

Patronage: Book vs Tax Basis

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Learning Objectives

- Understanding strategies of operating in accordance with Subchapter T utilizing available patronage allocation options and critical considerations associated with a selected option.
- Obtain an understanding of patronage net earnings determinations under a book, tax or hybrid method of patronage accounting.
- Understanding considerations and methods of patronage accounting in context of multiple patronage earning pools or allocation units
- Understanding the options and methods used in practice of allocating book /tax differences for the determination of patronage vs. nonpatronage taxable income.
- Understanding alternative choices for considering changes in existing patronage allocation methods



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Key Terminology



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Key Terms

- Income – All funds that flow into the cooperative from its business operations.
 - Patronage and Nonpatronage
- Earnings – Income less expenses
- Margins – Earnings on business conducted on a cooperative basis
- Patron – Any person with or for whom the cooperative associations does business on a cooperative basis, whether a member or nonmember of the cooperative association



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Key Terms

- Member – A person who has the right to vote on issues decided by the membership
- Patronage refund (dividend) – Net earnings from business done with or for patrons that are allocated or distributed to patrons on the basis of business done with or for such patron under an obligation to pay such amount
- Dividend – Earnings that are returned to investors based on the amount of investment in the company
- Unallocated – Permanent equity capital not assigned to a specific member's account



Operating as Subchapter T Cooperative

Discussion Topics:

1. Operating on a Cooperative Basis
2. Establishing Patronage Allocations
3. Allocating Book / Tax Differences
4. Changes in Patronage Allocation Methods



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Operating on a Cooperative Basis

Operation at Cost



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Operating on a Cooperative Basis

Focus of this session is on Principle of:

- Operation at Cost

In ***Puget Sound Plywood, Inc. v. Commissioner***, 44 T.C. 305 (1965), acq., 1966-1 C.B. 3, one of the three principles described as fundamental to cooperative operation is Operation at Cost

- **Rev. Rul. 93-21** states *“Whether a corporation is operating on a cooperative basis under section 1382(a)(2) of the Code will be determined from all the facts and circumstances and the cooperative principles enunciated in **Puget Sound Plywood**.”*



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Operation at Cost

The principle of Operation at Cost is explained by *Puget Sound* as:

- “...the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., **the excess of the operating revenues over the costs incurred in generating those revenues**), in proportion to the worker-members' active participation in the cooperative endeavor.”
- This “...is achieved through **statutes, bylaws, and contractual arrangements** between the association and its members, whereby the elected officers of the association are required to make **periodic allocations of the same among the members in proportion to their active participation as workers.**” *Puget Sound*, 44 T.C. at 308.



Operation at Cost

Subchapter T achieves the principle of Operation at Cost through mechanism of “patronage dividends” as defined in section 1388 and deductible pursuant to section 1382

- The term “*patronage dividend*” pursuant to section 1388(a) means “...an amount paid to a patron by an organization...”
 - “(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 so paid, and*
 - (3) which is *determined by reference to the net earnings of the organization from business done with or for its patrons.*”



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Operation at Cost

Subchapter T achieves the principle of Operation at Cost through mechanism of “patronage dividends” as defined in section 1388 and deductible pursuant to section 1382

- Section 1388(a) goes on to specify that in defining a patronage dividend:
 - ***“Such term does **not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.”*****



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Operation at Cost

Subchapter T achieves the principle of Operation at Cost through mechanism of “patronage dividends” as defined in section 1388 and deductible pursuant to section 1382

- **Three Basic Elements:**
 - Pre-existing legal obligation – a valid enforceable written obligation in bylaws
 - Patronage sourced net earnings - net earnings from business done with or for patrons
 - Equitable allocation – quantity or value of business done with or for patrons



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Establishing Patronage Allocations

Pre-Existing Legal Obligation



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Establishing Patronage Allocations

Patronage allocation framework is contained within the organizational governing documents of the cooperative including **articles of incorporation, bylaws, membership agreements**, inclusive of provisions of **state incorporation statutes**

- The **pre-existing legal obligation** required by section 1388(a), a **valid enforceable written obligation**, will be contained within one or more of the above governing documents
- Pre-existing means ***obligation existed before the organization received the amount so paid***. This generally means the obligation is **legally enforceable prior to commencement of the first day of the fiscal year** in which **business is done with or for its patrons**.
- The written obligation must define the elements of the **determination of patronage sourced net earnings** and the **method of equitable allocation**



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- Allocation may **not be left up to board discretion** at year end:
- Goldkist **TAM 8521003** Jan. 25, 1985 -- “[I]n order to **deduct patronage dividends**, a cooperative must operate under **a preexisting contractual obligation that fixes not only the amount of earnings that will be distributed as patronage dividends but also the recipients of the patronage dividends . . .**The charter, by-laws or some written agreement of the cooperative must set forth the means by which the amount of the recipients of the net margins of the cooperative can be determined without action by the board of directors of the cooperative at the close of the taxable year.”



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- This requirement is met **with including in bylaws, articles of incorporation** or both a description of the basis or determination of **net earnings**, net margins or savings of the cooperative from **business done with or for patrons**
- Typical net earnings determinations by cooperatives:
 - **Book Basis:** GAAP (or with variations, pre-tax or post tax, consolidated or separate, may specify equity method or dividends of subsidiaries, treatment of income from LLCs or partnerships, etc.)
 - **Book Hybrid:** GAAP excluding certain incomes (ex. unrealized gains or losses on hedges)
 - **Tax Basis:** Federal income taxable income
 - **Tax Hybrid:** Federal Taxable income with specified adjustments (ex. state income taxes, sec. 199A(g))



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- The **net earnings** determination **whether book, tax or hybrid**, should be sufficiently **descriptive in the bylaws** such that it is clear and **does not rely on discretion of management or board of directors**
- Other book basis considerations – Other Comprehensive Income – **typically excluded** from patronage sourced net earnings – **what about reclasses to P&L?**
- **Retrospective** adoption of book changes in accounting principle may result in **adjustments to beginning retained earnings – patronage net earnings?**



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- **Example of book basis modification from GAAP:** If a cooperative board of directors and/or members determine its appropriate **to adopt a modification from GAAP** in determining book basis, such modification should be adopted **prior to the fiscal year of change by amendment of the bylaws**, to describe the **modification of patronage net earnings**, such as for example, excluding unrealized gains and losses on hedging transactions



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is defining “**patronage sourced business**” **done with or for patrons**
 - This is typically described as business or transactions with or for patrons, using descriptions of activities and products such as marketing, processing, supply, purchasing lending, leasing or services and may describe farm products such as milk, fruit, grain, nuts, or services such as loans, leases, grain drying and storage, agronomy services, etc.
 - Cooperatives operating in multiple geographic regions, or with multiple business or product lines may separately describe these activities in defining patronage sourced business conducted with or for patrons and may provide for accounting to patrons for net earnings by establishing separate allocation units or patronage pools to achieve an equitable allocation of net earning to patrons



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is defining **“patronage sourced business” done with or for patrons**
 - To the extent **certain business or transactions with or for patrons is to be excluded from patronage sourced business**, it should be identified as such, as **net earnings from sources other than patronage**, or indicate by a **separate agreement with a patron, specifying certain business or transactions as nonpatronage** excluded from patronage sourced net earnings



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is defining “**patronage sourced business**” **done with or for patrons**
 - The bylaws should clearly describe the classification of net earnings attributable to **business or transactions with or for nonmember patrons**, whether **nonmembers are entitled to share in patronage dividends** on the same equitable basis as members.
 - **If yes**, such business **will be included in patronage sourced net earnings** eligible for distribution as **patronage dividends to patrons**, inclusive of nonmembers on same basis as members.



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- If net earnings attributable to **business or transactions with or for nonmember patrons are not entitled to share in patronage dividends**, such business with nonmember patrons is classified as **nonpatronage income or loss excluded** from patronage sourced net earnings.
- **Nonpatronage income** or loss will typically be recorded in **unallocated reserves (retained earnings)**
- Certain cooperative bylaws may provide a provision for **payment of dividends** to members of **nonpatronage income** on a patronage or per share basis



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- ***“Accumulated and maintained...reserve required by State law”*** (as per Section 521(b)(3)) or the bylaws may require a specific percentage of net earnings to be set aside as unallocated reserves, or such percentage may be established by the board of directors prior to the start of fiscal year.
- Alternatively, the bylaws may provide for board of directors’ discretion to set aside unallocated reserves for a ***“reasonable reserve for any necessary purpose”*** as per Section 521(b)(3) .
- Typically, such unallocated reserves to be set aside will first come from current year nonpatronage sourced net earnings prior to setting aside patronage sourced earnings
- Coop may maintain patron records to facilitate a future allocation of such reserves



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is describing the **method of equitable allocation based on the quantity or value of business done with or for patrons**
- As stated earlier, the term “**patronage dividend**” pursuant to **section 1388(a)** means “***...an amount paid to a patron by an organization...***”
 - “***...(1) on the basis of quantity or value of business done with or for such patron,...***”
 - “***Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.***”
 - As such, all allocations to patrons need to be done on an **equitable basis** with respect to **substantially identical transactions**



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is describing the **method of equitable allocation based on the quantity or value of business done with or for patrons**
- As stated earlier, the term “***patronage dividend***” pursuant to **section 1388(a)** means “***...an amount paid to a patron by an organization...***”
- “***...on the basis of quantity or value of business done with or for such patron,...***”
 - may be based on “quantity” – typically a physical amount such as cartons, tons, pounds or bushels delivered
 - may be based on “value” – typically the dollar volume
 - permissible to use either or combination of both



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is describing the **method of equitable allocation based on the quantity or value of business done with or for patrons**
 - Bylaws may contain a provision to allocate items **of substantial, extraordinary or nonoperating income, gains, losses or expenses**, as may be **identified within the sole discretion of the board of directors**, to separately equitably allocate to the patrons such gain or loss is attributable. See **PLR 200252027**.
 - For example, this type of provision typically is used to **allocate patronage sourced gain on sales of major assets to the patrons during the period which the asset was owned by the cooperative in proportion to the amount of business done by such members during that period, insofar as practicable**. See **question 5 of Rev. Rul. 72-36**.



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is describing the **method of equitable allocation based on the quantity or value of business done with or for patrons**
 - **Single allocation unit or patronage pool** – total patronage sourced net earnings of the cooperative **after setting aside amounts for unallocated reserves, and separately allocating any extraordinary gains and losses, if provided for in bylaws**, are allocated to current patrons based on the proportionate dollar amount of sales, purchases, services or quantity or units of measurement of product sold or purchased by each patron with the cooperative compared to the total of the same for all patrons



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- An essential description for the bylaws is describing the **method of equitable allocation based on the quantity or value of business done with or for patrons**
 - **Multiple allocation unit approach** – the bylaws may provide a cooperative may establish **multiple allocation units or patronage pools** to account for patronage business for multiple business lines such as marketing, purchasing, services, different crops, varieties, products, or geographic regions from which products are grown or sold.
 - Within **each allocation unit or pool**, patronage sourced net earnings **of each pool** after accounting for **reserves and extraordinary items**, are allocated to current patrons based on the proportionate dollar amount of sales, purchases, services or quantity or units of measurement of product sold or purchased by each patron **within the allocation unit** compared to the total of the same for the allocation unit.
 - **Different pools** can be established **for similar products** where the cooperative receives **different sales prices** - **Rev. Rul. 74-567** grain marketed directly vs. delivered to feed mill; **Rev. Rul. 66-98** similar products differentiated based on quality, size, location or time of delivery or service



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Establishing Patronage Allocations

The written obligation must define the elements of the determination of patronage sourced net earnings and the method of equitable allocation

- Multiple allocation units provide a basis for equitably allocating patronage sourced net earnings or loss within each allocation unit.
- For multiple allocation units with losses, the bylaws should provide rules for loss handling which may include netting losses with earnings in other allocation units
- For multiple allocation units with positive net earnings after netting from allocation units with losses, patronage dividend allocations from each allocation unit with earnings are determined on a patronage basis within each allocation unit



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Allocating Book / Tax Differences

Tax Return and ASC 740 Tax Provision



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Allocating Book / Tax Differences

Preparing Income Tax Return and ASC 740 Tax Provision of a Cooperative

- Patronage Sourced Net Earnings determined on a **Tax Basis**
 - In computing taxable income of the cooperative, taxable income will need to be allocated between patronage sourced taxable income and nonpatronage sourced taxable
 - For practical purposes, this exercise generally begins with allocating pre-tax book income between patronage and nonpatronage income, no different than book basis cooperatives
 - Next book tax differences are allocated between patronage and nonpatronage business based on all the facts and circumstances available to achieve a reasonable allocation, consistently applied
 - This means each separate book tax difference is evaluated based on its specific facts and allocation methodologies applied on a reasonable basis which may include grouping related book tax differences in applying consistent allocation methods where appropriate
 - For cooperatives with multiple allocation units or patronage pools, these allocation methods will likely be applied starting with pre-tax book income for each pool and performing the allocation of book tax differences on a pool-by-pool basis.



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Allocating Book / Tax Differences

Preparing Income Tax Return and ASC 740 Tax Provision of a Cooperative

- Patronage Sourced Net Earnings determined on a **Tax Basis**
 - In performing the computations of taxable income on a pool-by-pool basis, both patronage and nonpatronage income will be determined and should total taxable income before patronage dividend on Form 1120-C.
 - For cooperatives on a pure taxable income basis without adjustments for distributing patronage dividends, the patronage dividend deduction will equal patronage sourced taxable income, thus zeroing out final patronage taxable income.
 - From a practical perspective, there may be adjustments resulting in residual patronage sourced taxable income including adjustments for unallocated reserves, state income taxes in some cases, Section 199A(g) deductions not passed through, retainage of taxable income to offset net operating losses, etc.



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Allocating Book / Tax Differences

Preparing Income Tax Return and ASC 740 Tax Provision of a Cooperative

- Patronage Sourced Net Earnings determined on a **Book Basis**
 - Where a cooperative is on a book basis for allocating and distributing patronage sourced net earnings, book tax differences will not come into play in determining the amount of patronage dividends paid.
 - In the case of pure book basis with no retainage for reserves, the patronage dividend deduction may zero out patronage sourced book income depending on adjustments or presentation of financial statement tax expense in determining the amount of the patronage dividend.
 - Historically, for a book basis cooperative in computing taxable income, similar to tax basis cooperatives, book tax differences have been allocated in reporting the amount of patronage and nonpatronage taxable income on tax returns. This approach is based on the focus on a position that in applying the tax law, pre-deduction for patronage dividends, taxable income should be the same for book and tax basis cooperatives, the only difference the amount of the patronage dividend deduction computed on a book basis.



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Allocating Book / Tax Differences

Preparing Income Tax Return and ASC 740 Tax Provision of a Cooperative

- Patronage Sourced Net Earnings determined on a **Book Basis**
 - This historical approach however, of allocating book tax differences for book basis cooperatives ignores the fact that the pre-existing legal obligation in the bylaws to account to patrons for patronage sourced net earnings does not include book tax differences. Meaning book tax differences for book basis cooperatives are outside the scope of Subchapter T.
 - Meaning, for purposes of Section 1388(a)(3), book tax differences are not “*net earnings.... from business done with or for patrons*”.
 - Following the legal contract in the bylaws between the cooperative and the patrons for determining patronage sourced net earnings, book tax differences are retained by the cooperative permanently, they will never be allocated or distributed to patrons, in such case book tax differences inherently should have a nonpatronage classification. On this basis, many cooperatives on a book basis have consistently allocated all book tax differences to nonpatronage taxable income in preparing tax returns and tax provisions.



Changes in Patronage Allocation Methods



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Changes in Patronage Allocation Methods

Changes in Facts, Legal Obligation, Methods of Accounting Affecting Patronage Earnings

- Factual Changes – In the normal course of business from year to year, contracts, agreements and transactions experience changes in dealings with third parties, negotiations, changes in law and economic factors. These changes will impact the determination of patronage sourced net earnings in the normal course from year to year as they occur within the scope of the legal obligation with patrons.
- Changes in Pre-existing Legal Obligation – This would include changes in the determination of patronage sourced net earnings such as from tax basis to book basis. These types of changes would occur typically by amendment to the bylaws with notification to the patrons. A consideration for thoughtful analysis is the impact of book tax differences.
 - For example, if under prior tax basis, a book tax basis adjustment cumulatively reduced taxable income and tax basis patronage earnings which will reverse in periods after switching to book basis, a cooperative may consider tracking the reversal of that book tax difference over a transition period for modified book basis to account for the reversal if significantly large.



Changes in Patronage Allocation Methods

Changes in Facts, Legal Obligation, Methods of Accounting Affecting Patronage Earnings

- Changes in GAAP Book Methods of Accounting – These types of accounting method changes occur routinely under GAAP and normally the P&L effects of adoption of the change will all be reflected in current year book income. As such, under an unmodified book basis patronage sourced earnings approach these changes in book accounting are treated as normal book income items for patronage dividend purposes and do not require any special treatment.
 - If however, a book accounting change results in retrospective effect for prior years being reflected in opening retained earnings, the cooperative should consider whether its bylaws provide for the treatment of retrospective changes in accounting. For example, if the bylaws are silent, only referring to current year book income, barring any other provision, the amount of a retrospective accounting adjustment to retained earnings would not likely be allocated to patrons as part of the annual patronage dividend.
 - Consideration should be given to including in the bylaws a provision that would allow for either retainage or allocation of the retrospective adj. as part of the current year patronage dividend.



Changes in Patronage Allocation Methods

Changes in Facts, Legal Obligation, Methods of Accounting Affecting Patronage Earnings

- Changes in Tax Methods of Accounting – These types of changes occur when a cooperative changes a tax accounting method either by filing Form 3115 or where instructed, attaching a whitepaper statement to the tax return. These changes can be effected on a cutoff basis (meaning the change only effects the accounting for current and future year transactions, with prior years unchanged) or with a section 481(a) adjustment for the cumulative effect of the change as of the end of the prior tax year. Generally, if there is a negative (reduction in taxable income) 481(a) adjustment, the full 481(a) adjustment will be reflected in current taxable income. If however, the section 481(a) adjustment is positive, (increase in taxable income), the 481(a) adjustment is normally reflected in taxable income over a “4 year spread”, current and next 3 taxable years (25% each year). However, there is a special rule for cooperatives that directs a cooperative to reflect a positive 481(a) adjustment fully in the current year taxable income.



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Changes in Patronage Allocation Methods

Changes in Facts, Legal Obligation, Methods of Accounting Affecting Patronage Earnings

- Changes in Tax Methods of Accounting (continued) –The IRS rationale for a cooperative's positive 481(a) adjustment is to allow the cooperative to allocate the adjustment fully in one year to patrons. This is based on Rev. Rul. 79-45 where a taxpayer requested a change from LIFO to FIFO (normally spread over 4 years) to be included in taxable income all in the current year in order to allocate the income to patrons in a one-time adjustment.
 - For Book Basis Cooperatives there is an argument to include in the Form 3115 that Rev. Rul. 79-45 should not apply where there is no corresponding book accounting change. Where the current patronage dividend is unaffected by the change in tax accounting method, the cooperative should be able to spread a positive section 481(a) adjustment over a 4-year period. Recommend attaching an explanatory statement to Form 3115.
 - For Tax Basis Cooperatives the cooperative will generally be required to follow Rev. Rul. 79-45 and including the full positive 481(a) adjustment in current year taxable income. If the change relates wholly to nonpatronage business, an argument may exist for a 4-year spread.



Questions?



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