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CDS Consulting Co-op



SOLUTIONS FOR COOPERATIVES

# Thinking Strategically about Patronage Dividend Decisions

*CBLD Online Recorded Workshop*

*June 23, 2010*



*Presented by: Marilyn Scholl and Mark Goehring*

*Files and recording: Available in the CBLD Library at*

*<http://cdsconsulting.coop/cbldlibrary>*

*For information about the CBLD program:*

*<http://www.cdsconsulting.coop/cbld>*



**CBLD**

cooperative board  
leadership development

# Outline

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- ❏ **Introductions, outcomes, and outline (5 minutes)**
- ❏ **Review co-op ownership (5 minutes)**
- ❏ **Review patronage dividend basics (15 minutes)**
- ❏ **Annual patronage dividend decisions (20 minutes)**
- ❏ **Questions and Discussion (10 minutes)**
- ❏ **Review and wrap up (5 minutes)**

# Welcome Guests!

- ☞ Claire Carpenter, Good Foods Co-op, Lexington, KY



- ☞ Dave Hoffman-Dachelet, Seward Co-op, Minneapolis, Minnesota.



- ☞ Todd Wallace, People's Food Co-op, Portland, Oregon and CDS Consulting Co-op



# Desired Outcomes

- ❏ **Participants understand the benefits of patronage dividends**
- ❏ **Participants understand the annual decisions a board makes**
- ❏ **Boards understand the long term implications of annual decisions**
- ❏ **Co-ops make strategic patronage dividend decisions**

## NOTE:

All information provided and recommendations made are provided in good faith based upon the experience and judgment of the consultant. However, it should be understood that the co-op remains responsible for all decisions made and all actions or inactions that result from this work.

This workshop and these materials provide a general overview of patronage dividend distribution. Expert legal and accounting advice should be sought on specific issues.

# Ownership (any type)

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- ❏ Owners assume joint responsibility for business success
- ❏ Owners provide capital financing the business
- ❏ Owners control the business
- ❏ Owners benefit from the business they own
- ❏ The economic results of business activities (surplus or profit) belong to the owners

# Cooperative Ownership

- ❏ **The members control on a democratic basis - one member one vote - rather than on amount of investment**
- ❏ **Member's share of the benefit is based upon use, rather than on investment**
  - The more one uses the co-op, the more one benefits
- ❏ **Co-op members seek mutual benefit; none should benefit at the expense of another**
- ❏ **Members benefit economically and socially**
- ❏ **Through their elected board of directors, member-owners allocate surpluses**



**Sole proprietorship/partnership.** A business owned by one or more people, usually to provide employment and a return on investment to the owners. Local examples include restaurants, bakeries, and bookstores



**Investor Owner Corporation.** A business whose stock is traded publicly by any number of investors. Examples include Safeway, Whole Foods, Starbucks, Microsoft, and General Motors.



**Cooperative.** A member-owned and member-controlled business that operates for the mutual benefit of all members. Examples include your local food co-op, a local housing or child care co-op, and any credit union. The cooperative form of business is one that brings the owners, controllers, and users of together into one group.

# Why do members invest capital in their co-op?

- ❏ ***Because they trust that doing so will be in their own interest as well as the interest of other members***
- ❏ **Cooperatives earn this trust when members perceive it as an effective agent for themselves, dedicated to serving members' needs, not the needs of the organization or of any other group**
  - The cooperative must actually be an efficient agent for what its members want and need
  - The members must perceive that the co-op is an efficient agent
  - Perception, created by communication and experience, builds trust

From Brett Fairbairn, [Three Strategic Concepts for the Guidance of Co-operatives](#) 2003

<http://www.usaskstudies.coop/pdf-files/StratConcepts.pdf>



# Why Patronage Refunds?

## **Create a mutually beneficial relationship with owners**

- Encourage membership and member investment
- The co-op and the members prosper together
- Members trust the co-op's motivations
- Engage members as owners- people pay attention to profitability
- Encourage shopping at the co-op

## **Make use of a cooperative advantage**

- Build co-op capital
- Provide resources needed for future opportunities
- Keep more money in the local community
- Reduce the co-op's cash outlays
- Reduce the co-op's tax obligations
- Create appropriate pressure to generate profits

# How do patronage refunds work?

## Internal Revenue Service rules (Sub chapter T) formalize the procedures that must be followed to receive a tax deduction

- Understand and follow rules carefully
- Seek professional (legal and accounting) help
- Operate on a cooperative basis
- If at least 85% of gross receipts are for personal, living or family use, file a 3491 “Consumer Cooperative Exemption Application so 1099 PATR forms are not needed.
- Obtain consent of members (usually via the bylaws) to include patronage refunds in their taxable income, even though patronage refunds on purchases for personal use are not taxable,

## A pre-existing obligation must exist

- An agreement with members (signed or in bylaws)
- IRS treats a cooperative as a pass through entity; profits represent an overcharge to be returned
- Follow state incorporation rules

## Patronage net earnings

- Divide net income into member and non-member business
- Generally done by percentage of sales to members and non-members
- Calculate each member’s share on the bases of their purchases
- Non-patronage net income will be taxed
- At least 20% of the refund must be paid in cash to the member, remainder can be retained and allocated to members’ equity accounts

# Net income\*

\* our example does not include dividends to preferred shareholders or profit sharing, if any

**Member Patronage  
Sourced Net Income**

**Non-member and Non-Patronage  
Sourced Net Income**

**Allocated to  
Member/Owners**

Credited to individual  
member account based on  
patronage

Deducted from co-op's  
taxable income

**Unallocated  
Equity**

Not credited to  
individual member

Co-op pays tax

**Retained  
Earnings**

Co-op pays tax

Minimum:  
20% refund  
distribution to  
member required

Maximum:  
80% refund to  
member can be  
deferred

**Equity Capital:**  
reinvested in the co-op

# Benefits of Patronage Refunds

## For the co-op

- Responsible method of returning surplus to owners
- Encourages growth of membership
- Sustainable even if all customers are members
- Allows option of re-investing surplus to improve services
- Protects co-op against lean years
- Improves ability to manage and price competitively
- Flexible

## For the members

- Provides for a fair return on investment
- Can be applied to share payments
- Benefits accumulate during year
- Have no tax implications if purchases were made for personal use
- Encourages co-op to improve services
- Supports viability of business we own
- Can be supplemented with other tangible benefits throughout year (member appreciation days, coupons, member only specials, case purchases, etc)

# Member-owner benefits

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 **Patronage dividends are delayed, uncertain, and variable and should be supplemented other more immediate, tangible benefits such as**

- Member coupons
- Member only sales and specials
- Member appreciation days
- Special orders
- Case discounts
- Special prices (on classes, classified ads, etc.)

# Annual Decisions


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- ❏ **While the patronage dividend decisions are made annually, the board should think about the long term strategic implications**
- ❏ **Good annual decisions lead to:**
  - Stronger balance sheet
  - Ability to take advantage of opportunities to meet people's needs
  - More capital
  - Lower taxes
  - Satisfied and loyal member-owners

# Annual Decisions (1)

## **How much of the eligible profits will be allocated?**

- Calculate eligible profits. Most co-ops restrict patronage allocations to members so only profits from member sales are eligible.
- Increasing sales to members will increase the benefits of patronage dividends
- Considerations
  - » Cash reserve. Some state laws or bylaws allow a portion of member profits to be set aside for reserves.
  - » Tax implications. If the co-op has other available tax deductions, they may be more valuable than patronage dividends.
  - » Follow tax rules, state statutes and bylaws

 **Unless there is a compelling reason not to, we recommend allocating 100% of eligible profits for patronage dividends.**

# Annual Decisions (2)

## What percentage of the allocated profits will be distributed?

- The IRS requires that a minimum of 20% must be distributed to members. The rest (up to 80%) may be retained by the co-op. The Co-op's tax deduction is full amount (both paid out and retained portions).
- Considerations
  - » Building capital
    - ◆ Cash needs
    - ◆ Capital investment opportunities
    - ◆ Balance sheet strength
    - ◆ Member needs and expectations
  - » Fair return to members
  - » Follow tax rules, state statutes, and bylaws

 **We recommend distributing the minimum (20%) unless there is a reason for distributing more.**



# Annual Decisions (3)

## What will be the method of distribution?

- The distributed portion (usually 20%) may be paid in cash or with store credit (in some states). Upon member request, the amount must be paid in cash.
- Considerations
  - » Encourage use. Anyone not claiming their cash portion is excluded from patronage dividends. The co-op must pay tax on the total amount that would have been allocated to those members (paid and retained portions).
  - » Charitable donations. Provide options for those who wish to donate their dividend.
  - » Complete equity payments. The distributed portion may be applied to any unpaid balance on a member's equity account.
  - » Follow tax rules, state statutes, and bylaws

## We recommend issuing store credits if allowed in your state.

# Annual Decisions (4)

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## What will be the minimum amount of distribution?

- The co-op may set a minimum amount of payment that will be processed
- The co-op will pay tax on the earnings of those members whose distribution would be under the minimum.
- Consideration
  - » How does the cost of preparing and mailing checks or allocation notifications compare with the benefit to the co-op and the member?

## We recommend setting a minimum distribution amount between \$2-\$5

# Example

(Adapted from Bruce Mayer, CPA, Wegner, LLP)

	No Patronage Refund Allocation	Patronage Refund Allocation	
		Profit on Member Sales	Profit on Non-Member Sales
Taxable income	\$100,000	\$75,000	\$25,000
Patronage refunds allocated (decision point)	0	\$75,000	
Tax paid	\$22,500 (22.5% tax on \$100,000)		\$3,750 (15% tax on \$25,000)
20% patronage paid in cash (decision point)		\$15,000 ( $\$75,000 \times 20\%$ )	
Total cash outlay	\$22,500	\$18,750 ( $\$15,000 + \$3,750$ )	
Cash stays in co-op	\$77,500	\$81,250	
Cash stays in community	\$77,500	\$96,250	

# Summary of recommendations

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## **Unless there is a compelling reason not to, we recommend:**

- Allocate 100% of eligible profits for patronage dividends
- Distribute the minimum (20%), retain 80% to reinvest for the common good
- Issue store credits
- Set a minimum distribution amount between \$2-\$5

# Now available!

## CONTENTS

Introduction, *by Dave Gutknecht*

Membership is Ownership, *by Marilyn Scholl*

Patronage Dividend Primer *by Bruce Mayer*

Waking the Sleeping Giant, *by Marilyn Scholl with Bruce Mayer and Joel Dahlgren*

Patronage Refund Systems That Work, *by Elizabeth Archerd*

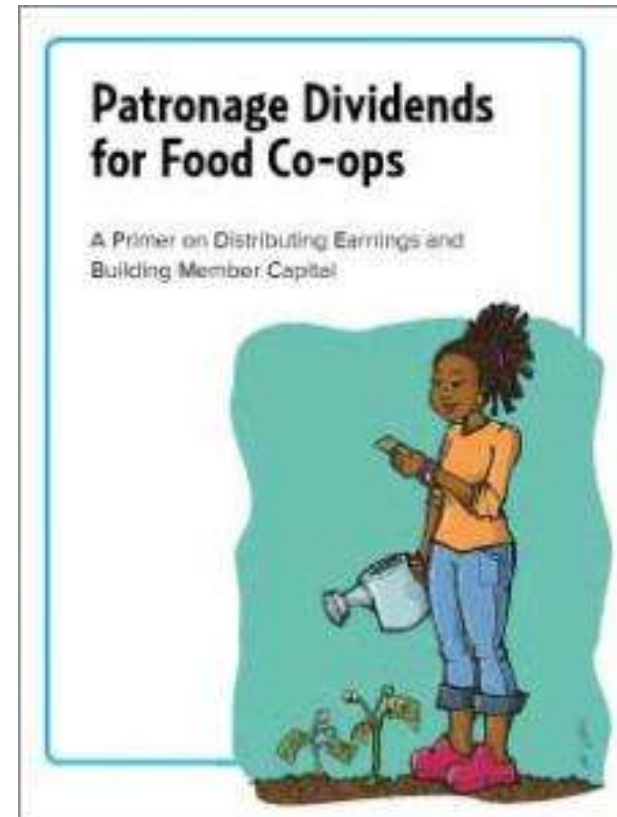
Implementing Patronage Dividends, *by Marilyn Scholl and Bruce Mayer*

## Appendices:

A. Examples of communicating to co-op members

B. Lexington Co-op educates its members

- Plan for engaging members
- Handouts: dividend calculation / FAQ
- Power point slides



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# Thank you!

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## Resources:

### Patronage Dividends for Food Co-ops

» <http://www.cdsconsulting.coop/patronagedividend>

– CBLD Library

<http://cdsconsulting.centraldesktop.com/cdsvideo/doc/6654769/w-MembersEconomicParticipation>

<http://cdsconsulting.centraldesktop.com/cdsvideo/doc/5564664/w-MemberEconomicParticipation>

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