Effect of Section 199A Tax Deduction on Agricultural Cooperatives and their Patrons
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The design of the tax code reflects the special role of patronage equity in cooperative finance. Income distribution choices by cooperatives have tax consequences. Federal income tax laws and policies allow agricultural cooperatives to retain net income as a source of equity capital by giving special tax deductions when income is allocated to patrons in proportion to their business with the cooperative.

The tax code allows cooperatives two options for making noncash distribution of income from patron-related business to the patrons: qualified (qualified allocations) and nonqualified (nonqualified allocations) written notices of allocation. The timing of the income tax consequences differs for each. Cooperatives deduct the value of qualified allocations from their taxable income; the patron pays personal income tax on the full amount in the year of allocation as if all the income was allocated to the patron. For nonqualified allocations, cooperatives pay corporate income tax on the full allocated amount and receive a deduction in the future when the allocated equity is redeemed; the patron pays no personal income tax on the allocation until the year equity is redeemed. Income from business with non-patrons is often not allocated; the cooperative bears full corporate income tax on the entire amount.

Tax deductions can encourage special kinds of activities and have the effect of reduced income tax liability. For instance, a tax deduction could be used to reduce, or even eliminate, the income tax liability associated with unallocated income derived from non-patron business. The value of the deduction can then be transferred to patrons as an increased pool of funds to distribute as qualified or nonqualified allocations. Alternatively, deductions can be used to reduce, or eliminate, the income tax liability associated with nonqualified allocations.

An important tax deduction used by agricultural cooperatives between the 2007 and 2017 tax years has been the Domestic Production Activities Deduction (DPAD), or, Section 199 deduction. The deduction applies to proceeds from agricultural products marketed by farmers through cooperatives, with marketing cooperatives being viewed as a jointly-owned extension of the farmer's business enterprise. One effect of the deduction has been to decrease an agricultural marketing cooperative's income tax liability. Funds otherwise used for tax payments have encouraged fixed asset purchases and increased equity—both patron-allocated and unallocated.

For instance, a sample of agricultural cooperatives in Nebraska increased their fixed assets by 23 percent, increased their unallocated (retained) income by 14 percent, and increased their allocations to member equity (qualified and nonqualified) by 28 percent between the 2015 and 2016 fiscal years. These balance sheet changes were, in part, due to the DPAD tax deduction and were influenced by income distribution decisions made by the cooperative. In addition, the "jointly-owned extension" nature of the cooperative allows the cooperative to pass through any fraction of the value of the DPAD to its patrons. Hence, another effect of the DPAD has been to reduce, in some cases, the income tax liability of patrons.

The legislation known as the Tax Cuts and Job Act (2017 tax law), signed into law on Dec. 22, 2017, repealed the DPAD and created a new income tax deduction for agricultural marketing cooperatives and a new income tax deduction for patrons in tax code Section 199A, which was amended on March 23, 2018. Agricultural marketing cooperatives, under the Dec. 22, 2017 version of Section 199A, were able to deduct 20 percent of their net income derived from sales of a patron's agricultural output from their corporate income taxes. Non-corporate farmers who patronized the cooperative were eligible to deduct 20 percent of the gross income from sales through the cooperative. In contrast, non-corporate farmers who patronized non-cooperative marketing firms were able to deduct 20 percent of their net income from sales through the firm. Allowing non-corporate farmers to deduct gross income from sales through the cooperatives, but net income from sales to non-cooperative firms, from their farm-level income taxes created a clear incentive for farmers to market their output through cooperatives.

The omnibus spending bill passed on March 23, 2018 modifies these additions to Section 199A . The new corporate income deduction for cooperatives is similar to the DPAD. Subject to certain limitations, cooperatives can deduct 9 percent of income derived from marketing patron output from their income tax liability. The value of the Section 199A tax deduction benefit for cooperatives will depend, in part, on the income distribution choices made by the cooperative.

Suppose the cooperative earns $1 million in net income from marketing patron output and that its board of directors resolves to retain all of it as unallocated (retained) income. The cooperative bears a corporate income tax liability at the 21 percent rate, totaling $210,000. Section 199A allows the cooperative to deduct 9 percent of the income, $90,000, resulting in total federal income tax liability of $120,000. The cooperative's total federal income tax liability would be the same if the board of directors resolved to pass the net income through to its patrons as non-qualified allocations. The cooperative's federal tax liability would be zero, however, if the board of directors resolved to pass the net income through to its patrons as qualified allocations. It can be shown that, while holding cash flow constant, the cooperative generates the greatest return to non-corporate patrons when using the Section 199A tax deduction to reduce the income tax liability associated with nonqualified allocations.

The new section 199A affects a cooperative farmer's personal income tax liability. For non-corporate farmers the value of the 199A deduction for farm level income taxes is complex, being a function of whether the farmer patronizes a cooperative or non-cooperative firm to market their output and, if a cooperative is patronized, the level of farm income, farm wages paid, sales revenue received from the cooperative, and on-farm expenses. A farmer is eligible for a 20 percent tax deduction on net income obtained by sales of output through a private or investorheld firm. The value of the 199A deduction on net income obtained by sales through a cooperative depends, in part, on farm income.

Non-corporate farmers with income from sales through a cooperative are eligible for the 20 percent deduction. This deduction is reduced by the lesser of the value of 50 percent of W-2 wages paid within the farm operation or 9 percent of the net income resulting from sales through the cooperative. If the farmer pays a fair amount of wages, the minimum deduction a farmer marketing through a cooperative is 11 percent of income. Non-corporate farmers with taxable income in excess of $315,000 (married filing jointly) apply a second set of limitations, which apply regardless of who they sell to. Deductions for income from sales to a cooperative in this case are limited to the greater of the following: 50 percent of the W-2 wages paid by the trade or business, or 25 percent of the W-2 wages paid plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. Alternatively, for a married farmer with income less than $315,000, if little wages are paid the deduction is reduced by 50 percent of the value of W-2 farm wages, making the deduction somewhere between 11 and 20 percent of net income; a farmer paying no wages has no reduction to the farm-level 199A deduction since zero is the lesser of the wage and net income conditions. The total amount of the deduction will depend on the circumstances of the farmer. Three examples, assuming a taxable income of $500,000, illustrate.

Since taxable income of $500,000 exceeds the $315,000 threshold the 20% farm-level income tax deduction is first limited to the greater of 50% of W-2 wages, or 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property. Suppose the farmer paid $50,000 of W-2 wages. If the farmer has no qualified property, their 20% deduction is first limited to $25,000 (50% x $50,000 of W-2 wages). An additional limitation is applied to that $25,000 deduction since the farmer sold to a cooperative. The value of the deduction is reduced by the lesser of 9% of taxable income $45,000 (9% x $500,000) or 50% of W-2 wages $25,000 (50% x $50,000). Therefore, under these facts, the farmer's 199A deduction is zero ($25,000 - $25,000 = 0). Suppose, instead, the farmer's W-2 wages are $100,000, taxable income remains $500,000, and no qualified property is considered. The 20% deduction is first limited to $50,000 (50% x $100,000). Then, the deduction is reduced by the lesser of $45,000 or $50,000 as previously calculated since the farmer sold to a cooperative. In this case, the farmer's 199A deduction is $5,000 ($50,000 - $45,000).

Finally, suppose the farmer had taxable income of $500,000, $50,000 of W-2 wages, but now has $1,000,000 of unadjusted basis in qualified property. Again, the 20% deduction is first limited to the greater of $25,000 (50% x $50,000 of W-2 wages), or $37,500 (25% x $50,000 of W-2 wages plus 2.5% x $1,000,000 of qualified property). The deduction is then limited by the conditions related to sale to a cooperative. The deduction is reduced by the lesser of $45,000 or $25,000 as previously calculated. Therefore, the farmer's 199A deduction is $12,500 ($37,500 - $25,000).

The total value of farm income tax deductions through Section 199A, however, is also related to the amount of the corporate 199A deduction the cooperative may choose to pass through to the patron. Cooperatives may elect to pass through, as done prior to the passage of the 2017 tax law, any portion of the value of the corporate 199A deduction to the member. The amount of the allocation depends on the tax strategy adopted by the cooperative and could, potentially, offset the entire reduction in the farmer's personal income tax deduction and, furthermore, could even increase the value of the deduction beyond the original 20 percent. In other words, a cooperative could elect to pass through corporate-level 199A deductions to its members that result in a deduction greater than 20 percent.

Furthermore, reduced corporate income tax rates reduce the total income tax liability of the cooperative, leaving a larger gap, all else equal, between the cooperatives' net income and its tax liability. The cooperative will have more of a deduction to pass through to patrons than prior to the 2017 tax law. Boards of directors may resolve to pass through greater fractions of the corporate 199A deduction than the fractions of DPAD passed through previously. Sales by a non-corporate farmer through a cooperative can result in situations in which 199A deductions are greater, or less, than 199A deductions resulting from sales to a non-cooperative firm.

Lastly, a farmer's benefit from the Section 199A tax deduction will depend on changes in patron demand for a cooperative's marketing and grain storage services. Patrons who do not currently sell their output to cooperatives may do so if the ultimate returns on grain sales are greater at the cooperative. Patrons will consider the relative costs of delivery to the cooperative; the combined value of passed through benefits and personal income tax benefits by sales to the cooperative must be no smaller than the increased cost of delivering grain to the cooperative. Also, the patron's value of any personal income tax deduction on net farm income will also depend on their tax management strategies. Finally, a farmer will also need to consider the value of patronage income from cooperatives obtained from purchase made through cooperatives providing both input sales and output marketing services. The farmer may obtain patronage income by virtue of making a delivery to the cooperative, and will obtain value of being able to have access to the cooperative's service in the market. It is common for cooperatives to provide an array of service and product offerings beyond marketing services at its business locations; this compares favorably with a privately held firm specializing only in marketing services.

The 2017 tax law offers a unique opportunity for cooperative patrons. Income tax deductions to the cooperative, cooperative patrons, and to non-cooperative corporations are unique features of the law. The ultimate value of the 199A deduction, and of the reduced corporate income tax rate, will depend on the income distribution decisions made by cooperatives and farm output delivery costs. Hence, the ultimate decision on whether farm returns are maximized by sales through cooperative or non-cooperative firms remains to be seen.