WHAT THE SEC 199A TAX FEATURE MEANS FOR CO-OPS AND PRODUCERS

NC Farm Management Extension Committee

May 18, 2018

Keri L. Jacobs, Asst. Prof & Extension Economist

IOWA STATE UNIVERSITY
Extension and Outreach

CARD
I am not a tax professional and relied heavily on the writings of tax professionals who understand these things. All errors are mine. Acknowledgement: Kristine Tidgren, Iowa State University Center for Ag Law & Taxation (CALT)

Please do not share co-op metrics figures/data beyond this group (preliminary)
1. The deduction for co-ops and their members (some)
2. The trade-offs
Good ‘Ole Section 199
WHERE WE WERE — SEC 199

- Domestic Production Activities Deduction (DPAD) enacted as part of the American Jobs Creation Act (P.L. 108-357 signed into law 10/22/2004).

- Intent was to spur jobs creation in manufacturing for all tax payers: a deduction based on qualified production activities income (QPAI: think net income), limited by W2 wages paid.

- The deduction phased in from 3% in 2005 to eventually 9% of QPAI in 2009.

- IRS rulings in 2008: Cooperatives were recognized as what they are—an extension of their members’ operations that produce a domestic product.
QPAI:

Domestic Production Gross Receipts (DPGR) $500,000
less: Cost of Goods Sold $450,000
Addl. exp/deductions allocable to DPGR $10,000
and share of exp for other income

QPAI $40,000

- Farmers: essentially Schedule F net income (profit or loss from farming) plus Form 4797 (gain from sale of raised livestock).
- The deduction in this case is 9% of QPAI, but limited to 50% of W2 wages or 9% of taxable income, whichever is less.
- Co-ops: QPAI is NOT reduced by COGS from members on grain and they have high W2 wages.
FARMERS’ BASIC (OLD) SEC 199 CHOICE

Sales to Co-op
Co-op level deduction:
- 9% of QPAI from member business, without deduction of qualified payments to patrons (no reduction by PURPIM, patronage)
  - No individual-level AGI or W2 wage limitation of passed-through DPAD.
  - Co-op designates members’ sales as PURPIM—there is no individual-level deduction.

Sales to Independent
- 9% of QPAI limited to lesser of:
  - 50% of W2 wages
  - 9% of taxable income

The more wages a farmer had, the less clear was this choice
WHERE WE WERE — CO-OP’S USE OF DPAD

- In order to qualify, co-ops’ payments to members must be per unit retains paid in money (PUMPIM)
- Co-ops rewrote membership agreements to ensure that payments for products marketed by the co-op are PUMPIMs

Why was the co-op’s role important?
  - Reduce overall system tax liabilities
  - Co-ops generated DPAD in cases their members could not, and passed it through.
  - In grain, members—particularly smaller ones—do not have W2 wages that qualify: the farm-level deduction is $0.
  - NCFC estimated the annual impact of $220 million!
WHERE WE WERE — CHALLENGES

Generally the qualification of payments for sales to the co-op as **PURPIM** helped producers, but there were consequences:

- Larger producers with wages questioned doing business as a member
- Co-ops’ unallocated retains grew quickly – pros and cons
- If regionals kept DPAD, the local co-ops lost out on “sales up”
- Disrupted the **predictable pass-through** feature of co-ops
- **Confusing** to members

IOWA STATE UNIVERSITY
Extension and Outreach

CARD
Tax Cuts and Jobs Act feat. Sec 199A (P.L. 115-97)
READ MY LIPS…
NO PASS-THROUGH DEDUCTIONS
GOAL: REDUCE AND SIMPLIFY TAXES

- Reduce corporate taxes: flat 21% (permanent)
- Repeal of Sec 199 DPAD (permanent)
- Sec 199A: 20% qualified business income (temporary)
  - Farmer selling to an independent: 20% deduction of QPAI
  - Farmer selling to a co-op: 20% deduction of gross sales—includes qualified cooperative dividends
  - Co-op: deduction is 20%*(gross sales – patronage), limited by greater of 50% wages or 25% wages plus 2.5% qualified property
  - An attempt to bring pass-through income taxation in line with the corporate tax reduction
WHERE WE ARE NOW - FEDERAL

- New Sec 199A: deduction (expires after 2025) on “qualified business income” for pass-through entities (non-C corp)
  - §199A(a) Farmer selling to an independent: 20% of QBI
  - §199A(a) Farmer selling to a co-op: 20% deduction of QBI MINUS (smaller of) 9% of QBI or 50% of W2 wages attributed to sales to co-op PLUS pass-through deduction from co-op.
  - §199A(g) Co-op: 9% of QPAI, including PURPIM, limited by 50% wages and taxable income

- Farmer-level component limitation: 50% of wages and 20% of taxable income minus capital gains
QBI FOR FARMERS

It’s complicated, and tax professionals are awaiting guidance from the IRS on how QBI is calculated.

(generally)   QBI = Net Income – 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
FARMERS SELLING TO AN INDEPENDENT

BEFORE (Sec 199)
- 9% of QPAI, limited by lesser of:
  - 50% of W2 wages
  - 9% of taxable income

AFTER (Sec 199A(a))
- 20% of QBI, limited by:
  - 20% of taxable income minus capital gains
  - wage/capital limits apply if income exceed $157,500 / $315,000 for singles / married filing jointly.

May be a bigger deal for some producers than others
FARMERS SELLING TO THEIR CO-OP

BEFORE (Sec 199)

Co-op level deduction:
- 9% of QPAI from member business, without deduction of qualified payments (no reduction by PURPIM, patronage)
- No individual-level AGI or W2 wage limitation of passed-through DPAD.
- Co-op designates members’ sales as PURPIM—there is no individual-level deduction.

AFTER (Sec 199A(a))

- 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
  - 0% - 9% of co-op DPAD-like, (based on QPAI), 199A(g))
  - Limited by farmer’s taxable income after QBI deduction taken

NOT the same 9%
SELLING TO CO-OP — W2 WAGES MATTER

Total Deduction:
1. Member portion of the co-op’s DPAD-like pass-through, calculated from the co-op’s QPAI, including PURPIM (199A(g))

2. PLUS
   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 additional 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.
The final Section 199A provides deductions for certain entities, and this excludes entities that file taxes as C-corps. The following can calculate Sec 199A deductions:

- Sole proprietors, partnerships, trusts, estates
- LLCs
- S corporations
- Cooperatives

For purposes of state income taxes, each state will decide whether to couple with the federal deduction. In IOWA, the deduction couples on an increasing scale over the next 4 – 5 years, starting at 25%.
Producers are now paying attention to the DPAD-like benefit. Whether they understand it or not—or think they do—it will matter.

Co-ops will get increased pressure to pass-through deduction.
<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grain</td>
<td>$110,898,520</td>
<td>$72,721,940</td>
</tr>
<tr>
<td>Farm Supplies</td>
<td>$36,995,170</td>
<td>$40,077,100</td>
</tr>
<tr>
<td><strong>Total Sales</strong></td>
<td>$147,893,690</td>
<td>$112,799,040</td>
</tr>
<tr>
<td><strong>Cost of Goods Sold</strong></td>
<td>$140,314,000</td>
<td>$105,545,570</td>
</tr>
<tr>
<td>Gross Margins</td>
<td>$7,579,690</td>
<td>$7,253,470</td>
</tr>
<tr>
<td><strong>Other Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service Income</td>
<td>$5,527,810</td>
<td>$5,142,900</td>
</tr>
<tr>
<td>Finance Charges</td>
<td>$702,040</td>
<td>$566,220</td>
</tr>
<tr>
<td><strong>Total Other Income</strong></td>
<td>$6,229,850</td>
<td>$5,709,120</td>
</tr>
<tr>
<td><strong>Gross Income</strong></td>
<td>$13,809,540</td>
<td>$12,962,590</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personnel Expense</td>
<td>$4,497,100</td>
<td>$4,589,870</td>
</tr>
<tr>
<td><strong>Fixed Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$1,628,210</td>
<td>$1,758,740</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$1,813,240</td>
<td>$1,740,870</td>
</tr>
<tr>
<td>Insurance</td>
<td>$261,130</td>
<td>$251,400</td>
</tr>
<tr>
<td>Property Taxes</td>
<td>$504,100</td>
<td>$565,500</td>
</tr>
<tr>
<td><strong>Variable Expenses</strong></td>
<td>$2,066,520</td>
<td>$3,338,980</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>$10,770,300</td>
<td>$12,245,360</td>
</tr>
<tr>
<td><strong>Local Savings (Loss)</strong></td>
<td>$3,039,240</td>
<td>$717,230</td>
</tr>
<tr>
<td><strong>Patronage Refunds Received</strong></td>
<td>$239,900</td>
<td>$477,700</td>
</tr>
<tr>
<td><strong>Net Savings (Loss)</strong></td>
<td>$3,279,140</td>
<td>$1,194,930</td>
</tr>
</tbody>
</table>

**Non-Operating Income**

- Patronage from regionals
- Other investments

**NOTE:** All *qualified* patronage allocated in the year is included here, but not all is received as cash. (Remember this for the balance sheet discussion)

Ex: AGP makes an allocation of $0.50/bu of soybeans:

- 50% cash
- 50% allocated qualified equity (paper)
<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash on hand</td>
<td>$1,542,630</td>
<td>$4,971,560</td>
</tr>
<tr>
<td>Accts Receivable</td>
<td>$5,792,150</td>
<td>$4,178,530</td>
</tr>
<tr>
<td>Inventories</td>
<td>$6,090,410</td>
<td>$4,697,820</td>
</tr>
<tr>
<td>Others</td>
<td>$2,362,500</td>
<td>$777,560</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>$15,787,690</td>
<td>$14,625,470</td>
</tr>
<tr>
<td>Fixed (Long Term) Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$1,751,110</td>
<td>$1,751,110</td>
</tr>
<tr>
<td>Building &amp; Equipment</td>
<td>$35,245,720</td>
<td>$35,608,220</td>
</tr>
<tr>
<td>Less: Accum Depreciation</td>
<td>$13,930,270</td>
<td>$15,605,890</td>
</tr>
<tr>
<td><strong>Total Fixed Assets</strong></td>
<td>$23,066,560</td>
<td>$21,753,440</td>
</tr>
<tr>
<td>Other Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in Co-ops</td>
<td>$8,774,160</td>
<td>$9,078,390</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$47,628,410</td>
<td>$45,457,300</td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accts Payable</td>
<td>$1,887,010</td>
<td>$82,530</td>
</tr>
<tr>
<td>Operating Line</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Current portion of long-term note</td>
<td>$1,420,000</td>
<td>$1,420,000</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>$2,118,930</td>
<td>$2,945,680</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>$5,425,940</td>
<td>$4,448,210</td>
</tr>
<tr>
<td>Term (Long Term) Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgages / Term Notes</td>
<td>$9,219,800</td>
<td>$7,799,800</td>
</tr>
<tr>
<td>Member Notes</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total Long Term Liabilities</strong></td>
<td>$9,219,800</td>
<td>$7,799,800</td>
</tr>
<tr>
<td><strong>EQUITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td>$156,500</td>
<td>$156,500</td>
</tr>
<tr>
<td>Deferred Patronage Refunds</td>
<td>$24,046,010</td>
<td>$23,980,270</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$8,780,160</td>
<td>$9,072,520</td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td>$32,982,670</td>
<td>$33,209,290</td>
</tr>
<tr>
<td><strong>Total Liabilities and Equity</strong></td>
<td>$47,628,410</td>
<td>$45,457,300</td>
</tr>
</tbody>
</table>
Co-op Returns Distribution Decision Tree (David Barton)

Pre-Tax Profits (Savings)

Source
- Patronage
  - Allocated Patronage
  - Unallocated
  - Non Patronage

Allocation
- Allocated Patronage
  - Qualified
    - Cash Patronage Refund
    - Retained Patronage Refund
    - Net Retained Patronage Refund
  - Non Qualified
    - Income Tax
    - Dividends
    - Income Tax
    - Net Retained Earnings

Unallocated
- Not Qualified
  - Cash Patronage Refund
  - Retained Patronage Refund
  - Income Tax
  - Dividends
  - Net Retained Earnings
  - Income Tax
Co-op Returns Distribution Decision Tree (David Barton)

Pre-Tax Profits (Savings)

Source
- Patronage
  - Allocated Patronage
  - Unallocated
- Non Patronage
  - Allocated Patronage
  - Unallocated

Allocation
- Allocated Patronage
- Non Allocated

Tax Status
- Qualified
- Non Qualified
- Not Qualified

Distributed As
- Cash Patronage Refund
- Retained Patronage Refund
- Net Retained Patronage Refund
- Income Tax
- Dividends
- Income Tax
- Net Retained Earnings
- Cash Patronage Refund
- Retained Patronage Refund
- Income Tax
- Dividends
- Net Retained Earnings
- Income Tax
Members’ Equity in name. The more “cash” and income the co-op has, the faster allocated retained patronage can be redeemed. But...
WHAT THIS IMPLIES — CO-OPS

Considerations:

- use of non-qualified allocations (allocated to member but co-op “pays” tax)
- status of regional patronage income
- member characteristics (org., wages, likely tax bracket)
- Impact/interruption to equity revolvement
PARTING THOUGHTS

- The original Sec 199A—"grain glitch"—created a perceived market distortion that was more or less predictable.

- The new Sec 199A also creates distortions, but not ones that are easy to anticipate.

- There exist compelling arguments for passing through a portion of the co-op level DPAD-like deduction given the restructuring in corporate and individual tax brackets.

- BUT...passing along the co-op DPAD-like deduction represents a significant shift to the current financing of some co-ops.
AN ASK:

WHAT RESOURCES DO PRODUCERS NEED REGARDING CO-OPS, PATRONAGE, SEC 199A, ETC?

Email me: kljacobs@iastate.edu
Co-ops' Local Return on Assets
(local profit ÷ net fixed assets)

Low
High
Co-ops' Local Return on Sales
(local profit ÷ sales)
Co-ops' Profit Margin w/ Patronage Income
(net profit margin ÷ sales)
Co-ops' Profit Margin \textit{w/out} Patronage Income
(net profit margin \div sales)

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Graph showing the profit margin of co-ops with and without patronage income from 2010.1 to 2017.4.}
\end{figure}