Producer Cooperatives and Membership in a Dynamic Marketplace

Iowa Women in Agriculture Conference
FFA Enrichment Center, Ankeny, Iowa

Keri L. Jacobs
August 2, 2018
DYNAMICS FACING PRODUCERS

- Changing economics of food production
- Changing market scope and structure
- Changing consumer preferences for foodstuffs
- Changing tax environment
- Changing social and political cultures

...AND CO-OPS

- Changing producer needs
IMPORTANT LAWS FOR CO-OPS

- Capper Volstead (1922)
- IA code Chapter 499 (1935)—producer co-ops
- IA code Chapter 501 (1996)—closed co-ops (aka “new generation”)
- IA code Chapter 501A (2005)—hybrid co-op and L.L.C.

✅ Democratic control in the hands of producers (production at risk requirement)
✅ Limited capital access members and accumulation
✅ Special tax treatment of co-op profits allocated to patron
**IMPORTANT TAX LAWS — PART 1**

**Subchapter T** — no changes

- Co-ops can allocate profits to patrons/members, and the income tax is paid either by the co-op or the patron/member (single taxation)
- Allocations can be “qualified” or “nonqualified”
- Minimum 20% of qualified allocation must be paid as cash in that year
- At least 50% of business must be with members
IMPORTANT TAX LAWS – PART 2

Section 199A(a) – ties back to Sec 199 DPAD

- Major changes to how taxable income is calculated at the farmer level (relies on QBI calculation)
- Deduction available for pass-through organizations: sole proprietors, partnerships, trusts, estates, LLCs, S-corporations, and cooperatives
- Deduction depends on who you sell to: co-op vs. not

For purposes of state income taxes, IOWA couples with the federal deduction on an increasing scale over the next 4 – 5 years, starting at 25%.
**QBI FOR FARMERS**

Calculation can be complicated, and tax professionals are awaiting guidance from the IRS, but generally…

\[ QBI = \text{Net Income} - \text{Capital Gains} \]

- **Does include** PURPIM and patronage from co-op
- **Does not include** wages, interest income, dividend income, capital gains.
- **Connected with a domestic trade or business**
- **Each “qualified trade or business” must be calculated separately**
Deduction on “qualified business income” (QBI) for pass-through entities (non C corp)

Expires after 2025 (Iowa will be fully coupled just before that); note corporate tax rate of 20% is permanent)

There are potentially two §199A deductions to calculate:

- §199A(a) is a farm-level deduction, depends on who the farmer sells to (co-op vs not), limited by 50% of wages + 20% of taxable income less cap gains
- §199A(g) is a co-op level deduction and may be passed through to co-op members
SEC 199A(a): THE FARMER-LEVEL DEDUCTION

Sales to Co-op

- 20% of QBI is initial deduction, then subtract the smaller of:
  - 9% of net income attributed to sale to co-op
  - 50% of W2 wages associated with sale to co-op
  - wage/capital limits apply

- Then ADD deduction passed through from co-op (if any)

Sales Not to Co-op

- 20% of QBI, limited by:
  - 20% of taxable income minus capital gains
  - wage/capital limits apply if income exceed $157,500 / $315,000 for single / married filing jointly.
SEC 199A(g): THE CO-OP LEVEL DEDUCTION

- **Co-ops** will calculate a deduction at their level, and **may** pass through a portion of it.
- Their deduction is 9% of QPAI attributable to patron/members, including PURPIM, limited by 50% of wages and taxable income.
- The co-op will choose how much to keep at the co-op level to offset their taxes or pass through (0% - 9%)
- A farmer’s total deduction is limited by **taxable income after QBI deduction taken**
CO-OP VS NOT?

Total Deduction if selling to a co-op:

1. Sec 199A(a) deduction
   a) If you have no W2 wages, your deduction will likely be 20% of QBI (on-par with selling to independent)
   b) If you have significant W2 wages, your deduction will likely be 11% of QBI, and you may be disadvantaged relative to selling to an independent unless the co-op deduction is passed-through.

2. PLUS Sec 199A(g) deduction: member’s portion of the co-op’s DPAD-like pass-through, calculated from the co-op’s QPAI, including PURPIM
WHAT THIS IMPLIES

- The choice of who to sell to will depend on more than price
- Co-ops may use non-qualified allocations to still allocate when taxable income is down—members don’t understand this
- Member characteristics complicate things (org., wages, likely tax bracket)
- Will impact equity redemption periods and capital accumulation
- Tax differential matters less as income declines.
Network of Iowa Co-ops in Iowa at 1979
Approximately 50 grain marketing & farm supply co-ops today

On average, 12 locations per co-op but as large as 70 locations
Consolidation Observations

- **Drivers**
  - Access to strategic assets
  - Succession and retention, access to talented GM
  - Enhanced operational efficiency
  - Access to capital
  - Market protection for producers
  - Everyone else is doing it
Profitability metrics are not enhanced by more sales alone
Has consolidation allowed co-ops to achieve purported efficiencies? (Correlations with Assets $)

- Profit margin
- Return on sales
- Return on assets
- Return on equity
- Asset Turnover \((-0.17 \text{ to } -0.21)\)
- Operational exp. \((-0.17 \text{ to } -0.27)\)
- Labor exp. efficiency \((0.19 \text{ to } 0.26)\)
- Members’ share of total equity
- Members’ share of local equity \((-0.17 \text{ to } -0.21)\)
Competitive Environment

- Co-ops are price takers
- Significant competition
- Co-ops unable to eliminate redundant assets
- A survey of Iowa landowners shows that approximately 45% of landowners use a co-op to some degree for marketing, custom services, or to purchase inputs; equates to approximately 33% of land (acres).
- Market share of co-ops is falling according to USDA data
What I Hear Farmers Saying

• “The co-op is just another big business.”
• “It’s not my co-op anymore.”
• “I’m not the type of farmer the co-op cares about.”

Consolidation – the act of it – is fundamentally putting at odds members’ values and perceptions with leaderships’ values and perceptions.
The Times They Are A Changin’

Cooperative formation and reformation occurs during periods of:

• *Social and political unrest*
• *Distrust of institutions*
• *Imbalances in market power*
• *Gaps in markets*
Are Cooperatives Relevant?

“A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise.”

- International Cooperative Alliance
E: kljacobs@iastate.edu
https://www.econ.iastate.edu/people/keri-jacobs

THANK YOU!