THE SEC 199A PASS-THROUGH DEDUCTION: WHAT IT MEANS FOR PRODUCERS AND CO-OPS

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OVERVIEW

- Historical context of the law
- Summary of the producer level deduction
- Summary of co-op level deduction and pass-through
- High-level take-away and key factors

Disclaimer: I am not a tax professional. Please seek the advice of a tax professional to understand your Sec 199A deduction.
LEGISLATIVE CONTEXT

2005 American Jobs Creation Act created a special tax deduction (DPAD/Sec 199) for manufacturers of agricultural products.

- Intent to spur jobs creation in manufacturing

- The deduction phased in from 3% in 2005 to eventually 9% of QPAI in 2009, limited by W2 wages.

- Cooperatives are an extension of their members’ operations that produce a domestic product; therefore, they could generate and pass-through the deduction to members.
LEGISLATIVE CONTEXT: CO-OPS USING 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
- The co-op’s role was significant
  - Reduced overall system tax liabilities
  - Generated DPAD and passed it through to members.
  - In grain, members—particularly smaller ones—did not have W2 wages that qualified so the farm-level deduction was $0.
**LEGISLATIVE CONTEXT**

Tax Cuts and Jobs Act (Dec 2017) with Consolidated Appropriations Act (March 2018)

- flattened corporate tax rate from max 35% to 21% (permanent)
- replaced the co-op DPAD deduction with Sec 199A deduction *(expires after 2025)* on “qualified business income” for pass-through entities (non-C corp)
  - Sec 199A(a) – farmer-level deduction
  - Sec 199A(g) – co-op level deduction
- The deduction may have an appreciable impact on final (net) marketing prices for producers.
WHERE WE ARE NOW – SEC 199A DEDUCTION

Sec 199A(a) deduction is based on QBI: “…the net amount of items of income, gain, deduction, and loss with respect to any qualified business of the taxpayer…” (Schedule F)

Calculation of farmer-level deduction §199A(a):

- Selling to an independent: 20% of QBI
- Selling to a co-op: 20% deduction of QBI LESS (smaller of):
  - 9% of QBI, or
  - 50% of W2 wages attributed to sales to co-op

- 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) \( QBI = \text{Net Income} - \text{Capital Gains} \)

- **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
WHERE WE ARE NOW — SEC 199A DEDUCTION

The co-op also generates a deduction §199A(g) based on qualified production activities income, and can keep or pass through any portion.

- Deduction is **lesser of:**
  - 9% of QPAI, including PURPIM
  - 50% W2 wages
  - Limited to taxable income
1. Your deduction depends on whether you sell to a cooperative or not (independent).

2. Your deduction may depend on your W2 wages.

3. Your deduction may depend on how much the co-op passes through – possible to get greater than 20% QBI if co-op passes through any and you have no W2 wages.
CO-OP BOARD CONSIDERATIONS

1. Producers calculate a different deduction depending on whether they sell to a co-op or independent.
   - This creates a potential competitive advantage/disadvantage

2. Deciding how much (if any) of the deduction to pass-through is challenging:
   - Cannot discriminate among producer-members in passing-through the deduction
   - Balancing act between co-op and producer
   - Is a deduction better than patronage?
CO-OP BOARD CONSIDERATIONS

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 be able to take more advantage of the deduction than an individual producer
EVIDENCE FROM A 'TYPICAL' IOWA PRODUCER

Tries to understand the average producer’s ‘offset’ for selling to a cooperative versus an independent.

- Producers offset is the lesser of 9% of QBI or 50% of W-2 wages and wage restriction is likely binding
- Producers with no W-2 wages will face no offset
- The potential offset for a typical corn and soybean producers was calculated using ISU AgDM Farm Costs and Returns data (Plastina)
### 'Typical' Corn/Soybean Producer

<table>
<thead>
<tr>
<th></th>
<th>Corn</th>
<th>Soybeans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yield (bushels)</td>
<td>214</td>
<td>60</td>
</tr>
<tr>
<td>Price/bushel</td>
<td>$3.28</td>
<td>$9.32</td>
</tr>
<tr>
<td>Revenue/acre</td>
<td>$701.92</td>
<td>$559.20</td>
</tr>
<tr>
<td>W-2 Wages/acre</td>
<td>$11.51</td>
<td>$9.32</td>
</tr>
<tr>
<td>Other expenses/acre</td>
<td>$591.32</td>
<td>$447.83</td>
</tr>
<tr>
<td>Qualified Production Income/acre</td>
<td>$99.09</td>
<td>$102.05</td>
</tr>
<tr>
<td>20% QPI/acre</td>
<td>$19.82</td>
<td>$20.41</td>
</tr>
<tr>
<td>50% W-2 Wages/acre</td>
<td>$5.76</td>
<td>$4.66</td>
</tr>
<tr>
<td>Binding offset (W-2 Wages)/acre</td>
<td>$5.76</td>
<td>$4.66</td>
</tr>
<tr>
<td>Offset per bushel</td>
<td>$0.03</td>
<td>$0.08</td>
</tr>
<tr>
<td>Section 199A at Cooperative Level/bushel</td>
<td>$0.08</td>
<td>$0.08</td>
</tr>
<tr>
<td>%Section 199A Pass Through Needed/bushel</td>
<td>34%</td>
<td>97%</td>
</tr>
<tr>
<td>Percent of total production (2017)</td>
<td>89%</td>
<td>11%</td>
</tr>
<tr>
<td>Weighted Average Pass Through Needed</td>
<td>41%</td>
<td></td>
</tr>
<tr>
<td>Pass Through Needed $/bushel</td>
<td>$0.032</td>
<td></td>
</tr>
</tbody>
</table>

*Note: The highlighted areas indicate the significant values for the comparison.*
If you market through a cooperative:
- consider the potential benefit of the pass-through Sec 199A(g)
- Your co-op may switch from qualified to non-qualified patronage allocations

Generally speaking, the lower are wages and taxable income, the smaller is the impact of Sec 199A.
QUESTIONS?

Email me: kljacobs@iastate.edu
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—their is no individual-level deduction.

AFTER (Sec 199A(a))

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

• THEN…ADD deduction passed through from co-op
  o 0% - 9% of co-op DPAD-like, based on QPAI, 199A(g))
  o 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.