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Tax Strategies for Farmers and Cooperatives under the New Section 199A

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Cornhusker Economics

Tax Strategies for Farmers and Cooperatives under the New Section 199A

Market Report	Year Ago	4 Wks Ago	1-25-19
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	125.00	No report	122.18
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	196.41	No report	178.48
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	154.79	No report	149.12
Choice Boxed Beef, 600-750 lb. Carcass.	206.70	No report	216.71
Western Corn Belt Base Hog Price Carcass, Negotiated	69.27	No report	50.91
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	81.41	No report	66.98
Slaughter Lambs, woolled and shorn, 135-165 lb. National.	133.29	No report	NA
National Carcass Lamb Cutout FOB.	362.34	No report	389.33
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	3.80	No report	4.59
Corn, No. 2, Yellow Columbus, bu.	3.32	No report	3.52
Soybeans, No. 1, Yellow Columbus, bu.	9.07	No report	8.17
Grain Sorghum, No.2, Yellow Dorchester, cwt.	6.58	No report	5.71
Oats, No. 2, Heavy Minneapolis, Mn, bu.	3.01	No report	3.25
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	166.25	No report	165.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	90.00	No report	105.00
Grass Hay, Large Rounds, Good Nebraska, ton.	82.50	No report	87.50
Dried Distillers Grains, 10% Moisture Nebraska Average.	150.00	No report	147.00
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	47.30	No report	56.00
* No Market			

This tax season will be the first time cooperatives and their patrons will consider the income tax consequences of the Tax Cuts and Jobs Act of 2017 (TCJA). A key element of the TCJA, Section 199A, affects farm income tax liability. Not only is the Section 199A deduction a good tax break for farmers, it changes incentives for farmer patrons to market through cooperatives. It also changes incentives for how cooperatives distribute their income. Cooperative members, their boards of directors, and management teams will have many tax strategy options to consider in 2019.

The good news about Section 199A is that it may reduce farmer income tax liability. The TCJA lowered income tax rates for corporate farms to 21 percent. Section 199A was developed to provide an income tax deduction for unincorporated farms. Subject to certain limitations, Section 199A allows non-corporate farms to receive a 20 percent deduction on farm income.

Farmers marketing through a cooperative, however, may only qualify for a modified deduction. Income tax laws consider cooperatives as extensions of a farmer's own operations. Section 199A allows cooperatives to deduct up to 9 percent of their income from their corporate income tax liability, to a maximum value of 50 percent the co-op's wages paid for marketing activities. Farmers benefit from this deduction by virtue of potentially increased patronage allocations (made either in cash or non-cash allocations). In

other words, the deduction allows the cooperative to pass through more income to the farmer than otherwise. Section 199A is written in a way that reduces the farm income tax portion of the 199A deduction so as to potentially reduce a farmer's ability to "double-dip" the deduction's benefits.

Farmers should be aware, however, that cooperatives can take steps to offset these modifications. Here are three options the cooperative could choose from.

- 1. Non-qualified allocations.** Non-qualified allocations are distributions of the cooperative's net income that retain all the income tax liability and pass none of it along to the farmer. Cooperatives are eligible to use the 199A deduction for income earned from marketing activities. By using the 199A deduction, cooperatives can reduce their corporate income tax liability. This leaves more income to allocate to farmers for future redemption or to pass through as cash. During the time the Domestic Production Activities Deduction (DPAD) existed, which was replaced by the 199A deduction, some of the largest Nebraska cooperatives began to make non-qualified allocations.

Example: Suppose a cooperative earns \$100,000 in income. By choosing to make a non-qualified allocation, the cooperative has a corporate income tax liability of \$21,000. If the 199A deduction is worth \$10,000 and the cooperative uses it, it pays \$11,000 in taxes. This leaves \$89,000 to allocate to members.

- 2. Retained income.** Cooperatives may choose to retain the income, thereby retaining all the corporate income tax liability. As with non-qualified allocations, the cooperative is eligible to reduce its income tax liability via the 199A deduction. Cooperatives can then invest increased funds in capital projects or reduce other expenses. During the time the DPAD deduction existed, many Nebraska cooperatives adopted this practice. For example, investments in services or facilities reduced the time farmers spent doing marketing activities and allowed the cooperative to offer services

(such as retail credit) that allowed farmers to leverage existing financial capital.

Example: Suppose a cooperative earns \$100,000 in income. By choosing to retain this income the cooperative has a corporate income tax liability of \$21,000. If the 199A deduction is worth \$10,000, the cooperative pays \$11,000 in taxes. This leaves \$89,000 for the cooperative to invest in projects that may enhance services farmers obtain through the cooperative. These enhancements could have the effect of reducing on-farm costs.

- 3. Pass through the cooperative's 199A deduction.** Cooperatives can also choose to forgo the use of the deduction and, instead, pass through the value of the deduction to patrons. This is possible, again, income tax laws are written with the view that, since farmers own the cooperative, the cooperative is simply an extension of the farmer's operations. Farmers, regardless of any modification to their own income tax liability, can apply the passed-through deduction to their own income taxes.

Example: Suppose the cooperative earns \$100,000 in income and makes a non-qualified allocation or retains the income. The cooperative is eligible for a 199A deduction. If the 199A deduction is worth \$10,000 the cooperative may simply distribute the value of that deduction as income deductions for its patrons. The value is distributed on a patronage basis. A farmer who did 5 percent of the cooperative's business, for example, would receive an additional income tax deduction of \$500 ($5\% \times \$10,000$) for their use.

These options mean that, depending on what actions cooperatives take, farmers could be better, the same, or worse off when marketing through a cooperative than with another type of company. Farmers can be better off when the cooperative allocates more funds to members than the value of any modification to their 199A deduction, or when the cooperative passes through the value of the cooperative-level 199A deduction that exceeds the value of the 199A modification, or both. Farmers who pay no W-2 wages are equally well off regard-

less of whether or not they market through the cooperative – the deduction is reduced by the minimum of 9 percent of income or 50 percent of wages; zero in this case. Farmers can be worse off when the cooperative allocates less funds to farmers than the value of any modification to their 199A deduction, or when the cooperative passes through the value of the cooperative-level 199A deduction that is less than the value of the modification, or when the sum of these is less than the required modification to the farmer's deduction. Research suggests cooperatives must pay farmers, for example, between \$0.03 and \$0.04 per bushel of corn to offset this.

Not all three options, then, have the same consequences for the cooperative and for the farmer. Research indicates the best financial returns to farmers from these three choices may be from the non-qualified allocations, especially if they are redeemed. Research also suggests that cooperatives are also often limited in the amount of 199A deduction they can earn, usually being limited by the value of W-2 wages paid for conducting their marketing operations. By passing along cash, such as in a nonqualified-allocation, the cooperative may offset some of the value of the farmer's tax liability modification; the cooperative, however, will not be able to grow its operations as rapidly as otherwise.

Farmers should consider which of these options they would benefit from most and ask the cooperative to provide value to them accordingly. If, for

instance, members are looking to obtain value from the cooperative through increased allocations of cooperative income then non-qualified allocations may be the best option. Farmers voice support, or opposition, for these options by communicating with members of the cooperative's management, participating in governance, or modifying their own tax planning. The ultimate decision is up to the board of directors. The cooperative's financial circumstances and the farmer's opinions can change which options are ultimately selected in any given year.

As suggested at the beginning of this article, the application of the 199A deduction is new and many lessons in tax planning will be learned at the farmer and cooperative levels this year. Final regulations for how 199A will be implemented were released on Friday, January 18, 2019. As these are interpreted, consultation with tax professionals will help cooperatives and their patrons select strategies that will drive the best value for the cooperative-patron relationship. Assistance is also available in the Department of Agricultural Economics at the University of Nebraska to simulate the potential financial performance consequences of various income distribution decisions cooperatives may make with respect to Section 199A. While it's around, the Section 199A deduction has the potential to strengthen the value of the farmer-cooperative relationship. By voicing their opinions about how the cooperative adds value to their operations, Section 199A has potential to increase farmer returns by doing business with cooperatives.

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