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**CDS** | Cooperative Development Services  
consulting services for food cooperatives



# Member Economic Participation

***Presented by Marilyn Scholl***

*An online CBL300 series course, Thinking and Acting Strategically*

*Provided as part of the CBLD program*

[www.cdsfood.coop/cbld](http://www.cdsfood.coop/cbld)

# Desired Outcomes

- ❏ Directors understand the cooperative's economic relationship with member owners
- ❏ Directors understand the role, challenges, and types of equity in a cooperative
- ❏ Directors understand patronage refunds as mutually beneficial for the co-op and the member

## 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 is an introduction to the economic relationship with members. The related legal, tax and accounting issues are complex. Expert legal and accounting advice should be sought on specific issues.

# Outline

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- ❶ **The overall economic relationship with member owners in a cooperative**
- ❷ **Member share investments**
- ❸ **Member economic benefits**

# Ownership

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

# Cooperative Ownership is unique (1)

- ❏ **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
- ❏ **Members benefit economically and socially**
- ❏ **Co-op members seek mutual benefit; none should benefit at the expense of another**
- ❏ **Member owners through their elected board of directors allocate surpluses**

# Cooperative Ownership is unique (2)

## **The relationship between members and the co-op is paramount**

- A cooperative is defined by and draws strength from its relationship with members
- Member owners are the source of not only capital and control but also sales
- The cooperative's activities promote the economic success and/or well being of the member. There is a close connection between the success of the co-op and the success of the member
- The co-op's products and services are tailored to specific member needs
- Linkages create incentives or rewards for the co-op to serve members and for the members to patronize the co-op

## **The strength or weakness of the relationship can be understood by considering:**

- How much and in what ways do the members trust the cooperative?
- How effective and to what extent does the co-op act as an agent for the members' interests?

# 3rd Cooperative Principle

## Member Economic Participation

- ❶ Members contribute equitably to, and democratically control, the capital of their cooperative.
- ❷ At least part of that capital is usually the common property of the cooperative.
- ❸ They (members) usually receive limited compensation, if any, on capital subscribed as a condition of membership.
- ❹ Members allocate surpluses for any or all of the following purposes:
  - developing the cooperative, possibly by setting up reserves, part of which at least would be indivisible;
  - benefiting members in proportion to their transactions with the cooperative;
  - and supporting other activities approved by the membership.

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

- ❶ ***Because they trust that doing so will be in their own interest as well as the interest of other members***
- ❷ **Cooperatives earn this trust when members perceive it as an effective agent for themselves, dedicated to serving member's 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>

# Overall Economic Relationship with Member Owners

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 Questions?

 Comments?

 Reflections?

# Member Share Investments

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## Examples from food co-ops

- St. Peter Food Co-op
- Wild Oats Food Co-op

# Member Shares (1)

- ❶ **Member/owners provide capital by investing in share(s).**
- ❷ **Member share programs have two main goals:**
  - Provide the co-op with an adequate capital base
  - Create a sense of ownership among members
- ❸ **All types of capital have advantages and disadvantages. Member shares have these features for the co-op:**
  - Not taxable to co-op
  - Can be low cost and/or interest free
  - Provides a base to leverage debt capital
  - Many people provide relatively small amounts that add up to a sizable base of funds.
  - Demonstrates member support

# Member Shares (2)

## Member share investment

- Should contribute to an adequate capital base
- Be flexible as needs of business change (Never use the term “life time”)
- Structured to ensure exemption from securities laws and from taxation
- Equitable with the same investment for each membership (whether it is held by an individual or a household)
- Use payment plans to accommodate different financial situations
- Is refundable to members, but refund policies should include restrictions that protect the solvency of the co-op

## The member investment program should:

- Be simple and easy to administer and maintain
- Be fair and discourage cheating
- Minimize any administrative fees
- Only be changed with member understanding and support

From “Best Practices for Membership Development in Food co-ops” by CoCoMamas/Let’s Soar  
<http://cdfsfood.coop/bestpractices>

# Member Shares (3)

## **As an investment, member equity is refundable to the member upon termination of membership**

- Establish some limits on refunds to protect the co-op's financial base. For example:
  - » Refund capital after receipt of replacement capital from another member
  - » No equity refunds if co-op has negative net worth or if the refund would cause negative net worth
  - » Deduct any amounts the member owes the co-op

## **Unclaimed and abandoned equity**

- Be familiar with the escheatment laws in your state and have a plan to address abandoned and unclaimed equity

# How much?

- ❏ Think strategically about the cooperative's long term capital needs
- ❏ Develop a long term capital plan that considers member investment, earnings, and retained patronage refunds
- ❏ Base equity requirement on the co-op's capital needs
- ❏ Consider an annual investment (instead of a set amount) that can continually build capital for the co-op and be easier for members to understand and afford

From "Best Practices for Membership Development in Food co-ops" by CoCoMamas/Let's Soar  
<http://cdfsfood.coop/bestpractices>

# Member share programs benefit members and the co-op

## Co-op

- Inexpensive source of capital
- No tax obligations
- Fair. Spreads capital needs over many users
- Flexible as capital needs change
- Increases ability to leverage other types of capital
- Builds sense of ownership among members

## Members

- Shares are fully refundable
- Investment helps the co-op meet member needs
- Members own the co-op
- Share contributions may end when the fair share amount is reached
- Payment options can be offered to make investment easier
- Can use retained patronage refunds to build investment

# Develop a member investment plan that communicates:

- ❏ **Ownership** – A mutually beneficial relationship between the owners and the co-op
- ❏ **Investment** – The money belongs to the member and is invested so the co-op can better meet the member's needs
- ❏ **Value** – Member investment helps to create a cooperative economy
- ❏ **Fair share** – The co-op's overall capital needs are divided among its members so the share requirement is based on each member's "fair share"
- ❏ **Consistency** – whatever terms are selected should be used consistently
- ❏ **Flexibility** - Reserve the right after proper notification to the membership to change the investment level

# Watch your language!

- ❏ **Use terms that communicate that shares are an investment in the cooperative**
  - Share, your share, invest, investment, your investment, risk capital, refundable to you, your stake in the business, your share in the co-op
- ❏ **Avoid inaccurate terms**
  - Don't use ~~pay, cost, price, fee, lifetime, or total~~ when talking about equity
- ❏ **Educate co-op members that they are truly owners**
  - A co-op is not a membership organization like Sam's Club or Costco - you don't own those organizations just because you are a member, but co-op members are owners
- ❏ **Focus on the annual investment and current capital needs**
  - Reserves the right to, after proper notification to the members, to change the "fair share" investment level to reflect changes in inflation and the co-op's capital needs
  - Consider an incentive or "thank you" for any member who brings their share up to full amount

# A word about fees and dues

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- ❏ Member fees and/or dues do not provide true ownership
- ❏ Fees and dues are included in the cooperative's taxable income
- ❏ Fees and dues are not typically refundable to the member
- ❏ Any administration fees or other fees that are assessed in addition to equity requirement should be minimal

# Member Share Investments

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 **Questions?**

 **Comments?**

 **Reflections?**

# Member Economic Benefits

## **Goal is to have benefits that members love and that strengthen and sustain the co-op**

- Primary overall benefit is the co-op itself and the value that it brings to members and the community
- For members to love the benefit plan, they need to value the benefits the co-op provides them perceive they need to be able to see through the co-op

## **Patronage refunds are an economic return that**

- Members love
- Strengthen and sustain the co-op

# Why Patronage Refunds?

-  **Creates a mutually beneficial relationship with owners**
  - Encourages membership and member investment
  - Both the co-op and the members prosper
  - The member trusts that the co-op will not profit off of the members business because surplus is returned in proportion to their business
  - Engages members - people pay attention to patronage
-  **Makes use of a cooperative advantage**
  - Builds co-op capital and provides resources needed for the future
  - More money stays in the community
  - Reduces co-op's cash outlays
  - Reduces the co-op's tax obligations
-  **Creates appropriate pressure to generate profits**
  - Returns a share of profit to members based on amount of purchases

# Patronage refunds are mutually beneficial

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## Examples from food co-ops

- Hanover Co-op
- Wedge Co-op
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# 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 requirements
- 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)

# 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,

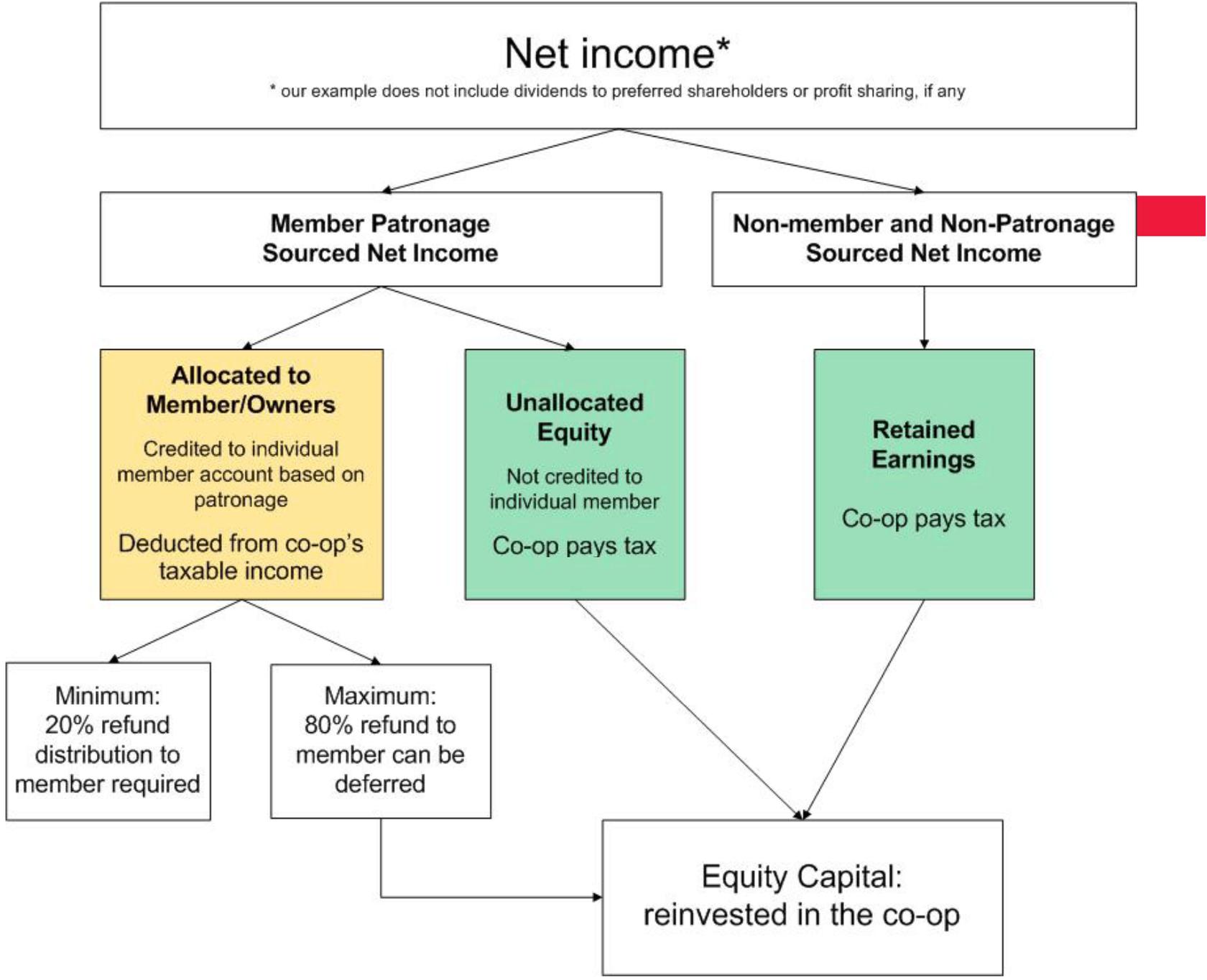
## A pre-existing obligation must exist

- 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 members 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





# Annual Decisions (1)

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## Amount of allocation

- Follow tax rules, state statutes and pre-existing agreement with members

## Amount of distribution

- At least 20% must be distributed to members in cash
- The rest may be retained by the co-op in the name of the member
- Get deduction for full amount even if not paid out

From Bruce Mayer, CPA, Wegner, LLP, CCMA workshop handouts

# Annual Decisions (2)

## Method of distribution

- Paid out portion, normally 20%, must be available as cash
- Can issue store certificate, but must pay out cash if requested
- Must initiate payouts within 8.5 months of year end and before filing taxes
- Retained portion is kept in account in name of each member separate from member investment
- May set a minimum amount of payment (example: \$1 or less will not be paid out) but if so, none of the allocation for those people can be deducted
- Anyone not claiming their cash portion is excluded from patronage and tax must be paid on the amount

From Bruce Mayer, CPA, Wegner, LLP, CCMA workshop handouts

# Example

(From Bruce Mayer, CPA, Wegner, LLP, CCMA workshop handouts)

	No Patronage Refund Allocation	Patronage Refund Allocation	
		Profit on Member Sales	Profit on Non-Member Sales
<b>Taxable income</b>	<b>\$100,000</b>	<b>\$75,000</b>	<b>\$25,000</b>
<b>Patronage refunds allocated</b> (decision point)	<b>0</b>	<b>\$70,000</b>	
<b>Tax paid</b>	<b>\$22,500</b> (tax on \$100,000)	<b>\$750</b> (tax on \$5,000)	<b>\$3,750</b> (tax on \$25,000)
<b>20% patronage paid in cash</b> (decision point)		<b>\$14,000</b> ( $\$70,000 \times 20\%$ )	
<b>Total cash outlay</b>	<b>\$22,500</b>	<b>\$18,500</b> ( $\$14,000 + \$3,750 + \$750$ )	
<b>Cash stays in community</b>	<b>\$77,500</b> ( $\$100,000 - \$22,500$ tax)	<b>\$95,500</b> ( $\$100,000 - \$4,500$ in taxes)	



# Patronage Refunds

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 Questions?

 Comments?

 Reflections?

# Other Member Benefits

## Other tangible benefits can provide an incentive to join or to increase purchases or both

- Generally are management prerogatives (member specials, coupons, member appreciation events, community partners programs, special orders, etc.)
- Should be sustainable
- Can be flexible, change over time

## Intangible benefits

- Members also value the intangible benefits they receive from the co-ops existence on the community
- Sense of belonging, pride and community well being can be strengthened and communicated

# A word about discounts

- ❏ Creates and perpetuates a sense entitlement as opposed to a sense of ownership
- ❏ Not flexible
  - Benefits are given to member owners before knowing whether the co-op had net earnings savings to distribute
  - Cannot manage or defer impact on cash
- ❏ Everyday discounts can be costly and unsustainable
- ❏ Monthly or quarterly discounts are not equitable for all members
- ❏ Can create disincentives to promote membership
- ❏ Reduces the co-op's ability to generate capital from operations
- ❏ Short term reward that doesn't build equity
- ❏ Inflates shelf prices
- ❏ Makes it harder to predict and manage margins

# Member Economic Benefits

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 Questions?

 Comments?

 Reflections?

# For more information

Best Practices for Membership Development in Food Co-ops, by CoCoMamas/Let's Soar, <http://cdfsfood.coop/bestpractices>

Capitalization Strategies By Bill Gessner Cooperative Grocer #129, March - April 2007

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Creating a Cooperative Legacy in Your Community, by Patricia Cumbie, Solutions V6, #1, January/February 2007

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Member Discounts: Measuring Their Cost, Considering Alternatives By Scott Beers and Margaret Lund, Cooperative Grocer #63, March-April 1996

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Member Equity: Essential Foundation, Educational Tool, by Patricia Cumbie, Solutions V3 N 3 Summer 2003,

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Planning and Marketing Capital: A greater share in your future? by David Thompson, Cooperative Grocer # 48, Sept/October 1993

<http://www.cooperativegrocer.coop/articles/index.php?id=142>

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