

# INTERNAL CAPITAL ACCOUNTS

AN ILLUSTRATED GUIDE TO THE INTERNAL CAPITAL ACCOUNT SYSTEM  
FOR WORKER COOPERATIVES





INTERNAL CAPITAL ACCOUNTS: AN ILLUSTRATED GUIDE TO THE INTERNAL CAPITAL ACCOUNT SYSTEM FOR WORKER COOPERATIVES

Introduction..... 3

Cooperative Construction: An Example ..... 4

Dealing with Losses ..... 11

Retiring or Terminating Membership ..... 12

Dissolution ..... 13

The importance of the collective account ..... 14

APPENDIX A: Taxation of Worker Cooperatives..... 15

APPENDIX B: Optimizing the Net Income Split..... 16

APPENDIX C: The Startup Loss Account ..... 18

APPENDIX D: Qualified Versus Non-qualified Notices of Allocation ..... 21

APPENDIX E: Glossary ..... 23

APPENDIX F: Further Reading ..... 25

Acknowledgements..... 25

About the ICA Group ..... 25

This manual is designed to give the reader a basic understanding of a worker cooperative structured according to the ICA Group’s Model Bylaws for a Worker Cooperative. For further information or a copy of the Model Bylaws, contact the **ICA Group** at [www.icagroup.org](http://www.icagroup.org).

**This publication is not intended to provide advice on the proper application of state, corporate or Federal tax law to worker cooperatives. A qualified attorney or other expert should be consulted for assistance with cooperative bylaw formation and tax law.**

INTRODUCTION

A worker cooperative is a type of business where the employees directly own and control the firm on a democratic basis of “one person, one vote”. The ownership structure is the basic building block of any enterprise. It determines how authority, responsibilities, risks, and rewards are distributed in a firm. It also determines how an owner enters and leaves the company.

In a worker co-op, ownership and control of the business are derived from working in the company, rather than from simply investing capital in it. A central element of this business structure is that labor employs capital, rather than capital employing labor. In this way, worker co-ops are structured to provide a stable source of profitable work for the worker-owners instead of a profitable investment for the shareholder-owners.

THE INTERNAL CAPITAL ACCOUNT COOPERATIVE

In an **internal capital account cooperative**<sup>1</sup>, the corporation’s net worth is reflected in a system of internal capital accounts. Each member has an **individual capital account (ICA)** to keep track of their portion of the firm’s net worth and reflect the value of the member’s relative equity in the corporation.

The internal capital account system shifts the function of carrying the net worth of the company away from shares and into the internal capital accounts.

In a conventional corporation, dividends are distributed according to each shareholder’s capital investment and number of shares, so they are called “capital dividends.” In a cooperative, dividends are allocated according to contributed labor or “patronage,” so they are called “patronage dividends.” Patronage dividends in a worker cooperative differ from capital dividends in a number of ways:

- 1. They represent a return on labor patronage rather than a return on capital investment,
- 2. Payment of patronage dividends (unlike capital dividends) is ultimately tax deductible by the corporation if the requirements of Subchapter T of the Internal Revenue Code are met, and
- 3. A corporation may allocate a **patronage dividend** partially or entirely on paper, and retain the profits for a period of time to use for any corporate purposes.

This model capital structure differs substantially from the capital structure in a conventional business corporation. The net worth of a conventional corporation is reflected in the stock shares. If the company succeeds and retains earnings, the net worth of the company (and thus the value of the shares) increases over time. If a cooperative records its value in the price of a share, then the appreciated value of these stocks might make them too expensive for new members to purchase. Historically, use of such capital shares has led to the demise of democratic structure in a variety of employee-owned firms.

Conventional Business

CONTROL IN A CONVENTIONAL CORPORATION IS BASED UPON THE CAPITAL INDIVIDUALS INVEST IN THE COMPANY.

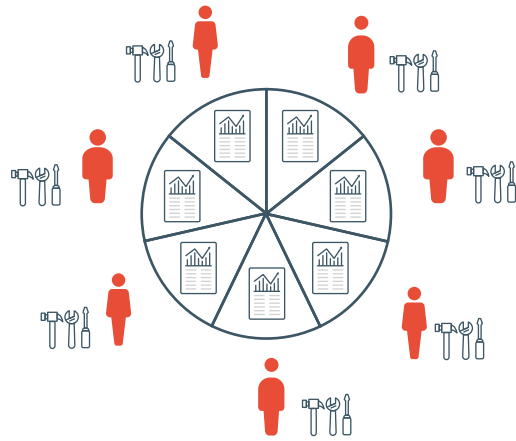


<sup>1</sup> Definitions for terms highlighted in red can be found in the Glossary.



## Worker Cooperative

CONTROL IN A COOPERATIVE IS BASED ON WORKING AT THE FIRM. TRADITIONALLY EVERYONE'S CAPITAL CONTRIBUTION IS EQUAL.



The internal capital account system addresses this issue by shifting the function of carrying the net worth of the company away from the shares and into the internal capital accounts. Increases in net worth will increase the balance in members' accounts, due back to them eventually in cash. The shares, however, remain at a reasonable value, enabling new members to pay an affordable membership fee when they join. At any given time, members may have differing claims on the company's net worth, but they all have the same membership rights and only one membership share each. This worker cooperative structure is designed to create a business that is multi- generational in nature and sustains the democratic corporate structure over time.

## COOPERATIVE CONSTRUCTION: AN EXAMPLE

To help explain how the internal capital account system works, we will use an example of an imaginary 14 member startup construction worker cooperative that has used the ICA Model By-Laws that we'll call Cooperative Construction. There are three main ways Cooperative Construction can get cash:

1. It can sell a product or a service to generate **revenues**,
2. It can sell **shares of stock** to its employees or outside investors, or
3. It can borrow money from a bank, a **Community Development Financial Institution (CDFI)**, a credit union or from individuals.

The last two types of money are types of **finance capital**, which means this money isn't treated as **income** and therefore doesn't show up on the company's **income statement**. When businesses raise money this way, it's referred to as financing. For simplicity's sake, we're not going to look at selling stock to outside investors, but rather focus on selling shares to the members of the cooperative and borrowing money from an institution.

## FINANCING

### How the Co-op Finances Itself: Equity

Cooperative Construction is a stock corporation, therefore when it raises money from its members, they buy a share of stock. In a worker cooperative, these shares are called **membership shares**. Each member paid a \$500 membership fee.<sup>2</sup> In exchange, they each received a **non-transferable** membership share which entitled the holder to full membership rights in the co-op. Since there are 14 members, each of whom buy 1 share for \$500, the co-op raised a total of \$7,000 this way.



### Membership Shares

A membership share does not increase or decrease in value like a share in a standard corporation. It can never be worth more than the membership fee. This allows new members to join a successful co-op easily. If the membership shares increased

in value with the success of the company, talented workers without enough money could not become members easily. It is the internal capital accounts that increase in value not the membership shares. The holder of a membership share is entitled to one vote. A membership share also gives the holder rights to an internal capital account and to a labor-based share of the **net income**. The member's share of the cooperative's retained profits and losses is tracked in the internal capital account.

### KEY ELEMENTS OF THE MEMBERSHIP SHARE

1. Can only be owned by a worker
2. Monetary value does not change
3. Entitles holder to one vote
4. Right to an internal capital account
5. Nontransferable
6. Is redeemed when member leaves

### How the Co-op Finances Itself: Debt

This \$7,000 isn't enough to get Cooperative Construction started, however, so they also need to borrow money. In this case, Cooperative Construction took out a \$50,000 loan from the Local Enterprise Assistance Fund, a CDFI affiliated with the ICA Group. For this loan, Cooperative Construction signed a loan agreement detailing the terms of the loan, including the repayment period and the interest rate. Because the business took out the loan, the individuals are not personally liable to pay back the loan in the event of a default.

In every case, however, if the business were to go bankrupt or cease operations and the **assets** were sold, the lender gets paid back before the shareholders do. In this way, equity is **subordinate** to debt. Shareholders, therefore take on greater risk than lenders, they're last in line to get paid back.



## COOPERATIVE CONSTRUCTION'S FIRST YEAR

### Beginning of the First Year

These contributed funds aren't enough to allow Cooperative Construction to function, however. It must use this money to buy things like tools and marketing materials it needs to do business. During this pre-launch phase, the co-op takes the \$57,000 it has raised from its members and the proceeds of its loan to buy \$3,000 in tools, leaving it with \$54,000 in cash. These tools and cash are referred to as the co-op's assets. The diagram below shows the co-op's assets on the left, and the co-op's **liabilities** and **shareholder equity** on the right. Note that these are equal.

Assets	Liabilities & Shareholder Equity
CASH: \$54,000	CDFI LOAN: \$50,000
EQUIPMENT & TOOLS: \$3,000	MEMBER EQUITY: \$7,000 (14 SHARES)
Total Assets: \$57,000	Total Liabilities & Shareholder: \$57,000

### The Balance Sheet

When it comes to accounting, we're focused on figuring out the value of the business at a given time, the value of the business is recorded on the company's balance sheet. There's one rule to the **balance sheet**:

$$\text{ASSETS} = \text{LIABILITIES} + \text{SHAREHOLDER EQUITY}$$

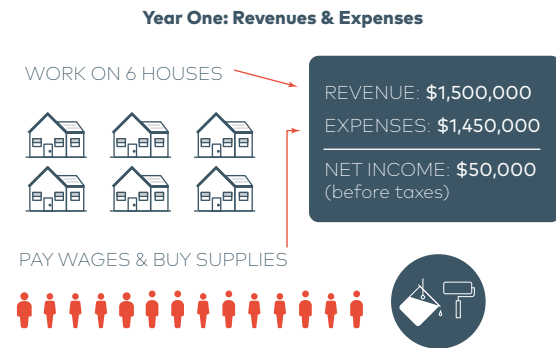
One of the three key financial statements used in financial accounting, the balance sheet summarizes a firm's assets, liabilities and shareholder equity at a specific point in time. The balance sheet must always balance, by having the assets equal the liabilities plus shareholder equity. Another way to think about this, is that the member's stake in the company (the equity) is equal to assets (things it owns) minus liabilities (the things it owes). What's left over is the value of the firm for the worker members.

<sup>2</sup> \$500 is only an example, the membership fee is set by the members or the Board of Directors.

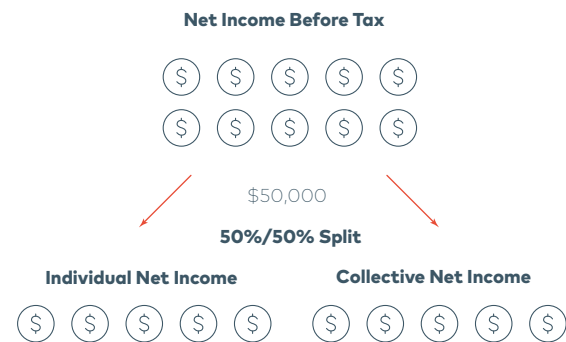


## End of the First Year

In Cooperative Construction's first year of operations, they worked on projects at six sites and had revenues of \$1.5 million. During that same year, excluding taxes, they paid out \$1.45 million in expenses (wages, supplies, interest on their loan, etc.). This leaves \$50,000 in net income (before taxes).



An internal capital account cooperative treats its net income quite differently from a standard corporation. Net income is split into two portions — **individual net income** and **collective net income**. It's important to remember that Cooperative Construction uses accrual accounting so their net income is different than the cash they earned from the business during the same year. When the co-op "splits" its net income, they're not actually putting money into an account, rather, they're tracking it in a certain account in their accounting software or their ledger.<sup>3</sup>

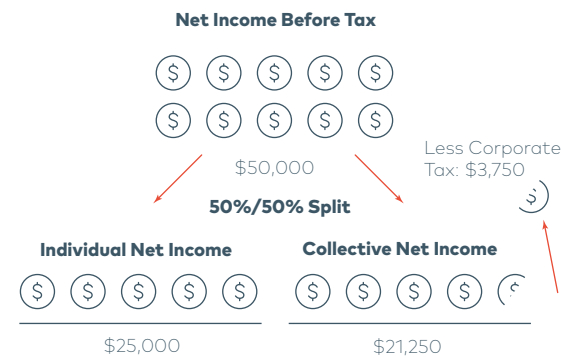


The individual net income is allocated to an account that is designated to be paid out to the individual

members, in other words, the individual member has a claim to the value tracked in this account. The collective net income on the other hand, is designated to be controlled by the cooperative as a whole. No individual member has a claim to the value associated with this account. It is critical that co-ops retain a certain amount of their income in a collective account for business stability and growth. For more information on the importance of the collective account and how to determine what the appropriate split is, see Appendix B. Co-ops can specify how this split will occur in their by-laws or the **Board of Directors** can make this decision on a year by year basis as well. In our example, Cooperative Construction specifies in its by-laws that half the net income will be considered individual net income and half is collective net income.

## Taxation

Normally, corporations are taxed on their total net income. However, because of a special Federal tax provision for cooperatives called Subchapter T (this is why co-ops are sometimes referred to as "T-Corporations"), cooperatives only pay federal corporate income tax on the collective net income and avoid what is referred to as **double taxation**. Individual net income ultimately avoids the Federal corporate income tax. It is taxed at the individual level, but it avoids the 'double taxation' of the typical corporate structure. (See Appendix A for more information on Subchapter T.)

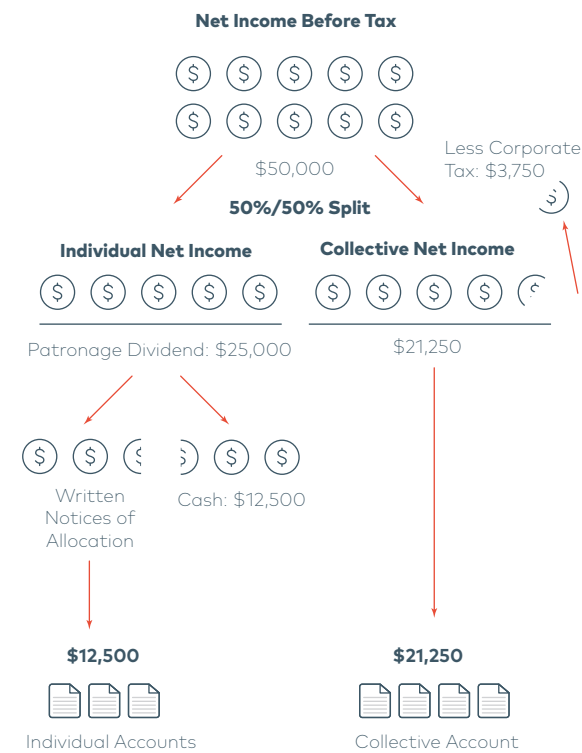


Without this tax benefit, Cooperative Construction would pay much more in taxes. If the federal tax rate was 15% and Cooperative Construction made \$50,000 in net income they would have to pay \$7,500 in taxes. Because only half of the income is

taxed at 15%, however, the co-op only pays \$3,750, cutting its tax bill in half.

## The Patronage Dividend

The total amount of individual net income is called the **patronage dividend**. The amount a member patronizes the co-op with his or her labor determines their share of the net income (or loss). **Labor patronage** is usually determined by the percentage of the total hours a given member worked, although other scenarios are possible.

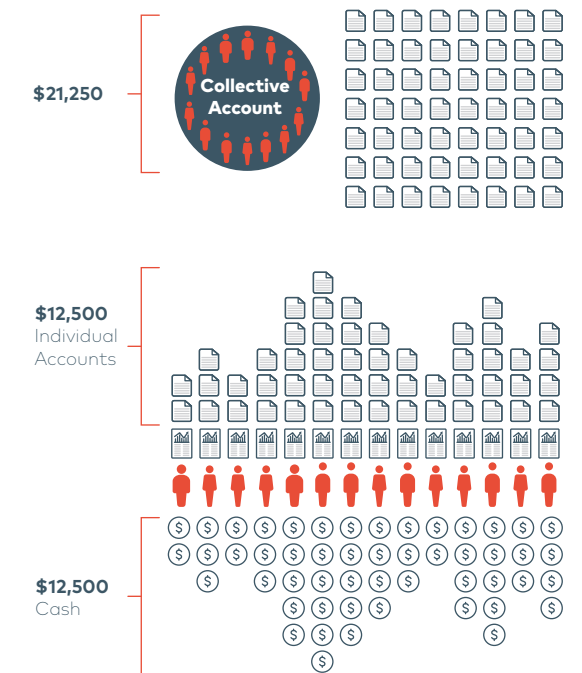


The patronage dividend can be paid out in cash or in a note called a **written notices of allocation** to a member's internal capital account. The membership, or the Board of Directors, decides how much of the individual net income to pay out in cash and how much to retain in members internal capital accounts.

At Cooperative Construction, half the \$25,000 in patronage dividends was paid out in cash and half was put into member's individual capital accounts. The membership or Board of Directors makes this decision. In both cases, the members' patronage

dividend is paid out in proportion to the total hours worked by all the members. So if the member Anna worked 6% of the total hours, she would receive 6% of the patronage dividend. In our example, therefore, she would get a check for \$750 and a written notice of allocation for \$750 to be recorded in her internal capital account, indicating that she had a claim on \$750 of the co-op's equity.

## Allocated Based on Patronage-Labor Worked at the Co-op



As the diagram above shows, at Cooperative Construction, \$12,500 was paid out to the 14 members in cash and \$12,500 put in their individual capital accounts. Not everyone worked the same number of hours, so not everyone got the same amount, but their proportion was based on the total hours they worked during the year. Each member received a note called a **qualified written notice of allocation** for how much the company retained in their name based on their individual labor patronage.<sup>4</sup> This amount was recorded in each member's internal capital account. The value of their membership share is also recorded in their internal capital account, but remember, the value of the share doesn't change over time or depending on how much is in an individual's account.

<sup>3</sup> The distinction between the cash your co-op earned and your co-op's net income is not intuitive, but is critical. If this isn't clear, see the ICA publication: Introduction to Accrual Accounting for Worker Cooperatives.

<sup>4</sup> See Appendix D for a discussion on the difference between Qualified and Non- Qualified Notices.





This written notice of allocation will be redeemed by the company for cash in the future. In the case of Cooperative Construction, they pay out the notices of allocation after 4 years, however, some co-ops don't pay out these accounts until the member has retired. The members or board decide this for each co-op.

### The Collective Account

The **collective allocation** is permanently retained by the corporation. This represents the collective net income after tax and is also called the self-insurance allocation. It is unavailable to the individual members during the lifetime of the corporation. There is no annual vote as to whether or not to retain the collective allocation; it is retained, according to the co-op's **bylaws**, for any and all cooperative uses. The amount retained is recorded in the **collective account**. In the case of Cooperative Construction, the \$21,500 (\$25,000 minus \$3,750 in taxes) was allocated to the collective account.

**Non-Member Income** - Because of Federal tax rules, net income from sub-contractors, non-member patronage, or unrelated investments cannot be declared as a patronage dividend. Income derived from the work of non-members must be allocated to the collective account. Therefore, if you have both members and non-members working in the co-op, it is essential to track revenues and hours of all workers.

### The Balance Sheet – Change in Net Book Value

At the end of the year, Cooperative Construction's **book value** went from \$57,000 to \$85,750 an increase of \$28,750. As you can see in the diagram below, the cash and **accounts receivables** (money customers owe you) increased to \$82,950, but the value of the tools decreased from \$3,000 to \$2,800. This is because equipment and tools **depreciate** or decline in value over time.

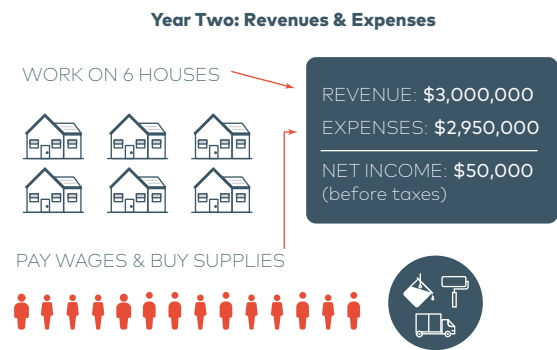
### Cooperative Construction Balance Sheet End of Year 1

On the right hand side, the liabilities changed as well. The amount of the loan decreased by \$5,000 because Cooperative Construction made \$5,000 in principal payments during the year. The member equity didn't change – remember membership shares don't change in value, while the individual accounts and the collective accounts increased by the amounts described above.

Assets	Liabilities & Shareholder Equity
CASH & RECEIVABLES: \$82,950	CDFI LOAN: \$45,000
EQUIPMENT & TOOLS: \$2,800	MEMBER EQUITY: \$7,000 (14 SHARES)
	INDIVIDUAL ACCOUNT: \$12,500
	COLLECTIVE ACCOUNT: \$21,250
<b>Total Assets: \$85,750</b>	<b>Total Liabilities &amp; Shareholder: \$85,750</b>

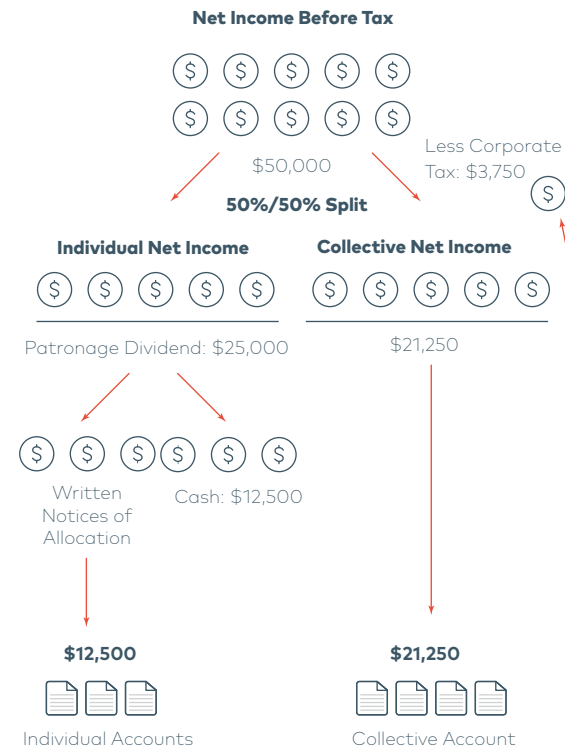
## COOPERATIVE CONSTRUCTION'S SECOND YEAR

In their second year of operations, Cooperative Construction doubled their sales to \$3 million, added to their productivity by investing in two trucks, and paid out \$2.95 million in wages and supplies, leaving them with \$50,000 in net income before taxes.



As the by-laws specify, the net income is split in two, 50% is collective net income, and 50% is individual net income. Once again, because of subchapter T, the corporation has to pay taxes on the collective net income, but does not pay income tax on the individual net income. The Board of Directors decided to split the patronage dividend

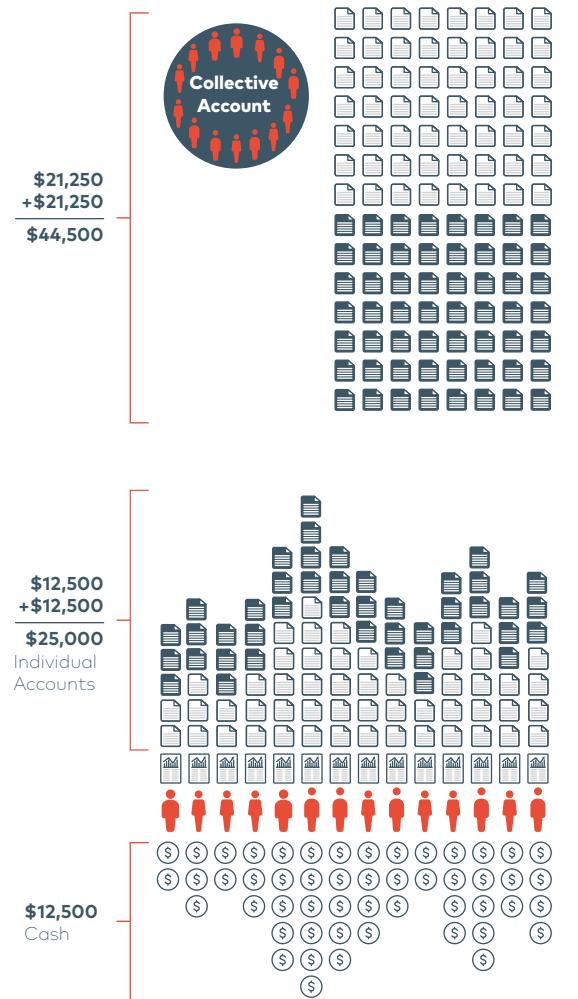
evenly, paying out half in cash and half in the form of written notices of allocation.



Given their \$50,000 of **accounting net income**, this means that the members get paid \$12,500 in cash, and \$12,500 in written notices of allocation and \$21,250 was recorded in the collective accounts.

At the end of the second year, each member's internal capital account is credited with their portion of the patronage dividend based on their patronage, the number of hours worked. Half is paid out in cash and half is paid in written notices of allocation. The \$21,250 in collective net income is also added to the collective account.

### Allocated Based on Patronage-Labor Worked at the Co-op



It's important to remember, however, that the co-op doesn't have a bank account with the amounts paid out in written notices of allocation for each member. In year two Anna worked 7% of the hours. So she would be paid \$875 in cash (7% X \$12,500) and \$875 in written notices of allocation (7% X \$12,500). From an operating standpoint, Anna's money is comingled with everyone else's and the co-op can use that money to fund its operations. The co-op must manage its cash wisely to ensure it can pay back Anna the value of her written notices, but in the meantime, it can use that money to pay wages, purchase equipment, or as a way to hire and train new worker owners.



IN A WORKER COOPERATIVE, THE ACCOUNTING NET INCOME IS SPLIT TWICE:

1. First to decide how much is designated for the collective account and how much for individual accounts (or and how much is should be retained and how much should be allocated for patronage dividends). It can be changed based on operating needs.
2. After that, the patronage dividend is split again – some portion is paid out in cash, while remainder is paid out in a written notice of allocation. Usually, a minimum of 20% of patronage dividend needs to be paid out in cash so the member can pay the personal income tax they owe on this income.

The portion paid out in cash obviously leaves the company, but the retained amount of the patronage dividend is represented in the individual capital accounts.

#### End of the Second Year

Cooperative Construction ended their second year having increased its net book value to \$116,500, up from \$85,750 from the end of the first year. They once again paid off \$5,000 in principle of their loan, the \$7,000 in membership shares remained the same, but the value in the individual accounts increased by \$12,500 to \$25,000, and the value in the collective account increased \$22,250 to \$44,500. Note, however, that their cash and receivables decreased from over \$80,000 to \$38,100. This is primarily because they paid \$76,000 in cash for two trucks.<sup>5</sup>

All told, Cooperative Construction has \$76,500 in equity. 58% of it is recorded in the collective account, while the remaining 42% is recorded in the member's individual capital accounts. While the shareholders have a claim of \$76,500, the company only has \$38,100 in cash. The co-op, under the leadership of the board and members has invested this money into two trucks which allow the co-op to bid on bigger jobs and operate more efficiently. The value in member's internal capital accounts are not cash accounts, however. The business could have only \$10,000 in cash and \$32,000 in member's internal capital accounts.

<sup>5</sup> Because the trucks are expected to last up to 20 years, while the co-op paid \$76,000 in cash, it only recognized \$3,800 of this cost on its income statement. This is because of depreciation.

<sup>6</sup> See Appendix D for more detail on qualified and non-qualified notices of allocation.

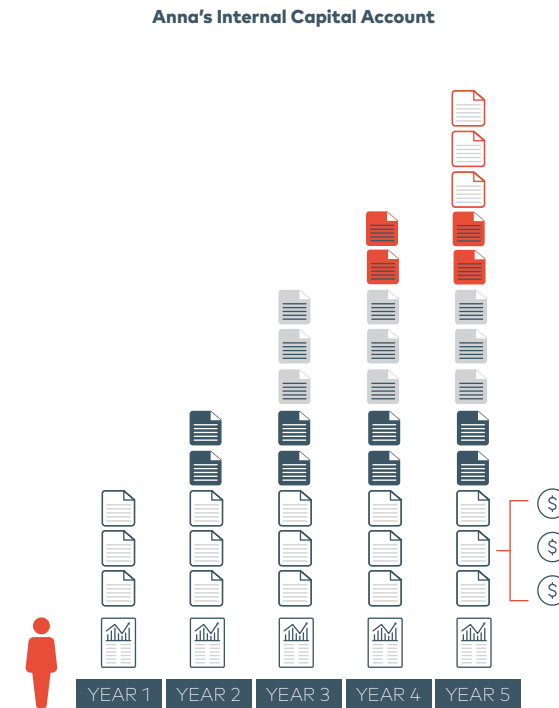
Assets	Liabilities & Shareholder Equity
CASH & RECEIVABLES: \$38,100	CDFI LOAN: \$45,000
EQUIPMENT & TOOLS: \$2,400	MEMBER EQUITY: \$7,000 (14 SHARES)
TRUCKS (2): \$76,000	INDIVIDUAL ACCOUNT: \$25,000
	COLLECTIVE ACCOUNT: \$44,500
Total Assets: \$116,500	Total Liabilities & Shareholder: \$116,500

#### Personal Taxation

The IRS requires that a member pay personal income tax on the total patronage dividend issued by the co-op. Personal tax is owed by the member both on the cash and any qualified notices of allocation received as part of a patronage dividend. Later, when a qualified notice is redeemed by the co-op for cash in a future year, no additional tax is owed personally by the member. If the cooperative chooses to use non-qualified notices, then the member does not pay tax on the notice when it is first issued but only when it is redeemed.<sup>6</sup> The corporation pays tax on non-qualified notices of allocation and that tax is refunded when the non-qualified notice is paid out in cash. Notices of allocation are not subject to Federal and state withholding or social security taxes (FICA and FUTA taxes).

While at first it may seem that members have to pay taxes on money that they don't receive, it's important to remember that when the value of the internal capital accounts are paid out in cash, the member receives that payment tax free. Since member's income should increase over time, by deferring this income, members wind up paying less in taxes than they would otherwise pay.

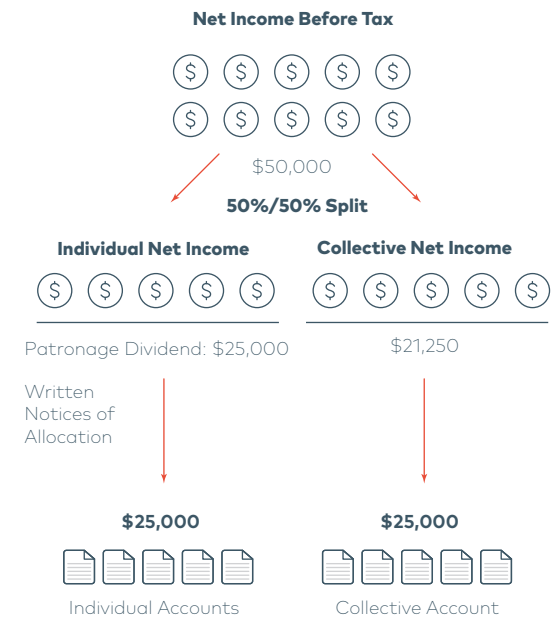
By retaining money in the cooperative, the business is able to invest in the firm, which should also increase the ability to raise income at a later date. The co-op does need to manage its money, however, therefore great attention must be paid to the schedule by which the co-op pays out its internal capital accounts values to ensure it does not negatively impact the company's operations.



Cooperative Construction pays out on a four year schedule, which means after four years, the co-op pays out the amount put in the member's internal capital account in Year 1 in Year 5. In year one, Anna had \$750 deposited into her account. At the end of the year 5, she is paid that \$750 in cash and the value of her account is adjusted. Because Cooperative Construction used qualified written notices of allocation and Anna paid taxes when the \$750 was put into her account, she does not pay taxes when she receives the money.

#### DEALING WITH LOSSES

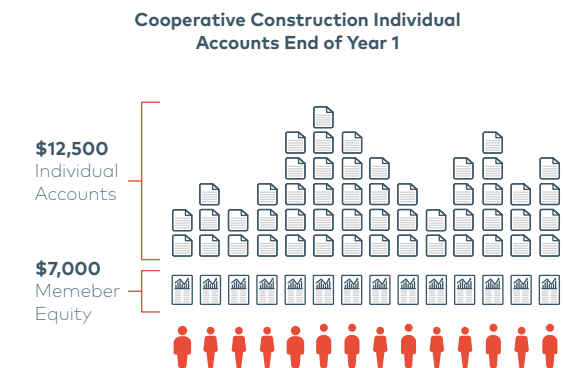
Losses reduce the net book value and therefore reduce the values in the internal capital accounts. Losses are split in the same way as income between the individual and collective accounts. For Cooperative Construction, fifty percent of the loss is taken against the collective account and fifty percent is taken against the individual accounts.



#### How Losses Affect Individual Accounts

In the case of a loss, members are given **negative patronage allocations** in accordance with their labor patronage. The members who work the most will have the larger share of the losses. This is only fair since those who have had access to the largest amount of regular wages will be more able to afford the losses. Typically, a negative patronage allocation will be applied first against the membership fee, then against the oldest written notice in the member's account.

If, for instance, Cooperative Construction had an accounting net income loss of \$50,000 in year two, the losses would be split the same way they are with a positive net income. Fifty percent is allocated to the collective account and 50% to the individual accounts.



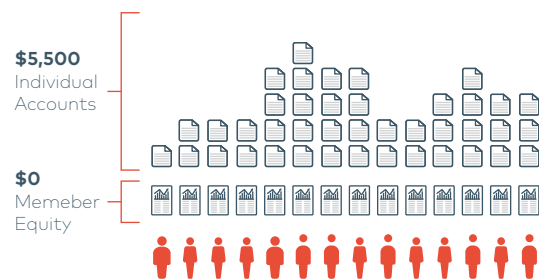


From our example above, at the end of year one, the 14 members of Cooperative Construction had \$19,500 in their internal capital accounts. \$7,000 from the membership shares and \$12,500 in their individual accounts from Year 1. Applying Year Two's \$25,000 loss to these accounts results in a total negative \$5,500 in the individual accounts.

$$\$19,500 - \$25,000 = (\$5,500)$$

After the \$25,000 loss is accounted for the value of each members internal capital account is negative. This doesn't mean they owe the co-op money, just that their share of the book value of the company has a negative value and if they were to leave, they would not receive any payout. Investing in a business as an owner carries risk, including the risk of loss. Note that while the value associated with the membership shares is wiped out, they still own these shares. However, they have no value.

Cooperative Construction Individual Accounts  
(After the Losses of Year 2 are Accounted For)



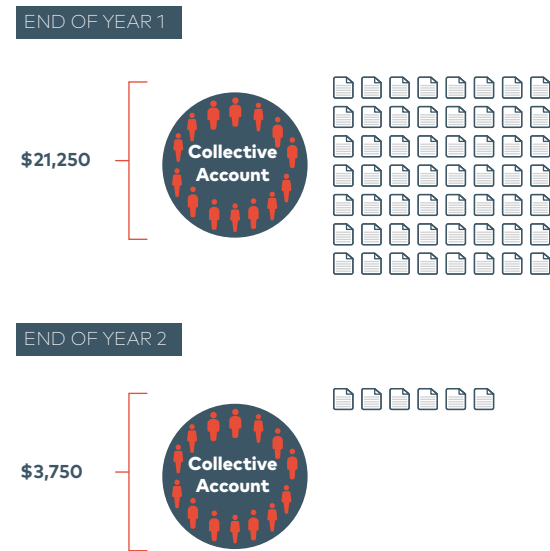
#### How Losses Affect Collective Accounts

The same thing happens to the collective account. At the end of Year 1, there was \$21,250 in the collective account. After accounting for the \$25,000 loss in Year 2, the collective account has negative \$3,750.

$$\$21,250 - \$25,000 = (\$3,750)$$

So at the end of Year 2, the firm has a total Equity Value of (\$9,250). Remember, this doesn't mean the business has a negative amount in their bank account. If they did, they would likely have to cease operations. It just means that on their balance sheet, their equity has a negative value. This is usually referred to as retained earnings.

Cooperative Construction Collective Account



#### RETIRING OR TERMINATING MEMBERSHIP

Two accounting steps occur when a member retires or terminates membership. First, the member's account is closed to future profits or losses at the end of the fiscal year. They will continue to receive pay-outs of past years' written notices of allocation (assuming that the notices survived any losses during the member's employment). Second, the member will turn in his or her membership share and receive the membership fee or a promissory note for the fee (assuming it survived any losses during the worker's membership).

#### The Roll-Over Plan

In the internal capital account cooperative, notices are scheduled to be redeemed within a fixed number of years from issuance. This is called the "roll-over plan" to redeem the written notices. With a roll-over plan notices are paid out on a first-in / first out basis, that is, in the order retained with the oldest notices paid out first. (A redemption of a notice is subject to postponement if the co-op has no funds available.) The roll-over of written notices is not effected by the termination of membership.

Worker co-ops generally take one of two approaches to paying out the value in a member's internal capital account, they either pay out the value in the internal account after a set number of years, or the value in the members account is retained until they retire or leave the firm. In the first option, the amount put into a members account is held for a period set

by the Board or the Members (at a minimum, your co-op should choose 3 years). After that amount of time, the co-op pays the member the cash value of the amount credited to their account and their account balance is adjusted accordingly.

In the second option, the value in the member's capital account is retained until they retire or leave the co-op. Under this scenario, members are usually paid out the value of their internal capital account in the form of an annuity. So the entire value of the account (including the membership share) is divided by the number of years the payout will occur (often 10 or 15) and the member receives equal payments each year.

In both cases, the co-op needs to be careful to ensure they have the cash to make these payments. It is critical that your by-laws have language that ensures in the event that the co-op board determines that there is not enough cash to make these payments they are deferred. One simple way to address this is to set a target amount to be held in the collective account (and a set amount of reserves to be held in cash), if the account balance falls below this level, the co-op will delay making any cash disbursements to members.

#### DISSOLUTION

When a worker cooperative goes out of business or is sold, it is dissolved or **de-mutualized**. If an internal capital account cooperative corporation dissolves, the assets that remain after paying off normal debts and the individual accounts are assigned to the collective account. All past members contributed to the collective account. So it would be unfair for the current members to pocket the remaining collective assets.

#### Indivisible Versus Divisible Reserves

Depending upon how your collective account is structured in your by-laws, upon dissolution, the remaining collective assets are either:

1. Divided up amongst all past and present members according to labor patronage (the divisible reserve);
2. Are paid out to a charity or the holder of the "trust share" (the indivisible reserves); or
3. Some combination of the two.

For co-ops with divisible reserves, the assets that remain are paid out to all the past and present

members based upon their historical patronage. For example if a firm had been in operation for 10 years and during that time a total of 300,000 hours had been worked, each individual would be entitled to a percentage based on the proportion of their total hours compared to the total for the firm. Therefore, if Anna had worked full time for those 10 years (for a total of 20,800 hours), she would be entitled to 6.9% of the remaining assets (20,800 hours ÷ 300,000 hours). However, if Jonathan had only worked 5,000 hours, he would be entitled to 1.6% of the total (5,000 ÷ 300,000). If you are going to have a divisible reserve, it is important to specify in your by-laws that you will notify past members by sending a notice to their last known address and ensure that members have the obligation to notify the co-op of any change in address.

For co-ops with an indivisible reserve, the process is much simpler. After the debts of the firm have been paid and the balances in members individual accounts have been paid out, the remaining assets are paid to the organization specified in the by-laws or by a process specified in the by-laws. Co-ops that have an indivisible reserve can specify organizations that support worker co-ops, such as the US Federation of Worker Cooperatives, a loan fund that supports the sector such as LEAF, the organizations that helped establish the co-op, or a charity related to the mission of the business.

If a worker cooperative fails, members may lose their equity investment (membership fees) and any profits (notices of allocation) accumulated in their accounts. They are not personally liable for any outstanding company debts, however, due to the limited liability they enjoy from having formed a corporation or an LLC.

The ICA Group recommends that worker co-ops establish indivisible reserves. These reserves are part of the collective account, but are not split amongst past members in the event of dissolution or de-mutualization. A core principle of an internal capital account cooperative is to establish a company that operates for the benefit of its past, current, and future members. In this way, a worker cooperative is an inter-generational business, designed as a mechanism to create value for past, current, and future members. Given that this is at the core of the business, establishing an indivisible reserve deters current members from selling off the company to a conventionally organized firm that may not consider the long term health of their community in their day to day business decisions.







On a practical level, it is possible to specify that a set percentage of the net income (say 30%) is set aside in an indivisible reserve and the remainder is split between collective and individual accounts based on the short and medium term needs of the business.

## THE IMPORTANCE OF THE COLLECTIVE ACCOUNT

### Why have a collective account?

The collective account records a set amount of unindividualized **retained earnings** available for any and all cooperative uses. It is an integral part of the internal capital account system that enables the payoff of notices of allocation and contributes to the financial strength of the cooperative.

Internal growth (versus growth through mergers and acquisitions) can be financed in a variety of ways. While many companies take on debt and outside investments to finance growth, the most sustainable and least risky way to grow is through the reinvestment of retained earnings. To ensure a co-op can fuel this internal growth, it should not commit 100% of its net income to the membership, but rather split it between the membership and the cooperative's collective account.

The individual-collective split of net income represents a balance between what is fair for current members and what is needed to keep the co-op strong for the future. A cooperative that commits most of its net income to the membership does so at the expense of its own capital base. A co-op that returns little of its net income to the worker-owners will foster dissatisfaction. In an internal capital account cooperative, the needs of the individual members are balanced with the needs of the business entity by the net income split.

### Determining the Appropriate Net Income Split

There are three competing goals that a co-op must balance in setting its allocation strategy:

1. **Sustainable Business Growth:** By maximizing the firm's collective retained earnings, you will likely have a higher tax obligation, and thus less funds to reinvest in growth. However, the funds you do retain can be reinvested in growth without regard to having to any cash payments in the future.<sup>7</sup>
2. **Long-Term Member Wealth:** By maximizing your Written Notices of Allocation, which are temporarily reinvested in business free of corporate income tax, you can likely lower your tax obligation (especially if you have net income of more than \$50,000). These additional funds can then be used to fuel greater growth than if you simply retained the earnings collectively. However, WNAs eventually need to be paid out, this creates a liability that could negatively impact your growth in the future.
3. **Regular Cash Payouts:** By maximizing the cash paid out to members, you increase member income in the short term. However, the cash that you pay out as patronage dividends cannot be used by the firm to fuel growth or increased productivity, which could negatively impact the firm's growth potential.<sup>8</sup>

The other key consideration is how long the co-op will retain written notices of allocation. The best way to think about WNAs is that they are investments members make in the future growth of the business. Therefore, the longer the co-op is able to retain the funds (such as 15 or even as long as retirement) the greater impact this investment can have on future growth. It is also worth noting that in both the cases of Mondragon in Spain and the Employee Stock Ownership Plans (ESOP) in the US, the ownership share is not redeemed until retirement.

The split your co-op chooses will vary with capital needs of the firm and length of redemption period for the notices of allocation. A good starting point for determining the split is 50-50, although we recommend that at a minimum, 30% of net income

is allocated to the collective account. If your co-op has less than \$50,000 in net income, it is very likely that you can maximize the funds available for business growth by directing 100% to the collective account. You can use the Equity Distribution Model developed by ICA and the Democracy at Work Institute to assess the impact of various allocation strategies on your particular co-op.

### Conclusion

A strong collective account and the use of an indivisible reserve, along with sound financial planning, makes the cash-out of members' equity more achievable in good times as well as bad. By strengthening your balance sheet, you are better prepared to be able to secure bank financing and ensure that the banks do not require a personal guarantee on these loans. Furthermore, the experience of Spain, Italy, and France indicate that a central element of building a thriving democratic economy requires reinvestment. In the Basque country, Italy and France anywhere from 30% to 45% of net income is retained by the company. Simply put, by making a commitment to the collective account (and the liberal use of written notices of allocation) your co-op is making an investment in its own future.

## APPENDIX A: "TAXATION OF WORKER COOPERATIVES"

BY PETER PITEGOFF

A worker cooperative, like any business, faces a battery of Federal and state taxes. Careful tax planning can minimize this burden, through special tax benefits for cooperatives as well as tax breaks available for any corporate enterprise. This article presents a brief introduction to the primary cooperative tax advantage: Subchapter T of the Federal Internal Revenue Code.

Ordinarily, corporate earnings are subject to double taxation. The corporation pays corporate income tax on its taxable income and individual shareholders pay personal income tax on their share of corporate earnings distributed as dividends. Subchapter T enables a cooperative to avoid this double taxation, by legally avoiding the corporate level tax.

Subchapter T works as follows. The worker cooperative deducts from corporate taxable income any earnings allocated to members on the basis of work performed (called "patronage," often measured by hours worked). These allocations or

"patronage dividends" may be in the form of cash distributions. Alternatively, patronage dividends may be in the form of written obligations ("written notices of allocation") credited to members' individual capital accounts. Thus, Subchapter T can provide a dual benefit. The cooperative can avoid double taxation and, at the same time, retain and reinvest a portion of the earnings allocated to members. Such allocations, of course, would be in addition to ordinary cash wages. There are two different ways to use Subchapter T, each with different cash flow implications depending on the particular tax brackets of the cooperative and the members. Patronage dividends in the form of "qualified" written notices of allocation are currently deductible by the corporation.

However, the member must pay personal tax currently on any allocations, and the corporation must pay at least 20% of the dividend in cash to the member immediately, presumably to enable the member to pay the personal tax. Alternatively, "non-qualified" written notices require no upfront personal tax payment, but also offer no current corporate deduction for the patronage dividend. In a later year, when the written notice is paid out in cash to the member, the member pays personal tax, and the cooperative deducts the amount of the cash pay-out. The choice between qualified and non-qualified written notices requires careful attention to Subchapter T provisions and to a cash-flow analysis.

The benefits of Subchapter T are available, in the words of the Tax Code, to "any corporation operating on a cooperative basis." Unfortunately, the IRS and the courts have produced no precise definition of "operating on a cooperative basis."

Nonetheless, IRS rulings and court cases tend to cite certain criteria for use of Subchapter T. Two criteria appear to be most important: (1) a worker cooperative must allocate earnings on the basis of patronage, as opposed to relative capital investment; and (2) the cooperative must be democratically controlled by the members. Clearly, some variation from these criteria will not necessarily preclude use of Subchapter T — courts have allowed non-cooperative elements within corporations using Subchapter T.

But, the tax benefit becomes less certain as one strays away from patronage allocations and democratic structure. A note of caution: consult with your lawyer before relying on Subchapter T.

<sup>7</sup> If your firm has more than \$250,000 in retained earnings, you may be subject to the Accumulated Earnings Tax (20% for C-Corps, 40% for LLCs on anything above \$250K) unless you have a legitimate business purpose for which these funds are to be used. It is critical that if you believe you may be subject to this tax, that you have documentation (i.e. minutes from Board meetings) demonstrating the reason for retaining these earnings.

<sup>8</sup> It's important to remember that sometimes the IRS questions whether patronage dividends are really wages, and should be subject to payroll tax withholdings. Patronage isn't wages and shouldn't have to be held for any period. If patronage is held for a three years, however, we have found that these funds are viewed as patronage. Many co-ops do pay out patronage dividends on a faster schedule.







Two other important points are established by case law. First, Subchapter T is expressly available to worker cooperatives, although it originated as a tax break for agricultural cooperatives. Second, the particular state-level incorporation statute is not controlling for Federal tax purposes. For instance, if an enterprise is incorporated as a business corporation but operates in substance on a cooperative basis, can still qualify under Subchapter T.

The mechanics of using Subchapter T are simple. No prior election or approval is required. A corporation that is operating on a cooperative basis simply files the appropriate IRS forms (1099-PATR and 1066) when paying taxes.

The potential for creative tax planning by a worker cooperative extends far beyond Subchapter T. This article merely scratches the surface. For more information on cooperative taxation, consult with your lawyer or accountant, or contact the ICA Group ([www.ica-group.org](http://www.ica-group.org)).

*Peter Pitegoff served as the ICA Group's General Counsel from the organization's founding through the late 1980's. He served as Dean of the University of Maine School of Law until June 2015 and previously was a law professor at the State University of New York Buffalo.*

## APPENDIX B: OPTIMIZING THE NET INCOME SPLIT

Because of the preferential tax treatment cooperatives have under Subchapter T, they are able to affect their corporate tax rate in ways that reduce the cost of business reinvestment and growth. While a co-op is taxed in the same way as a traditional corporation on earnings it retains collectively, earnings allocated as member patronage through written notices of allocation (and not as cash) are effectively reinvested in the business tax-free on a temporary basis. Through paying lower taxes, the co-op is able put more of its earnings back in the business, which creates an opportunity to fuel growth in the short run to a greater extent than would otherwise be possible for a traditional corporation.

Of course, allocating earnings as patronage, and not collectively, also creates a future refund obligation that is important to manage. The more earnings that are allocated as patronage (either as cash or written notices of allocation), the more wealth

is accrued for current members, but at the cost of the co-op's future financial position and the ability of the co-op to generate wealth for forthcoming members.

Ultimately, the 'best' way for a co-op to allocate its earnings is based on the intersection of the co-op's unique goals and a long-term view of the effects of a particular allocation strategy.

### Return on Assets

To determine how effectively a co-op can leverage this reinvestment to spur future growth, you need to determine your firm's Return on Assets. The return on assets measures how effectively a business uses its assets to create income in the future. The return on assets is calculated by dividing the net income by the total assets.

Imagine two firms, Company A, a firm with \$2.5 million in assets that was able to consistently generate \$250,000 in net income, and Company B, a firm in the same line of business with assets of \$5 million that could also consistently generate \$250,000 in net income. Company A would have a return on assets (ROA) of 10% ( $250,000 \div 2,500,000$ ), while Company B would have an ROA of only 5% ( $250,000 \div 5,000,000$ ). If we assume that both companies can maintain that ROA as their assets grow, then by retaining income in the firm (and growing the assets), the net income could grow accordingly.

For instance, if Company A reinvested its \$250,000 of net income in growth (and therefore increased its assets to \$2.75 million), it could expect to generate \$275,000 in net income the following year ( $\$2.75 \text{ million} \times 10\%$ ). On the other hand, if Company B invested its \$250,000 in net income in growth and increased its assets to \$5.25 million, we would only expect it to generate \$262,000 in net income ( $\$5.25 \text{ million} \times 5\%$ ). The higher the ROA, the more effective a company is at using its assets to generate income.

How realistic is this scenario? If a firm invests its net income in new machinery that increases productivity or additional staff that can increase sales, it's probable that the net income will increase (although it might take more than one year to realize these gains). It's important to recognize, however, that for the above scenario to play out, a firm must actually be able to leverage its assets to spur growth. For instance if Company A's assets were higher because it owned the building it operated

out of and Company B's assets were lower because it leased its office, we might not expect Company A to leverage that asset in the way described above. The business reality facing each firm might limit its annual growth to a set percentage, regardless of its assets base. If this were the case, using ROA to try and predict growth would not be an effective strategy.

However, firms should be able to leverage their assets to spur growth in the future. The more money a firm is able to devote to business growth, the more likely it should be able to create future income. For a co-op, this presents a unique opportunity. The lower tax rate co-ops pay on written notices of allocation means it can increase the funds it has to reinvest in the firm. For instance a traditional firm that made \$250,000 in net income (before taxes) would realize a total net income of \$170,250 after taxes. The same company, if it were a cooperative, and sought to minimize its tax obligation using qualified written notices of allocation would have a net income of \$202,500,

\$32,250 more than a traditional company.<sup>9</sup> Each year, the co-op has more money to reinvest in the firm, and therefore has a greater opportunity to increase its net income, and therefore its member's wealth.

The tax advantage issuing qualified written notices of allocation present are not indefinite, however. The funds a co-op sets aside in individual capital accounts must eventually be paid in cash to the members. The members are effectively investing their share of the profits in the business to allow it to grow. The longer a co-op is able to retain these funds, the more likely they are to be able to leverage that investment into future growth. If a co-op held onto its WNAs for five years, it must plan to have the cash to make that payment when it comes due. Therefore, while some of those funds can be used for medium or long term growth, a sizable portion should be retained as cash to ensure the firm has the funds to pay back the WNAs in the future. While this cash plays a critical business function in terms of managing the firms cash flow (and therefore reduce its need to take on debt for instance), firms cannot expect funds that are not invested for growth to capture a return. However,

if a co-op used its internal capital accounts as a supplemental retirement plan, they might have access to those funds for up to 20 years, giving the firm plenty of time to reinvest in future growth. In this way, the longer a co-op retains its qualified WNAs, the greater the impact it can expect to have on future growth.

To illustrate this point, imagine a business with \$2 million in assets, a ROA of 6% and net income in year 1 of \$120,000. As a co-op, the firm consistently follows the strategy of paying a maximum of \$50,000 in collective net income and the remaining income paid out as qualified written notices (paying out 20% in cash and retaining the remainder) payable after five years. At the end of a 20 year period, this co-op could expect to have cumulative assets of \$3.4 million, paid out a total of \$1.7 million in patronage dividends, and \$150,000 in federal taxes. In contrast, a comparable conventional firm that paid the same total amount in dividend and taxes could only expect to have \$3.3 million in assets. More significantly, they would have only paid out

\$1 million in dividends, while incurring cumulative tax burden of \$933,000. Of course this example does not account for the many factors that might drastically change these results, but holding all else equal, it is a clear demonstration of the power the cooperative structure can bring.

### Prioritizing Growth & Stability

A co-op that highly values bringing economic sustainability to its members and the greater community for years to come, but also cares about building wealth through retirement accounts, would probably be served well through retaining a large portion of earnings collectively, and then electing to put as much of the remaining patronage as possible in written notices payable upon separation.

### Maximizing Business Reinvestment

A more complicated scenario could involve a co-op that needs to grow its business quickly in order to capitalize on an emerging market. At present, this co-op should likely retain all earnings collectively until its earnings before taxes exceed \$50,000 (the top of the lowest corporate income tax bracket with a 15% rate). Then, the co-op should move to

<sup>9</sup> This scenario assumes the co-op retained \$50,000 in collective income and paid a 15% tax on that \$50,000, leaving \$42,500 in the collective account. It allocates the remaining \$200,000 as written notices of allocation and pays out 20% in cash (to allow members to pay their tax obligation), leaving \$160,000 in the individual capital accounts. \$42,500 plus \$160,000 equals \$202,500. The traditional company paid a graduated income tax on its \$250,000 in net income, leaving only \$170,250.



allocating all earnings above \$50,000 in the short run as member patronage payable as qualified written notices of allocation. Because qualified notices must pay out 20% as cash, this effectively creates a 'tax rate' of 20% for the co-op based on the requisite percentage of cash payouts. This is lower than the second-lowest corporate tax bracket that has a 25% rate. This allocation strategy, when used on a temporary basis, helps to minimize the cost of business reinvestment.

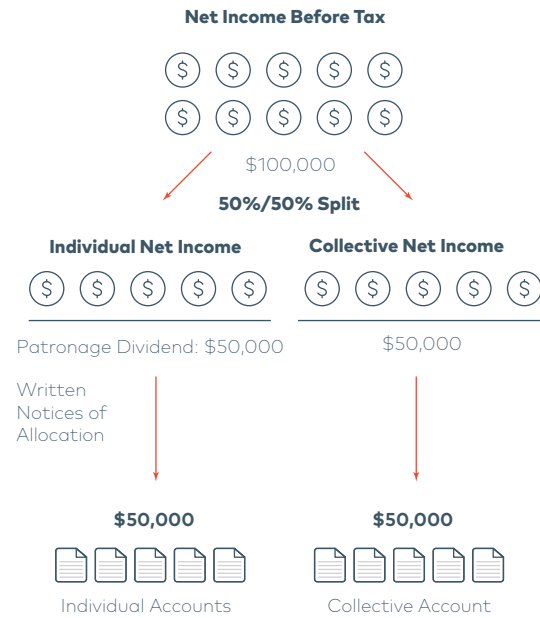
Finally, as the co-op begins to establish itself in the market, they should find the balance between collective and individual accounts that best allows them to manage the future refund obligation that is accrued through issuing written notices. Otherwise, the pace of growth would slow as refund obligations are paid, as a result of diminished business reinvestment.

### APPENDIX C: THE STARTUP LOSS ACCOUNT: A METHOD TO AMORTIZE STARTUP LOSSES

The period before a company makes its first profit or breaks even is called the startup period. A startup period can last from a few months to a few years. During startup, sizable losses are often incurred due to the costs of organization, product and market development, etc. These losses are called startup losses.

In a worker cooperative, if startup losses are accounted for in the normal fashion, the founders receive sizable negative allocations. After a few years, when the cooperative is profitable, a new member could join and share in the profits without sharing in the startup losses. These new members benefits unfairly from the beginning losses borne by the founders.

The **startup loss account** is an option which spreads the burden of the startup losses over a multi-year period such as five years. Instead of giving the founders one large negative allocation initially, a startup loss is stretched over five years and seeped out with five small negative allocations to all the individual capital accounts. With this method a new member will share in the startup losses. A negative allocation seeped out from the startup loss account is distributed according to labor patronage to all members. After the firm breaks even, the startup period ends and future losses are accounted for in the regular way. Let's look at an example to illustrate the workings of the startup loss account.



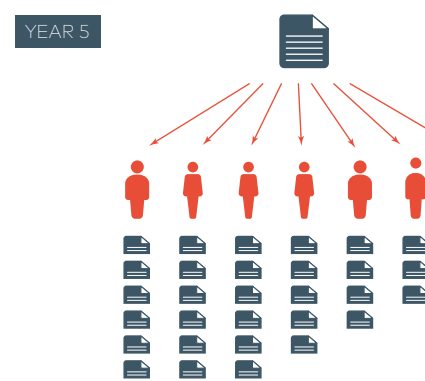
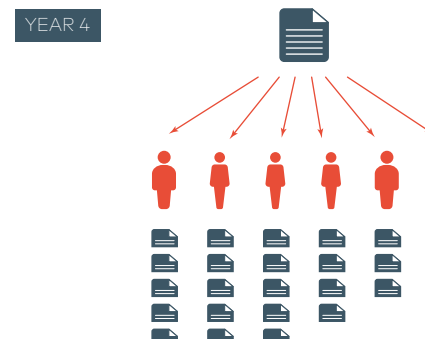
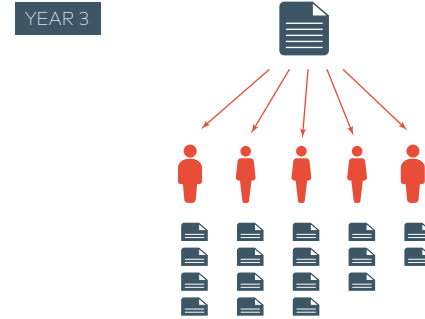
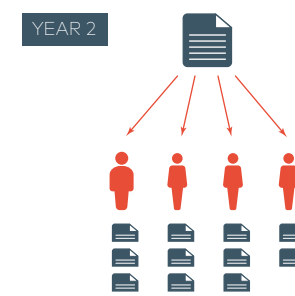
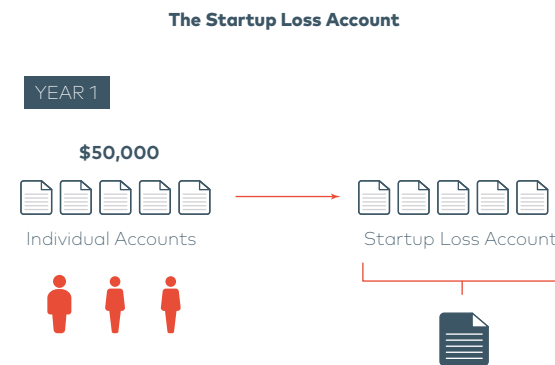
Imagine Cooperative Construction was started by 3 members, each of whom paid their \$500 membership fee. In their first year of operations, the firm had an accounting net income of negative \$50,000. According to their by-laws, 50% is directed to the collective account and 50% is allocated to the individual accounts. If that \$50,000 loss was allocated to the three founding member's internal capital accounts (and they each worked the same number of hours), each member would have negative \$16,667 in their account.

By using a startup loss account however, these losses can be spread across the accounts of new members as they join. So in year 1, instead of having the whole \$50,000 loss allocated to the individual accounts, only \$10,000 is. Assuming each member worked the same number of hours, each member's account would have negative \$3,333 allocated to it (one third of the \$10,000 loss). In year 2, however, when a new member was added. The \$10,000 designated for year 2 would be split four ways.

If over the course of five years, the co-op added one additional member each year, by year five, the seven members would be allocated one seventh of the that year's portion of the startup loss account.

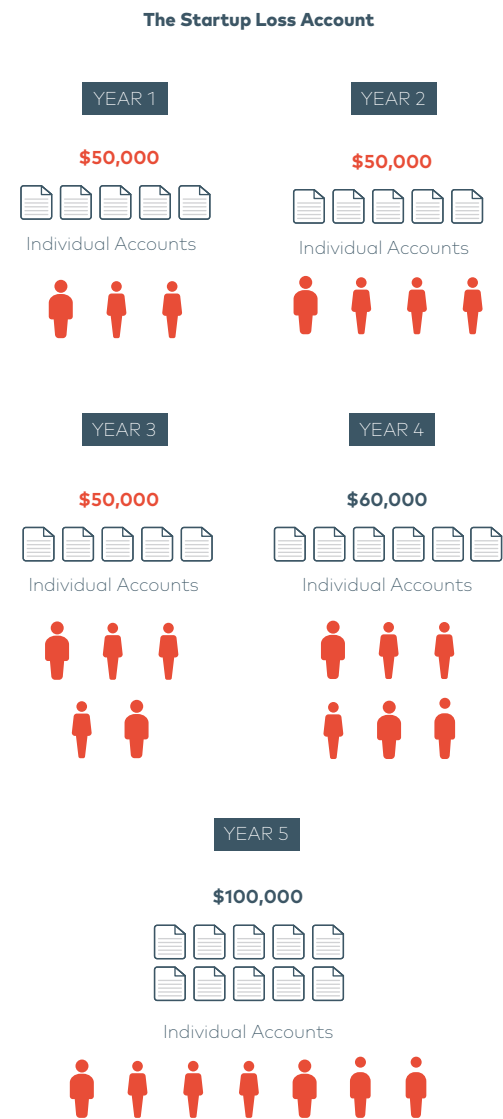
If a loss occurred in the co-op's second year of business, this loss would also be a startup loss. The loss portion scheduled from Year 1 would be added to the portion from the Year 2 startup loss. The total from the matrix in Year 2 would be allocated to the members as a negative patronage allocation for Year two.

It is important to inform new members that a startup loss account is being used. The existence of a startup loss account can be disclosed and explained in the cooperative membership agreement new members must sign upon joining.

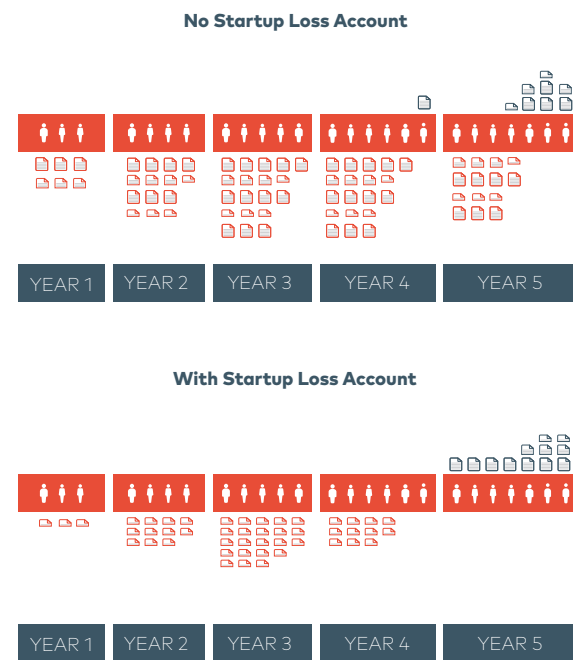




Playing this scenario out, let us assume that Cooperative Construction had losses of \$100,000 in each of its first three years (and therefore negative \$50,000 was allocated to the individual accounts) but made profits of \$120,000 in year 4 (where \$60,000 is allocated to the individual accounts) and \$200,000 in year 5 (where \$100,000 is allocated to the individual accounts).



Under this scenario (and assuming for simplicity sake that everyone always worked the same number of hours), without a startup loss account, after 5 years of operations, even though the total amount allocated to the individual accounts was positive \$10,000<sup>10</sup>, the three founding members would have negative values in their capital accounts. Yet the members who joined after year two would have positive values. Yet, by using a startup loss account, by year five, all of the members have positive amounts in their accounts. While members who joined later do have higher values, the co-op can offset this by increasing pay through seniority, or awarding bonuses.



### Why Not Just Allocate Losses to the Collective Account?

It's not strictly necessary to have a startup loss account, however, the problem is not mitigated by simply allocating any losses to the Collective Account during the startup period. The Collective Account could incur all the losses, however, this also means that the collective account needs to incur all of the net income until it hits at least a zero balance, although we recommend that based upon your business needs, you set a minimum target collective account balance and direct 100% of the net income to the collective net income until you hit this target.

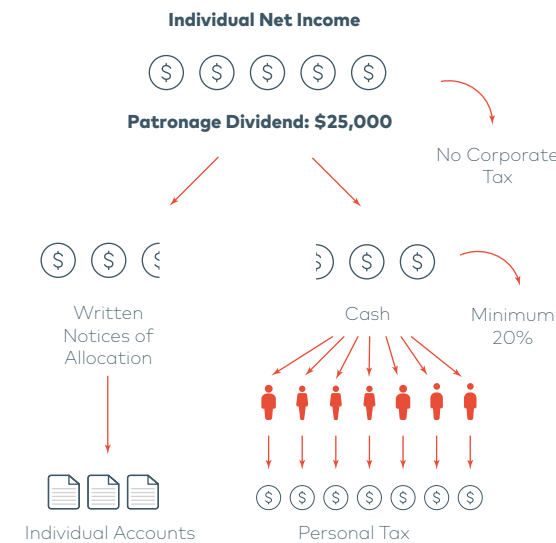
<sup>10</sup> Individual accounts were allocated losses of \$50,000 for the first three years, and \$60,000 for year four, and \$100,000 for year 5 for a net allocation of positive \$10,000 over the first five years.

If this target is specified in your by-laws, you will not need to amend your by-laws once you start making a profit.

## APPENDIX D: QUALIFIED VERSUS NON-QUALIFIED NOTICES OF ALLOCATION

### Qualified Notices of Allocation

When a co-op that is electing to be taxed under subchapter T and distributes its patronage dividend using a qualified notice of allocation, it pays no corporate income tax on this amount. However, the members that receive that dividend pay income tax on total value of the patronage – both the cash they receive and the amounts allocated to their internal capital account. As a consequence, co-ops are required to pay out a minimum of 20% of the patronage dividend in cash to ensure members can pay their income tax obligation.

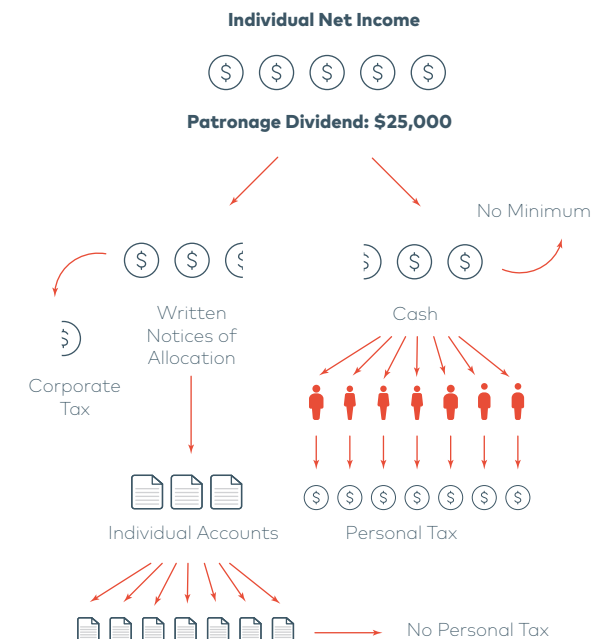


### Non-Qualified Notices of Allocation

Co-ops can also elect to issue allocations to member's internal capital accounts using a Non-Qualified Written Notice of Allocation. A "Non-Qualified" Written Notice is any Written Notice of Allocation of Patronage Dividends which fails to satisfy any one of the qualification conditions – ordinarily the 20% cash payment component.

Thus, for example, a Written Notice of Allocation that comprises an entire Patronage Dividend to a Member would be Non-Qualified, since the co-op would have failed to distribute at least 20% of the Patronage Dividend in cash. Members do not pay personal tax on Non-Qualified Written Notices, but the co-op does have to pay corporate tax on that portion of the net income. Hence income allocated with Non-Qualified Written Notices is taxable "upfront" at the corporate level.

In a later year, when such notices are paid out in cash to the Members, the Members pay personal tax and the cooperative deducts the amount of the cash payout, thus capturing the tax benefit in this later year.



If a member's marginal tax rate on income from the cooperative is above 20%, then the cooperative should consider paying out more than 20% to that Member. The tax laws also require that the Members consent to include the face amount of any Qualified Written Notices plus the cash received in their reported taxable income. If the marginal tax bracket for the cooperative is below 20%, then the cooperative would pay out less cash by using Non-Qualified Written Notices of Allocation. Cooperatives in a higher tax bracket might prefer to use the Qualified Written Notices of Allocation in addition to the Non-Qualified Notices.





### When Should You Elect Non-Qualified Written Notices?

The main reason to choose non-qualified notices is if by selecting one or the other, you can impact either the corporations or a member's taxable income. This strategy is used frequently in agriculture, where farmer-members often have a year where they make a profit, and the next where they don't. By shifting between qualified and non-qualified written notices, these farms better manage their income and losses. For most worker co-ops, however,

workers will not have incomes that move between tax brackets, therefore it is unlikely a worker co-op would employ the use of non-qualified notices.

To illustrate the difference between how the different notices are treated, the table below lays out how notices issued in year one and redeemed in year six would be treated if they were qualified versus non-qualified.

	Qualified Written Notices of Allocation	Non-Qualified Written Notices of Allocation
YEAR 1	<ul style="list-style-type: none"><li>• Corporate taxable income reduced by amount of Qualified WNAs and cash patronage dividend.</li><li>• Members owe tax on qualified written notices of allocation issued.</li><li>• Members owe taxes on cash portion of patronage dividend received.</li></ul>	<ul style="list-style-type: none"><li>• Corporate taxable incwome reduced only by amount of cash patronage dividend, NOT written notices of allocation.</li><li>• Members do not owe taxes on non-qualified WNAs issued.</li><li>• Members owe taxes on cash portion of patronage dividend received.</li></ul>
YEAR 6 (ASSUMES A 5 YEAR HOLD PERIOD)	<ul style="list-style-type: none"><li>• When WNAs from year one are paid out or redeemed, members do not owe taxes on the proceeds.</li></ul>	<ul style="list-style-type: none"><li>• When WNAs from year one are paid out or redeemed, members owe taxes on redeemed Year 1 non-qualified WNAs.</li><li>• Corporate taxable income in Year 6 is reduced by amount of redeemed Year 1 non-qualified WNAs.</li></ul>

### APPENDIX E: GLOSSARY

**Accounting net income:** In this publication, we refer to the net income before taxes (also referred to as Earnings Before Interest) as accounting net income.

**Accounts receivables:** Money that a customer owes a firm. When a firm has made a sale, but has yet to collect the money, it is considered a receivable.

**Assets:** Things of value which a company owns. Cash, savings accounts, tools, and land are examples of assets. Assets are recorded on the balance sheet and must equal the liabilities plus shareholder equity.

**Balance sheet:** One of the three key financial statements used in financial accounting. The balance sheet summarizes a firm's assets, liabilities and shareholder equity at a specific point in time. The balance sheet must always balance, by having the assets equal the liabilities plus shareholder equity.

**Board of Directors:** Body elected by the shareholder-members to govern the company; make policy decisions; and hire or fire management.

**Community Development Financial Institution:** a specialized financial institution that lends money or makes equity investments in parts of the economy that are underserved by traditional financial institutions.

**Collective account:** Unindividualized or unallocated portion of the net book value that is not to be returned to individual members during the lifetime of the corporation.

**Collective net income (or loss):** Portion of the net income that includes any nonmember sourced income and will affect the collective account.

**Collective allocation:** (also called the self-insurance allocation) Collective net income minus the corporate taxes.

**Demutualization:** The process by which a cooperative changes its legal form to a conventional stock corporation that does not operate on a cooperative basis.

**Depreciation:** A method of allocating the cost of a tangible asset over its useful life. Depreciation is used to match the cost of an asset to the time that the asset is used to generate income. When a firm purchases an asset, it only recognizes a portion

of the cost of that purchase in any given year, in this way larger purchases do not adversely affect income.

**Double taxation:** Taxation of net income at the corporate level first then again at the personal level with the payment of dividends.

**Individual capital account:** Internal capital accounts maintained for each member which records the part of the net book value ultimately to be returned to each member. An individual account consists of a membership fee (contributed capital) and written notices of allocation (retained earnings).

**Individual net income (or loss):** Percentage of the net income (or loss) which will be allocated to individual members.

**Internal capital account cooperative:** An employee cooperative whose entire net book value is reflected in internal capital accounts, one for each member, and a collective account.

**Labor patronage:** Number of hours worked for the company or total labor compensation received from the company by a member or non-member during the fiscal year.

**Liabilities:** A firm's debts or obligations owed to others by a company. Liabilities include loans, accounts payable, mortgages and deferred revenue. Liabilities are recorded on a firm's balance sheet.

**Membership fee:** Cost of a membership share.

**Membership share:** Single class of non-transferable voting stock. Each member owns one and only one membership share. Membership shares are usually common shares and have the highest voting rights within the firm.

**Negative patronage allocation:** Negative amount allocated to the individual capital accounts of the members in proportion to their labor patronage.

**Net income:** Amount by which revenues exceed expenses; the bottom line.

**Net book value:** Difference between the assets and liabilities on the corporate books. In an ICAC, net book value consists of the individual plus the collective accounts and is sometimes referred to as net worth.





**Non-member income:** The proportion of net income that is derived from the labor of non-members. Non-member income does not receive preferential tax treatment under Subchapter T and is taxed at both the corporate and individual level.

**Non-qualified written notice of allocation:** A written notice of allocation that fails to meet all of the conditions of the IRS code.

**Non-transferable shares:** Stocks that cannot be sold or otherwise transferred to an outside party. In a worker co-op, only workers are allowed to own shares and when a member leaves the co-op, the co-op must purchase the share from the member.

**Patronage dividend:** A dividend or distribution of net income that a co-op makes to its members. Under Subchapter T, earnings allocated to members on the basis of labor patronage; can be in the form of cash or written notices of allocation. Patronage dividends may not be declared on non-member or unrelated business income.

**Qualified written notice of allocation:** A written notice of allocation that meets all of the conditions of the IRS code. Usually, when the taxable portion of a patronage dividend is paid out in cash, a written notice is considered 'qualified' and the firm does not have to pay corporate income tax on this portion of its accounting net income.

**Retained earnings:** The portion of net earnings not paid out as dividends, but retained by the firm to reinvest in its business operations or pay off debt. Retained earnings increase the net book value resulting from the operations of the firm. In an internal capital account cooperative, the retained earnings is the value in the individual accounts and collective accounts less the value of membership shares.

**Return on Assets:** A measure of how effectively a business uses its assets to create income in the future. The return on assets is calculated by dividing the net income by the total assets. The ROA is displayed as a percentage, sometimes it is referred to as return on investment.

**Revenues:** The money a firm receives from its business activities. It is also referred to as "top line" or "gross income."

**Shareholder equity:** The original equity investment in a firm plus any retained earnings. It is calculated by taking a firm's total assets and subtracting its total liabilities. In an Internal Capital Account Cooperative, the shareholder equity is the value in the individual and collective accounts, plus any preferred or other outside equity.

**Shares of stock:** a document that indicates an ownership stake in a firm and entitles the holder to part of the firm's earnings and assets.

**Single taxation:** Taxation of corporate net income only at the personal level.

**Startup loss account:** Optional debit-balance contra equity account which records the startup losses to be allocated to the individual capital accounts over an extended period of time.

**Subordinate:** A loan or asset that gets paid out after other loans or assets. In the event of bankruptcy or liquidation, debtors are usually paid before holders of equity. Similarly, preferred shareholders are paid out before common shareholders.

**Written notices of allocation:** Notes that disclose to the recipient the stated dollar amount of the patronage dividend allocated to him or her and retained in the cooperative.



## APPENDIX F: FURTHER READING

Ellerman, David P. (1982). *Worker Cooperatives: The Question of Legal Structure*. Boston, MA: The ICA Group.

Ellerman, David P. (1982). *Theory of Legal Structure: Worker Cooperatives*. Boston, MA: The ICA Group.

Ellerman, David P. and Pitegoff, Peter (1983). "The Democratic Corporation: The New Worker Cooperative Statute in Massachusetts." *Review of Law and Social Change*. Vol. XI, No. 3. 441-472.

ICA Group. *Model By-Laws for a Worker Cooperative*. Boston, MA: ICA Group.

Pitegoff, Peter (1982). *The New Massachusetts Law for Worker Cooperatives: MGL Chapter 157A*. Boston, MA: ICA Group

Sedo, Kathryn (1987). "Legal Issues in Worker Cooperatives." *Employee Ownership for Smaller Companies*. Oakland, CA: National Center for Employee Ownership.

Thomas, Henk and Logan, Chris (1982). *Mondragon: An Economic Analysis*. London: George Allen & Unwin.

### Acknowledgements

This guide was originally conceived and written by Richard Feldman, this updated version was written by David Hammer and Jonathan Ward of the ICA Group. Assistance in developing this guide was given by the worker cooperatives of Port Townsend, Washington, Frank Adams, Carol DiMarcello, Steve Brault, Richard Callicrate, David Ellerman, Margaret Lund, and Corey Rosen. Funding for the updated version was provided by The CHS Foundation.

### About the ICA Group

The ICA Group, the country's oldest national organization dedicated to the development of worker cooperatives, was founded on the belief that all people should enjoy economic self-determination as a means to foster an environment where workers' livelihoods and the communities where they live are stable and secure. We strive to facilitate such a society by acting as a catalyst for groups working to ensure workers have a meaningful say in their own economic future and through the development of firms that put these ideals into practice. [www.icagroup.org](http://www.icagroup.org).