



Ag Decision Maker



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Romance vs. reality: Hard lessons learned in grass-fed beef marketing cooperative—Part one

by Annie Wilson, member and former business manager, Tallgrass Prairie Producers Co-op, Rural Papers Newsletter, Kansas Rural Center, October 2001

Editor's Note: Tallgrass Prairie Producers Co-op operated from 1995 to 2000, raising and marketing grass-fed beef from ten Kansas ranches. It ceased active operation in 2000. Below is the story of why and how. While the cluster continues to explore ways to work together, former business manager Annie Wilson offers the following as their lessons learned in the hopes that others will benefit from what they've learned.

The purpose of this article is not to discourage other producers from niche marketing, but to share our experiences in our five years of marketing grass-fed beef. The variables in any business effort are so endless that we cannot conclusively pronounce what will or won't work for others. Times change and undoubtedly some of the

production and marketing realities we faced are different now. A new and different formula may work today. We only know what happened to us, and will try to communicate our perspective here.

First we will give a general overview of our history, followed by what we see as the critical elements of success, (some of which we unfortunately lacked).

Business history

Tallgrass Beef is a product produced by ten ranch families in a marketing cooperative called Tallgrass Prairie Producers Co-op. Our original mission was "to produce and market meat products from livestock raised in a way to maximize conservation of

natural resources and minimize use of fossil fuels and farm chemicals." We decided to raise cattle that spent their entire lives on the pasture, never in the feedlot, avoiding the grain and feedlot production model and producing a unique lean, grass-fed beef product raised without hormones or sub-therapeutic antibiotics.

To do this, we organized ourselves into a formal marketing cooperative in 1995 to develop our product, market, and distribution strategies. We received some grant assistance. But all our operating capital was generated

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Handbook Updates

For those of you subscribing to the *Ag Decision Maker Handbook*, the following updates are included.

Historic Cash Corn and Soybean Prices—File A2-11 (2 pages)

2002 Iowa Farm Custom Rate Survey—File A3-10 (4 pages)

Historic Hog and Lamb Prices—File B2-10 (2 pages)

Historic Cattle Prices—File B2-12 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

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from investment in co-op stock by the ten ranch families.

The organizational structure was member-based, with someone from each ranch serving either individually or as husband-wife teams on our Board of Directors which met monthly. All ranches also had to serve on either our Marketing or Production Committees which also met monthly, and our officers had an additional monthly meeting as our Executive Committee.

We had one non-member employee who provided part-time marketing and operations management services; and one member who served as business manager, taking orders, doing billing, handling communications; and another member who worked part-time at our storage unit assembling large orders for out-of-state shipment. All other jobs were performed by co-op members on a volunteer basis.

Early on we did nutritional testing on our grass-fed beef, discovering that it had an extraordinary nutritional profile, even better than we had thought, with a very low fat content and high nutrient content. We went through the onerous process of obtaining USDA approval for Nutrition Facts labels for all our products, as well as unique special label claims including natural, free range, grassfed, (to our knowledge, the first beef product in the nation to obtain this designation), raised without hormones, etc. We maintained intricate documentation on every animal processed, and recorded carcass data for all beef processed. (The advantages of CLA and Omega-3 fatty acids were an area we had only begun to explore toward the end of our production.)

Market successes

One of our great market successes was the effectiveness with which our members could personally market our beef. We attended promotions and trade shows in which our passionate, western-clad ranchers were popular attractions and generated great consumer enthusiasm. People loved to meet and visit with the actual producers. The only problem was this was time-consuming and expensive.

At first we assembled our own promotional material, but later hired professional graphic designers who produced award-winning labels and promotional materials. We were fortunate to receive attention from local and national media, and won Best of Show awards in our state food exhibition. It is our strong opinion that we had one of the most healthy, delicious and environmentally sustainable food products ever offered to the American consumer.

At our peak, we were marketing our beef in 23 states through three large natural food distributors. From the beginning, we also direct marketed some beef in our local area. However, our local markets were so low in volume and high cost in service that they were never profitable. The markets that worked best economically were the large distributor markets.

Catch-22 or barriers

Barriers we encountered were numerous. Many we were able to overcome through hard work and determination. Others had become insurmountable by the time we perceived them clearly, and we found ourselves caught in a vicious cycle.

Our volume was too low to obtain processing of our product at an economically viable, competitive rate (our costs were triple those of other high volume suppliers). Yet even managing the volume of orders we had was exhausting our members and employees. We lacked adequate supply to access the markets we needed to reach the volume we needed to obtain affordable processing and transportation. Additionally, we did not have the capital to acquire professional management to guide our company in these directions.

Despite painstaking monthly analysis of our gross margin and exploring every cost-cutting measure we could think of, including heroic subsidization of our business with free labor from our members, we were consistently losing equity. We could not see any improvement in sight within the economic structure in which we were trapped. At that point, we used our now considerable experience to produce a thorough business plan.

Using this plan, we looked for outside help including private investors, financial institutions, government agencies, foundations, and other rancher alliances. However, we could not find the help we needed. Ultimately, we lacked the capital to escape our quandary. Our members, who had already made significant financial investments in the co-op, faced the prospect of mortgaging their family ranches to back what we knew was a worthy but risky enterprise, to compete in a cut-throat and volatile commercial arena.

In 2000, after five years of intense struggle, we made the painful decision to terminate our sales and stem our loss of equity, so that we would be able to pay all of our co-op's bills and would not cause financial injury to others. In hindsight, we realize that we should have initially leveraged our investments and borrowed heavily from a financial institution, based on a sound business plan developed by professionals

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that would have established a larger, viable scale, professionally managed operation.

Instead we tried to avoid co-op debt and do it all ourselves, learning as we went. In retrospect, we also learned that even larger specialty meat companies we had thought were very successful also are struggling. The phenomena of concentration both within the processing industry and retail arena is so intense that the profit margins are slim for everyone. There are fewer and fewer processors available for mid-size companies. The expense and burden of service and promotion are almost entirely passed on to the supplier by retailers. We wonder now if it would even be possible to survive as a "mid-size" company, with volume of around 30,000 head a year, which was what we were considering as our expansion level goal, an astronomical increase from our peak of 400 head a year.

Our co-op is made up of committed, active members. We feel the co-op model is an excellent one, except a professional manager should run the business and not the Board of Directors. We attribute our remarkable level of progress on so little capital and without professional guidance to the sheer commitment of our member families.

As we see it

The fundamentals of success profitability depends on three elements:

- Professional management of operations and marketing to establish and manage legal, safe operations, to penetrate the market and to navigate the complex food distribution system. This is essential for the business to succeed and to allow producers the time to do what they know how to do, which is to produce high quality products.
- A successful business needs access to volume markets to reach breakeven (when gross profit on sales exceeds overheads). A business may be able to break the paradigm of huge scale production and survive on lower volume, but in so doing it must practice honest accounting for

personal time and must reach a volume that covers these overheads.

- Cost-effective operations are necessary to realistically price the product and reach the volume needed to be profitable.

The two keys to acquiring the above three elements are a critical mass of supply and capital.

Supply

- An adequate supply is critical to access cost-efficient processing. The smaller the volume, the more expensive the processing. Only high volume, highly-efficient processing operations can turn commodity into a safe product and keep direct costs within reason. Unless a business can offer a significant supply on a regular basis, these operations will not bother with it.
- The ability to access volume markets depends on an adequate supply. Buyers won't even talk to a business unless it can consistently deliver a quality product with no interruptions in supply.
- On a related note: adequate supply is a prerequisite to offering fresh product, which has significant market advantages over frozen beef. We found consumers really wanted fresh beef, and that frozen product severely limited our marketability, except in very low volume, tiny outlets. But since a fresh product has such a short shelf life, it requires a steady, consistent volume of product turnover.

Capital

- Adequate capital is necessary to acquire expertise and information to develop a feasible business plan, to acquire competent management to run the business, and to cash flow the operation. The basic formula summary for economic sustainability: supply + capital = Lower-cost processing + volume markets + professional management.

Next month—further lessons learned by Tallgrass Prairie Producers Coop.



Final regulations on income averaging for farmers*

by Neil E. Harl, Charles F. Curtiss Professor in Agriculture, professor of economics, 515-294-6354, harl@iastate.edu

The proposed regulations for the income averaging provisions for farmers were made final on January 7, 2002. The final regulations addressed several of the shortcomings in the proposed regulations issued in 1999.

Farm landlords

The proposed regulations did not address the question of whether farm landlords were eligible for income averaging. However, the final regulations provide that rental income that is based on a tenant's production (a share rent lease) is treated as income from a farming business if, after December 31, 2002, the landlord's share of a tenant's production is set in a written rental agreement entered into before the tenant begins significant activities.

The final regulations make it clear that a landlord is not considered to be engaged in a farming business if the rental is either a fixed rent (cash rent) or, for amounts received on or after January 1, 2003, even share rents based on a share of a tenant's production determined under an unwritten agreement or a written agreement entered into after the tenant has begun significant activities on the land. Surprisingly, the final regulations specify that whether the landlord materially participates in the tenant's farming business "is irrelevant for purposes of section 1301." Therefore, non-materially participating filers under Form 4835 or even filers on Schedule E are eligible for income averaging if the landlord's share of a tenant's production is set in a written rental agreement before the tenant begins significant activities on the land.

This places a premium on assuring that leases are in writing.

Eligibility of wages

The proposed regulations stated that, in general, income items passed through to partners or other owners in a pass-through entity, were eligible for income averaging. For S corporations, the character of income from corporate distributions continues in the hands of the shareholders who are eligible to average their incomes. However, under the proposed regulations, farm income did not include "wages."

The final regulations state specifically that "a shareholder of an S corporation engaged in a farming business" may treat compensation received from the corporation that is attributable to the farming business as farm income.

The summary to T.D. 8972 (but not the final regulations themselves) states that the income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.

Negative taxable income

The final regulations embrace the change in position first announced in the 2001 Farmers Tax Guide and in the Schedule J instructions allowing a base year's taxable income to be negative. However, amounts such as a net operating loss or capital loss that may be deducted in one or more other taxable years in the form of a carryback or carryforward must be added back in computing negative taxable income.

Change in filing status

As did the proposed regulations, the final regulations state that an individual is not prohibited from making an income averaging election solely because the individual's filing status is not the same as in the base years. However, the final regulations do not provide guidance on how the remaining bracket amounts are to be divided between the spouses if both spouses have elected farm income in a year following marriage dissolution, which was a shortcoming of the proposed regulations.

Amending returns

Under the proposed regulations, an individual could not make a late election, change an election or revoke an election unless there had been an adjustment to taxable income or tax liability or the Commissioner of Internal Revenue had consented. That requirement has been eliminated in the final regulations with the provision now stating simply that an election can be made on a "late or amended return if the period of limitations on filing a claim for credit or refund has not expired..." and that a previous election can be changed or revoked if the period of limitations has not expired.

Effective dates

In general, the final regulations are effective for taxable years beginning after December 31, 2001. However, the requirement for a written lease agreement does not apply until after December 31, 2002.

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Are we courting disaster?

by *Daryll E. Ray, Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and director, UT Agricultural Policy Analysis Center, 865-974-7407; dray@utk.edu; http://www.agpolicy.org.*

The 2001 corn stocks-to-use-ratio for the United States is projected to be 0.159, the twelfth lowest in the last forty years (for the world less China it is projected to be 0.129, also the twelfth lowest level). If China is included—China's stock levels are as usual, uncertain and unverified—then the stocks-to-use ratio is 0.206, the fourteenth lowest level in the last forty years.

With stocks at those levels why are prices at record lows? From the U.S. perspective, there are two reasons. The first is that in many of the past years government or Farmer-Owned-Reserve stocks—although isolated from the market for a range of prices—were available and made the stock-to-use ratio larger for a given level of price. The other reason market prices tend to be low even though stocks are low is that the market knows there are no farm program instruments that will kick in now, or next crop year, to raise prices. Market participants would bid up prices if they anticipated additions to government stocks or the Farmer Owned Reserve this year or if acreage reduction programs were likely to be instituted next crop year. Since none of these actions are possible under current legislation, buyers have every reason to believe that prices will be just a low or lower next crop year. And with continued good weather providing trend level or better increases in yield, crop prices will indeed remain low.

But low prices are not the only thing that farmers and the nation have to be on the lookout for. In some ways, we have the worst of all possible worlds. Prices remain low, although stocks are relatively small compared to the past. However, if a yield catastrophe hits, there are no stocks to buffer prices and to provide assurance to exporters and domestic demanders that the U.S. is a dependable supplier of grain. With stocks at the present relatively low levels, what would happen if we had a drop in corn yield similar to the ones we experienced in 1993 or 1988 or 1983? What would happen

to our projected 2001 corn carryover levels of 1.57 billion bushels, if we had two poor crops in a row?

If we had a 23–29 percent drop in yields like we saw in 1983, 1988, and 1993 along with the concomitant increase in the abandonment of planted acres, we could see the current modest carryover levels drop significantly and prices rise to unprecedented levels. It is not inconceivable that producers could see a lot of \$5 corn with peaks as high as \$10. The other crops would be affected as well resulting in some utilization changes being made due to the shortage of “cheap” corn. Again it is not inconceivable that we might see \$10 beans with higher peaks.

While prices like that would be good for those who have something to sell, the repercussions would be dramatic. Some of our steady export customers would have to develop contacts elsewhere in the world. Like Charlie who got on the Kingston's Trio's MTA, one has to wonder “if they would ever return.” Some of our largest hog and poultry conglomerates would likely become significant importers of grain and soybean meal—a practice they might become comfortable with. For those who have both grain and livestock, what they gained in the grain prices would be lost on the livestock side of the operation.

Besides not satisfying the needs of traditional demanders, the high prices would cause countries around the world to further step-up major-crop production. It is one thing to talk about raising loan rates \$0.20, it is quite another to have \$4, \$5, or \$6 corn. And, we know that when new acreage is brought into production, the increase tends to be relatively permanent.

All of this brings us back to a point we have made before. Properly administered, an emergency food reserve could be of vital importance to producers and consumers in the US and around the world. While short-term high prices might feel good, everyone may benefit more in the long run with a more stable food supply system that can accommodate significant weather-related production problems.



Handling gains and losses on cooperative stock *

by *Neil E. Harl, Charles F. Curtiss Professor in Agriculture, professor of economics, 515-294-6354, harl@iastate.edu*

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The reporting of gains and losses on the stock of cooperatives has been a pressing issue in many farm communities as value-added cooperatives

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and other cooperatives have failed or merged with cancellation of patronage equities. In many instances, the question is the proper characterization of the equity interest relinquished by the patron and whether losses are ordinary losses or capital losses.

Rev. Rul. 70-64

A 1970 revenue ruling, Rev. Rul. 70-64, has provided helpful guidance for situations similar factually to the facts in the ruling. In that ruling, a taxpayer operating a chicken farm became a member of an agricultural cooperative for purposes of acquiring supplies and marketing eggs and chickens. The cooperative followed the practice of retaining patronage dividends to augment capital with qualified written notices of allocation. The cooperative normally redeemed the qualified notices of allocation, usually within one to two years. In the year in question, the cooperative redeemed the qualified written notices of allocation but at less than their stated amount on issuance. Thus, the taxpayer incurred a loss when the allocation was redeemed. The question was the nature of the loss—whether an ordinary loss or a capital loss.

The ruling states that—

“...the taxpayer joined the cooperative to facilitate his business and to make it more profitable. The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer’s trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified written notice of allocation is an ordinary loss deductible...under the provisions of section 165 of the Code.”

The loss was measured by the difference between the stated amount included in income in the earlier year and the amount received upon redemption.

It is noted that the loss did not involve an equity investment by the patron in the cooperative; rather, the loss involved the failure to receive the benefit of amounts reported into income in the earlier year.

Investment in cooperatives

The more difficult question is the proper treatment of gains and losses for equity interests in a cooperative which were purchased or otherwise acquired in a transaction that did not involve allocated patronage earnings.

It is important to note that all assets are considered to be capital assets other than for specified exceptions. The exceptions are for:

- 1. inventory property,
2. property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business,
3. depreciable property used in the trade or business,
4. real property used in the trade or business,
5. copyrights and compositions, and
6. U.S. Government publications.

Stock in a cooperative does not seem to fall within any of the exceptions. [Cf. Peake v. Comm’r, 10 TCM 577 (1951) (taxpayer’s interest in a cooperative apartment venture consisted of stock in a cooperative apartment corporation rather than of a proprietary lease and deduction for loss in year investment became worthless was long-term capital loss).] Therefore, it would appear that an investment in stock of a cooperative, including a value-added cooperative, would be a capital asset with a loss properly characterized as a capital loss.

Cooperative part of “trade or business”?

A further question is whether an equity interest in a cooperative could be classified as a “Section 1231 asset” which would permit net losses to be treated as ordinary losses. Some have argued that, since membership in some cooperatives requires members to be producing a particular product (e.g., corn or sugar beets), membership in the cooperative could be deemed a part of the trade or business.

The problem with that argument is that the definition of “property used in the trade or business” for purposes of Section 1231 capital gain (or ordinary loss) treatment is relatively narrow—

“The term ‘property used in the trade or business’ means property used in the trade or business, of a character which is subject to the allowance of depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year....”

Obviously, cooperative stock or other equity instruments in a cooperative are neither depreciable property nor real property used in the trade or business.

In conclusion

Losses attributable to allocated patronage, which has been reported into income appear to be deductible as ordinary trade or business losses. However, losses from investments in cooperative equities would seem to be properly characterized as capital losses.

... and justice for all

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