What the Sec 199A Tax Feature Means for Co-ops and Producers

NC Farm Management Extension Committee

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OBLIGATORY FRONT MATTER

- 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 and share of exp for other income	$ 10,000
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

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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!

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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

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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

NEW & IMPROVED SEC 199A

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

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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

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, withou[t ...] of qualified paym[...] (no reduction[...] patronage)

NOT the same 9%

- No individual-lev[...]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.

CAVEATS

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%.

WHAT THIS IMPLIES - FARMERS

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.

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

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)

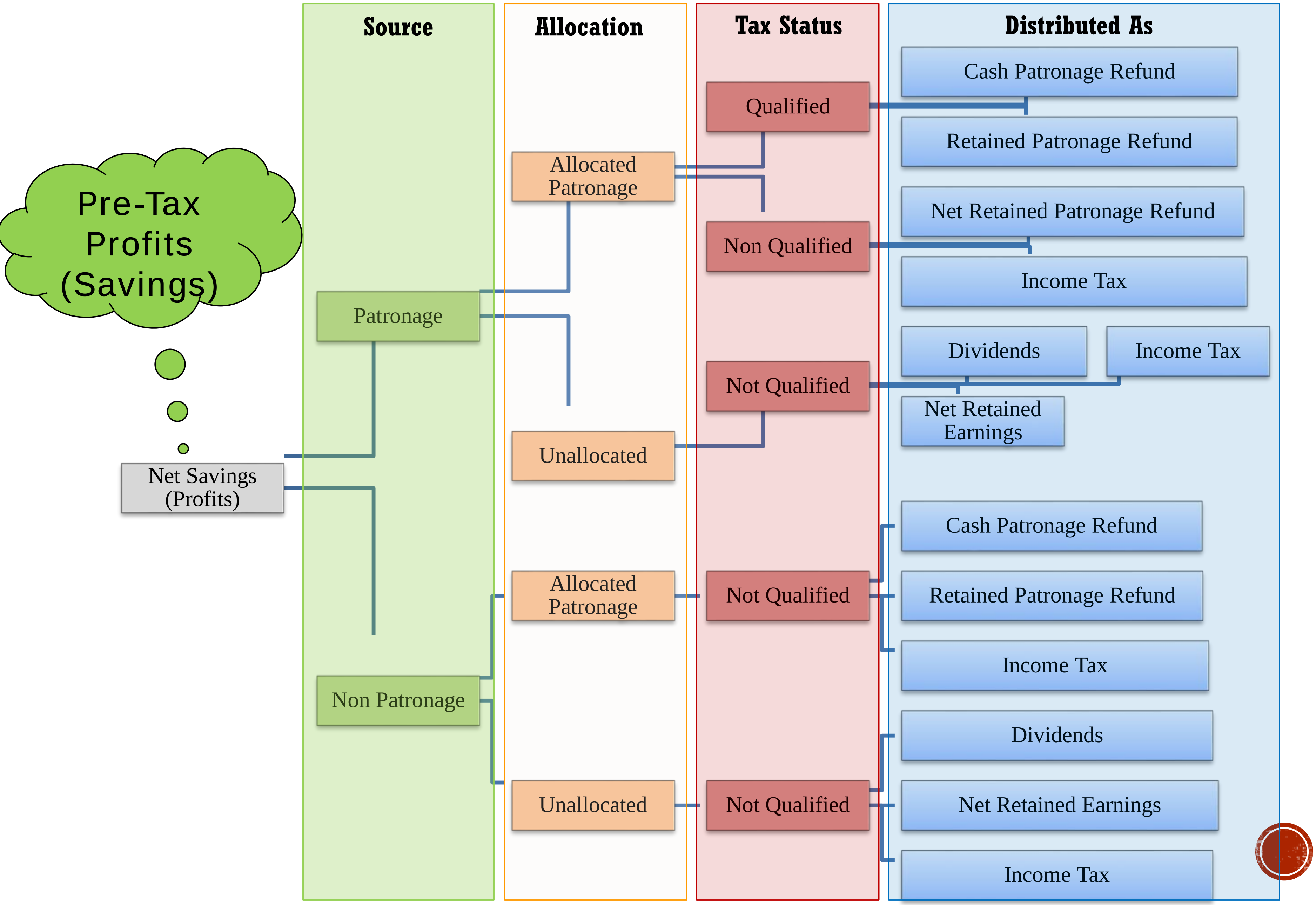
Ex: AGP makes an allocation of $0.50/bu of soybeans:

- 50% cash
- 50% allocated qualified equity (paper)

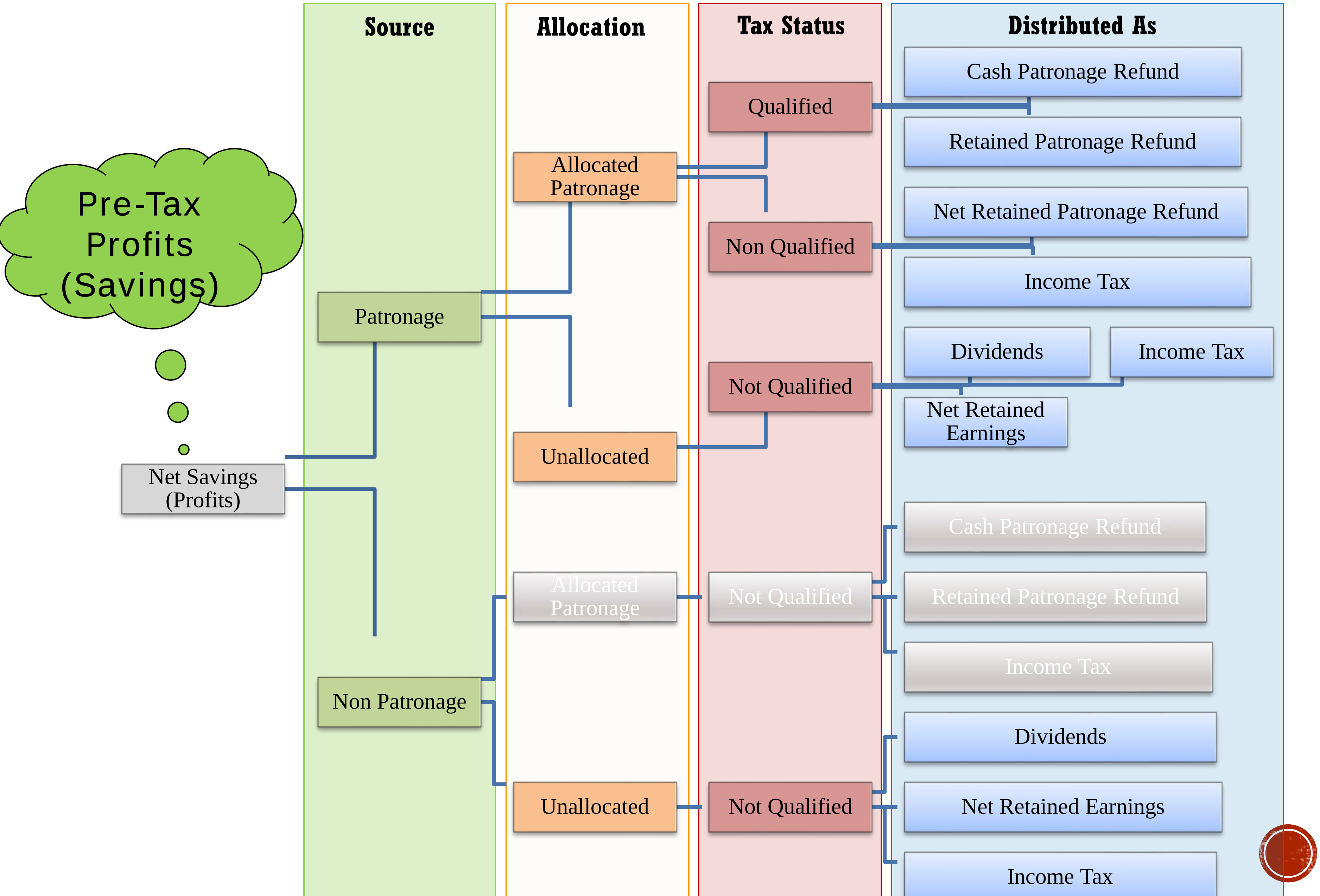
	2015	2016
ASSETS		
Current Assets		
Cash on hand	$1,542,630	$4,971,560
Accts Receivable	$5,792,150	$4,178,530
Inventories	$6,090,410	$4,697,820
Others	$2,362,500	$777,560
Total Current Assets	$15,787,690	$14,625,470
Fixed (Long Term) Assets		
Land	$1,751,110	$1,751,110
Building & Equipment	$35,245,720	$35,608,220
Less: Accum Depreciation	$13,930,270	$15,605,890
Total Fixed Assets	$23,066,560	$21,753,440
Other Assets		
Investments in Co-ops	$8,774,160	$9,078,390
Total Assets	$47,628,410	$45,457,300

	2015	2016
LIABILITIES		
Current Liabilities		
Accts Payable	$1,887,010	$82,530
Operating Line	$0	$0
Current portion of long-term note	$1,420,000	$1,420,000
Accrued Expenses	$2,118,930	$2,945,680
Total Current Liabilities	$5,425,940	$4,448,210
Term (Long Term) Liabilities		
Mortgages / Term Notes	$9,219,800	$7,799,800
Member Notes	$0	$0
Total Long Term Liabilities	$9,219,800	$7,799,800
EQUITY		
Common Stock	$156,500	$156,500
Deferred Patronage Refunds	$24,046,010	$23,980,270
Retained Earnings	$8,780,160	$9,072,520
Total Equity	$32,982,670	$33,209,290
Total Liabilities and Equity	$47,628,410	$45,457,300

Co-op Returns Distribution Decision Tree (David Barton)



Co-op Returns Distribution Decision Tree (David Barton)



Members' Equity in name.
The more "cash" and income the co-op has, the faster allocated retained patronage can be redeemed. But…

		Liabilities
		ent (< 12 months)
		Patronage payable
		Current portion of long term
Fixed		Long Term
Accumulated depreciation		Notes, mortgages, long-term leases
		Total Liabilities
Other: Investments in Co-ops		**Equity**
		Stock – Member Certs & Subscriptions
		Allocated Retained Patronage
		Retained Earnings (Unallocated Reserves)
Total Assets	=	**Total Liabilities & Total Equity**

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

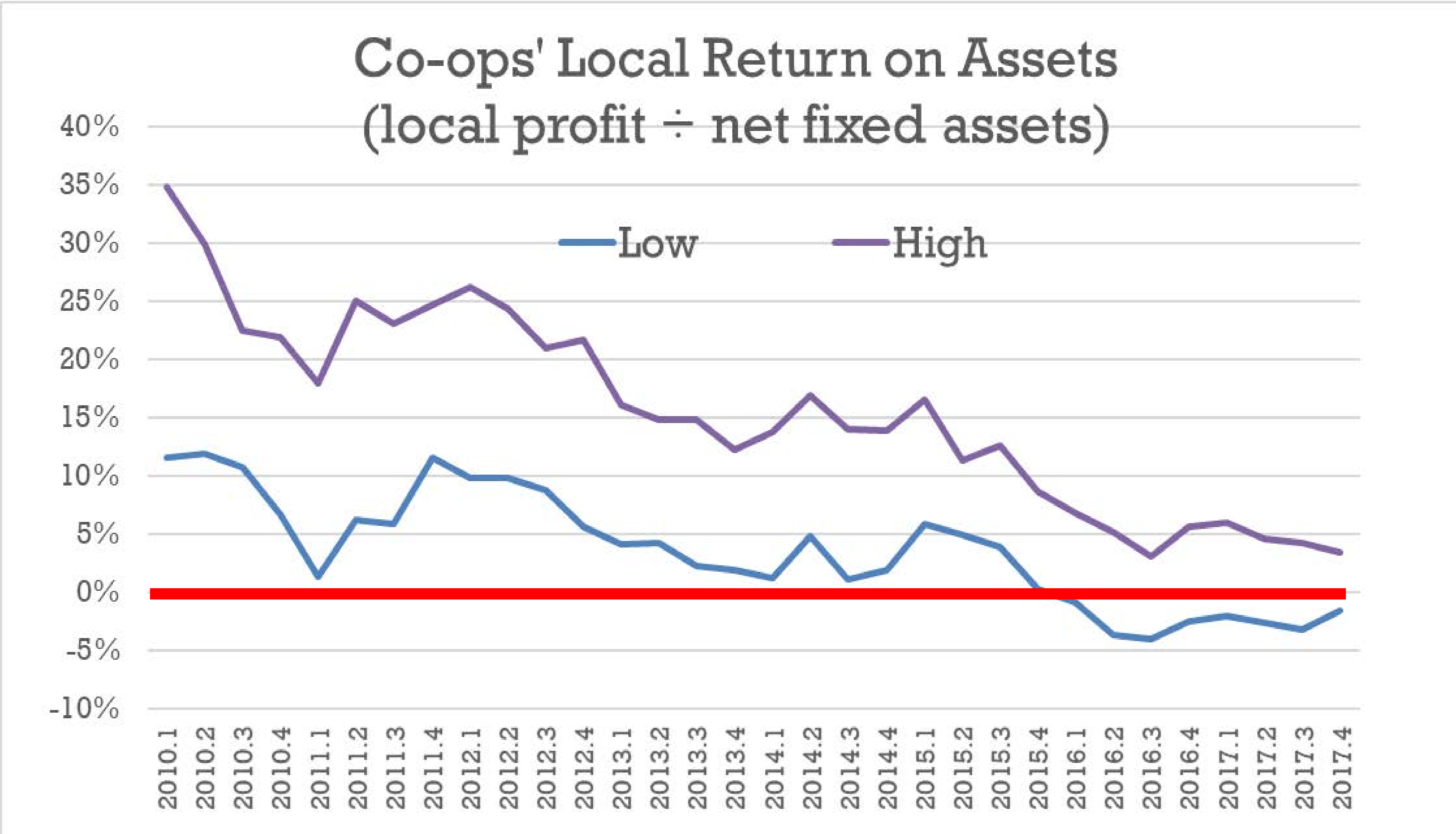
- The original Sec 199A—"grain glitch"—created a perceived market distortion that was more or less predictable.
- The new Sec 199A also creates distortions, but not ones that are easy to anticipate.
- There exist compelling arguments for passing through a portion of the co-op level DPAD-like deduction 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-OP METRICS


Co-ops' Local Return on Assets
(local profit ÷ net fixed assets)
Low
High
40%
35%
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
2010.1
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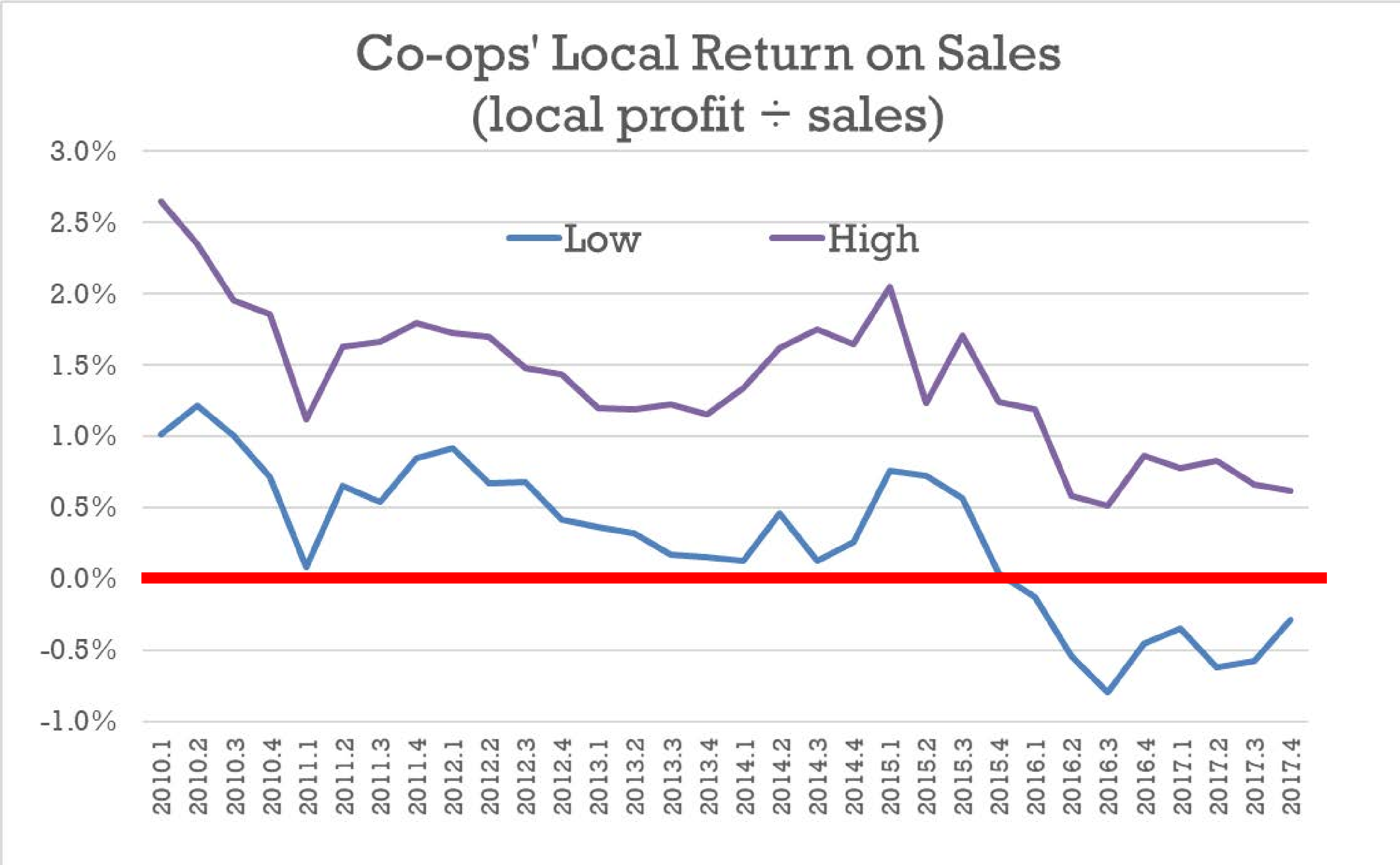

Co-ops' Local Return on Sales
(local profit ÷ sales)
Low
High
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
-0.5%
-1.0%
2010.1
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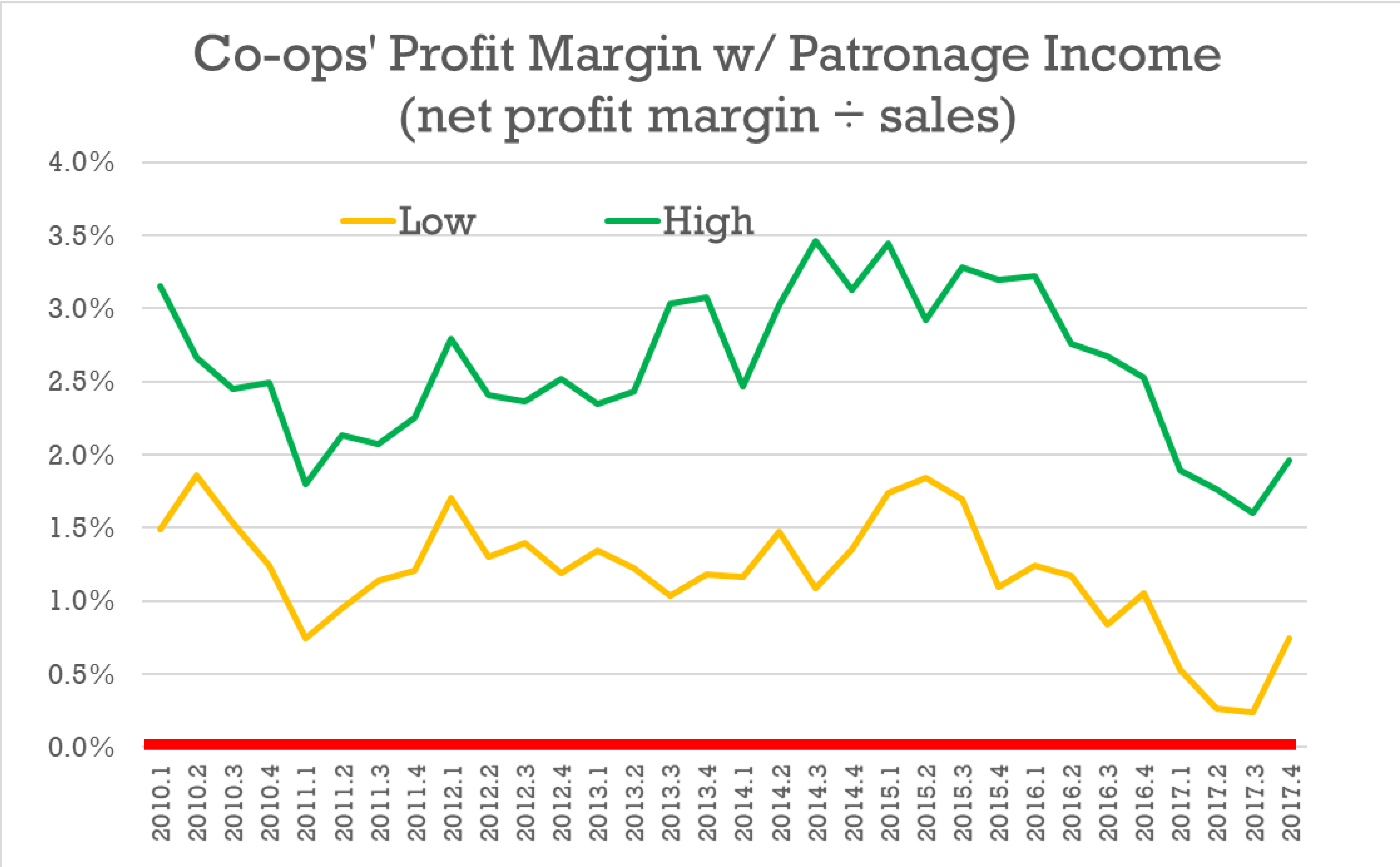
Co-ops' Profit Margin w/ Patronage Income
(net profit margin ÷ sales)
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
Low
High
2010.1
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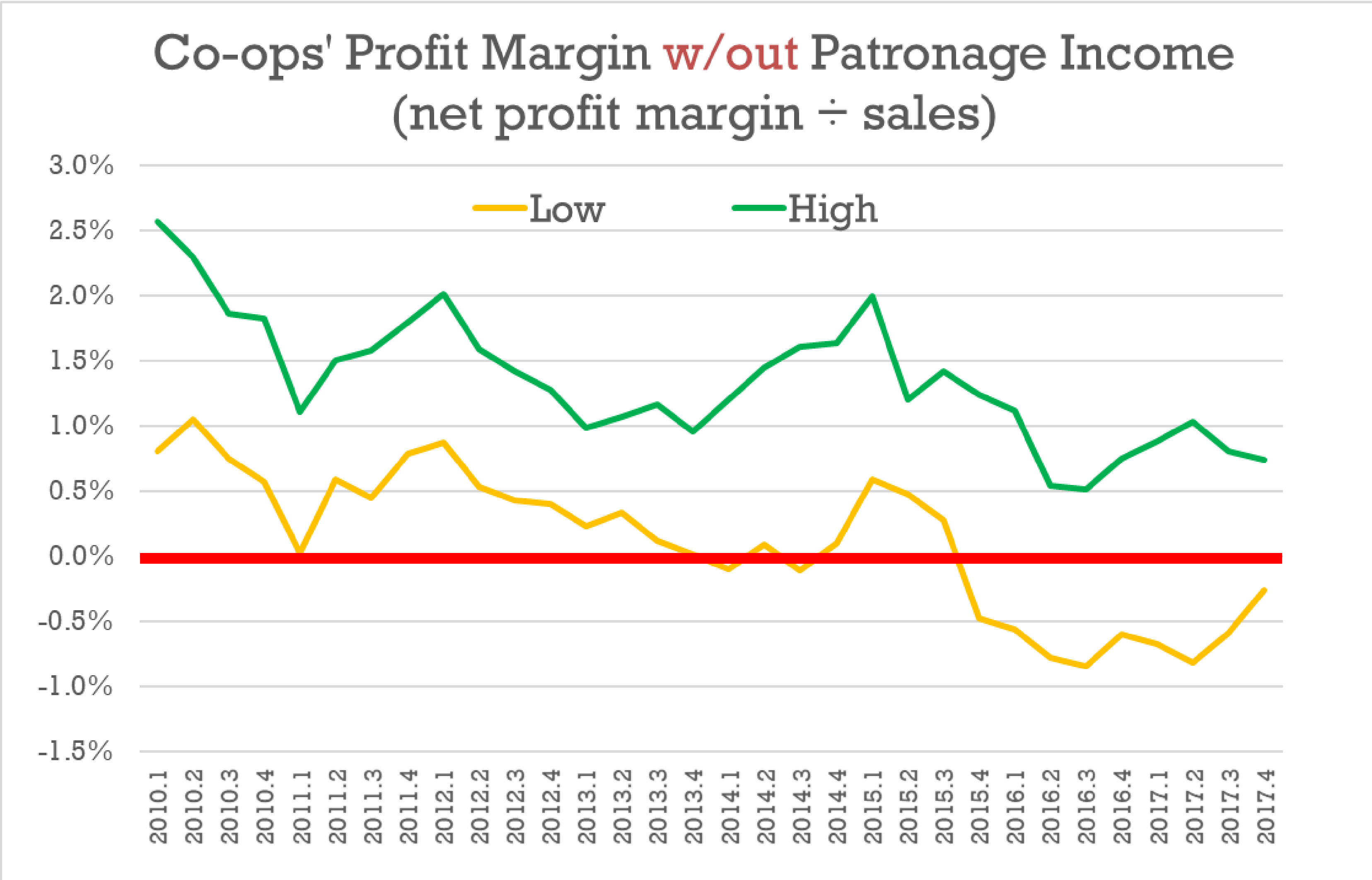
Co-ops' Profit Margin w/out Patronage Income
(net profit margin ÷ sales)
Low
High
3.0%
2.5%
2.0%
1.5%
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