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

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K. Jacobs acknowledges funding, in part, from the USDA National Institute of Food and Agriculture Hatch Project 1010309

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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.

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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

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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

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

PRODUCER (NON C-CORP) CONSIDERATIONS

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

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

WHAT THIS IMPLIES FOR PRODUCERS

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?

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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.