

WHAT THE TAX REFORM MEANS FOR YOUR COOPERATIVE AND ITS MEMBERS

**Cooperative Network's Federal Dairy
Issues Forum**

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1. How did we get here?
2. What are the trade-offs farmers and co-ops will have to consider?
3. A **challenge**



OBLIGATORY DISCLAIMERS

- 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):**

<https://www.calt.iastate.edu/>

- All co-ops and producers need to decide for themselves how best to navigate these changes.





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 FOR FARMERS IS, COARSELY, NET INCOME

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	<hr/>
QPAI	\$ 40,000

QPAI is 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.



FARMERS' BASIC 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 has, the less clear is this choice



WHERE WE WERE — CO-OP'S USE OF DPAD AND BENEFITS

- 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!**

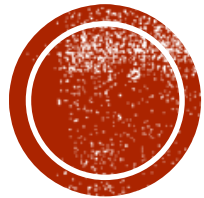


WHERE WE WERE – CHALLENGES BROUGHT BY DPAD

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



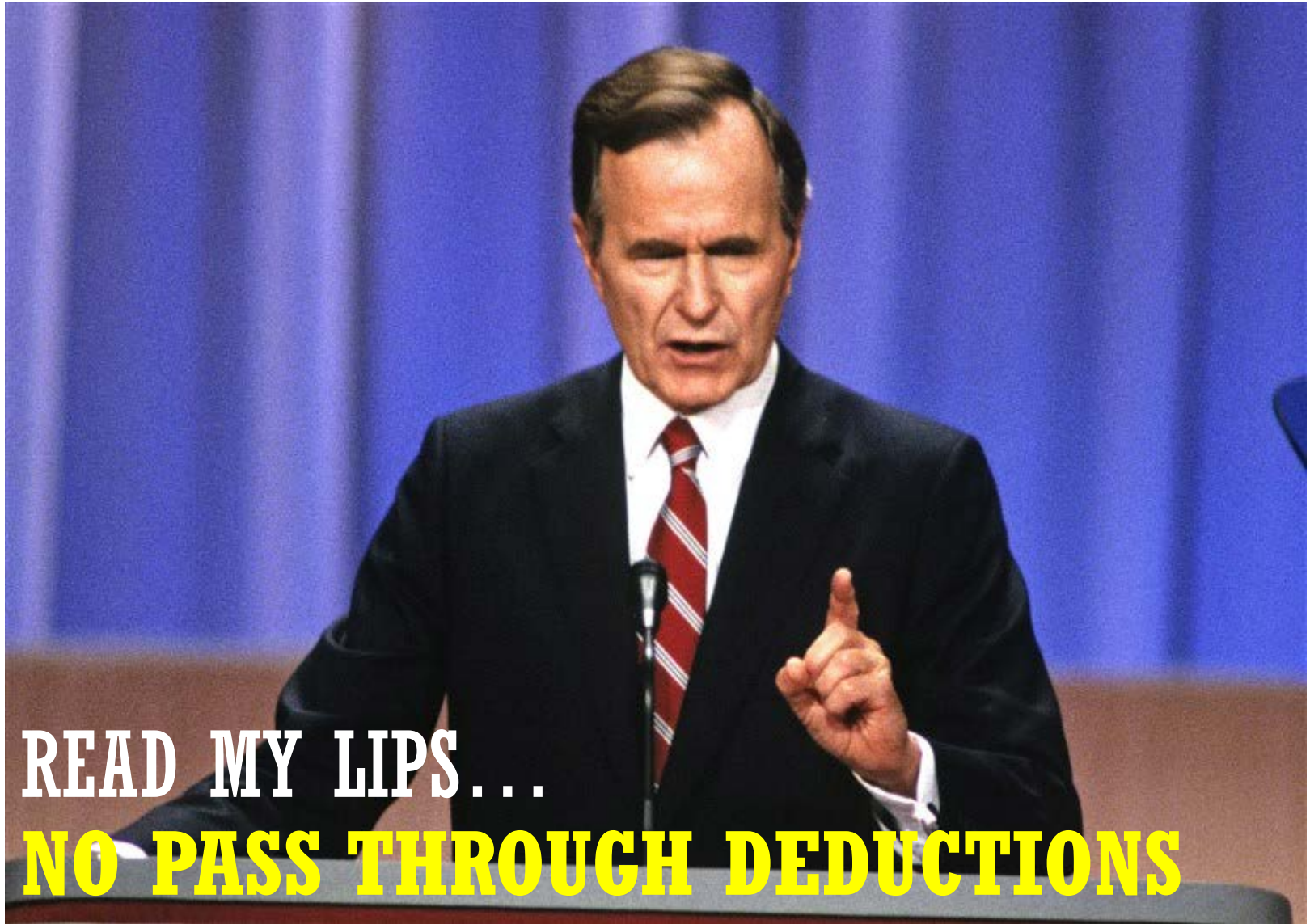


Tax Cuts and Jobs Act feat. Sec 199A (P.L. 115-97)

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—qualified cooperative dividends, including
 - 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





READ MY LIPS...

NO PASS THROUGH DEDUCTIONS





NEW & IMPROVED SEC 199A

WHERE WE ARE NOW

- New Sec 199A: deduction (**expires 2025**) on income from pass-through entities: (§199A(a) and 199A(g))
 - 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** 9% of share of distributed co-op QPAI.
 - Co-op: 9% of QPAI, including PURPIM, limited to 50% wages and taxable income
- Wage-property limitation and limited to 20% of modified taxable income on **farmer-level** deductions
- For the co-op member, this "fix" looks like a blend of the first Sec 199A and the old DPAD...ish.



QBI

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



CHANGES FOR 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 restriction applies if income exceed \$157,500 / \$315,000 for singles / married filing jointly.

How big a deal is this for dairy?



CHANGES FOR FARMERS SELLING TO THEIR CO-OP

BEFORE (Sec 199)

Co-op level deduction

- 9% of QPAI from business, with qualified pay (no reduction for 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.

NOT the same 9%

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
- **THEN...ADD** 0% - 9% of co-op DPAD-like allocation passed through (based on QPAI), 199A(g)

(same wage/capital limitations apply)



FARMER-MEMBERS OF CO-OPS WHO SELL TO THEIR CO-OP

Your Deduction:

1. Your portion of the co-op's DPAD-like pass-through, calculated from the co-op's QPAI, including PURPIM (199A(g))

PLUS

2. Either...
 - 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.



WHAT THIS IMPLIES (INCENTIVES)



Producers are now paying attention to the DPAD-like benefit. Whether they understand it or not—or think they do—it will matter.

It is not predictable early in the year.



CHALLENGE

Co-ops have a real opportunity to get their arms around:

- **Education** about the nature of the relationship between farmers and their co-ops
- **Education** about the financial value of the relationship between farmers and their co-ops
- Education about the strategic trajectory of **capital structure**.

How/will you educate your members about this?



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.
- This is an opportunity for co-ops to capitalize on a new “value” of doing business with the cooperative.
- 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.
- Competitors will use messaging to compare and compete favorably.
- BUT...passing along the co-op DPAD-like deduction represents a significant shift to the current financing of some co-ops.





THANK YOU!

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