AGRICULTURAL ECONOMICS

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Cornhusker Economics

Using Unallocated Retained Earnings to Finance Agricultural Cooperatives

Market Report	Year Ago	4 Wks Ago	
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	110.00	*	*
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	152.80	160.70	177.83
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	141.68	158.25	160.86
Choice Boxed Beef, 600-750 lb. Carcass.	186.48	197.06	191.03
Western Corn Belt Base Hog Price Carcass, Negotiated	54.03	71.62	52.30
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	80.04	91.07	78.52
Slaughter Lambs, wooled and shorn, 135-165 lb. National.	160.13	175.55	168.50
National Carcass Lamb Cutout FOB.	355.69	416.66	403.44
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	2.74	3.03	3.22
Corn, No. 2, Yellow **Columbus**, bu.	2.89	3.22	3.09
Soybeans, No. 1, Yellow **Columbus,** bu.	9.11	8.49	8.84
Grain Sorghum, No.2, Yellow Dorchester, cwt.	4.50	5.38	5.21
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.26	2.89	2.83
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	145.00	*	*
Alfalfa, Large Rounds, Good Platte Valley, ton.	65.00	82.50	87.50
Grass Hay, Large Rounds, Good Nebraska, ton.	70.00	85.00	87.50
Dried Distillers Grains, 10% Moisture Nebraska Average.	120.50	107.00	115.00
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	34.25	39.00	40.00

* **No Market**

Historically, U.S. agricultural cooperatives have relied primarily on retained patronage refunds for accumulating equity capital. Typically, a cooperative returns its net earnings to members as a combination of cash and noncash patronage refund allocations. Members maintain ownership of the noncash allocations, which provide equity until the cooperative eventually redeems them in cash when they are replaced by future allocations.

Over time, however, retained earnings have become an increasingly important source of equity capital for cooperatives. Retained earnings consist of net income that a cooperative does not allocate or distribute to members. The equity obtained from retained earnings is not allocated to individual members, and generally there is no expectation that it will be distributed to members except upon dissolution of the cooperative.

In 2008, cooperatives kept 31.2 percent of their net income as retained earnings, more than eight times as much as in 1962. In fact, cooperatives retained a greater proportion of their net income as retained earnings than as noncash patronage refund allocations. That same year, 32.1 percent of cooperative equity was held as unallocated retained earnings, almost three times as much as in 1962. By 2015, both marketing and farm supply cooperatives held about 40 percent of their equity in unallocated form. Cooperatives marketing grains

and oilseeds, livestock, poultry, and rice all held over 50 percent of their equity in unallocated form.

Several factors have contributed to the growing use of retained earnings. Some of the increase has been attributed a rise in nonpatronage and nonmember business, particularly in local grain and farm supply cooperatives. Many of those cooperatives are unable to satisfy the requirements for section 521 federal income tax status because of the business they conduct with nonmembers and nonproducers. Consequently, they may find it advantageous to keep nonpatronage income as retained earnings because it cannot be distributed as patronage refunds excludable from taxable income. Other cooperatives maintain unallocated reserve accounts consisting of retained earnings against which operating losses can be charged in an effort to avoid writing them off against individual patron equity accounts.

Marketing cooperatives have increased their retention of unallocated earnings in response to the American Jobs Creation Act of 2004, which allows businesses to deduct a proportion of qualified production activities income (QPAI) from taxable income. QPAI is broadly defined to include most taxable income from manufacturing, producing, growing, and extracting goods. It can include income from storing and handling, but not transporting, agricultural products. Since 2010, a business has been allowed to deduct up to 9 percent of its QPAI. Cooperatives can choose to use this deduction to offset taxable income on retained earnings or nonqualified patronage refund allocations or pass all or part of the deduction to patrons for their use.

Some accountants have urged cooperatives to replace revolving funds consisting of noncash patronage refunds with permanent unallocated equity from retained earnings because of the financial advantages the latter may offer. Many cooperatives have been reluctant to pursue that strategy because, based on a 1979 Internal Revenue Service memorandum, they have operated under the presumption that they must allocate all or substantially all of their patronage income as patronage refunds. In recent years, however, cooperatives have increased the accumulation of retained earnings from patronage income as that notion has been challenged to a greater extent.

A recent University of Nebraska–Lincoln Department of Agricultural Economics study evaluated the advantages equity capitalization plans based on retained earnings may provide cooperatives by comparing the after-tax present value of the cash flows members receive under such a plan to that of a plan based on noncash patronage refunds.[1] The study found that the cooperatives that are most likely to benefit from obtaining equity from retained earnings are those characterized by low marginal tax and growth rates and whose members are characterized by high marginal tax and discount rates. The study also found that the plans that provide the greatest present values are based entirely on either retained earnings or noncash patronage refunds rather than a combination of the two. An analysis focused on the tax deductions created by the American Jobs Creation Act concluded that those deductions were more valuable when applied at the patron level than when used at the cooperative level to offset taxable income on retained earnings.

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[1] Jeffrey S. Royer, "Financing Agricultural Cooperatives with Retained Earnings," *Agricultural Finance Review* 77, 3 (2017): 393–411. Download available at *http://www.emeraldinsight.com/doi/full/10.1108/AFR-06-2016-0060.*

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