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How Will the Section 199(a) Tax Deduction Affect Cooperatives?

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Market Report	Year Ago	4 Wks Ago	1-26-18-
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	NA	No Report	125.00
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	159.85	"	196.41
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	134.77	"	154.79
Choice Boxed Beef, 600-750 lb. Carcass.	192.09	"	206.70
Western Corn Belt Base Hog Price Carcass, Negotiated	65.14	"	69.27
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	82.06	"	81.41
Slaughter Lambs, wooled and shorn, 135-165 lb. National.	NA	'	133.29
National Carcass Lamb Cutout FOB.	345.37	"	362.34
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	2.88	"	3.80
Corn, No. 2, Yellow **Columbus**, bu.	3.14	"	3.32
Soybeans, No. 1, Yellow **Columbus,** bu.	9.23	"	9.07
Grain Sorghum, No.2, Yellow Dorchester, cwt.	4.87	"	6.58
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.96	"	3.01
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	145.00	"	166.25
Alfalfa, Large Rounds, Good Platte Valley, ton.	70.00	"	90.00
Grass Hay, Large Rounds, Good Nebraska, ton.	67.50	"	82.50
Dried Distillers Grains, 10% Moisture Nebraska Average.	67.50	"	150.00
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	42.00	"	47.50
*** No Market**			

The design of the income tax code reflects the special role of patronage equity in cooperative finance. Federal 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. Income distribution choices by cooperatives have tax consequences.

The tax code allows cooperatives two options for making noncash distribution of income from patron-related business: qualified and nonqualified written notices of allocation. The income tax consequences of each differ based on their timing. Cooperatives deduct the value of qualified allocations from its taxable income; the patron pays personal income tax on the full amount as if all of the income was allocated to them. 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 pays income tax on the entire amount.

Tax deductions can encourage special kinds of activities and have the effect of reductions in 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 members 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 Nebraska agricultural cooperatives since the 2007 tax year has been the Domestic Production Activities Deduction (DPAD). The deduction applies to proceeds from agricultural products that are manufactured or marketed through cooperatives. One effect of the deduction was to decrease a cooperative's income tax liability. Funds otherwise used for tax payments encouraged fixed asset purchases and increased equity—both patron-allocated and unallocated. For instance, a sample of 25 Nebraska cooperatives increased their fixed assets by 23 percent in 2016 relative to 2015, increased their unallocated income by 14 percent over the same period, and increased their allocations to member equity (qualified and nonqualified) by 28 percent over the same period. These balance sheet changes were, in part, due to the DPAD tax deduction and were influenced by income distribution decisions made by the cooperative. Another effect of the DPAD was to reduce, in some cases, the income tax liability of patrons.

The Tax Cuts and Job Act, signed into law on Dec. 22, 2017, ended DPAD and created a new tax deduction for cooperatives and a tax benefit for patrons. Subject to certain conditions, the new deduction under Section 199(a) of the Federal income tax code, allows a 20 percent income tax deduction for Nebraska agricultural cooperatives. In addition, non-corporate patrons of the cooperative who receive allocations from the cooperative are eligible for a 20 percent deduction for qualified business income.

As written in the Dec. 22, 2017 version of the Act, the magnitude of the Section 199(a) tax deduction benefit for Nebraska cooperatives will depend, in part, on the income distribution choices made by the cooperative. Suppose the cooperative earns $1,000,000 in net income, is subject to the 28 percent income tax rate (allocated its income to patrons), and that its board of directors decides to retain all of it as unallocated income. Provisions of the Act allow the cooperative to deduct up to 20 percent of $280,000, or $56,000, from its Federal income tax liability. The values change if the board of directors decides to retain all of it as unallocated income. The cooperative would be subject to the 21 percent corporate tax rate and could, again, deduct up to 20 percent of $210,000 income tax liability, or $42,000. It can be shown that, while holding cash flow constant, the cooperative generates the greatest return to patrons, when using the Section 199(a) tax deduction, by distributing its income as nonqualified allocations. Qualified allocations and unallocated distributions generate returns for members as well under the new law.

A Nebraska cooperative's benefit from the Section 199(a) tax deduction will also depend, in part, on choices made by patrons. A novel feature of the 199(a) deduction is that its value depends, in some cases, on the value of commodity sales made by the patron to the cooperative. The tax savings per bushel sold to the cooperative depends on price and the income tax bracket of the farmer. For instance, a patron in the 28 percent tax bracket receiving a 20 percent federal tax deduction on sales to the cooperative results in (0.28 x 0.20 = 0.056%) about 5.6 percent of the sale price. A $4.00 bushel of wheat would receive a ($4.00 x 0.056 = $0.22) $0.22/bushel deduction when sold to a cooperative. Hence, the total value of the deduction depends on the market price at the time of sale, total volume sold to the cooperative, and the patron's personal income tax liability. Reduced personal income tax liability may be an attractive benefit to patrons and encourage sales to the cooperative.

It is possible that the language of the Act will be interpreted to also allow the cooperative to deduct up to 20 percent of gross income from grain purchased and then sold, as well as sales of inputs to patrons, from tax consideration. Input sales have heretofore not been considered for DPAD-related deductions. These funds could then be used to either increase income allocations to members or provide cash for fixed asset purchases, for example.

A Nebraska cooperative's benefit from the Section 199(a) tax deduction will also depend, in part, on the relative price offered by cooperatives and non-cooperative grain buyers. The Act reduces the top corporate income tax rate from 34 percent to 21 percent. Cooperatives receive benefit from this reduction only when they do not allocate their income to patrons; cooperatives are taxed under subchapter T when allocating their income to patrons. If the income of a subchapter T corporation (e.g. agricultural cooperatives) were distributed via nonqualified allocations, and its income was taxed at the 28 percent level, it would have a greater initial income tax liability for any level of income than a subchapter C (e.g. investor owned grain buyer) corporation. For example, the tax liability for $1,000,000 income for a subchapter C corporation would be $14,000 less than for a cooperative that passes its income through to its patrons. Furthermore, the 20 percent deduction mentioned above, which would help eliminate the greater income tax liability for subchapter T corporations, expires at the end of 2025.

Lastly, a Nebraska cooperative's benefit from the Section 199(a) tax deduction will depend on changes in patron demand for its marketing and grain storage services. Patrons who do not currently sell their output to cooperatives may do so if the relative price is greater at the cooperative. Patrons will also consider the relative costs of transportation 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 transporting grain to the cooperative. Also, patrons not currently selling their output to cooperatives may also need to consider the capacity of the cooperative to store their grain. Many Nebraska cooperatives currently store grain on the ground during harvest. It may be that little excess storage capacity remains for additional grain purchases; significant excess capacity could result in grain price changes or facility investments. The patron's value of the 20percent deduction on net farm income will also depend on their tax management strategies.

The Tax Cuts and Jobs Act 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 Act. The ultimate value of the 199(a) deduction, and of the reduced income corporate tax rate, will depend on relative prices, transportation costs, and the capacity of the cooperative to accept more grain volume. Additionally, correction or modification of the Act's language could affect these benefits. The tax deduction will affect the capital structure of cooperatives and may affect the incentives patrons have to sell grain to them.

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