SEC 199A PASS-THROUGH DECISIONS FOR CO-OP BOARDS

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OVERVIEW

- Historical context of the law
- Summary of the co-op level deduction
- Philosophy and practice
- High-level take-away and key factors

TIMELINE

- Section 199, part of the 2005 American Jobs Creation Act, created a special tax deduction (DPAD) for manufacturers of agricultural products. Ag co-ops could pass through this deduction to their members.
- Tax Cuts and Jobs Act (Dec 2017) flattened corporate tax rates and replaced the co-op DPAD deduction with a deduction that farmers could take for selling products to a co-op. This was coined the "grain glitch."
- Consolidated Appropriations Act (Mar 2018) restored much of the original DPAD, but calls it Sec 199A deduction. The co-op calculates a deduction that can be passed-through, and establishes different deductions for producers selling to a co-op vs. a non-co-op (an independent).

WHERE WE WERE – SEC 199

- 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.

WHERE WE WERE – CO-OPS 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—did not have W2 wages that qualify so the farm-level deduction was $0.

WHERE WE ARE NOW

- 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, up to 50% W2 wages and taxable income
- Farmer-level component limitation: 50% of wages and 20% of taxable income minus capital gains

BOARD CONSIDERATIONS

1. Producers – calculate a different deduction depending on whether they sell to a co-op or independent.
2. The Co-op – calculation is straightforward, but how much of the deduction to pass through is not.

- How much can members use?
- How much can the co-op use?
- What is the trade-off with patronage for both?
- What is the role for non-qualified allocations?

BOARD CONSIDERATIONS: PRODUCERS

Producers: 20% deduction or 11%+ deduction depending on producer's W2 wages and pass-through from co-op

- ✓ Uncertainty in marketing decisions
- ✓ Producers may have an expectation of a benefit that is incorrect
  - How much can they use?
  - Is a deduction allocation better than patronage?

BOARD CONSIDERATIONS: CO-OPS

2. The co-op calculation is straightforward, but how much of the deduction to pass through is not.

Philosophical perspective: the co-op should strive to retain what is needed for strategic growth, and return the residuals.

- Implies the co-op keeps only as much deduction as it needs to sustain a growth rate (investments).
- Complicated by uncertainty and tax strategies.
- At what point does benefit of tax reductions to the co-op underserve the needs of the members? (marginal analysis)

BOARD CONSIDERATIONS: CO-OPS

2. The co-op calculation is straightforward, but how much of the deduction to pass through is not.

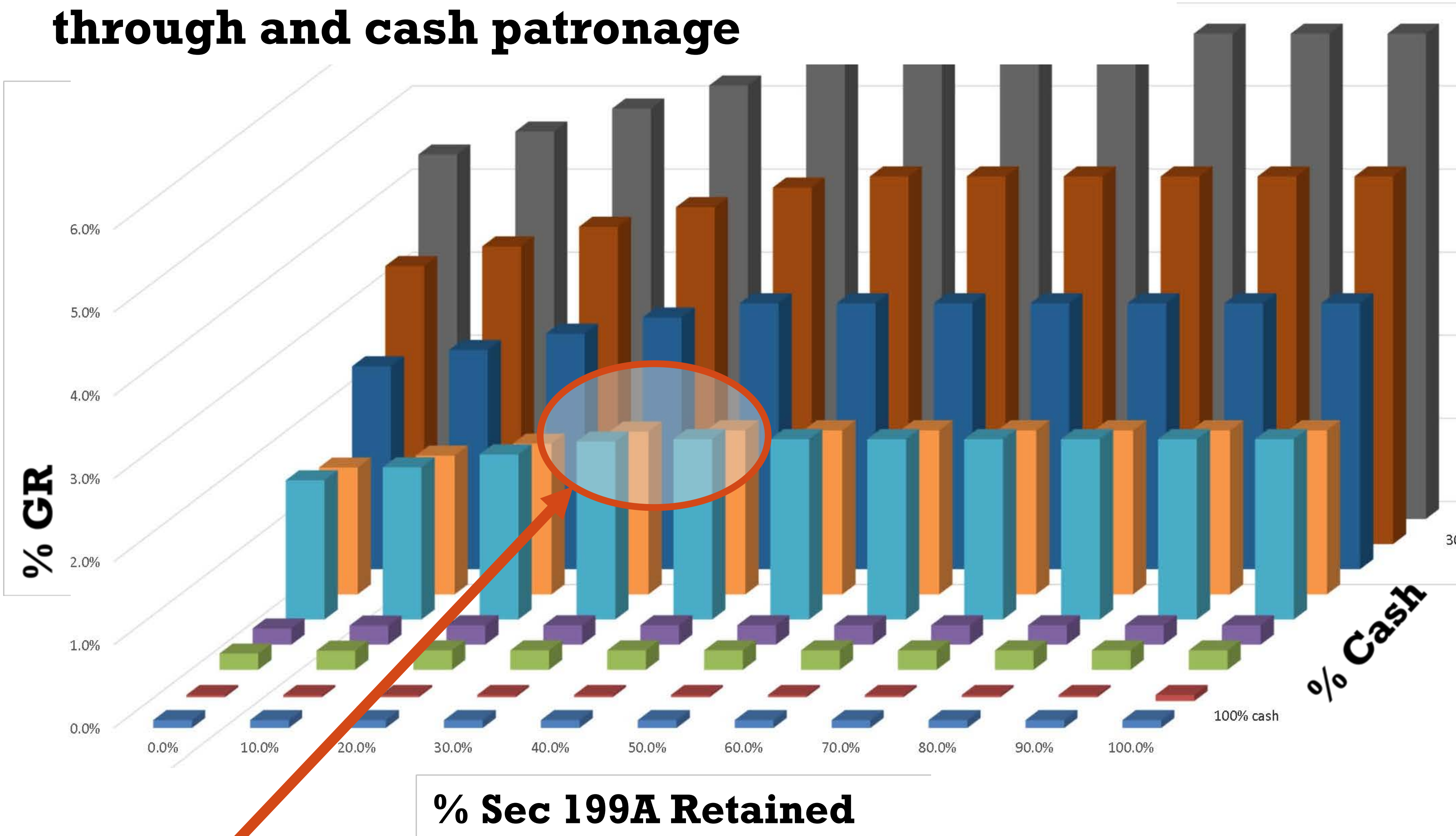
Practical perspective: producers have heterogeneous tax circumstances, but co-ops cannot implement discriminatory pass-through of the deduction; must play the averages.

- On average, producers likely have more levers for reducing taxable income than co-ops
- Co-op likely to take more advantage (to a point) of the deduction than an individual producer

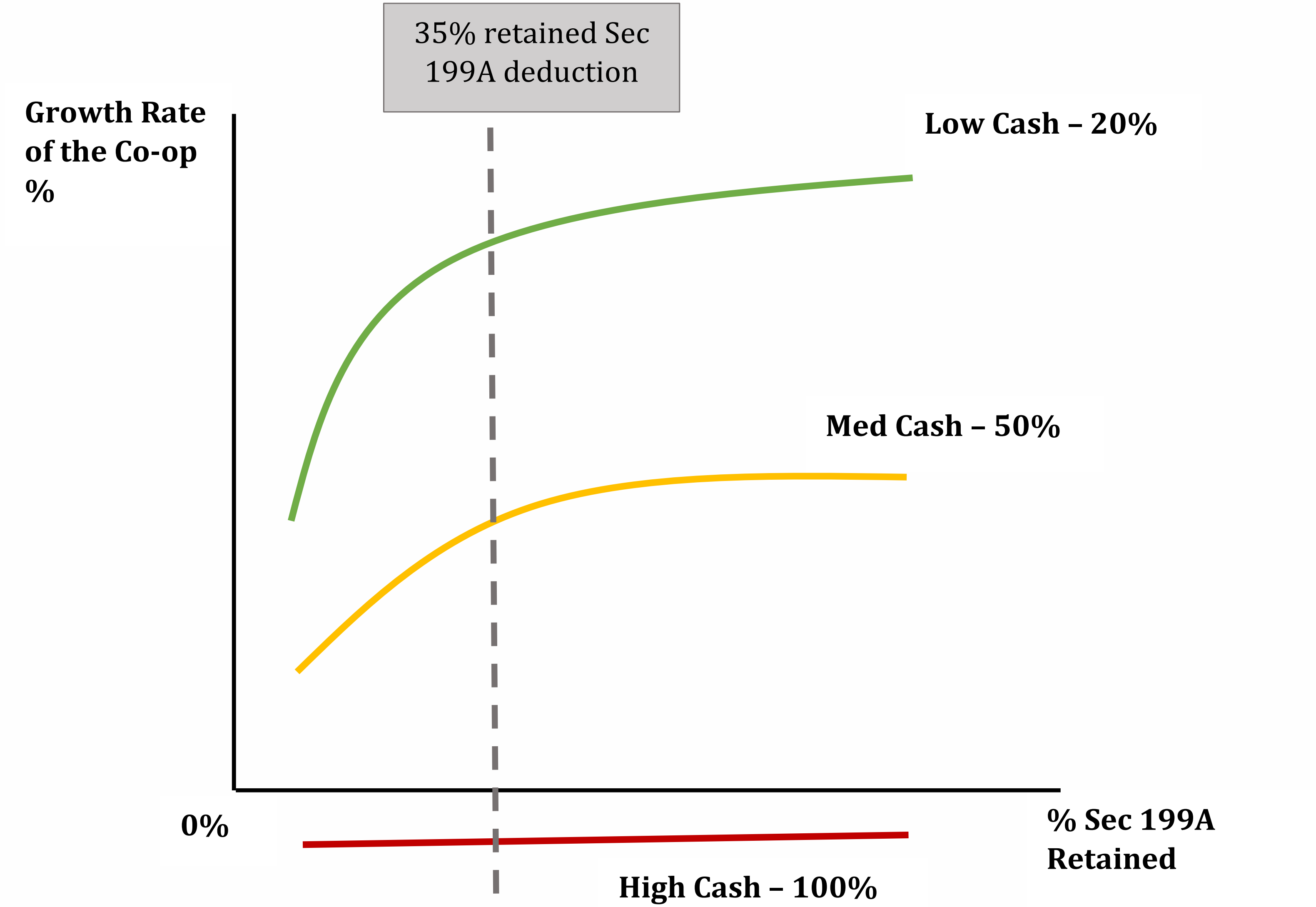
EVIDENCE FROM AN IOWA CO-OP

- The deduction pass-through decision is about the growth rate (GR) of the cooperative relative to members' benefits.

Co-op GR with varying Sec 199A pass-through and cash patronage



At 50% cash, no add'l benefit of retaining more Sec199A.



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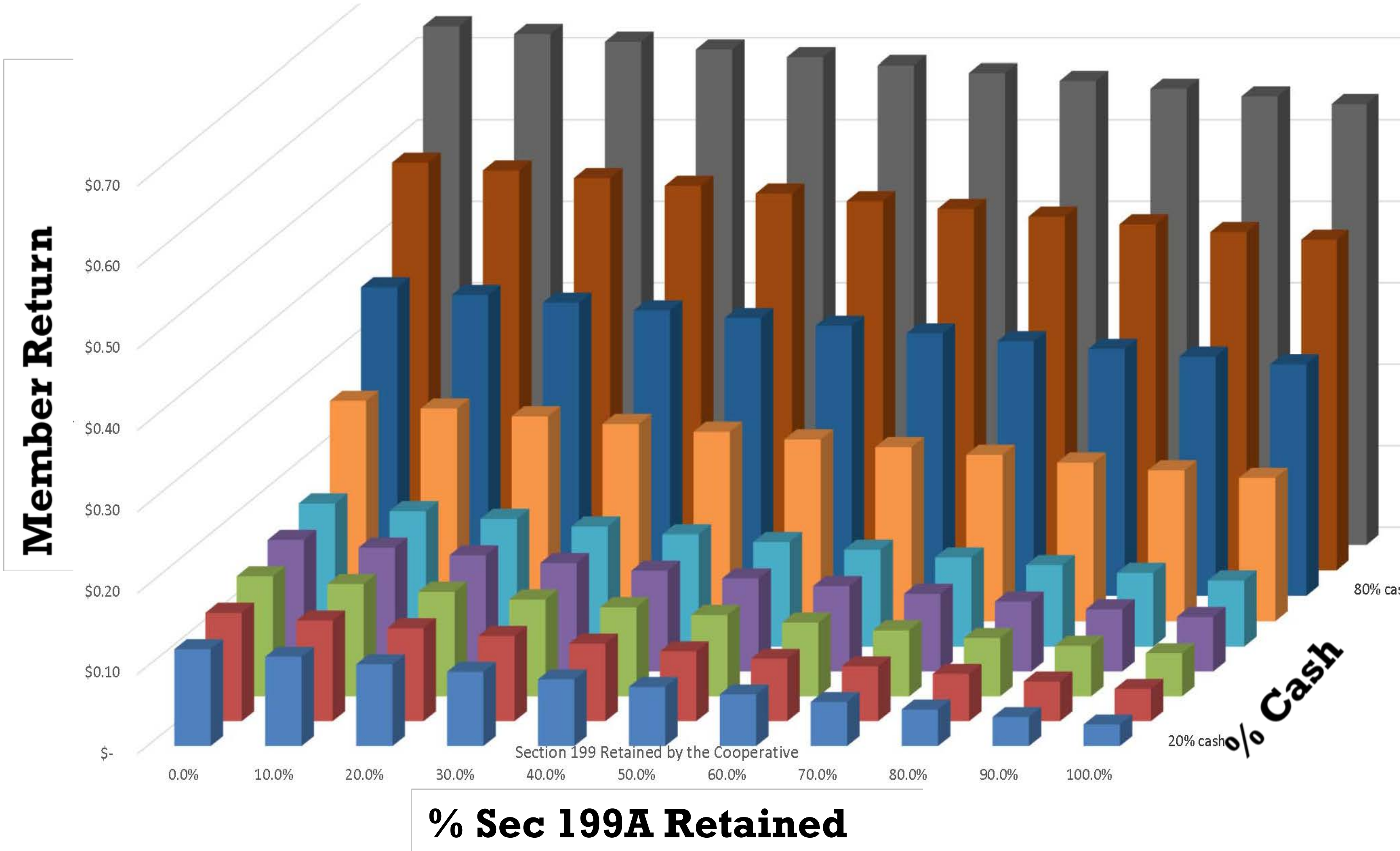
Member return with varying Sec 199A pass-through and cash patronage



Cash patronage has the biggest impact on member return

EVIDENCE FROM AN IOWA CO-OP

- The deduction pass-through decision is about the growth rate (GR) of the cooperative relative to members' benefits.
- Given a 50% qualified allocation (100% cash):
  - there was no GR benefit to retaining more than approx. 30% of deduction
  - the members' benefit nearly doubles (¢/bu) when the deduction pass through increases from 0% to 100%
- Cash patronage is the major determinant of:
  - the co-op's GR holding profitability constant
  - Members' return from the co-op (more than the pass-through)

EVIDENCE FROM AN IOWA CO-OP

- Retaining the deduction necessarily means increasing retained earnings, which is a reduction in members' benefits.
- Non-qualified equity allocations make the most sense in this environment versus qualified allocated equity.
- In corn/soybeans, the member will likely need about 35-45% of the pass-through, the co-op needs approximately 35-40% of the pass-through – room for both!
- The lower is income, the less this decision will impact net grain prices.

WHY NON-QUALIFIED MAKES SENSE

- At 50% cash: equity retirement payments contribute approx. 25% of member return if NQ (50%) is used; therefore, retaining earnings in lieu of allocation reduces member returns by 25%
- At 50% cash: a member's IRR is 15.8% is 50% NQ is used versus 10% if Q is used
- The typical corn/soybean producer will use approx. 35% of the Sec 199A deduction to make them equivalent to using an independent (assuming equal market prices)
  - The co-op can retain sufficient Sec 199A to offset the NQ tax effect while still keeping their members equivalent.

WHAT THIS IMPLIES FOR PRODUCERS

- 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 likely experience increased pressure to pass-through the deduction.

WHAT THIS IMPLIES FOR CO-OPS

Considerations:

- use of non-qualified allocations
- status of regional patronage income
- member characteristics (org structure, W2 wages, likely tax bracket)
- Impact to revolving equity

PARTING THOUGHTS

- There exist compelling arguments for passing through a portion of the co-op level Sec 199A deduction.
- It is possible to pass-through the deduction, achieve consistent growth, and make members better off through cash patronage.
- These strategies represent a significant shift in the current financing of many co-ops and will require member education to be successful.

QUESTIONS?

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SIMULATION ASSUMPTIONS – OK STATE

- Simulated 30-yr pro-forma financial statements of representative corn & soybean marketing co-op in Iowa
- Price, volume, margin and expense info based on 7-yr financial time series
- Maintenance, depreciation, insurance and property taxes modeled as a percent of fixed assets
- AR, inventory and regional patronage modeled as a percent of farm supply sales

SIMULATION ASSUMPTIONS – OK STATE

- Co-op distributes profits as: 50% retained earnings, 25% cash and 25% qualified equity, uses an age of patron equity program
- Assumed 20-yr age of equity for baseline
- Max Sec 199A credit limited to 50% of W2 wages associated with commodities marketed: total personnel expense adjusted by grain-to-total sales (62%); taxes and benefits were 30% of personnel expense.
- Co-op starts with 35% allocated equity; at 50% cash and 50% NQ, allocated equity increases to 48% over 10 years.

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 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.

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

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.