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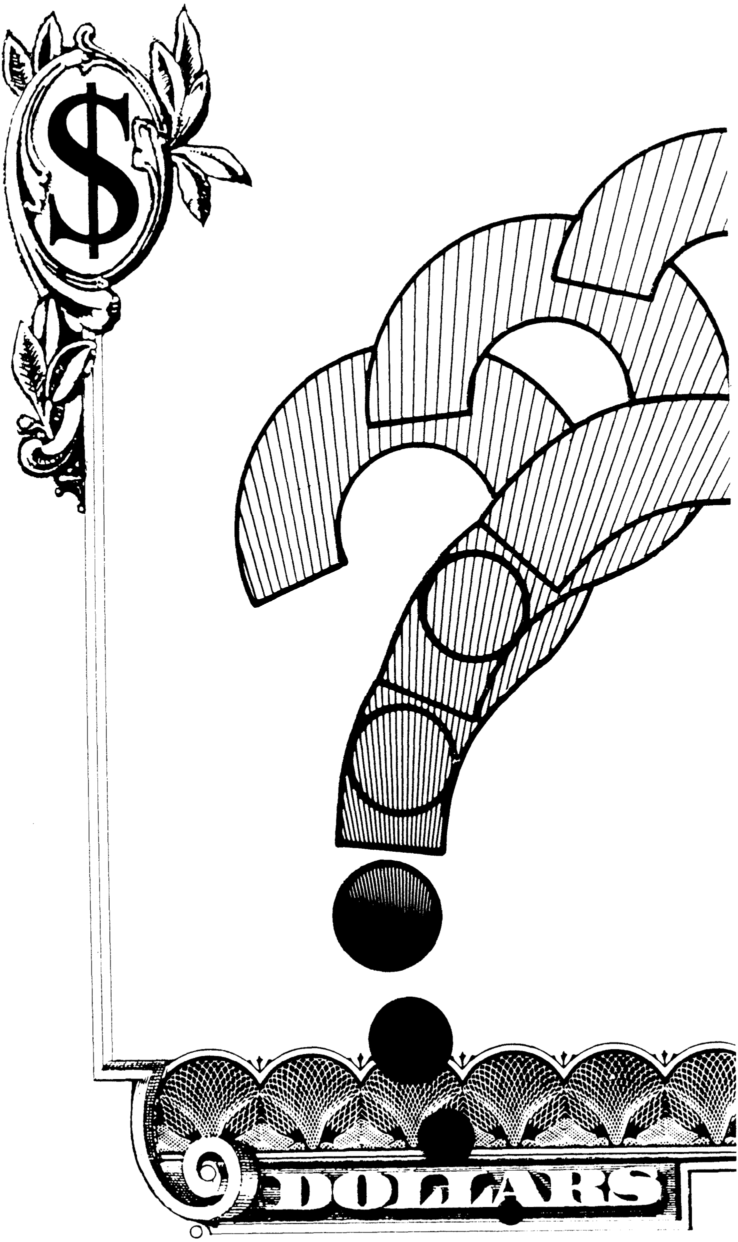
# What Are Patronage Refunds?



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# What Are Patronage Refunds ?

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*Patronage refunds* thing distinctive about the cooperative form of business.

The phrase is a tipoff to what a cooperative is, how it operates, and the special relationship between it and its owners.

## What a Cooperative Is

A cooperative is a business owned and controlled by the people using its services.

That brief definition doesn't cover all the variations and complexities of cooperatives. But it captures the central difference between a cooperative and other businesses. In the cooperative, the owners and the users are the same people; they are the members.

Key operating principles of cooperatives are:

- *Service at* cost-The purpose of a cooperative is to provide a service to its user-owners at the lowest possible cost, rather than generate a profit for investors. However, the cooperative must generate income sufficient to cover operating expenses and meet continuing capital needs.

- *Financial obligation and benefits proportional to use*— Benefits are distributed according to use rather than on the amount of investment. Therefore, it follows that members are obligated to provide financing in proportion to the use that produced those benefits.

- *Democratic control-The* Rochdale pioneers formed their cooperative as individuals and exercised control through one-member one-vote. Subsequently, we've labeled that concept democratic control. Our political democratic process allows also for representative or proportional voting. A few cooperatives, applying that concept, use proportional voting based on use,

- *Limited return on equity capital--The* overriding value of the cooperative to its owners is in the services provided. Limiting the return on equity capital is a mechanism to support distribution of benefits according to use.

Important cooperative practices are:

- *Continuing member education-Keeping* owners educated on what's going on is an important practice for any business. It is particularly vital for members to understand what their cooperative is and how it operates for at least two major reasons: (1) The democratic control principle, exercised through majority rule, requires that the entire ownership be informed to assure enlightened decisionmaking; and (2) because cooperatives are not as numerous as other types of business, the cooperative form of business does not receive much attention in business and economic courses of our education system. Therefore, each cooperative must be the educational institution for itself.

- *Operations on a sound financial basis-A* cooperative must be viewed as a business and must have flexibility to adjust to the changing business climate.

- *Cooperation among* cooperatives-Cooperatives need to work together to hold member production input costs to a minimum and market member products efficiently to meet the requirements of their customers.

## Patronage Refund Importance

Patronage refunds are directly related to key principles and important practices, and the responsibilities the cooperative and its owners have to each other.

The purpose of a cooperative is to provide a service to its member-users at the lowest possible cost, rather than generate a profit for investors. However, service at cost doesn't mean the cooperative operates that way on a daily basis. It doesn't for at least two good reasons: (1) it doesn't know exactly what its costs are on a daily basis; and (2) as a business in the private enterprise system, the prices it pays for products purchased and receives for goods sold fluctuate with the market.

Once a year, a formal accounting determines the cooperative’s income and expenses. Income remaining after deducting all expenses (net margin) is then distributed in proportion to patronage. The income in excess of expenses generated by the members’ use of their business is thus refunded to them. This income returned or refunded is called a patronage refund. The patronage refund is one measure of the key operating principle that ownership benefits are generally in proportion to use.

The patronage refund is an important source of financing for cooperatives. Members usually elect to leave a portion of the refund in the cooperative to help keep its operations on a sound financial basis. The retained portion of the patronage refund is allocated to the member’s equity account and paid out at a later date.

The special nature and purpose of a cooperative places the responsibility to finance the business on its member-users. Benefits are tied to use. Those benefits do not enhance the value of shares of stock or other equity capital. Therefore, the incentives that cause persons to invest in stock of other corporations are not present in cooperative stock. Consequently, members of the cooperative must provide most of its equity capital, either by direct investment or through retained patronage allocations.

The cooperative has a responsibility, acting collectively for members, to develop a financing and ownership transfer plan that’s equitable to members individually and that is in keeping with cooperative principles. As members use the cooperative, they assume the basic responsibility of providing capital according to their use. When patronage terminates so does the financing responsibility. Unless the cooperative adopts a systematic plan to redeem equities, an increasing amount of capital will be held by inactive members. Such a situation can lead to less participation by members in their cooperative’s affairs and conflicting objectives.

Financing the cooperative through reinvestment of patronage refunds is a simple and straightforward way for members to carry out their obligation to finance according to use. Equity redemption serves to keep the cooperative’s ownership in the hands of current users.

The important key to understanding what a cooperative is and how it operates is knowing those words and terms that are distinctive to the cooperative form of business. Some terms, though used in other business types, have special meaning in a cooperative. A glossary of basic terms to better understand a cooperative follows:

*Allocation:* Patron's share of the cooperative's net margin, or obligation for its loss.

Cooperatives typically commingle products of members for marketing and purchase supplies in bulk for resale. These activities generate margins and per-unit retains on a continuous basis. Cooperatives allocate (recognize the ownership of) these funds to patrons according to their use of the cooperative.

Tax laws require allocations retained by the cooperative be evidenced by a document issued to the patron by the cooperative. A document reporting a dollar amount allocated to the patron and the portion thereof that constitutes a patronage refund is called a *written notice of allocation,* one reporting per-unit retains is a *per-unit retain certificate.*

If the allocation and the document are structured to comply with specific requirements of the Internal Revenue Code, they are *qualified.* The cooperative deducts the amount of the patronage refund or per-unit retain from taxable income and the patron agrees to include it in taxable income as if it had all been paid in cash. The principal requirement for qualification is consent by the patron to include the total amount of the patronage refund or per-unit retain in taxable income. Also, the cooperative must pay at least 20 percent of any covered patronage refund in cash.[1]

Allocations and documents not so structured are *nonqualified.* The cooperative pays tax on these monies in the year obtained. When a nonqualified allocation is redeemed, the cooperative deducts the allocation from taxable income and the patron includes it in taxable income in the year of redemption.

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[1] See Cooperative Information Report 23, "Tax Treatment of Cooperatives," Agricultural Cooperative Service, U.S. Department of Agriculture.

*Centralized, Federated, Mixed-Structure Cooperatives.* In a *centralized cooperative,* producers themselves belong directly to the cooperative and make up the entire membership. In a *federated cooperative*, other cooperatives are the direct members. A *mixed structure* cooperative has both producers and other cooperatives as direct members.

*Democratic Control:* Members, by majority vote, determine how their cooperative will operate. Decisions can be reached on the basis of one-member, one-vote or through proportional voting based on patronage.

*Equity Redemption:* The payment of cash or other property to return previously invested funds. A *revolving fund plan* is a system of equity redemption where the earliest investments are redeemed first, on a reasonably regular schedule.

*Member:* A person or organization joining a cooperative and agreeing to abide by the conditions of membership.

*Member Equity* The capital investment of each member in the cooperative. Such investments are usually in the form of cash, retained patronage refunds, and per-unit retains.

*Net Margin:* Total income from all sources minus expenses.

*Patron:* A person who uses the services of a cooperative and agrees to share the margins in proportion to use. A patron can be either a member or a nonmember of the cooperative, an individual or another business.

*Patronage Refund:* A payment from a cooperative to a patron from net margins based on quantity or value of business done with or for the patron.

The refund may be in cash and/or in the form of a document evidencing the patron’s decision to have the cooperative retain the refund as an investment by the patron. Patronage refunds may be paid only to members, or to both member and nonmember users.

The term “refund” is appropriate to emphasize the cooperative’s service orientation. When a margin occurs in the performance of a service, regardless of the source — reduction in cost, underpayment for product, or enhanced value from processing — it belongs to the user and is refunded on the basis of patronage. This action is required for the cooperative to fulfill the principle of service at cost.

A patronage refund should not be confused with a dividend on capital stock. A *dividend* is a distribution to a shareholder based on investment or ownership. A patronage refund is a distribution based on use.

*Per-Unit Retain:* A deduction by the cooperative from the proceeds of sale based on the value or quantity of products marketed for the patron.

Patronage refunds and per-unit retains are sometimes confused. Patronage refunds are based on net margins generated during the year. Per-unit retains are based on the number, or dollar value, of units marketed.

*Pooling* An averaging process wherein producers who market a commodity through a cooperative during a fixed period of time agree to share expenses and returns associated with that commodity handled during the period on a pro rata basis.

*Section 521 Cooperative:* A cooperative that meets specific requirements of section 521 of the Internal Revenue Code and has received written authority from IRS to use this tax section. Only agricultural cooperatives can qualify for section 521 status. Such a cooperative is not totally exempt from taxation. It can, in addition to other lawful deductions, deduct from taxable income dividends paid on capital stock and nonpatronage income distributed on a patronage basis.

## Other Publications

Farmer Cooperative Publications. Gene Ingulsbe CIR 4. Revised 1992. 59 pp.

Tax Treatment of Cooperatives. Donald A. Frederick. CIR 23. Revised **1984. 12** pp.

Cooperative Principles and Legal Foundations. Martin A. Abrahamsen, J. Warren Mather, James R. Baarda, and James Kelly. CIR 1, Sec. 1. 1977. 26 pp.

Equity Redemption Guide. Jeffrey S. Royer and Gene Ingalsbe. CIR 31.1983.12 pp.

Federal Income Taxes, Part II-Legal Phases of Farmer Cooperatives. Morrison Neely. FCS Inf. 100. May 1976. 126 pp.

Income Tax Treatment of Cooperatives CIR 44, Sec. 1 and 2.

For copies, write Agricultural Cooperative Service, U.S. Department of Agriculture, Washington, D.C., 20250.