Shumaker, Loop & Kendrick, LLP

CO-OP NEWSLETTER

January, 2010

It is time for another Co-op Newsletter. The New York Times masthead motto is: *"All The News That's Fit To Print."* The Co-op Newsletter's motto is: *"Suitable For Framing Or Wrapping Fish."*

Some of the articles in this issue are not the specific practice tips that usually appear in the Co-op Newsletter. They are heavier and more theoretical. We hope you find value in them. You will also find content from two new contributors.

This issue includes:

1. A re-written version of a presentation to the National Cooperative Business Association (**NCBA**) Purchasing Cooperative Conference (September, 2009) on policy cues found in cooperative articles and bylaws. Page 1

2. A re-written version of a Subcommittee Report to the Legal Tax & Accounting (**LTA**) Committee of the National Council of Farmer Cooperatives (**NCFC**) on the nature of cooperatives and their Patronage Refunds and why this matters. Page 8

3. A discussion of situations in which a cooperative should consider whether using non-GAAP accounting would satisfy a **first principle** of stating its financial condition fairly and meaningfully. Page 12

4. Employment practice notes from a new contributor and member of the Shumaker **Cooperative Practice Group**. Page 17

5. Specific practice tips for a purchasing or marketing cooperative's compliance with the "Red Flags Rules" of the Federal Trade Commission. Page 18

1. Policy Cues In Your Articles And Bylaws.

You can describe the purpose and function of cooperative Articles and Bylaws several ways, but one way is to classify their function as:

Governance;
Allocation and Distribution of Net Margins;
and
Capitalization

Allocation and Distribution of Net Margins means how the Articles and Bylaws control tax treatment of the cooperative and the rights of Patrons to the cooperative's earnings.

Capitalization means the various financing options found in a cooperative's Articles and Bylaws. Some Articles and Bylaws are liberally studded with these features and others are quite barren.

The **governance** function occupies much of the text of cooperative Articles and Bylaws. Since cooperative Articles and Bylaws are Member-made policies and the first act of the Members for cooperative governance, the Articles and Bylaws should be where you find cues for Board and Management policy-making. By "cooperative governance" I mean the process by which Member control of the cooperative enterprise devolves to the Board, Management, and employees so that they can actually conduct (govern) the enterprise. The Articles and Bylaws should include broad delegation of authority and responsibility to progressively smaller groups of decision makers – for example, Members → Board → Management. This delegation should not be too specific. Policy made in the Articles and Bylaws cannot anticipate and make appropriate decisions for all the circumstances the Board and Management encounter in the enterprise. Most policy-making should be left to decision makers who are as close as possible to the circumstance. The decisions these people make often become policy.

It is worthwhile to examine your Articles and Bylaws for policy cues. Here are some illustrations:

**ARTICLES OF INCORPORATION
OF
____________________ COOPERATIVE, INC.
(the ASSOCIATION)**

**ARTICLE ______
PURPOSE; POWERS**

___ **PURPOSE.** The purpose of the Association is to associate Producers and others to provide them economic benefit through joint action in procuring supplies, services and equipment and in marketing products they produce. The primary purpose of the Association and the general nature of its business is ___________________________________. The Association may engage in any other lawful business or activity for which an association may be organized under the Ohio Cooperative Law (Ohio Revised Code Chapter 1729).

___ **POWERS.** The Association is a corporation organized as a cooperative association under the Ohio Cooperative Law. It has all powers and rights conferred on cooperative associations by the Ohio Cooperative Law. These powers include the power to form, acquire or hold an interest in any corporation or other entity and the power to enter into partnerships, joint ventures and other business relationships.

Policy Cues:

» Define scope of business. What is the cooperative's mission?
» Describe trade area.
» Identify enterprises and lines of business that the Association will <u>not</u> do. How do you know when the cooperative strays off message?
» What about subsidiaries and joint ventures? Who are appropriate business partners and affiliates?

ARTICLE ______
MEMBERSHIP

___ **MEMBER ELIGIBILITY.** The Association may admit as Members only eligible persons. To be eligible for Membership in the Association a person must:

A. [**Producer**]. Be a [producer or Cooperative] as defined in these Articles;
B. **Active Patron.** Agree to become and remain an active Patron of the Association;
C. **Acceptance.** Be accepted to Membership by the Board of Directors; and
D. **Membership Stock.** Make an initial capital contribution consisting of ____.

___ **FURTHER DEFINITION OF MEMBERS.** The Bylaws may further define and restrict Membership in the Association.

Policy Cue:

» Who is suitable for Membership? If your cooperative is a "farmer cooperative", there are important legal reasons to restrict Membership to farmers and other farmer cooperatives.
» How will the Board admit Members? How will Membership be terminated?
» What is the initial capital contribution to become a Member?

___ **VOTING.** The Members exercise all of the voting control of the Association. Each Member is entitled to **[one vote? or patronage-weighted voting? or combination?]** on any matter submitted to a vote of the Members.

A. Membership or ownership of capital stock or other equity interests in the Association does not otherwise confer upon the holder any voting rights in the Association;
B. Except that **affected stockholders** are entitled to notice and participation in matters to be decided by the Members only as provided in the Ohio Cooperative Law; and
C. Absentee Votes may be cast as provided in the Bylaws.

Policy Cues:

- » How will Members vote?
- » How and when do you use absentee voting?
- » "Affected stockholders" are non-Member shareholders. What corporate votes must or should include them?

ARTICLE ______
BOARD OF DIRECTORS

Government of the Association and the management of its affairs are vested in a Board of Directors.

Policy Cues:

- » This is the most important delegation of authority by the Members.
- » What authority is reserved to the Members?

ARTICLE ______
AMENDMENT OF ARTICLES OF INCORPORATION

Policy Cues:

- » When is amendment appropriate?
- » What information should accompany a proposal to amend the Articles?
- » Dependent on state corporation law.

BYLAWS
OF
______________________ COOPERATIVE, INC.

ARTICLE ______
DEFINITIONS

As used or referred to in these Bylaws, and in the Articles of Incorporation, the following terms have the meanings provided next to them:

[Examples]

___ **Absentee Vote** means the vote of a Member or an Affected Stockholder that is cast without the Member's or Affected Stockholder's physical presence at the meeting in which the vote is tallied.

___ **Affected Stockholder** means any equityholder of the Association who is not a Member and becomes an affected stockholder as described in the Ohio Cooperative

Law.

Policy Cues:

- » Consistent cooperative-style terminology in the Articles, Bylaws and other communications within and from the cooperative is important.
- » Are there other important terms that should be defined for better understanding of the Articles/Bylaws?

ARTICLE ______
MEMBERSHIP

___ **Admission to Membership.** Only an eligible person (as described in the Articles) accepted to Membership by the Board may become a Member of the Association upon agreement to comply with **uniform conditions of Membership prescribed by the Board.**

Policy Cue:

- » What are those "uniform conditions of Membership"?

___ **Termination of Membership.** The Board may terminate the Membership of a Member who becomes ineligible or who has intentionally or repeatedly violated any Bylaw or condition of Membership in the Association, breached any contract with the Association, or **obstructed or engaged in a material conflict with** any lawful purpose or activity of the Association. A person whose Membership is terminated has no voting right in the Association. Termination of Membership does not alter the obligations of the person whose Membership is terminated under any agreement between the Association and that person.

Policy Cues:

- » What is a "material conflict"?
- » Termination of Membership may disqualify a Director whose tenure depends on maintaining Membership in the cooperative.
- » How will the Board terminate Membership? What happens to the Member's equity account?
- » Should other marketing agreements with the Member require maintenance of Membership in good standing? Should Membership require good faith compliance with other agreements?

___ **Affected Stockholders.** Affected Stockholders are entitled to notice and participation in matters to be decided by the Members only as required under the Ohio Cooperative Law. If Affected Stockholders are provided the right to vote on a matter to be

decided by the Members, the Board may authorize an Absentee Vote for Affected Stockholders.

Policy Cues:

» This is a contentious issue in cooperative law. It is a counter-part to conventional "dissenter's rights" in other corporate statutes. How is it reconciled with Member control of the cooperative?

» The Ohio Cooperative Law presents the Board of the cooperative with a decision-making obligation when Affected Stockholder rights arise.

ARTICLE ______
BOARD OF DIRECTORS

___ **Elected Directors**.

A. **Number of Elected Directors.**

B. **Election of Directors.**

C. **Eligibility.** To be eligible for election as an Elected Director, a person must be and remain a Member of the Association. Any Elected Director who ceases to be a Member is disqualified and that Director position is vacant. An employee of the Association may not be an Elected Director.

D. **Term.** Each Elected Director is elected for a term of three (3) years and until a successor is elected and qualified. [**term limit**?]

E. **Nomination and Election of Elected Directors.**

F. **Vacancy.**

Policy Cues:

» Policy cues abound in the selection and election of Directors. Are there guidelines for recruiting Director candidates?

___ **Appointed Director.** The Elected Directors may appoint one (1) or two (2) additional Director(s) to the Board. An Appointed Director need not be a Member of the Association. The Board may remove an Appointed Director from the Board by a majority vote of the Elected Directors. An Appointed Director has the same status on the Board as the Elected Directors, including the right to vote as a Director.

Policy Cues:

» Not standard in cooperative governance. When, if ever, would an "outside" Director be appropriate?

» Dependent on state corporate law.

» Who does the Board engage as an Appointed Director? and how do they do it?

___ **Faithful Performance.** The Board must require that each person who has control or custody of material amounts of the Association's funds or property is insured for faithful performance. The cost of this is borne by the Association.

___ **Audits.** The Board must have the financial records and statements of the Association audited by an independent certified public accountant at least once each fiscal year. A report of this audit must be made at the next Annual Meeting of the Members.

Policy Cues:

» Regular review of the cooperative's risk management by the Board.
» Audit committee?

___ **Committees.** The Board may appoint an Executive Committee, Audit Committee, Patronage/Governance Committee, and other committees, and delegate authority and responsibility to these committee(s) as the Board determines. The decision or act of any committee may be amended or repealed by the Board in accordance with any condition imposed by the Board in its delegation or charge to the committee. Each committee must make timely report of their activities and recommendations to the Board.

Policy Cues:

» Should the Board do more work by committee?
» What committees? and what is their charge?
» May committees include persons other than Directors? other than Members?

ARTICLE______
OFFICERS

___ **Election of Officers.** The Board must elect officers of the Association at each organizational meeting. These officers must include a **Chair**, **Vice Chair**, **Secretary**, and **Treasurer**, and may include other officers as the Board considers necessary or desirable. The Chair and Vice Chair must be Directors of the Association. Officers serve at the pleasure of the Board and the Board may remove and replace any officer whenever the Board determines that the best interest of the Association is served by removal and replacement. If any vacancy occurs among the officers of the Association, it must be filled by the Board.

Policy Cues:

» Exactly what are the duties and authority of these and other officers?
» Should there be other officers?
» Board evaluation of officer performance?

___ **President.** The Board must appoint and employ a President who is the General Manager and **Chief Executive Officer** of the Association. The Board may terminate this employment at its discretion. The President must actively supervise the business of the Association; control the employment, compensation, supervision, discipline and discharge of the Association's employees; and perform other duties and have authority as the Board requires or delegates.

Policy Cues:

» Define the respective role of Board and Management and how they relate.
» Evaluation of Management performance.
» Extent of delegation of duty and authority to Management.

ARTICLE ______
AMENDMENT OF BYLAWS

Policy Cues:

» Some state statutes permit amendment of Bylaws by the Board. Is this a good idea?
» Information accompanying a proposed amendment?

Mark C. Stewart

2. The Nature of A Cooperative

Have you ever been asked to describe a cooperative? The readers of this Newsletter probably have a good idea of at least one practical and accurate application of the cooperative business model, but most people are not familiar with cooperatives. Some are attracted to the term "cooperative" and attach all sorts of idealistic but improbable attributes to it. Others are genuinely curious when they learn that you are associated with a cooperative. How do you respond?

Here is a revised version of my Subcommittee report to the NCFC-LTA Committee in which I attempt to explain why understanding the elusive nature of a cooperative is important. The Subcommittee's topic is "Calculating Patronage Dividends".

THE NATURE OF A PATRONAGE DIVIDEND

Why should we be interested in the nature of a patronage dividend? And what do we mean by "nature"?

This discussion will consider underlying economic and corporate law theory for patronage dividends. Economic theory and corporate law are important to an examination of patronage dividends because they determine why and how a cooperative calculates its patronage dividends, and how this is (or should be) described in the patronage contract found in either the cooperative's bylaws or in a separate written patronage agreement. While Subchapter T of the Code has become a dominant force in defining what it means to do business **on a cooperative basis**, the current tax law applicable to cooperatives and their patronage dividends is derived from economic and corporate law theories of what it means to allocate and distribute the fruits of a commercial enterprise **on a cooperative basis**.

It is said that a cooperative is not a pass-through entity (as that term is understood by tax practitioners) and this is true. There are many things that a cooperative is not. For example, a cooperative is, in some important respects, not really a nonprofit corporation, and yet we often find it helpful to consider a cooperative as **nonprofit**. Many state cooperative statutes specifically designate cooperatives as **nonprofit** for certain applications of corporate, tax, and regulatory law. This is because cooperatives have attributes of nonprofit entities (principally, governance and subordination of capital interests) that for certain corporate and tax law purposes, justify lumping them with other nonprofit entities.

To say that a cooperative is <u>not</u> a pass-through entity, or even that it <u>is</u> a nonprofit corporation does not help us describe a cooperative's patronage dividends. Because Subchapter T of the Code and many features of cooperatives are different from anything else in corporate and tax law, we are left with the need to describe these features as being <u>like</u> more familiar items. This can be helpful in describing how cooperatives work. For example:

- Cooperatives pass certain profits, losses and tax credits through to their Patrons as patronage dividends – but not at all in the same manner or for the same reason as partnership-style entities (Subchapter S corporations, LLC's, LLP's, etc.);

- Allocation and distribution of a patronage dividend is like a price or cost adjustment with respect to a Patron's patronage transactions, but it is not a price discount or rebate;

- The cooperative is a conduit for Patron-earned profits that are distributed to the Patrons in the form of patronage dividends;

- The cooperative is an agent acting on behalf of the Patrons with respect to patronage dividends; or

- The cooperative allocates and distributes its profits as patronage dividends to its Patrons, just as other corporations distribute their profits as dividends to their shareholders.

All of these are descriptions of what happens when patronage dividends are distributed to Patrons, but no one of them fully describes what patronage dividends are from the standpoint of corporate or tax law or under relevant economic theory. It is the unique nature and purpose of the cooperative business model that gives substance to a description of patronage dividends. This is why cooperative taxation and accounting are derived from the corporate law and economic theories of the cooperative business model.

Through much of the last century the battle lines for describing the true nature of a patronage dividend were drawn over economic and corporate law theory. Cooperatives maintained that their Patrons are the real actors in the cooperative enterprise and that the cooperative is a facilitator in the collective economic and property interests of the Patrons. This resulted in a federal income tax policy that the cooperative is not a taxpayer with respect to its **net margins** to the extent those net margins are allocated to the Patrons as patronage dividends. The opposing position – most strenuously voiced by the National Tax Equality Association – is that Patronage dividends are:

- Merely a distribution of the cooperative's profits;
- No different than the dividends that other corporations distribute to their shareholders; and
- Should be taxed at the corporate level the same as other corporate dividends.

In short, opponents of the prevailing tax treatment of cooperative patronage dividends insisted that there is nothing distinctive about cooperatives in corporate law or economics that justifies different treatment (tax or otherwise) of patronage dividends. A prominent example of the competing theories are the opposing positions of the pre-Subchapter T cooperative community and the National Tax Equality Association laid out in an article by Albert W. Adcock, General Counsel for the National Tax Equality Association in 1948[1].

Adoption of Subchapter T of the Code (which became effective in 1963) eventually took the wind out of the sails of the National Tax Equality Association, but it did not precisely settle the nature of a patronage dividend. Subchapter T begins with:

> "**(b) Patronage Dividends and Per unit Retain Allocations**. – In determining the taxable income of an organization to which this part [Subchapter T] applies, there shall not be taken into account amounts paid during the payment period for the taxable year – (1) as patronage dividends

[1] "Patronage Dividends: Income Distribution Or Price Adjustment" 13 Law & Contemporary Problems 505 (1948).

(as defined in section 1388(a)) ****"[2]

This suggests that the cooperative principles of "operations at cost" and cooperative as a "conduit" or "agent" are in play; that cooperative net margins belong to the patrons in the first instance and are not corporate profits of the cooperative as such. But, Subchapter T concludes with a definition of "patronage dividend"[3]. Of course "dividend" is a well recognized corporate law concept for the distribution of corporate profits.

NCFC has occasionally invited IRS officials to address cooperative tax theory at NCFC-LTA Committee Annual Meetings. On at least one occasion in the 1980's, the LTA Committee heard a Service analysis of patronage dividends in terms of the cooperative as "agent" and a "conduit" for the Patrons. And yet, it is well settled that IRS pronouncements and tax forms treat patronage dividends as deductions from the cooperative's adjusted gross income, not exclusions from gross receipts as stated in Subchapter T.

So, why does any of this matter? It may not matter for federal income tax reporting by the cooperative. But it does matter for drafting corporate documents such as bylaws and patron contracts. The distinction between a "conduit" or "agency" theory of patronage dividends and a "distribution of corporate profits" theory (a true corporate dividend) has come into focus for:

- Employee cooperatives currently being audited with respect to alleged employer liability for withholding and FICA contributions on patronage dividends allocated and distributed to employee patrons; and

- Patronage dividend as a "rebate" in cooperative insurance arrangements.

A PROBLEM OF PATRONAGE DIVIDENDS CHARACTERIZED AS REBATES

From time to time it is advantageous for a cooperative to advocate one or another of apparently opposing theories of patronage dividend characterization. Recently, it was necessary to assert that a cooperative who acquired an interest in a crop insurance agency could allocate and distribute net margins from this enterprise as patronage dividends to Patrons of the enterprise without violating state anti-rebate statutes. Competitors claimed that these patronage dividends were illegal rebates under applicable state insurance law. The cooperative argued that a patronage dividend is a distribution of its corporate net profit and that a rebate is something else entirely.

There is a thorough analysis of the distinction between a patronage dividend and a rebate in a 2007 Tax Court decision, Affiliated Foods, Inc. v. Commissioner[4]. If Mr. Adcock of the National Tax Equality Association were alive today, he would probably applaud the decision and its reasoning because it comes down on the side of patronage dividends as a

---

[2] 26 USC §1382(b).
[3] 26 USC §1388(a).
[4] 128 T.C. 62 (March 29, 2007).

distribution of the cooperative's net profit.

This analysis makes perfect sense when comparing patronage dividends to rebates in a commercial transaction, but is this the only answer as to the nature of a patronage dividend and the cooperative that allocates and distributes the patronage dividend? Referring back to the beginning of this discussion, we analyze and describe cooperatives and what they do – calculate, allocate, and distribute patronage dividends – using familiar terms borrowed from other entities and their income distributions. In various respects, patronage dividends are like something else that the observer, unfamiliar with cooperatives, can understand. One can learn something of the nature of cooperatives and their patronage dividends by reading Subchapter T, state cooperative statutes, and a cooperative's articles of incorporation and bylaws, but these alone do not describe why patronage dividends and the cooperative that allocates them are so distinctive under corporate and tax law. The nature of patronage dividends is elusive. Those who defend the distinctive treatment of patronage dividends (and cooperatives) in various contexts must be prepared to argue one or another theory of their nature depending on the context.

Mark C. Stewart

3. Can GAAP Obstruct Fairness And Meaningfulness Of Cooperative Financial Statements?

Let's begin by saying that Shumaker is not an accounting firm. We do not practice accountancy, nor do we claim professional competency in matters of the creation and auditing of financial records. But there are important legal implications in the presentation of financial statements. Recall the furry of litigation and legislative action that followed the fiascos of Enron, Tyco, WorldCom and others, and again upon the failure of a major part of the financial industry a year ago.

An essay in the November, 2009 issue of The Business Lawyer[5], a quarterly journal of the Section of Business Law, American Bar Association, raises an issue about how merely confirming that the financial statements are consistent with GAAP can conflict with the quality of audit and financial statement presentation. In the essay, the auditor argues:

- That Management, Board, and auditors must be persuaded to accept responsibility for higher quality accounting;

- That financial statements and audit opinions that are considered acceptable only because they conform to GAAP may not accomplish this goal; and

- "The answer lies in going back to the historic first principle of auditing, which was to provide reasonable assurance [to owners and creditors] of the fairness and meaningfulness of the financial statements of the enterprise***."

[5] "Caveat Auditor: Back to First Principals" by David R. Herwitz. Business Lawyer, Vol. 65, No. 1, pages 95-106.

The author summarizes the point and his suggestion for response:

- The auditor should express its "present fairly" opinion (in the audit opinion) without any limitation based upon GAAP; and

- Whenever there are reasonable alternatives to any of the accounting treatments used in the financial statements, the auditor's report should disclose the reason for the choice made, as well as whether the auditor would have made the same choice.

This is strong stuff, but it touches on some of the financial accounting dilemmas that cooperatives face as they reconcile accounting principles derived from the experience and context of investor oriented companies (especially publicly-traded companies) with the peculiar ownership and accountability of the cooperative business model.

There are instances when Management and auditors of a cooperative wonder whether accounting decisions that strictly conform to GAAP are fair and meaningful to the cooperative's Members and creditors. Here are two that come to mind.

In the February, 2009 Co-op Newsletter, I argued that strict application of GAAP, specifically SFAS 141 R, to cooperative mergers and consolidations as they are commonly structured in this region cannot result in a fair or meaningful financial statement for the resulting entity. I cited 6 reasons for my conclusion. After that issue of the Co-op Newsletter, the final version of SFAS 164 – Accounting For Mergers and Acquisitions By Not-For-Profit Entities -emerged. SFAS 164 requires "carryover" accounting for mergers of not-for-profit entities (i.e., similar to the traditional way cooperatives have accounted for mergers), citing exactly the same reasons.

SFAS 164 describes "a merger of not-for-profit entities" and a "not-for-profit entity" in terms that match many cooperatives and their merger transactions in every material detail. Even so, the definition of "not-for-profit entity" in SFAS 164[6] specifically excludes mutual insurance companies, credit unions, <u>farm</u> and <u>rural electric cooperatives</u>, and employee benefit plans. One wonders whether purchasing, housing, food, and employee cooperatives are similarly excluded, since they are not mentioned.

Application of SFAS 141 R to certain cooperative mergers is one instance in which strict adherence to GAAP may produce a dysfunctional result in terms of the "first principle" of financial statement presentation – presenting financial statements that fairly and meaningfully describe the condition of the enterprise.

A second instance of possible conflict between GAAP and appropriate cooperative accounting principles is the matter of a cooperative's gross receipts and how those are parlayed into amounts allocable and distributable to the cooperative's Patrons as Patronage Refunds. In some cases, amounts that the cooperative includes in its calculation of Net Margins under GAAP are doubtful of realization or just too weird to be allocated to Patrons. A case for non-GAAP accounting can be made in this case. Dan Schultz, the Vice Chair of the NCFC-LTA subcommittee mentioned in

---

[6] SFAS 164, section 3(u).

2. above, addressed this issue in the second part of the Subcommittee's Report. The author is an experienced and very competent cooperative financial officer and tax advisor, now in private practice. His part of the Report follows.

2009 Practice Notes on Computing Patronage Dividends

Patronage dividend basics

Agricultural cooperatives are formed to create value for their farmer-patrons by creating economies of scale through horizontal and vertical integration into the markets for their production inputs and outputs. The patronage dividend system is the contractual device unique to cooperatives for measuring value created in terms of annual net earnings, and distributing it to patrons in proportion to their participation. For patrons of a marketing cooperative, the patronage dividend is considered additional sales proceeds; for patrons of a purchasing cooperative it's considered a reduction in the cost of inputs. Consistent with their economic effect, patronage dividends are considered deferred and corrective price adjustments. Farmers join marketing and purchasing cooperatives to gain the economic benefit of patronage dividends, so patrons must be satisfied that their patronage dividends represent an accurate measure of each year's **economic income**. Cooperative principles are the framework for the legal relationships necessary to bind a group of unrelated farmers together to operate on a cooperative basis and were established long before our federal income tax system was enacted.

Consistent with general income tax principles, Subchapter T was designed to apply the corporate income tax law to the economic reality of a cooperative. Accordingly, cooperative operating principles were adopted by Congress as the framework for the tax principles governing patronage dividends at both the cooperative and patron levels. Specifically, Congress based the definition and taxation of a patronage dividend on its economic reality as a contractual price adjustment determined with reference to annual net earnings from business done with or for patrons.[7]

Historically, cooperatives have either used GAAP or tax accounting principles to compute patronage dividends because each offers a widely-used, objective set of rules for computing net earnings. However, both GAAP and tax accounting principles were developed to serve broad investor and government policy objectives that often come in conflict with reaching an accurate measure of a cooperative's economic performance on behalf of its patrons for a given year. Thus, cooperatives have always been in the position of striking a balance between the objective results of GAAP or tax accounting and the need to justify to their patrons (and to the various constituencies within the patron group) that each year's patronage dividend is a reasonable and fair measure of their **economic income**, and that an item of income or expense is not being shifted to patrons of past or future years due to an arbitrary policy-driven accounting adjustment that distorts the final price they receive for their crops or the amount they pay for their inputs.

---

[7] S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 822 ("patronage dividends represent price adjustments"); H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 485-486 (similar).

What problems do cooperatives face today when computing patronage dividends?

GAAP accounting and tax accounting rules are continually being revised in significant ways to serve evolving national and, increasingly, international policy objectives. This makes it increasingly difficult for cooperatives to reconcile their annual GAAP or tax net earnings to a reasonable measure of **economic income**. Where patronage dividend bylaws provide that net earnings are equal to current year GAAP earnings (book basis) or taxable income (tax basis), a significant **policy risk** is created that the patronage dividend may vary materially from what the cooperative and its patrons believe is true **economic income**. For example, the **policy risk** to a patronage program based on taxable income is subject to tax policies that create major tax deductions like bonus depreciation or the section 199 deduction; the policy risks to GAAP basis patronage programs include changes in acceptable financial accounting principles requiring direct charges or credits to equity rather than to current net income, or dramatic changes to the timing of income or expense items that happen to be significant in the cooperative's business. As a result, many cooperatives, especially the larger and more complex businesses, are either considering or have already amended their patronage dividend bylaw to adjust the formula for computing patronage net earnings to provide an alternative accounting treatment for specified items where the GAAP or tax method could otherwise materially distort their patronage dividend and compromise their ability to make good on the cooperative's obligation to return a realistic patronage dividend to its patrons.

Here are a few examples of adjustments cooperatives have made to their patronage dividend bylaw to better match the GAAP or tax accounting computations to the economic reality of their business:

A. A book basis cooperative amended its bylaws and now determines overall net earnings in accordance with GAAP with exceptions for alternative non-GAAP accounting treatment for its hedging operations and certain rebates. The bylaws also provide authority and criteria for other exceptions to GAAP if:

1. GAAP accounting for a particular item will not reflect the year in which the item should be recognized for patronage accounting purposes as accurately as an alternative method of accounting would;

2. The effect of using GAAP for the item over a period of years on the sharing of patronage dividends is expected to be material; and

3. Using the alternative method results in a more fair and equitable patronage accounting system.

B. A cooperative's patronage bylaw contract provided for a patronage dividend based on taxable income. As the distortion caused by its non-cash section 199 deduction grew in significance, the cooperative amended its patronage bylaw to provide that the section 199 deduction would no longer be taken into account in arriving at tax basis patronage net earnings.

C. A book basis cooperative eliminated the distortion caused by an extraordinary GAAP deduction for merger costs by amortizing the costs into patronage net earnings over a term of future years.

Clearly, providing alternative accounting treatment for selected items as exceptions from GAAP or tax basis patronage accounting is not a step cooperatives are willing take without careful consideration. The objectivity gained by conforming completely to the cooperative's financial statement GAAP or its tax return accounting in computing patronage dividends unfortunately carries with it the risk of significant distortions if FASB financial accounting or U.S. federal tax policies create income or expense amounts or timing differences that conflict with fair and meaningful patronage dividend accounting, i.e., **policy risk**. Reducing **policy risk** by authorizing alternative accounting treatment for selected items in order to preserve the integrity of a cooperative's patronage dividend system is consistent with cooperative operating principles and with the Subchapter T rules based on cooperative principles.[8]

Taking another look at amending bylaws to avoid the dividend allocation rule.

The American Jobs Creation Act of 2004 included an amendment to section 1388(a)(3) allowing cooperatives to amend their bylaws or other contract with patrons to provide that dividends on capital stock or equity capital will not reduce patronage net earnings for purposes of computing deductible patronage dividends. Specifically –

> "…net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year."

Without the required bylaw provision, ordinary dividends paid during the year are allocated and charged against patronage and nonpatronage earnings, thus reducing the pool of patronage net earnings available to distribute as deductible patronage dividends. This allocation is known as the "dividend allocation rule".

Our anecdotal observation is that many cooperatives have not amended their bylaws to take advantage of this 2004 relief provision, probably because a large number of cooperatives aren't authorized or don't intend to pay dividends on capital. However, the downside of making this amendment is probably negligible, and it may have a welcome value for tax planning in the future even if no ordinary dividends are contemplated.

---

[8] It shouldn't be forgotten that Congress struggled with its own version of tax **policy risk** in the form of tax incentives that distorted (and often eliminated) taxable income, until it passed the alternative minimum tax as an attempt to define and tax **economic income**. If nothing else, this experience should help the IRS understand why cooperatives and patrons would also prefer to compute patronage dividends in terms of **economic income**.

One situation that could arise is where patronage dividends paid in the form of qualified written notices of allocation are deducted but turn out to be defective for some reason and the deduction is later disallowed. The patrons holding these notices after paying tax on them still expect the cooperative to redeem them at some point, and if it does, the distribution might be considered an ordinary dividend in the year of distribution. If the dividend allocation rule is applied to this distribution because the bylaw was not amended, it would be allocated between patronage and nonpatronage income. The amount allocated to patronage income would then reduce the deductible patronage dividend pool for the year of distribution.

Another risk of not amending the bylaw is that circumstances often change, and cooperatives with no current plans to pay dividends may change their plans, or they may adopt a strategy to use expiring patronage losses by substituting ordinary dividends, taxable to patrons at lower rates, for patronage dividends.[9]

Finally, it is very likely that a number of cooperatives that do pay significant dividends just aren't aware of this fairly recent change in the law and need to be made aware of it. Cooperative tax advisors should consider revisiting this law change with their clients to make sure they're fully informed.

Daniel R. Schultz, CPA
Cooperative Consulting LLC
1710 Carriage Path
Minneapolis, MN 55422
Telephone: 763.360.7160
E-Mail: danschultz@co-optax.com

4. Employment Law Update

COBRA Subsidy Extension.

Congress recently extended the COBRA subsidy beyond the December 31, 2009 deadline that was included in the original law. Under the original law, employees who were involuntarily terminated from employment between September 1, 2008 and December 31, 2009, and eligible for COBRA, were eligible to receive a nine-month subsidy for their COBRA premium (to continue group health insurance). Under this program, the employer paid 65% of the employee's COBRA premium, which it could then take as a credit against quarterly tax payments. The subsidy was originally available for a maximum of nine months for a terminated or laid-off employee.

The new law increases the maximum subsidy period from 9 months to 15 months. Additionally, employees involuntarily terminated between December 31, 2009 and February 28, 2010 are now also eligible for the subsidy.

Individuals who exhausted their subsidy before the new law passed now have up to 60 days (or until February 20, 2010) to make 35% premium payments (after the 65% subsidy

[9] This is complex planning and involves tax and nontax considerations beyond the scope of this Note.

reduction) in order to restore coverage on a retroactive basis. Any employee who continued COBRA coverage on an unsubsidized basis after expiration of the nine-month subsidy period must be reimbursed for 65% of the unsubsidized premium paid after expiration of that period.

As part of the new law, the Department of Labor adopted various notification requirements for employers. The new employer notification requirements are for employees who become newly eligible for the COBRA subsidy, those who paid unsubsidized COBRA premiums, and those who are eligible to continue their subsidy under the new law. Delay in providing notice to eligible employees may extend the time period for retroactive restoration of subsidized coverage. On January 19, 2010, the Department of Labor published model notification forms, which are located at http://www.dol.gov/ebsa/COBRAmodelnotice.html.

For any employer who had layoffs in the fall of 2008 or early 2009, the new law and new notification requirements will result in a significant amount of paperwork for certain laid off or terminated employees. Additional information regarding the notification requirements may be obtained from the Department of Labor's website, or by contacting us.

Other Employment Law Developments.

Because Congress' attention over the past year was devoted first to the economic relief package, and then to health care legislation, there has not yet been much in the way of new employment or labor law legislation under the Obama Administration. You have probably heard about the effort last spring to pass the Employee Free Choice Act (EFCA), which would make it easier for employees to unionize. That attempt failed, and it is not likely to resurface until sometime after the 2010 elections. Additionally, Congress is considering legislation that would require paid sick days for employers who do not now provide this benefit. This also is likely to be delayed for some time given Congress' current preoccupation with other matters.

In the past year, there have been expansions of both the Family Medical Leave Act and the Americans with Disabilities Act. If you have not updated your FMLA policy, now is the time to do it. Additionally, because of the expansion of ADA coverage, employers should be even more sensitive to employee requests for accommodation (or potential accommodation situations even when an employee has not made a specific request). Direct any questions about either of these matters to Mark or Greg.

Gregory T. Lodge

5. Practice Tips For Red Flags Rule Compliance

By now you may have seen numerous alerts and offers to help you on compliance with the Federal Trade Commission's **Red Flags Rule** from lawyers, accountants, and various consultants.

The U.S. Federal Trade Commission intends to impose a requirement on all businesses who extend or handle credit to adopt an "Identity Theft Program". The original effective date for this was January 1, 2008, but the effective date has been deferred several times and continues to move into the future at about the same rate we all do. The current effective date is June 1, 2010.

Your business is probably required to adopt an Identity Theft Program. If yours is a typical commercial cooperative, you are probably at "low risk for identity theft" and, therefore, may only be required to have a very simple program consisting of a written policy and a few procedures to assure yourself against credit fraud and identity theft.

The FTC has published online a thorough and easy to read explanation, guidebook and even a fill-in-the-blanks template for writing your own policy. Check out www.ftc.gov/redflagsrule. You probably do not need our help with this, but call us if you do.

Greg Lodge Is On The Co-op Team

Finally, many of you have met Greg Lodge personally or have spoken with him on the phone. Greg is an experienced labor and employment law attorney and a partner in Shumaker, Loop & Kendrick, LLP. He has worked with several Shumaker cooperative clients on a wide variety of workplace employment and safety issues. Greg has good knowledge of the law and a natural affinity for the sort of corporate cooperative work we do. He has agreed to devote more of his time and attention to our cooperative practice, and he is currently doing in-depth reading and research to develop a deeper understanding of the cooperative business model and related corporate and tax law. You don't learn this stuff by osmosis.

We think Greg's practice experience, knowledge of the law, intellect, and devotion to client service will take our cooperative practice to a higher level of performance for the cooperative community.

Mark C. Stewart
Shumaker, Loop & Kendrick, LLP
1000 Jackson Street
Toledo, Ohio 43604
Direct Dial: 419.321.1456
Toll Free: 800.444.6659
E-Mail: mstewart@slk-law.com

Gregory T. Lodge
Shumaker, Loop & Kendrick, LLP
1000 Jackson Street
Toledo, Ohio 43604
Direct Dial: 419-321-1318
Toll Free: 800.444.6659
E-Mail: glodge@slk-law.com

MCS:baf