Nebraska Agricultural Cooperatives and their New Tax Deduction Distribution Role

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The Tax Cuts and Jobs Act of 2017 eliminated DPAD but, together with legislation in 2018, created a new tax deduction (Section 199A) which was similar to DPAD and applied only to agricultural cooperatives. This deduction raises the possibility that choices related to the 199A deduction could become a significant part of the agricultural cooperative value package. By 2025, the year of its anticipated expiration, cooperatives will understand further the impact of the 199A deduction on its income tax strategy. In this article, the specifics of the tax deduction of how it affects agricultural cooperatives and their farmer members is discussed.

A cooperative engaged in marketing agricultural products on behalf of its members may be considered as having produced the associated commodities. The DPAD for products sold by the cooperative can be calculated at the cooperative level. Additionally, the cooperative can elect to retain the deduction or pass all or part of it to its members in proportion to their patronage. The cooperative board of directors make the decision about what share to pass to the members. Many cooperatives take the deduction and the portion retained varies.

Section 199A also involves a tax deduction offset, or reduction, in an otherwise available deduction at the producer level. The value of the deduction is modified when a farmer markets their production through cooperatives. A producer marketing through a cooperative can be advantaged, equivalent or disadvantaged relative to a producer marketing to a non-cooperative firm depending on the amount of Section 199A deduction passed on by the cooperative and their producer level offset. The structure of Section 199A makes the tax deduction decision an important part of the cooperative value package and an important decision for the cooperative board. Under the previous structure of DPAD, a cooperative board could ignore the potential deduction and concentrate on other aspects of the value package. Under the producer level offset provision of Section 199A, it is essential for marketing cooperatives to take the deduction and pass on an appropriate percentage or risk having their producer members disadvantaged by patronizing the cooperative. This article demonstrates an example pass through decision to mitigate any disadvantage.

Illustrated 199A Deduction Distribution with Representative Nebraska Farms and Cooperative

Section 199A deduction calculations are firm and farm specific depending on the qualifying income and wage levels of both the cooperative and the patron. The 2018 weighted financial characteristics of ten Nebraska agricultural cooperatives appear in Table 1.

Table 1. Financial Characteristics of Representative NE Cooperative, 2018

Grain sales to total sales	70.52%
Profit margin	1.55%
Personnel expense to gross margin	48.44%
Personnel expense per bushel	0.40
Sales/total assets	1.93
ROA	2.98%
Cash patronage per bu (50%)	$ 0.02

Each cooperative in the sample had grain and supply sales. It is assumed, for purposes of calculation, that each cooperative pays 50% of its allocated patronage in cash.

The weighted average cooperative level Section 199A deduction is displayed in Table 2. The deduction, for each cooperative, is calculated as the minimum of 20% of qualified business income or 50% of W-2 wages (salaries and wages). The W-2 wage restriction was the binding constraint for cooperatives, resulting in deductions from $0.08 per bushel to $0.30 per bushel.

Table 2. NE Cooperative Level Section 199A Deduction per Bushel, 2018

	NE Cooperatives
Average cooperative section 199A deduction	$0.14

The producer level offset is calculated as the minimum of 20% of the producers' qualified business income or 50% of the producers' W-2 wages (Table 3). Information from Nebraska Farm Business, Inc. is used to model the cost and returns of a 2018 representative NE irrigated corn and irrigated soybean producer. Similar to the cooperative level calculation, the binding deduction is the producers' W-2 wage expense. The resulting tax deduction offset was determined to be $0.05 per bushel for a typical irrigated corn and irrigated soybean producer and $0.14 per bushel for a typical dryland wheat producer.

Table 3. Producer Level Calculations for 199A Deduction, 2018

	Corn	Soybeans	Wheat
Yield per acre	232.25	69.25	53.92
Price per bushel	3.48	8.45	4.24
Gross income/acre	743.34	623.3	204.61
W-2 wage/acre	23.24	20.07	2.27
Other expenses/acre	547.24	443.68	243.77
Qualified business income/acre	172.86	159.55	-41.43
9% of QBI/acre	$15.56	$14.36	$(3.73)
50% of W-2 wage/acre	11.62	10.04	1.14
Binding offset/acre	$11.62	$10.04	$(3.73)
Section 199A offset per bushel	0.05	0.14	-0.07
Section 199A offset per bushel - weighted average 80% corn, 20% soybeans		$0.07	

Cooperatives can retain the Section 199A deduction or pass on any portion to members marketing commodities through the cooperative. The producer's offset is independent of the amount pass through. Under that structure, a producer delivering to a cooperative is disadvantaged unless the cooperative passes a portion of the cooperative level deduction that is at least equal to their offset. The required pass through depends on the producer's W-2 wages, and other conditions. Each patron will likely face a different situation. The percentage pass through, about 50%, to keep the representative farm operator equivalent to a non-cooperative marketing cooperative is illustrated in Table 4.

Table 4. Portion of the Pass Through Necessary for Producer Equivalency in Bushels, 2018

	Average of NE Cooperatives
Cooperative 199A deduction ($/bu)	$0.14
Producer offset (Corn and soy only) ($/bu)	$0.07
Required pass through	47.97%
Cash patronage ($/bu)	$0.02

The pass through needed by the producer in this example is based on representative Nebraska crop production budgets and reflects the amount needed by the average producer. Producers with lower than average W-2 wage expense would face a lower offset and require a smaller pass through to remain equivalent. Conversely, producers with higher than average W-2 wages would face higher offsets and require a higher pass through to remain equivalent.

The total cooperative level Section 199A deduction in this example is significantly larger than the cash patronage distribution for each selected cooperative. As discussed, cooperatives may adopt a strategy of passing through a portion of the cooperative level deduction to prevent the "average" patron from being disadvantaged by marketing through the cooperative. Regardless, the Section 199A deduction can clearly be an important part of the cooperative value package.

Implications for Cooperative Board of Directors and Executives

Cooperative boards of directors already face complex financial decisions relating to profit distribution and equity management. Those decisions have cash flow and taxation impacts for both the cooperative and the patron owners. Section 199A has added another layer to that complexity. The provisions of Section 199A are multifaceted and cooperative boards must balance the value of the deduction at the cooperative level with the benefits of passing on the deduction to their members. Another consideration is the relative productivity of keeping more of the value of the deduction at the cooperative since the cooperative cannot predict the usefulness of the pass through at the farm level but may be well informed about the potential returns of using it at the cooperative. The producer level impacts are also farm specific. Larger producers likely have different wage expense structures and Section 199A impacts relative to smaller producers. Cooperative boards may need to educate themselves about the wage and tax situations of their farmer members and make strategic decisions as to the importance of tax deductions in their value package.

Given the relative complexity of Section 199A with respect to tax alternatives for both the cooperative and the members, it is incumbent on cooperative managers to fully understand the provisions of this legislation. Learning the outcomes of tax consequences currently is desirable since this provision is anticipated to expire in 2025. This is a time horizon that may be beneficial to certain members while also having tax consequences for the cooperative.

For Further Reading

Kenkel, P., G. McKee, M. Boland, and K. Jacobs. 2019. "The New Role of Agricultural Cooperatives in Pooling and Distributing Tax Deductions". Western Economics Forum 17 (2) (http://www.waeaonline.org/publications/western-economics-forum)

Kenkel, P., G. McKee, M. Boland, and K. Jacobs. 2018. "Impacts of Section 199A and Profit Distribution on Representative Marketing Cooperatives". Available at https://ideas.repec.org/p/ags/ncer18/280133.html

McKee, G. 2018. "Effect of Section 199A Tax Deduction on Agricultural Cooperatives and their Patrons" Available at https://agecon.unl.edu/Cooperatives/Section%20199A%20update%20and%20cooperatives%20040218.pdf