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Fiduciary Responsibilities of Cooperative Board of Directors



When one is on the board of directors of a corporation, they have particular responsibilities to make sure the business is managed effectively. A director for a cooperative business has those same responsibilities. However,

cooperative boards have the added task of governing the business while being user-members. Thus, cooperative boards have additional fiduciary responsibilities.

Fiduciary is defined as “of or relating to holding of something in trust for another.” Since cooperatives are owned by its members, the membership elects their directors and entrusts them with the business’s governing decisions. There are three basic fiduciary responsibilities of cooperative boards of directors: duty of obedience; duty of loyalty; and duty of care. The explanation presented here for these duties comes from a memorandum to the Kentucky Center for Cooperative Development from Sam Hinkle, Esq. and Emily Pagorski, Esq., April 2005.

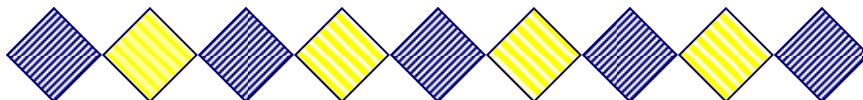
The **duty of obedience** establishes the director’s responsibility to act in compliance with the cooperative’s bylaws, articles of incorporation, and applicable statutes and contracts. It also means that the board should establish the necessary recordkeeping and bookkeeping practices and develop appropriate internal controls systems to protect the business from improper or illegal activities. This includes the duty to properly supervise cooperative employees.

The **duty of loyalty** requires the director to act

honestly and in good faith. For example, the director must avoid conflicts of interest, refrain from self-dealing and to not seek for themselves business opportunities away from the cooperative. When a cooperative faces difficult financial times, directors may be tempted to make decisions that would be to the benefit of themselves personally and not for the benefit of the cooperative. However, they have a duty of loyalty to act in the best interest of the cooperative, not for their own personal business. A director can also breach the duty of loyalty if they take over a business opportunity that the cooperative could and would have invested into for itself.

The final fiduciary responsibility of a cooperative board of director is the **duty of care**. This duty “requires a director to act in good faith while exercising the care that ‘an ordinary person in a like position would in similar situations.’” When making decisions for the cooperative, the director must do so in a manner that he or she reasonably believes to be in the best interests of the cooperative.” This duty includes hiring and supervising management. “The board must ensure that management is acting in an ethical and legal manner when handling cooperative affairs.” Directors also have the duty to know and understand the business’s financial statements.

Because the entire membership cannot reasonably govern the cooperative, they elect representatives to the Board of Directors to do the job for them. The membership expects that the Board will act in good faith and will look out for the cooperative’s best interest. Directors can work to minimize their liability when they take a proactive attitude and understand their roles and responsibilities. Many problems can be avoided with proper board structure, governing documents, use of committees and solid board and management communication.



Our Newsletter

Look for *The Kentucky Cooperator* quarterly in your mailbox. We hope you find the newsletter to be informative. We invite all suggestions towards its format and/or material. If you have suggestions or need to be added to our mailing list, please call us at (270) 763-8258.



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From the Executive Director

Good Communication is vital to the success of any business, large or small, but it is of the utmost importance to a cooperative business because of the ownership structure of the business. The owners are the members that patronize the business by supplying products to be marketed or as customers that purchase the goods or services of the cooperative. In some instances the members do both. Communication is the exchange of thoughts, messages or information. In a cooperative it is imperative that the communication process continually takes place between the manager, the board of directors and the members. Most are aware of the many ways that the process can be accomplished so I won't waste your time by listing them. For good communication to take place, there must be a conscious effort on the part of all parties to continually work at it to make it better. Informed cooperative managers, directors and members can make good decisions because they have the necessary information. If they do not have the necessary information or worse yet, if they have misinformation, they are subject to make decisions that can be detrimental to the business. Often parties can fall into the trap of communicating only the good things that are happening and avoid the bad things that are occurring at the same time. It is much harder to communicate about problems than it is about successes. Another problem area is communicating too late. This is another example of not giving conscious effort to the process. We are all guilty of conveying the good news as fast as possible because it is an enjoyable process. The bad news is delayed because it is an uncomfortable process to deal with. A staff that isn't informed cannot function at its best for the cooperative if it does not have direct communication on a daily basis with the manager. Members will not be better producers or customers if they aren't informed of the needs of the cooperative. The manager and directors cannot make improvements in the cooperative's services if the members don't communicate their needs to them. The circle of communication must continue to occur if the cooperative is to be successful.

Larry K. Snell, Executive Director

The more elaborate our means of communication, the less we communicate.

- Joseph Priestley

Tax Law Changes Affect Cooperatives and LLC's



Effective for 2005 and beyond, the Kentucky General Assembly made changes to the Kentucky tax code that will affect pass-through entities. This article provides a brief summary of those changes. KCCD has been working with Certified Public

Accountants at Mountjoy & Bressler, LLP to more clearly understand the changes and how they will affect Kentucky cooperatives. This newsletter also contains an insert answering specific questions regarding the tax code changes.

Corporations will pay taxes based on the greater of three amounts: regular net income tax based on graduated rates; the Alternative Minimum Calculation (AMC); or \$175. The AMC will be calculated based on the lesser of two options: the gross receipts tax or the gross profits tax. The gross receipts tax will be calculated on \$0.095 for every \$100 of gross receipts (gross sales). The gross profits tax will be calculated on \$0.75 for every \$100 of gross profits. Gross profits equals the gross receipts minus the cost of goods sold (COGS). COGS will be

calculated using the same method specified by the IRS for computing federal income taxes.

The new law also specifies that the minimum tax liability for a business is \$175. Therefore, even if the business loses money and there is no federal tax liability, there will still be at least \$175 in state tax liability.

These changes also require that businesses apply for a state tax identification number. This is NOT the federal tax ID number currently used. Most businesses should have already received information from the state regarding the state ID number. Additional information on these changes can be found at the Kentucky Department of Revenue's website at <http://revenue.ky.gov>. Their website also has downloadable forms for the state tax identification number. It is recommended to apply for this number before September 30, 2005 to take advantage of the shorter application.

The Cooperative Principles: Principle #2 (part two of seven part series)



The second cooperative principle is "Democratic Member Control". This means "cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In cooperatives, members have equal voting rights—"one member, one vote."

Principle one discussed open and voluntary membership and the need for members to accept the cooperative's values and responsibilities. After members have accepted these values and responsibilities, members should exercise their democratic control. Principle two assumes that members will participate in setting policy and giving broad direction to cooperative activities. Democratic control involves voting to elect representatives to serve on the board of directors. No member has greater control than the next member in a

democratic organization.

Members participate in the democratic process in three distinctive ways: vote for representatives on the board of directors; attend membership meetings, and; vote for structural changes as defined by the bylaws and as requested by the board of directors.

Members democratically elect board of directors and the board then becomes the members' representative body on cooperative issues. Since the board is elected from members, by members, cooperatives will always be controlled by members (or at least a representation of the members). It is not necessary for all members to have a say in all issues concerning the cooperative. This can easily hinder efficient management of the cooperative. Members should trust their elected representatives to better the cooperative to the best of their collective abilities.

CooperationWorks! Training May 16-20

KCCD staff members Heath Hoagland and Laura Powers were invited by CooperationWorks! to lead a teaching session on cooperative governance and management. The training program was held at the J.F. Friedrich Center on the University of Wisconsin campus in Madison, Wisconsin. This was the first of two five-day sessions designed to provide training to persons entering the cooperative development profession. There were approximately thirty participants from twenty-one cooperative development centers representing forty-five states.

This session in the program explored skills and key development steps required for the successful development of cooperative businesses. The topics included cooperative history, principles and economics; comparative business models; critical development steps, feasibility analysis and business planning, co-op finance, equity, law; cooperative governance and management; and resources and keys to success.

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The New Kentucky Tax Modernization Act

Prepared by Mountjoy & Bressler, LLP

On March 18, 2005, Governor Fletcher signed into law House Bill 272, making several important changes to Kentucky's tax laws. In broad terms, the new law affects individual taxpayers and pass-through entities (S corporations, limited partnerships, LLCs). Additionally, this new tax act will affect cooperatives that are not exempt. Cooperatives that are not exempt include rural electric, telephone and certain bank co-ops. The following are a list of questions related to the new tax act and their related answers.

1. What is a pass-through entity and what is the new tax structure for these entities? What types of entities are exempt from this new structure and why are certain cooperatives exempt?

A pass-through entity is an entity that is not taxed on its share of net income, but instead passes the income through to its individual shareholders or members. These types of entities consist of S-corporations, partnerships, LLCs or limited liability partnerships. Under the tax act the following types of pass-through entities are now required to pay a corporate level income tax (like regular corporations) in addition to nonexempt cooperatives:

- Multi-member Limited Liability Companies
- Single member Limited Liability Companies
- Limited Partnerships
- Limited Liability Partnerships
- S-Corporations

General partnerships, sole proprietors and trusts are not considered a "corporation" and are not required to pay the new entity level tax. Additionally, rural electric cooperatives and telephone cooperatives are exempt from Kentucky Corporate Income Tax under KRS Sec. 279.200 and are not subject to the new tax act because of this exemption.

2. What is the effective date of the new corporate tax structure?

The change to corporate tax structure is effective for tax periods beginning on or after January 1, 2005.

3. How does this new tax structure affect my cooperative or LLC?

Under the tax act your cooperative or LLC will now be required to pay either a corporate tax based on net income or an alternative minimum calculation (AMC) based on either gross receipts or gross profits, as calculated in question four below.

4. What is the new tax rate and how is it computed?

You will pay the maximum of:

- Regular tax based on graduated rates; or
 - 4% of first \$50,000
 - 5% of second \$50,000
 - 7% on the amount over \$100,000 (6% for years 2006 and thereafter)
- AMC calculation (lesser of A or B); or
 - \$.095 per \$100 of Kentucky gross receipts; or
 - \$.75 per \$100 of Kentucky gross profits.
- \$175 minimum tax

5. Even if our cooperative or LLC has a loss, will we still have to pay state taxes?

Yes, it is possible for the cooperative or LLC to have a loss and still pay state taxes due to the new alternative minimum calculation, based on the gross receipts or gross profit of the entity.

6. How is the new tax structure different from the corporate license fee that cooperatives used to have to pay?

Under the previous tax law, corporations paid a license tax calculated at a rate of .21 per \$100 of capital. This license tax was repealed with the passage of the new tax act and replaced by the tax structure discussed in question four.

7. How does this affect the Federal taxes?

Since this tax is a corporate level tax, the entity will now be able to take a deduction on its Federal income tax return for the taxes paid to the State. Otherwise, this new Kentucky law will not effect the tax treatment of entities under Federal tax law.

8. With this change, are cooperatives only taxed at the corporate level or will members also have to pay taxes on their share of patronage?

Nothing will change with regard to patronage. The cooperative will still be entitled to a deduction for the amount of patronage dividends paid to its members. However, the cooperative will be required to calculate its tax based on the structure discussed earlier in question four and members will still be required to pay tax on their share of patronage.

9. What effect could this have on my individual income tax return?

Individual owners of unincorporated cooperatives and other pass-through entities will continue to pay tax on their share of the income from these entities. However, they will also receive a nonrefundable tax credit for their proportionate share of the tax paid by the entity. The credit will be equal to the increase in the individual tax paid by the member due to their share of the income passed through to them.

Shareholders of a cooperative that is treated as a corporation for Federal tax purposes will not pay Kentucky tax on their share of the cooperative's taxable income.

10. How do I go about getting a State tax identification number?

Existing pass-through entities that currently have a Kentucky sales, withholding or coal tax account number will be assigned a corporation income tax account number by the Department of Revenue and will be notified by letter when the account number is assigned. Existing pass-through entities subject to the corporation income tax under the provisions of House Bill 272 but not registered for sales, withholding or coal tax must file Form 10A100 Kentucky Tax Registration Application.

There may be planning opportunities that will allow for minimizing the tax burden through restructuring and other means. You should consult your tax professional or visit our website at www.mountjoybressler.com for further information. This information has been provided by Mountjoy & Bressler, LLP Certified Public Accounts with offices in Louisville, Lexington, Frankfort, and Covington, Kentucky.