

The Farmer's Cooperative Yardstick: Cooperative Refunds: Patronage and Revolving

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Cooperative Refunds: Patronage and Revolving

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Cooperatives, like most other businesses, cannot predict exactly what their operating costs will be. To be safe, they try to operate with enough margin for their income to exceed their operating expenses.

Funds remaining in the co-op's account after all operating expenses, interest and depreciation have been accounted for are called net margins. Net margins might be distributed to member-patrons as patronage refunds in accordance with bylaw provisions and board actions.

Bylaw provisions and board actions must take into account the IRS requirement that at least 20% of the patronage refund must be paid in cash. This requirement allows the board to retain up to 80% of patronage refunds to finance needed facilities and operations. For the co-op to legally defer payment of patronage refunds, certain IRS requirements must be met. These requirements will be discussed in a later section.

The portion of a patronage refund deferred by the co-op is called the non-cash portion. This noncash portion, invested by member-patrons in their co-op, represents member-equity. However, as the co-op reaches its capital requirements, a mechanism is needed to return members' equity or deferred patronage refunds. Many co-ops accomplish this objective through revolving fund plans, one of several ways co-ops systematically return members' equity capital.

Patronage refunds are best described as "group savings," returned to the individual patron in proportion to the volume of business he/she does with the cooperative. They typically occur when the co-op is relatively efficient and realizes savings.

Patronage Refund, Cash and Non-Cash

Patronage refunds may be cash or non-cash. Cash patronage refunds are those returned to patrons after each year's operations end, while noncash refunds are those that members invest in their co-op. Amendments to the federal income tax law of 1966 require that 20% of all allocated patronage refunds must be in cash.

For cooperatives to exclude patronage refunds, they must be distributed in cash (20%) or in "qualified written notices of allocation" (1) that the patron has the option to redeem the refund in cash during a 90-day period after issuance, or (2) that the patron has consented to treat the refund as current income. The patron may give this consent individually in writing; the cooperative bylaws may require members to give this consent; or, patrons may consent by endorsing and cashing a check representing at least 20% of the total patronage refund. In any event, an allocation is deductible if at least 20% is paid in cash.

Computing Patronage Refunds

Co-ops may use 4 methods for computing refunds:

1. **Total Business Basis**

To compute patronage refunds on a co-op wide basis, a single or blanket rate of refund is figured for net savings, no matter what types of products are handled or what departments or divisions the co-op has. To compute this rate, the co-op divides net margins to be distributed by volume of business.

2. **Divisional Basis**

In a division method the co-op separates operations by major functions such as marketing or farm supply. It computes two or more divisional rates of refund by dividing each division's net savings by its business volume.

3. **Departmental Basis**

In a departmental method, the co-op further separates the operations within a division into various departments. To figure refunds on a departmental basis, the co-op arrives at each rate by dividing the net savings of the department by its business volume.

4. **Combination of Methods**

A co-op with two or more divisions may compute its refund rate on a divisional basis for marketing but use a departmental basis for its farm supplies.

amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

The IRS definition points to several key requirements that should be emphasized:

- Patronage refunds must be made according to a contractual arrangement between the co-op and its patrons.
- Patronage refund distributions are based on the quantity or value of business done with or for such patrons. This requirement implements the co-op's central objective of distributing financial benefits to patrons based on their use of the co-op's services rather than based on their investment in the co-op's capital structure.
- Patronage refunds arise only from transactions with the co-op's patrons. Thus, income that a co-op receives from so-called unrelated activities is not included in the IRS' definition of a patronage refund. Such distributions, however, may be computed and distributed on a patronage basis in compliance with Section 521 of the IRS Code.
- The co-op's obligation to pay patronage refunds must exist before any patronage transaction takes place. Such provisions are usually set forth in the Cooperative's Bylaws. Under such a pre-existing mandatory obligation to pay patronage refunds, a co-op's board has no discretion as to whether the co-op will pay a patronage refund. The board's decision only involves the time and form of the patronage refund.

When Are Refunds Calculated?

Net margins may be computed monthly, quarterly or annually, but most co-ops declare patronage refunds annually. Refunds are distributed within 8 months after the close of the co-op's fiscal year to comply with Internal Revenue regulations.

What Are The Basic Requirements?

The Internal Revenue Code of 1954 as amended, defines a patronage refund as "... an amount paid to a patron by an organization: (1) on the basis of quantity or volume of business done with or for such patron; (2) under obligation of such organization to pay such amount which obligation existed before the organization received the amount so paid; and (3) which is determined by reference to the net margins of the organization from business done with or for its patrons."

Such terms do not include any amount paid to a patron to the extent that: "(1) such amount is out of earnings other than from business done with or for patrons, or (2) such amount is out of earnings from business done with or for other patrons to whom no

Relation of Patronage Refunds To Cooperative Features

Four characteristics are hallmarks of cooperatives:

1. member ownership and control;
2. service at cost;
3. limited returns on capital; and
4. obligation to finance.

The relationship and impact of these key features on patronage refunds are discussed here.

Member Ownership and Control

As patrons increase their equity interest in their co-ops because they receive patronage distributions in the form of allocated equities, their ownership interest increases. But their patronage, the resulting patronage allocations, other forms of participation in their co-op's affairs, and, in fact, their loyalties, are unequal. So, to achieve equality, some co-ops use weighted voting. In other words, patronage refunds appear to contribute to a Shift from democratic control to so-called equitable control.

Service at Cost

Patronage refunds strengthen the operation-at-cost concept. Because costs cannot be estimated accurately in advance, patrons of a co-op usually pay the "going or competitive price" for goods or services. Adjustments are made at the end of the year when costs are known, with member-patrons receiving any necessary adjustments as refunds based on patronage. This system of refunds reduces the operation to a cost basis. Because of the refund, the co-op does not make a profit for itself nor for nonpatron investors.

Limited Returns on Capital

Members of a cooperative are primarily interested in the benefits they receive from patronizing the organization. Because a co-op's benefits are distributed to patrons based on their use of its services, such benefits do not enhance the value of shares of stock or other equity capital, or provide a return on invested capital.

Hence, members of a co-op must provide most of its capital either by direct subscription or by investing their patronage allocations. The incentives to invest in corporation stocks are not present for co-op stock. For this reason, the capital of a co-op, for the most part, comes only from its member-patrons.

On the other hand, as equities fall into hands of persons no longer using the co-op's services, some mechanism should be triggered to either redeem such equities or to shift their character to give their holders a return.

Obligation to Finance

A cooperative is organized to benefit its members as patrons and not as investors. A co-op patron's return on investment is reckoned in terms of how he improved his farm income by using the coop's services, not in terms of returns on capital furnished. Member-patrons are those primarily interested in and benefiting from the enterprise's success. As they use its services, they assume the basic responsibility of providing capital through investing their share of the earnings derived from their patronage transactions.

But as patronage ends, so does the financing responsibility. Unless a co-op adopts a system to redeem equities held by people who no longer patronize their co-op, an increasing amount of ownership capital could be held by inactive farmer-patrons.

Patronage Refunds as a Capital Source

Co-ops need capital to purchase facilities, equipment and land and to pay for long-term and short-term operations. Capital for these and other purposes is either obtained from member-patrons or borrowed from non-patrons. Retaining net savings is the basic method co-ops use to accumulate equity capital. In 1976 about 3 of every 4 dollars of allocated equity capital outstanding was acquired from savings distributed as patronage refunds and reinvested in the co-op by patrons. The most common forms in which net savings are retained are:

1. noncash or deferred patronage refunds and
 2. unallocated capital reserves.
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Revolving Fund Financing

Up to 80% of a co-op member's annual patronage refund can be retained by the co-op for capitalization purposes if certain requirements are met. A co-op's board of directors may plan to return patronage refunds as follows:

- Pay 20% or more of the patronage refund in cash (IRS rules).
- Revolve the remainder on a definite short-term basis (not more than 5 years), but
 - a. pay 8% interest annually on retains and
 - b. permit patrons to cash in the retains if the board of directors justifies that action.
- Pay out all patronage refunds in cash and then ask each member to voluntarily reinvest all or part of the retain in stocks or bonds or debentures at a fixed rate of interest subject to cashing in as the need arises.
- Substitute per unit retains for all or part of patronage retains and pay-out balance of patronage dividends in cash.

As a financing device, the revolving fund method is peculiarly cooperative. Unlike businesses where profits are shared in proportion to investment, the net margins of co-ops are distributed according to member patronage. Early co-ops were faced with the problem of how best to capitalize their business so the proportion furnished by each member was relative to his patronage. They developed the revolving fund plan of financing to solve this problem.

Essentially, revolving fund financing involves funds which members and patrons provide to the co-op. A revolving fund retires the oldest funds first. Ordinarily, the plan does not become fully operative when an association is new. The association must first accumulate enough equity capital and be in a financial position to start retiring its oldest membership equities. This method of financing gives co-ops an opportunity to constantly renew their capital structures, to provide an unending source of member capital, and at the same time to assure that the oldest equities are paid back first.

Under the revolving fund plan, members' revolving equities are allocated to them on the co-op's books (or in many cases by various types of certificates), and these equities are used to conduct the business. Except for a limited number of co-ops having a fixed revolving period, members' equities are returned to them periodically in the order in which they were provided. This return occurs when the board decides that the co-op's financial needs justify such action. The length of the revolving period usually ranges from 3 to 15 years, sometimes more.

In more recent years as capital needs of co-ops have increased, many have abandoned revolving fund financing for alternative financing plans to avoid continually extending their revolving fund periods.

Today, some co-ops have difficulty retaining enough current net margins to meet current financing requirements and at the same time revolve old equity capital allocations. This difficulty arises because of their accelerated growth, along with current IRS tax regulations requiring increased cash distributions of net margins.

Advantages of a Revolving Capital Plan

Many cooperatives, especially new ones, may elect to accumulate equity capital. They can use the revolving fund plan to return this capital to member-patrons at some future date after the co-op's financing capital needs have been satisfied. Principal advantages of a revolving capital plan are:

- Members contribute capital to the co-op in the same proportion that they use it and share its benefits.
- Ownership is maintained in the hands of current member-patrons.
- Members can acquire increased ownership in the co-op.
- Once this plan is put into place, a minimum of administrative cost is necessary for maintaining the capital required.
- This plan reduces the co-op's operating costs because it does not have to pay interest to attract investor capital.

- Members can borrow from financial institutions on the basis of their revolving fund certificates, usually at some percentage of the face value.

Disadvantages of a Revolving Capital Plan

Several potential disadvantages of a revolving capital plan are:

- The plan does not take into account the differences in the individual members ability to provide capital.
- The period required for the fund to revolve cannot be maintained where continuous expansion takes place unless some other method is used to obtain capital for expansion.

- The plan may permit the co-op to expand too rapidly without the explicit approval of a majority of the members.
- The plan may become unworkable if the co-op's capital requirements make a long revolving period necessary, due to the co-op's lower net margins.

Other Publications about Cooperatives

The organization and operation of a successful cooperative requires detailed information, above average managers and informed, concerned decision makers. To help your cooperative succeed, the Kentucky Cooperative Extension Service publications will be available through your local Extension office.

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