



Current Report

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Impact of a Stock Write Down on Cooperative Members

Phil Kenkel
Professor, Fitzwater Chair

Bill Fitzwater
Endowed Cooperatives Chair

In the wake of the Farmland bankruptcy, Oklahoma agricultural cooperatives were forced to write-off the value of their farmland stock from their balance sheets. This generated a non-operating loss on local cooperative income statements. Some local cooperatives also experienced an operating loss due to low crop volumes and a difficult operating environment. In response to these losses, several Oklahoma cooperatives have announced a write-down of member stock. Other terms for this event include: "a reduction of stock value" and "cancellation of member equities." This fact sheet describes the rationale and mechanics of a cooperative stock write-down and how cooperative losses and stock write-downs affect cooperative members. These impact include stock value, timing of equity redemption, and tax impacts.

Cooperative Equity

Cooperatives generate profits (termed: net savings) through business with member/patrons and business with non-members. These profits are distributed to members in the form of cash and stock patronage allocations. Both the stock and cash portion are taxable income to the member in the year that they are issued. Cooperative stock is eventually redeemed for cash.

Local cooperatives also receive patronage refunds from regional cooperatives. These refunds are paid in both stock and cash. They represent the local cooperatives pro-rata share of the regional cooperative's profits. A local cooperative's net savings are distributed to members in the form of cash and stock patronage dividends. Over time regional cooperatives redeem their stock for cash. These cash redemptions help the local cooperative fund the redemption of their members' stock.

Methods of Handling Losses

A regional stock write-down and associated loss destroys equity on the local cooperative's balance sheet. There are several methods for passing this loss through the cooperative:

- Reduce Unallocated Reserves
- Carry Loss Forward
- Cancellation of Member Stock

The two most common systems are the cancellation of member stock and reduction of unallocated reserves.

This decline in equity may be covered by a reduction in the value of "unallocated reserves." Large losses often force a cooperative to reduce the value of their stock.

Reduction of Unallocated Reserves

This method involves reducing the value of "unallocated reserves" on the cooperative balance sheet. Unallocated reserves represent equity that is not attributed to any particular members. The unallocated reserves account is the cooperative's financial emergency cushion. It is similar to "Retained Earnings" shown on corporate balance sheets. Reducing unallocated reserves is not an option for all cooperatives. The amount of unallocated reserves must obviously exceed the value of the loss.

Reducing unallocated reserves does not reduce the face value of member stock. The timing of redemption may be impacted. The loss of value in the regional stock will reduce future patronage redemptions from the regional cooperative. This reduces the funds that the local cooperative will have to redeem its stock. Reducing unallocated reserves also reduces the cooperative's ability to absorb future losses or meet other financial needs. Reducing unallocated reserves does not generate any tax impact for the cooperative member.

Loss Carry Forward

Some cooperatives with sufficient reserves may elect to permanently reduce unallocated reserves. Other cooperatives may temporarily reduce unallocated reserves while they carry the loss forward. Under this scenario, the cooperative offsets future profits against the loss instead of making cash or stock distributions. The funds are used to rebuild the level of unallocated reserves.

Cancellation of Member Stock

Cancellation involves reducing the value of member equity in the amount of the loss. The allocation of the cancellation to individual members may be based on the percentage of business done in a certain time period (called a look-back

period), by canceling a percentage of all equities held by that member or any other method that is fair and equitable. Most cooperatives use the percentage of all equities method because of its simplicity.

Canceling member equities reduces the value of an individual member's stock. However the timing of future equity redemptions should not be impacted.

Tax Implications

When members receive stock allocations from their local cooperative called a "qualified allocation" the value of the stock is included in their taxable income in the year received. When a cooperative writes down stock, the member is entitled to show the reduction as an ordinary loss in the year that the member receives a written notice of equity cancellation. This loss is shown on the Schedule F tax return as an operating loss. It does not have to be treated as a passive loss. Like other operating losses the loss from the cooperative stock write-down can be carried back for up to 5 years and carried forward for up to 20 years.

Cooperative members receiving notice of cancellation of equities should consult their tax advisor. They should refer their advisor to IRS Revenue Rulings 70-64 and 70-407. The principle point in these rulings is that a patron of a

farm cooperative is entitled to ordinary loss for federal income tax purposes upon the cancellation of his/her cooperative equities.

What Does This Mean for Members?

Losses due to the reduction of the value of regional cooperative stock are difficult for both the local cooperative and the members. Writing down the value of member stock is often the most financially responsible option for the local cooperative. The stock write-down preserves the financial cushion account for the cooperative and should allow the cooperative to maintain the timing of equity redemptions.

A member who receives written notice that the value of their cooperative stock has been reduced can generally treat the loss as an ordinary loss on their Schedule F tax return. Producers who have received a notice of cooperative stock write-down should discuss the implications with their accountant or tax specialist.

For more Information on Cooperative Equity

Contact Phil Kenkel by e-mail at kenkel@okstate.edu or by phone at 405-744-9818.

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