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Abstract

The newly passed Tax Cuts and Jobs Act of 2017 introduced substantive changes to individual and entity-level tax rates and deductions, many of them welcomed by individuals and corporations. One section of the Internal Revenue Code (IRC) in particular—IRC § 199A Deduction for Qualified Business Income of Pass-Through Entities (Sec 199A hereafter)—is getting a lot of attention, raising questions and eyebrows for its potential impacts on grain marketing decisions. In essence, language in this section of code gives producers marketing grain a significant incentive to sell to a cooperative rather than a non-cooperative firm.

The purpose of this article is to highlight the primary features of the Sec 199A deduction causing concern and discuss potential implications for producers and grain marketing firms. Note that at one month into the new tax year, there are ongoing efforts directed at modifying the language in the code to correct the unintended effects on producers and grain marketing firms.

Disciplines

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The newly passed Tax Cuts and Jobs Act of 2017 introduced substantive changes to individual and entity-level tax rates and deductions, many of them welcomed by individuals and corporations. One section of the Internal Revenue Code (IRC) in particular—IRC § 199A Deduction for Qualified Business Income of Pass-Through Entities (Sec 199A hereafter)—is getting a lot of attention, raising questions and eyebrows for its potential impacts on grain marketing decisions. In essence, language in this section of code gives producers marketing grain a significant incentive to sell to a cooperative rather than a non-cooperative firm.

The purpose of this article is to highlight the primary features of the Sec 199A deduction causing concern and discuss potential implications for producers and grain marketing firms. Note that at one month into the new tax year, there are ongoing efforts directed at modifying the language in the code to correct the unintended effects on producers and grain marketing firms.

What Does Sec 199A Do?

Sec 199A is a deduction that applies to income earned from the business activities of pass-through entities, like S corporations, sole proprietorships, partnerships, and so forth. These are businesses whose income is not taxed at the entity level, but passed-through to its owners. The intent in crafting Sec 199A was two-pronged: 1) to ensure that these pass-through, non-corporate entities had a deduction similar to the reduction in the corporate tax rate, which dropped from a maximum of 35% to a flat rate of 21%, and 2) to retain, for cooperative organizations, a prior deduction that was removed: Domestic Productions Activity Deduction (DPAD), or Sec 199. This is not a typo: Sec 199A replaces Sec 199 of the 2001 Bush tax cuts. Note that the DPAD was a jobs-creation deduction and available to manufacturing firms across many sectors, including agricultural cooperatives marketing farmers' domestic production of grain.

The Sec 199A deduction for pass-through entities is based on qualified business income (QBI). There are restrictions on what qualifies as a business activity for this deduction (many services, for example, do not), and both the definition of qualified business income and calculation of the actual deduction are complicated. But in simple terms, the deduction is 20% of the qualified business income, subset to a wage limitation. Though complicated, this portion of the code is not contentious.

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Sec 199A has a second feature, and this is the part that leaves open a number of questions about unintended consequences. In addition to the deduction related to qualified business income, it provides a 20% deduction on 'qualified cooperative dividends.' Typically we think of qualified cooperative dividends as the annual allocation of profits from a cooperative to its members—these are better called qualified cooperative patronage allocations. In this new law, those are indeed included in the payments eligible for 20% deduction and also not hugely controversial. However, another payment by cooperatives to its members is also included in the definition of 'qualified cooperative dividends': per unit retains (more correctly called per unit retains paid in money, or PURPIM). Per unit retains, in the simplest terms, are the payments from cooperatives to members for their grain or other agricultural production. Note the deduction applies only to the marketing or pooling functions (grain and other agricultural products) and does not include purchases by members for agronomy, seed, fuel, etc.

Per unit retains were defined as 'qualified cooperative dividends.' As a result, a producer selling grain can receive a 20% deduction of gross grain sales (before farm expenses) from taxable income less capital gains if s/he is a member selling to a cooperative. If instead the sale is to a non-cooperative marketing firm or processor (e.g., ADM, Cargill, or any number of independent grain marketing firms), the deduction is 20% of the net income. At the surface, this creates a significant effective basis gap between otherwise equal basis bids for grain or other agricultural commodities. A simple example, abstracting from the complexities of QBI and marginal tax calculations shows the potential.

A farmer has \$500k in gross grain sales (140,000 bushels) and \$100,000 in net farm income, all from selling grain. If she markets through a cooperative, she anticipates a patronage allocation of \$0.025 cents per bushel, or \$3,500.

- Choice A: She markets the crop to an independent grain firm or processor and, through Sec 199A, she deducts up to 20% of her QBI: $20\% \times \$100,000 = \$20,000$ potential deduction.
- Choice B: If she markets the crop to her cooperative, she deducts up to 20% of gross sales ($20\% \times \$500,000 = \$100,000$) because they qualify as per unit retains, plus 20% of any qualified patronage allocation ($20\% \times \$3,500 = \700). The potential deduction is \$100,700.

At a 22% marginal tax rate based on selling to an independent marketing firm or processor (Choice A), the deduction difference between these two choices is \$80,700, which equates to \$0.12 per bushel in taxes. Estimates from tax professionals working with producers is that the tax effect may range from \$0.05 - \$0.20 per bushel.

It is clear to see why producers are eager for clarification on this law and why independent grain firms and processors want it changed. Facing equivalent cash bids in the market, the signal is pretty clear that it is advantageous to market to a cooperative.

What if it stays as written?

The above example is meant for illustration, and there are a number of factors that might mitigate the true differential created by the law, and these are producer-specific. Still, contemplating its preservation, a cascade of questions emerge regarding grain and agricultural product movements, local capacity, optimal organizational structures for farmers, and the fate of independents. Below are my thoughts summarized in the two broader questions I receive, vetted with trusted colleagues and grain marketing experts. The perspective I provide here applies to agricultural producers and grain marketing in the Midwest, but certainly there are related or larger impacts for other types of ag cooperatives throughout the country.

1. *Do cooperatives have the storage and transport capacity to handle agricultural products if all producers sell to a cooperative? What happens if not? What will be the local price impacts?*

Generally speaking, it is unlikely that cooperatives have sufficient facilities currently to handle the harvest grain movements and other seasonal gluts that arise in the Midwest. But storage is a local phenomenon and each region will be different. In Iowa, for example, approximately 72% of the 1.4 billion bushels of licensed grain warehouse capacity (state and federally licensed) is held by a cooperative. If one considers on-farm storage, the argument could be made that this law wouldn't create a significant grain-movement challenge in a number of parts of Iowa. In Kansas, approximately 70% of the grain storage is held by cooperatives or on-farm. Cooperatives in both states use ground piles to manage harvest gluts, and if this law sticks, that challenge may be exacerbated in the short term. But cooperatives and

producers would respond to the economic incentives to invest in grain storage in that case. Condominium grain storage is another option for producers to mitigate storage constraints.

Grain storage facilities aside, a number of mitigating origination options are already used. In regions where processors and ethanol plants exist, producers use 'direct-ship' contracts to haul grain directly to a processor even though it is sold to the cooperative. Without recent data regarding the proportion of grain moving this way, it is hard to say whether we will see a significant change in those patterns, and even if so, grain movements and prices will find an equilibrium. Independent grain firms and processors likely will seek to establish marketing arrangements with cooperatives as a way to secure footing locally in the grain business.

Local price impacts are another unknown. On the one hand, some independents and corporations received a nearly 40% reduction in taxes (from 35% to 21%) via Sec 199A that cooperatives, which pass through member-based income to patron-members did not. The argument has been made that they can use those tax savings to be price competitive in the eyes of producers making the marketing decision. On the other hand, local capacity constraints at cooperatives may depress local basis, particularly during harvest, which partially mitigates the tax-differential created by Sec 199A. Cooperatives typically do not turn away grain from members, which is why we observe large grain piles on the ground during harvest. Producers individually will need to weigh the potential tax deduction benefit with other costs associated with marketing grain: hauling distance, local basis differential, differentials in wait times at grain dumps, and so on. If net farm income is expected to be low, the per-bushel estimated tax difference created by Sec 199A dissipates.

2. Will producers form their own cooperatives or independents reorganize as a cooperative?

In local areas without grain/oilseed marketing cooperatives, the potential exists to see producers forming closed cooperative organizations to capitalize on the Sec 199A deduction. More likely, however, is that existing cooperatives acquire or build assets in those areas, or as mentioned above, form marketing arrangements with existing firms. In much of the Midwest, existing cooperatives are of sufficient size and capitalization and have the spatial presence to respond much faster to the need for capacity and changing grain dynamics than a start-up could accomplish. Alongside the temptation to form a cooperative, the new tax code creates incentives for producers to reconsider their own operation's structure, potentially reorganizing as a C corporation or S corporation or changing from one to the other. Those details aren't discussed here, but are complicating factors in determining how the farm economy might change if Sec 199A holds as written.

Effects on grain cooperatives

Producers will be impacted not only by the farm-level deduction of Sec 199A but, as members of cooperatives, stand to notice positive changes related to their cooperative's patronage allocations and equity redemption. The tax savings to cooperatives on non-member business and the supply-side of their business are just like those for other corporations, and the new tax rate is 21% instead of a maximum of 35%. However, if the Sec 199A deduction for producers marketing through a cooperative holds, all producers selling grain to a cooperative will choose membership, effectively eliminating any non-member marketing business. That aside, tax savings on cooperative profits related to input supply or other non-marketing functions could be used to accelerate the cooperative's equity redemption which gets income into the members' hands more quickly. Alternatively, the tax savings could be used to improve facilities and service offerings to benefit members.

For those wanting more details, the fact sheet "Impact of Tax Reform on Agricultural Cooperatives" (Briggeman and Kenkel, 2018) dives into the expected changes in cooperative patronage allocation and member-level returns from the law using simulation.

Conclusion

The questions that fall out of the reality of the Sec 199A code as written are important ones, as their answers weigh on the potential for significant changes in the structure of the agricultural supply chain for crops, in grain movements, and in farm-level incomes.

In a statement on January 12, 2018, the U.S. Department of Agriculture's Under Secretary for Marketing and Regulatory Programs Greg Ibach wrote, "*The aim of the Tax Cuts and Jobs Act was to spur*

economic growth across the entire American economy, including the agricultural sector. While the goal was to preserve benefits in Section 199A for cooperatives and their patrons, the unintended consequences of the current language disadvantage the independent operators in the same industry. The federal tax code should not pick winners and losers in the marketplace. We applaud Congress for acknowledging and moving to correct the disparity, and our expectation is that a solution is forthcoming. USDA stands ready to assist in any way necessary.”

The agricultural industry—cooperatives, too—anticipated that the existing DPAD deduction would not stand in the tax reform negotiations, but thought a similar provision would replace it. Few, if any, anticipated that a cooperative deduction would be expanded to the producer-level, or believe it will stand as written. Organizations such as the National Grain and Feed Association (NGFA) and the National Council of Farmer Cooperatives (NCFC) are working jointly on a revision with Congress. Tax professionals, agricultural businesses, and producers are waiting for clarification on whether the law will stay as-is or be changed, and will then await guidance from the IRS on interpretation.

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