest retained patronage or per-unit retains are redeemed first—assures that current users of the cooperative are largely the ones financing it.
2) Equity account balances must be adequate to finance the cooperative.
   (a) Timeliness of redemption is determined by the board.

III. Who Finances The Business (Creditors) (S 4.7)

Cooperatives may borrow debt capital from traditional and nontraditional sources. Debt capital has a fixed rate of interest (money cost) and a fixed repayment date. The less a cooperative has to pay as interest on its debt capital, the greater the amount of patronage refunds it can allocate to its patrons.

a) Sources of long-term credit:

CoBank, Denver, CO
National Cooperative Bank, Washington, DC
Insurance Companies
Commercial Banking System
State governments
Sale of commercial paper
Leasing

b) Sources of short-term credit:

Commercial Banking System
Credit Unions
Suppliers
CoBank, Denver, CO
National Cooperative Bank, Washington, DC

IV. How Cooperatives are Taxed (S 4.8 & S 4.9)

How qualified retained equity affects the cooperative and the member. The cooperative deducts patronage paid to members from its taxable income during the year the profits are earned. Members include the patronage (both cash paid to them and the amount retained by the cooperative) received from the cooperative in their taxable income. The member pays the tax on the net earning of the cooperative that he/she receives.

V. How Cooperatives are Taxed (S 4.10 & S 4.11)

Single tax treatment is accomplished by permitting a cooperative to deduct patronage refunds distributed.

a) Distributed to Members/users.
   1) Based on volume of business ($ or Units) done with the cooperative.
   2) From the cooperative's earnings done with or for all members/users.
b) Income earned from business with nonmembers.
   1) Is subject to federal tax at the cooperative level when earned.

2) If paid out to member/users, they are responsible for a second tax liability.

VI. Flow of Funds to Finance a Cooperative Business (S 4.12 & S 4.13)

Cash comes into cooperative businesses from:

Equity investments by members.
Purchase of common stock.
Purchase of preferred stock or delivery shares.
Membership fees.
Sales of fixed assets.
Sales of inventory.
Collection of accounts receivables.
Depreciation is a noncash expense.
Creditors (e.g., 30 days terms of purchases).
Advances on products marketed.

Cash flows out of the business:

Purchases of fixed assets.
Purchases of inventory.
Advances on products purchased.
Paying accounts payable.
Customer credit (e.g., granting 30 days credit to customers).

Have students complete Quiz 4 and then discuss answers.

Quiz 4

1. List two ways cooperative member-owners help to capitalize their business.
   a)

   b)

2. Explain in a short paragraph the difference between retained patronage and per-unit retains.

3. Explain in a short paragraph the difference between equity capital and debt capital.

4. List three sources of long-term credit for cooperatives
   a)

   b)

   c)

5. The statement "cooperatives do not pay taxes" is not true because:

6. Explain the single tax principle, and how it works for cooperatives.

7. Classify the following area as either a cash source (S) or cash use (U) in a cooperative business.
   ______ Sale of fixed assets
   ______ Members purchase common stock
   ______ Giving customers credit
   ______ Buying inventory
   ______ Sale of inventory
   ______ Purchasing members production
   ______ Collecting accounts receivable
   ______ Nonmembers purchase preferred stock
   ______ Suppliers give 30 day credit
   ______ Paying accounts receivables

8. Thought question for extra credit. Why can the business expense depreciation be considered as a source of cash in the cooperative's cashflow?

Quiz 4 Answers

1. Cooperative members capitalize their business by purchasing:
   a. Common Stock
   b. Preferred Stock
   c. Transferable Delivery Rights

2. Retained patronage refers to the proceeds from net income generated by the cooperative allocated to users and then kept in the business.

Per-unit retains is capital kept by the cooperative based on the volume or units handled by the cooperative for the users.

3. Equity capital is supplied by the members and usually does not have a specific due date or regular rate of interest. Debt capital is borrowed money and generally has a due date and an assigned rate of interest.

4. Sources of long-term credit are:
   Commercial banks
   National Cooperative Bank
   CoBank
   Commercial paper
   Leasing
   Capital stock purchased by member or nonmembers
   Insurance companies
   State governments

5. Cooperatives do pay taxes, which include:
   Personal property tax
   Social security tax
   Fuel tax
   Sales tax
   Real estate tax
   Excise tax

The liability for taxes on net earnings (profit) for business operations is transferred to members when the net earnings are allocated to the members, otherwise the cooperative pays the tax.

6. The single tax principle means the profits of the business are taxed only one time either at the business level or at the member level.

7. (S) Sources of cash (U) Uses of cash for the business
   (S) Sale of fixed assets
   (S) Members purchase common stock
   (U) Giving customers credit
   (U) Buying inventory
   (S) Sale of inventory
   (U) Purchasing members' production
   (S) Collecting accounts receivable
   (S) Nonmembers purchase preferred stock
   (S) Suppliers give 30 day credit
   (U) Paying accounts receivables

Quiz 4 Answers (continued)

8. Depreciation is classified as an expense when determining the profitability of the business. The operating statement and balance sheet show depreciation as an expense. However, depreciation expense isn’t paid in cash like other expenses such as salary and wages or the electric bill.