A Patronage Dividends Primer, Revised

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This article revises a *Cooperative Grocer* article first published in January-February 2008. The key changes relate to trying to reduce the problem of unclaimed patronage dividends and correcting an error about the definition of patronage vs. non-patronage for tax reporting purposes.

Patronage dividends represent a unique opportunity for retail food cooperatives to avoid taxation at any level on some or all of the cooperative's earnings. The tax laws allow patronage dividends to your individual members to be a tax deduction. Since these are deductible by the cooperative and not taxable to members, the patronage dividend amount is not taxed at any level. Reduced taxation is a significant advantage to patronage refunds for retail food cooperatives.

Patronage dividends originated with the Rochdale Society cooperative principles that included "net margins distributed according to patronage," part of Principle 3. Since cooperatives had a long history prior to the enactment of the U.S. income tax laws, cooperatives were accommodated in these laws. The Internal Revenue Service (IRS) rules formalize the procedures that result in a tax deduction. These rules treat a cooperative as having the option of operating as a pass-through entity where profits are considered an overcharge to be returned to patrons.

Subchapter T

The IRS rules for patronage dividends are outlined in Subchapter T of the Internal Revenue Code. The five code sections comprising Subchapter T are:

- 1381—what is a cooperative under Subchapter T?
- 1382—how are income and patronage dividends calculated?
- 1383—what is nonqualified patronage?
- 1385—how are patrons taxed on the dividend?
- 1388—what do the terms mean?

These are the rules that apply to non-exempt cooperatives. There are exempt cooperatives, normally only agricultural, which must apply for exempt status and follow somewhat different rules. All cooperative accountants and their outside accounting advisors must be familiar with Subchapter T, even if your cooperative only receives patronage dividends from other cooperatives. Accountants should also be familiar with the accounting guidance available in the American Institute of CPA's (AICPA) "Audit and Accounting Guide for Agricultural Producers and Agricultural Cooperatives." Additional information on accounting and tax issues is available by joining the National Society

of Accountants for Cooperatives (www.nsac.coop). Your finance manager and your outside advisor should both be members of NSAC in order to keep up on cooperative tax and financial issues.

Subchapter T lays out three basic criteria for patronage dividends. To be deductible the patronage dividend must be paid:

1. "on the basis of quantity or value of business done with or for such patron,
2. "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount paid, and
3. "which is determined by reference to the net earnings of the organization from business done with or for its patrons."

Item 1 requires the cooperative to specify the basis for calculating patronage. For a consumer-owned cooperative it will be sales. For a worker owned cooperative it will be hours worked by or dollars paid to workers. We will use consumer owned cooperatives in the examples below. The patronage dividend must be proportionally allocated based on business done with everyone including non-members.

Item 2 requires that the cooperative operate under a pre-existing obligation to pay patronage dividends. This is normally part of the bylaws but may also be in the form of a written agreement with the members. State law normally allows a board to determine that some or all of income be set aside as a reserve not to be paid out as patronage. This tempers the pre-existing obligation. But patronage dividends are not allowed if there was not an obligation established at the beginning of the tax year from which patronage is paid. Part of establishing the obligation is informing members that they may receive a patronage dividend. This is one reason cooperatives should distribute their bylaws to new members. Be sure you consult a qualified attorney on the precise wording of your bylaws, as they must be in accordance with the IRS rules and with applicable state laws.

Item 3 specifies that the base for patronage is net income. The IRS prefers taxable income as the patronage base. This is what most cooperatives use, although book income may also be used. The basis for patronage should be used consistently and should be specified in the bylaws.

Determine amount eligible for patronage dividend

The starting place in allocating patronage is to determine net income for tax or for book purposes. The next step is determining who is eligible for the patronage dividend.

A co-op can pay a patronage dividend to anyone who has purchased products from the co-op. Most co-ops do not pay patronage dividends to non-owners. Co-ops can also further limit patronage dividends to fully paid owners and to owners who retained membership through the date of the patronage dividend. The eligibility criteria should be considered for inclusion in the bylaws. In addition, the co-op can decide to exclude certain sales, such as for a sushi contractor selling in the store, class fees, and fundraiser ticket sales from total sales and from each owner's sales. For any sales excluded, the profits from the activity should also be excluded from the patronage dividend calculation.

Using the calculated net income, most cooperatives simply apply the percentage of all sales that were to eligible patrons to determine the net income generated by them. A more detailed analysis of net income earned from eligible patrons is possible. The eligible patron net income is then allocated to each patron based on the percentage of that patron's sales to total eligible patron sales. The net

income from non-eligible patrons is not allocated and will potentially be subject to income tax.

The practical method of determining the patronage allocation to each patron is to download the annual sales by patron from your point of sale system to a spreadsheet. This can then be sorted from largest to smallest, ineligible patrons removed, and sales adjusted for excluded items. A ratio of each eligible patron's sales to all sales is then easily calculated, as is multiplying this percentage times net income to calculate the amount of patronage dividend that could be allocated to each patron. A mail merge can then be used to generate the actual notices to members of their patronage.

Most cooperatives apply a minimum dividend amount that they will process. For instance, anyone who would receive under $2 could be cut out of further processing. This does mean that the cooperative will pay tax on those earnings of owners who would have received under $2.

The board will need to determine the actual dividend payout. The maximum dividend amount will be the net income earned from eligible patrons. The dividend may be paid out with a minimum of 20% as some form of funds with the balance being held by the cooperative as equity in the name of the owner as retained patronage dividends.

Now comes a major change from the previous article I wrote on this topic. There are two paths a co-op can take to get the patronage dividend to the eligible owners. Whatever path you use should be outlined in the bylaws to meet the pre-existing obligation rules. The method outlined in my prior article is to make the act of cashing of the check or use of the store credit constitute acceptance of the entire patronage dividend. The advantage of this is that it avoids unclaimed property rules.

If someone does not claim their allocated funds by the deadline, they forfeit the amount and it goes back to the co-op, including the retained patronage portion. This method requires that the owner have at least 90 days to accept the patronage dividend by claiming their funds. It also sets a maximum time to claim the patronage dividend, which is 90 days after the extended due date of the tax return. Any check cashed after that date would not qualify as a deductible patronage dividend. This method has clear drawbacks, the biggest being the large amount of unclaimed patronage dividends that revert to the co-op, requiring that tax be paid.

A useful alternative to requiring claiming the funds to signal acceptance of the patronage dividend is to make acceptance of the patronage dividend a condition of membership. Added on top of that, anyone not claiming the allocated funds by the due date agrees that the co-op can direct the funds as it sees fit. This allows the retained portion of the patronage dividend to stay in the name of the owner and continue to be a tax deduction for the co-op. For the cash portion not claimed, the co-op can decide to keep the funds and pay tax on them, or direct the funds to charity or other purpose after the cutoff. This method reduces the dollar amount of unclaimed patronage dividends and also avoids unclaimed property rules. This method also removes the deadlines for action since the member has accepted the patronage dividend from the start. The acceptance of patronage dividends as a condition of membership should be stated in the bylaws.

Regardless of the method above, in order for the cooperative to retain part of the patronage dividend, owners must receive a qualified written notice of allocation. This notice outlines what the funds are and the amount of the non-cash portion retained by the cooperative. This notice must specify any deadlines and the consequences of using or not using the funds. Issuing a qualified notice of allocation allows the cooperative to deduct the patronage dividend. The IRS issued a private letter ruling (PLR 201413002 - March 6, 2014) outlining an example of using electronic communication

for the written notice of allocation. Please read it if you plan to use email instead of a letter.

Food cooperatives will normally only use qualified patronage dividends. The non-qualified patronage is non-deductible at the time it is issued but is deductible when cash is paid.

Form of payment

The minimum 20% paid-out portion of a patronage dividend is traditionally in the form of a check, but the payment may be in the form of a store credit redeemable in the store for purchases. You must allow the eligible owner to get cash if they prefer that. This is much easier than issuing checks and limits the problems with un-cashed checks. Using a credit also encourages members to use it on groceries, keeping the funds in the cooperative. Your point-of-sale system can be used to keep track of these credits.

Payouts to members from the income of a given tax year must be made no later than 8.5 months after year-end. This allowable timeframe is called the payment period. The IRS is very particular about this and will classify any payment made outside of the allowable payment period as an ordinary corporate dividend—nondeductible for the cooperative and taxable to the recipient. A 1099-DIV would need to be issued to each member.

Allocating Income/Expenses: Form 1120-C

The specific IRS income tax form for cooperatives is the 1120-C. The primary difference from the 1120 is the addition of Schedule G that specifically requires the allocation of all income and expense items into patronage and non-patronage columns for all cooperatives over $250,000 of gross receipts. (See accompanying image of Schedule G.) One result of allocating income in Schedule G is that net operating losses stay segregated by patronage and non-patronage sources. The IRS rules prevent patronage losses from offsetting non-patronage income. However, this is not typically an issue for food co-ops.

Schedule G **Allocation of Patronage and Nonpatronage Income and Deductions.** Before completing, see Question 14 of Schedule K.

			(a) Patronage	(b) Nonpatronage
1	Gross receipts or sales	1		
2	Cost of goods sold	2		
3	Gross profit	3		
4	Other income	4		
5	**Total income.** Add lines 1 through 4	5		
6a	Domestic production activities deduction (attach Form 8903)	6a		
b	Other deductions	6b		
c	Total deductions (add lines 6a and 6b)	6c		
7	Taxable income before section 1382, NOL, and special deductions. Subtract line 6c from line 5	7		
8	Deductions and adjustments under section 1382	8		
9a	Net operating loss deduction (attach schedule)	9a		
b	Special deductions (see instructions)	9b		
10	**Taxable income.** Subtract the total of lines 8, 9a, and 9b from line 7	10		
11	Unused patronage loss (see instructions)	11		
12	Unused nonpatronage loss (see instructions)	12		

The IRS instructions for Schedule G state: "If the transaction producing the income merely enhances the overall profitability of the cooperative, being merely incidental to the cooperative's operation, the income is from a nonpatronage source." This means that sales to non-members are not non-patronage and that food co-ops will usually report all activity in the patronage column of Schedule G. This was incorrectly stated in my original article. The correct interpretation that non-member sales are in the patronage column simplifies co-op tax return preparation.

Filing 1099-PATR forms Is not required

Food cooperatives should file IRS form 3491 to elect not to issue the 1099-PATR form. Form 3491 is filed in the first year patronage dividends are paid and does not need to be filed again. This exemption is allowed for cooperatives that have at least 85% of gross receipts from the sale of "personal, living, or family items." The tax code allows someone who purchases such items from a cooperative to exclude any patronage dividend from taxable income even if they receive a 1099-PATR. The reasoning is that individuals may not deduct personal use items and so any dividend on them is not taxable. Not issuing the 1099-PATR does not relieve co-op members who are required to claim the patronage dividend as income from doing so. Some possible members who should claim a patronage dividend as income are restaurants and day care centers.

An additional issue with patronage dividends is the financial statement presentation. There is no definitive requirement for treating patronage dividends as a deduction from income or as an equity transaction similar to corporate dividends. The guidance from the AICPA in the "Audit and Accounting Guide" mentioned earlier is that patronage dividends are an equity transaction. The reporting examples given in the Guide follow that equity transaction format. On the other hand, the CoCoFiSt format uses the income statement treatment. In considering your cooperative's treatment, one question to ask is: If we are retaining 80% of the payment, why should it be expensed? Showing patronage dividends as an expense reduces net income, and that may make your cooperative look weaker to a banker or other reader who does not understand cooperatives.

Related issues include the balance sheet presentation of the retained patronage dividend and the policy for eventually paying it out to members. The retained portion of a patronage dividend is equity of the cooperative and should be presented along with retained earnings and member shares in the equity section of the balance sheet. This retained patronage is only paid out by the decision of the board. Most cooperatives do not return the retained patronage even if a member requests it back. This is also generally the case in agricultural cooperatives. One advantage food cooperatives have in withholding retained patronage is that almost all members never paid tax on it and already received some cash. This removes the basic fairness argument that agricultural cooperatives must face since their members normally did pay tax on the retained patronage.

If your cooperative does plan to revolve back this equity, it should lay out a plan for it. If it does not plan to revolve back this equity back in the near future, that should be made clear. Most cooperative members should be receptive to the idea that they get some cash back, and the rest is an easy way to avoid paying taxes and keep the money in the cooperative working for them.

Patronage is a simple set of rules, but you do need to actually learn them and keep them in mind so that your cooperative can follow the applicable laws and make sound decisions.