MEMORANDUM REGARDING COOPERATIVE ASSOCIATION ACT

Date: January 25, 2006
Re: Issue Discussion: Section 904 - Illustrations

PART I

BACKGROUND POINTS

(1) Subsection 904(c) now provides that the BOD may set aside reserves (whether or not allocated) and it is not limited to "from patron participants;"

(2) The default rule is that 100 percent of "profits" will be allocated to patron participants (there may be a slight drafting glitch in the interrelationship of this provision and subsection (c)) and that the allocation cannot go below 30 percent (*See* Reporter's Note);

(3) The Reporters "listened-in" on a conference call between Dan Mott and Craig Houghton about revising the language "net proceeds, savings, margins and profits" and Dan and Craig have suggested replacing the language with the undefined term "profit (and losses)." The Reporters will give additional background about the recommendation orally. (*See, generally*, Part II of this Issue Briefing). Recall that Dan and Craig volunteered to review the language at the Committee's October 2005 meeting.

PART II

ISSUE DISCUSSION

Introduction. The suggested change in the language from "net proceeds, savings, margins and profits" to "profits and losses" is more than just wordsmithing. It dances around a fundamental substantive issue and suggests another issue in need of discussion.

Substantive Issue. The substantive issue has been described in previous Committee meetings as "agency v. sale" arrangements. "Net proceeds" draws attention to this distinction and the distinction has importance for measuring the "30 percent" floor for allocations to investor participants in this section.

Ex 1. Assume a "typical" producer cooperative. The members deliver product to the co-op and get paid a market price. There is a product sale. At the end of the year the books are closed and the price paid to producers for product is subtracted (as "cost of goods sold" in the books of the cooperative association) to help determine "profit."

Thus, if gross revenue were $1,600 and the only "expenses" were the costs of the product to the co-op association (assume $1,000) and administrative expenses of $100; the "profit" would be $500. If the organic documents allocate 50% to patron participants and 50% to investor participants each group would receive $250. The patron participants therefore received the market price for the product $1,000 plus a profit allocation of $250 for a total of $1250. The investor participants would be allocated $250. This is the "sale" method.

Ex 2. Now assume an agency method (according to AICPA Audit Guidelines 2002, this method is used most frequently for specialty produce). Here, there is no market price contract between the co-op association and the producer. Rather the association acts as an agent for the producer. The association sells the product (gross revenue) for $1,600 (as in Ex. 1). However, there is no "cost of goods sold" because the co-op association did not contract for the product with the producer. Thus the only expense was an administrative expense of $100. Assuming the same 50-50 split as in Ex. 1 the investor participants and the patron participants would be allocated $750.

Ex 3. A value added pasta production facility will cost $2,000,000 to construct. To become a patron participant requires a 5 year delivery contract and an investment of $10,000 under the organic rules. Forty producers become patron members (and their aggregate investment, therefore, is $400,000 or 20% of the necessary investment). A commercial pasta maker agrees to contribute $600,000 (30% of the necessary investment) and supply manufacturing management for 5 years. In order to get the remaining $1,000,000 from traditional lending sources the pasta maker agrees to execute a $300,000 stand-by letter of credit.

(a) One "50-50" allocation split of a first year "profit" of $100,000 (after paying the producers $200,000 for under their delivery contracts) would be $50,000 to investor participants and $50,000 to patron participants. The patron participants also receive $200,000 under contract for a total of $250,000.

(b) In what category is the $400,000 patron "investment"? *Maybe* each patron participant is in dual capacity. Thus, the $400,000 investment could be categorized as each patron participant also being an investor participant to the extent of the up-front investment. If so the results:

- Patron participants as patron participants $50,000 (on patronage basis)
- Patron participants own 40% of the investor participant interests so they receive $20,000 in that capacity.
- Patron participants receive $200,000 under their contracts.
- As a result participants whom are patrons receive $270,000.
- Nonpatron investor participants receive $30,000.

Ex 4. Assume the same facts as in Example 3, (a) except it is an agency (net proceeds) arrangement. This means the patron participants will not receive the $200,000 under the delivery contract. Thus, "profit" is $100,000 plus $200,000. This $300,000 would be allocated 50-50. Investor participants and patron participants would be allocated $150,000 each (assuming patron "investment" is not investor participation, see Es. 3(b)).

Ex 5. Assume the same facts as in example 4 except pasta maker contracts to manage the manufacturing plant for $200,000 annually. So XYZ again has $100,000 profit split 50-50 but the pasta maker receives $200,000 under the management contract (rather than the producers receiving that amount for their product as in example 3(a)). Patron participants would be allocated $50,000. Investor participants would be allocated $50,000 but also receive a $200,000 management fee for a total of $250,000 (but see Ex. 3(b)).

The results in examples 3 through 5 would meet the 50-50 test provided by the organic rules but the results vary as follows:

- Ex. 3(a): Investor participants (IP) $50,000; patron participants (PP) $250,000.

- Ex. 3(b): Non dual capacity IPs, $30,000; PP (but including their dual IP-PP capacity), $270,000.

- Ex. 4: IP, $150,000; PP, $150,000.

- Ex. 5: IP, $250,000; PP, $50,000.

The range for IPs is from $30,000 to $250,000; for PPs from $50,000 to $270,000 even though each variation meets the hypothetical 50-50 split. Please note that the numbers are "out of thin air." They can easily be manipulated (using the "sale" method) to illustrate situations where almost all the risk of loss, and little upside gain, accrues to investor participants. Now compare another variation as set forth in Example 6, below.

Ex. 6. Same facts as in example 5 but the $200,000 value on the management contract is categorized as patronage service. "Profit" is $300,000. Assuming the $400,000 patron participation contribution is not IP and, further, "agency" accounting: the PPs would receive 50% of the $300,000 profit which is $150,000.

However, both IPs as service PPs ($200,000 of "worker" product) would share the $150,000 equally on a patronage basis. So IPs (as PPs) would be allocated $75,000 and PPs would be allocated $75,000. The other $150,000 would be allocated to IPs as IPs. Thus IPs in their dual role would receive $225,000 and "producer" PPs would be allocated $75,000 (even though the "value" of the product on a "contract" basis is $200,000).

The first substantive question, therefore is whether these results are consistent with Committee intention and, if not, how flexible is flexible "enough"? The answer implicates related tax and secured lending issues if the act "forces" a "sale" arrangement.

Finally, under this example, how would one "fairly" value IPs' stand-by letter of credit? Could the IP claim additional economic compensation for the cost (including a risk component)?

Related Substantive Issue. The second, and related, issue raised by this discussion is whether it applies "in gross" (as is arguably the best interpretation of this draft) or whether the percentage floor applies only to patronage based income. A new inartful example may help delineate the issue:

> **Ex. 7**. XYZ Cooperative Association purchases 60 percent of its raw product from patron participants and 40 percent from other producers (who are not participants nor participating). Assume a market cost of goods purchased of $100, a "profit" of $50, and a 50-50 split between investor participants and patron participants.
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> The $50 of "profit" ratably allocated on product delivered means the cooperative association "makes" $30 from patronage based business and $20 from non patronage based business. The question is whether, for allocation purposes, profit may be defined to mean "profit from patronage based business only" ($30 profit meaning a 50-50 split of $15) or from "all profit" ($50 profit meaning a 50-50 split of $25). What flexibility could/should the cooperative association have concerning the allocation of the $20 non patronage based profit?

Income tax law has considered a related issue for Subchapter T qualification purposes. While the purposes of tax and state law are clearly different, the tax resolution is briefly described, for informational purposes herein, in another "Memorandum Regarding Cooperative Association Act" dated January 25, 2006: "Re: Issue Discussion: Status of a Cooperative Association under various other statutes." What if there was another $50 profit from the sale of one of the cooperative association's several product processing plants? How could/should the $50 asset-based (extraordinary) profit be allocated?

Tom Geu and Jim Dean