

Inside A Farmers' Cooperative: How the Alpaca Fiber Cooperative of North America, Inc. Works

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Twenty-six years ago my wife and I decided to buy some acreage and build a house. We were not sure how many rooms or stories we wanted. Do we wish a basement and if so should it be finished? Should the kitchen be eat-in or not? What should the room layout be? And, are there to be porches?

It was a challenge. There was an endless list of possible sizes, layouts, styles and features. Wishing a pleasing, comfortable shelter for our family and possessions was the only certainty we had. We then realized that our preferences and needs must be understood before we could select size, layout, style and features. This selection process was easy once we knew what desired house function they must serve. A blue print drawing design of our custom house structure was then prepared from this component selection.

While houses have both function and structure, selection of structural parts is more effective if the function of the desired house is first understood. If houses were only clear span 60 feet long, 40 feet wide and 10 feet high boxes, it would not matter if you choose the structure before defining a particular function.

Farmers' cooperatives are like houses. They have function and structure. They are also like houses in that as structure options increase so does the need to first understand function before selecting a structure. Both are not one size fits all clear span 60' x 40' x 10' boxes.

Accordingly, understanding what the Alpaca Fiber Cooperative of North America, Inc. ("AFCNA") is and how it works must start with exploring the cooperative function. As with houses, this gives a framework within which cooperative parts are selected then custom assembled into AFCNA.

Before discussing function, it is important to know how AFCNA began life. Farmers' cooperatives are incorporated under state statutes specifically providing for the cooperative business model. Members who are farmers own them. AFCNA was incorporated under the laws of the state of Colorado. Colorado laws are particularly favorable to farmers' cooperatives.

The farmers' cooperative function has three parts. The first part is service at cost. The cooperative business model serves its members by doing something for them that is more effectively done collectively than individually. For example, it is more cost effective for 100 cranberry farmers to collectively buy a cranberry juicing machine that can squeeze 50,000 barrels of cranberries than each of the 100 farmers buying their own machine and individually squeezing their 500 barrels of cranberries. The farmers' cooperative, Ocean Spray Cranberries, Inc., does this collective juicing for its member cranberry farmers.

The "at cost" part of "service at cost" is really a non-profit goal. Making a profit is not a cooperative goal. Profits go to the members. When a cranberry farmer's cranberries are juiced more inexpensively by Ocean Spray, he is the one that makes more money, not Ocean Spray. Since Ocean Spray only serves its members, it can sell its service "at cost" and not at a profit making market price.

Since it is hard for any business to project overhead and operating capital reserve expenses, cooperatives set prices for members that are expected to cover expenses plus a safety margin. Generally, they end up with income in excess of expenses. This is why cooperatives are not the charitable "non-profit" business you think of when the term "non-profit" is used.

Even though cooperatives regularly generate income greater than expenses, they essentially end up with a non-profit bottom line. This results from making distributions of the excess income to members based on their business done with the cooperative. These distributions are known as patronage allocations.

The second cooperative function part is one level of Federal taxation. The Federal tax code taxes corporate net income once when generated and again when dividends are paid to shareholders. This is known as double taxation.

Cooperatives, on the other hand, can maneuver under various tax code cooperative preferential and other sections to have their patronage allocations taxed only once. Patronage allocation is the distribution of net income to members doing business with the cooperative based upon the amount of that business. Accordingly, cooperative income in excess of expenses can be exempt from Federal taxation on the cooperative level to the extent of patronage allocations to the farmer members. Only members are subject to taxation on the amount allocated.

The third cooperative function part is cooperative advantage. The advantage of cooperatives is that through economies of scale, centralized management and vertical integration they are able to do what the individual farmer cannot. For cooperative marketing services, this means that farmers are able to capture the higher value of products manufactured from their raw agricultural commodities. I explained this cooperative benefit in my *Alpacas Magazine* (Spring '06 issue) article *Cranberries to Alpacas – The Benefits of a Farmers' Cooperative*.

Agricultural commodities that are not useable by a consumer in the raw state are worthless except to the extent they can be made into something a consumer will buy. The manufacturer and seller of the consumer product, though, get most of the money since they are the ones who add the consumer value to the raw agricultural commodity. The farmer has little bargaining power to muscle in on this consumer value since generally there are few manufacturers and sellers in relation to the many farmers.

Cranberries cannot be eaten raw in any quantity since they are very tart. This is where Ocean Spray comes in. With the cooperative advantage (economies of scale, centralized

management and vertical integration), this large cooperative efficiently juices cranberries and cooks cranberries into sauce where sugar is added to make delicious products enjoyed by many consumers.

Control of product manufacture and sale is key. It reads like a Chinese proverb. He who controls manufacturing and selling captures the added consumer value. By manufacturing and selling consumer products, cooperatives capture for their farmer members this greater product value.

Cranberry juice and sauce sell for a lot more per cranberry pound than raw cranberries. The Ocean Spray cooperative business model allocates this greater profit to the cranberry farmer.

For cooperative purchasing services, the cooperative advantage means that farmers are able to capture the large volume price discounts and a broad selection of the supplies and services they need to run their farms. This is simply - strength in numbers.

Now that the cooperative function is clear, cooperative structural parts can be selected and then assembled into a viable business entity benefiting its member participating farmers. There are many windows, doors, roof pitches, room layouts, floor coverings, etc. to choose from for assembly into a custom farmers' cooperative house.

Cooperative services are basically marketing, purchasing or a combination of both. This combination is frequently known as a multiple service cooperative. AFCNA is a multiple service cooperative.

As mentioned, the marketing cooperative advantage allows farmers to capture the value added by manufacturing and selling consumer products from their agricultural commodities. The purchasing cooperative advantage allows farmers to purchase a broad selection of supplies and services at large volume price discounts.

Accounting for cooperative services can be approached as net proceeds, net profits or a combination of both. AFCNA's marketing services are accounted for following the net proceeds approach. Its purchasing services are accounted for following the net profits approach. This starts to get really complicated – I know. But, it falls in place if you keep in mind the cooperative function framework.

AFCNA's marketing division collects member submitted fleece, adds consumer value through product manufacture and sells the products – scoured fleece, tops, yarn, hats, scarves, etc. It seeks to participate in the large volume commercial textile market place.

The purchasing division of AFCNA buys a broad selection of alpaca products and supplies from its marketing division and outside vendors. These products and supplies are then sold to members and non-members.

AFCNA's business and accounting parts have been carefully selected to provide member services within the framework of cooperative function theory. The AFCNA story

continues with Federal tax treatment and patronage allocations.

Farmers' cooperatives may choose to be taxed on the Federal level as regular "C" corporations, under Subchapter T of the Internal Revenue Code or a combination of both. Net income of regular "C" corporations is taxed at the corporate level then again at the investor level to the extent net income is distributed as dividends to shareholders.

If there is no corporate level net income, however, double taxation is avoided. Corporate level net income does not arise if all net proceeds from the sale of agricultural commodity products are paid to members as the purchase price for their agricultural commodity. Thus, corporate level net sales proceeds become costs of goods sold and no taxable income arises. These payments to members as the purchase price for their agricultural commodity is taxable to the members receiving them.

Subchapter T gives farmers' cooperatives preferential tax treatment. Net income is computed the same as for a regular "C" corporation but if net income is allocated to members based on their business with the cooperative (called patronage), it is taxed only once instead of twice. Subchapter T gives cooperatives a deduction from net income for the net income amount allocated to patron members. These patronage allocations are taxable to the members receiving them.

Section 521 of the Internal Revenue Code offers limited additional tax advantages to farmers' cooperatives but it requires cooperatives to meet eight tests that significantly limit their activities. If used, Section 521 is applied along with Subchapter T. AFCNA chooses not to use this section since these limitations restrict its services to members.

AFCNA uses the regular "C" corporation tax treatment for its marketing division, Subchapter T tax treatment for its purchasing division sales to members and regular "C" corporation tax treatment for its purchasing division sales to non-members. Marketing division net proceeds are paid (allocated) to marketing patron members as payment for their submitted fleece. Payment for fleece under regular "C" corporation tax treatment becomes costs of goods sold thus generating no taxable income to AFCNA. There is only one level of tax with this method. Patron members are taxable since they are the only ones receiving the net proceeds from the sale of their fleece.

Purchasing division net profits from sales to members are allocated to purchasing patron members, as patronage refunds. Under Subchapter T, AFCNA can deduct these refunds from its net profits resulting in no taxable income. There is only one level of tax with this method. Patron members are taxable since they are the only ones receiving the net profits.

Purchasing division net profits from sales to non-members cannot be allocated to purchasing members under Subchapter T. Accordingly, these net profits are taxed to AFCNA under regular "C" corporation tax provisions. These net profits are used by AFCNA to build permanent operating

capital reserves. This reduces the amount AFCNA must withhold from member patronage allocations to fund its operating capital reserves.

Examples always help. Since AFCNA has two divisions, below is an example for each division based upon hypothetical quantities and prices, but real methods of calculation, allocation and payment.

Marketing Division – A net proceeds accounting approach is used for this division. Assume AFCNA purchases 10,000 pounds of alpaca fleece from its members all of the same grade. No specific purchase price is set. Rather, AFCNA is to pay members for each pound of submitted fleece an amount equal to 1/10,000 of the net proceeds from selling the fleece whether raw or in a value added manufactured product. AFCNA receives gross proceeds equivalent to \$2.10 per pound of submitted fleece. Its costs of operations for the applicable period are \$750.00. This works as follows:

Total sales	\$21,000.00
Less operating expenses	<u>(\$750.00)</u>
Net proceeds	\$20,250.00
Divided by patronage pounds	<u>÷10,000</u>
Fleece submitting members sales price per pound	\$2.03

The \$20,250.00 net proceeds are paid to members as payment for their fleece based upon amount submitted. AFCNA pays no tax because it deducts \$2.03 per pound as the amount it pays for the alpaca fleece and the \$750.00 as ordinary operating expenses. No AFCNA taxable income is left. Each submitting farmer member includes in his gross farm income for tax purposes the \$2.03 per pound as the sales price for his fleece.

Purchasing Division – A net profits accounting approach is used for this division. Assume AFCNA purchases 5,000 alpaca scarves from a vendor at a price of \$8.00 per scarf. It resells the scarves to members at a wholesale price of \$10.00 per scarf. Its costs of operations for the applicable period are \$750.00. This works as follows:

Total sales	\$50,000.00
Less costs of goods sold	<u>(\$40,000.00)</u>
Gross profits	\$10,000.00
Less operating expenses	<u>(\$750.00)</u>
Net profits	\$9,250.00
Divided by patronage sales	<u>÷\$50,000.00</u>
Purchasing members refunds per sales dollar	\$0.185

The \$9,250.00 net profits are available for allocation to purchasing members. AFCNA may withhold some of the allocated net profits to fund operating capital reserves. This example illustrates all of the allocated net profits being paid to members purchasing products based upon purchasing volume. AFCNA pays no taxes because it has no taxable income after properly allocating and paying the \$9,250.00 net profits to purchasing members. Each purchasing farmer member includes \$0.185 per dollar of his purchases from AFCNA in his gross farm income for tax purposes as a received patronage refund.

AFCNA has been custom crafted to bring participating alpaca farmers a broad selection of alpaca consumer products at a large volume price discount as well as sustainable income from their alpaca fleece. These goals,

however, are achievable only to the extent alpaca farmers participate. AFCNA is a cooperative experience for all of us. It cannot build a sustainable North

American alpaca fiber industry without you as a member and, once you are a member, without your patronage. The future of fiber is your choice and yours to benefit from!

