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White paper

Before you sell

Understanding the tax impact of sales to cooperatives

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Key highlights

- Qualified buisiness income deduction
- Non-cooperative sales
- Cooperative sales made by patrons
- The potential benefits of selling to a cooperative
- The potential disadvantage of selling to a cooperative
- How they compare
- Cooperative patrons and other deductions
- Planning consideration to discuss with trusted attorneys and accountants

On March 23, 2018 President Trump signed the Consolidated Appropriations Act, 2018, H.R. 1625 into law. The 2,232-page piece of legislation included a fix to the "grain glitch" that was created under the Tax Cuts and Jobs Act of 2017. The "grain glitch" under the 2017 act significantly favored sales to cooperatives for most farm producers. Farmers that were able to sell to cooperatives were able to take a potential 20% deduction based on sales that were made to that cooperative as opposed to a 20% deduction based on taxable income. This allowed many farmers the ability to claim a deduction that would bring their taxable income to zero. The new legislation addresses the treatment of sales to cooperatives and cooperative tax deductions. To better understand how these changes will impact the manner in which farmers will market their products, selling to cooperatives or selling to non-cooperatives, we must first look to Internal Revenue Code (IRC or Code) §199A and any updates that apply.

Qualified business income deduction

Under the new Code section all pass-through entities will be able to deduct 20% of their qualified business income if the tax payer has an adjusted gross income of no more than $157,500 ($315,000 if joint return), adjusted for inflation after 2018. For amounts above those figures, the deduction is phased out over the next $50,000 ($100,000 for joint tax filers) of income. This creates an effective top marginal rate of 29.6%.

"The term 'qualified business income' means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends or qualified publicly traded partnership income." IRC §199A(c).

The calculation to determine what the tax payer will be able to deduct for QBI is based on a few factors. First, combined QBI needs to be calculated.[1] IRC §199A(b)(2) states that the combined QBI is equal to the lesser of:

- 20% of the taxpayer's QBI or
- The greater of-
  - o 50% of the W-2 wages with respect to the qualified trade or business, or
  - o The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.[2]

Once the combined QBI is determined the tax payer moves to the next limitation, taxable income. The QBI deduction is the lesser of:

- The combined qualified income amount of the taxpayer, or
- An amount equal to 20% of the excess (if any) of-
  - o The taxable income of the taxpayer for the taxable year, over
  - o The net capital gain (as defined in section 1(h)) of the taxpayer for the taxable year.[3]

Under the new legislation, a further calculation is now required that serves as a reduction of qualified business income with respect to income received from cooperatives.[4]

In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under paragraph (2) with respect to such trade or business shall be reduced by the lesser of:

- 9% of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or
- 50% of so much of the W-2 wages with respect to such trade or business as are so allocable.[5]

Let's take a look at how the new Code section could affect a non-corporate seller.

For our purposes, the below examples will not exceed the QBI limitations ($157,500 for single individuals or $315,000 for married individuals). If QBI exceeds the limitations defined under IRC §199A, the complexity of your clients tax strategies will likely increase.

Non-cooperative sales

John Smith, a single, individual tax filer, operating as a sole proprietor, is a row crop farmer with a Schedule F income of $150,000 and no other income. His income is derived from $400,000 of grain sales (to a buyer other than a cooperative) and his expenses are $250,000.

Based on these facts, his QBI deduction would be calculated as follows:

		Potential QBI deduction
Sale of grain (non-coop buyer)	$400,000	
Expenses	-$250,000	
Net Business Income	$150,000	$30,000 (a)
Less: Standard Deduction	-$12,000	
Taxable Income	$138,000	$27,600 (b)
Taxable Income after QBI deduction applied	$110,400	
Total IRC §199A deduction*	$27,600	

* QBI deduction application is equal to the lesser of: (a) 20% of all QBI or 20% of taxable income (less capital gains) ($150,000 X 20% = $30,000) **or** (b) 20% of taxable income ($138,000 X 20% = $27,600)

In this scenario, John would be entitled to the $27,600 deduction in addition to the standard deduction of $12,000, bringing his taxable income for the year down to $110,400. John's total deduction equals 20% of his taxable income, however, as a result of the new law, John's QBI deduction could be different if he had sold to a cooperative instead of an independent purchaser.

Cooperative sales made by patrons

As IRC §199A(b)(7) states above, the fix has now given cooperative patrons a deduction that is a mix of the old 199 DPAD (Domestic Production Activities Deduction) and the new IRC §199A. While this new form of deduction calculation does not significantly advantage cooperative patrons as the Code did when first introduced in January, farmers may see this new deduction as favorable, unfavorable or roughly a similar outcome as if they had sold to a noncooperative buyer.

Similar to the above, John has decided to sell all of his crops to a cooperative. In doing so, John receives his $400,000 pay in the form of $350,000 as a per unit retain paid in money (PURPIM) and $50,000 as an end-of-year patronage dividend. These payments from the cooperative would be considered "properly allocable to qualified payments received from such cooperative."[6] As in the above 199A calculations, John starts off with the same potential deduction that would be applicable under IRC §199A if he had not sold to a cooperative, $27,600. Now we subtract[7] from our initial IRC §199A deduction the **lesser** of the following amounts:

- 9% of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or
- 50% of so much of the W-2 wages with respect to such trade or business as are so allocable.[8]

Let's take a look at how John could fair if sales are made to a cooperative.

				Potential QBI deduction
Sale of grain (coop buyer)	$400,000			
Expenses	-$250,000			
Net Business Income	$150,000			$30,000 (a)
Less: Standard Deduction	-$12,000			
Taxable Income	$138,000			$27,600 (b)
Potential reduction of deduction pursuant to IRC §199A(b)(7)				
Subtract the lesser amount	9%*	$12,420 (c)	50% of W-2 Wages	$0 (d)
Taxable Income after QBI deduction applied	$110,400			
Total IRC §199A deductions**	$27,600 - $0 = $27,600			

* 9% of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative.

** Plugging in our figures, John will need to subtract from $27,600 the lesser of: (c) $12,420 (9% X $138,000) or (d) $0 (50% X W-2 wages which were $0) Therefore, in this example, John will see the same benefit selling to a cooperative vs a noncooperative.

The potential benefit of selling to a cooperative of which you are a member

As the above illustrates, the new law may not favor sales to cooperatives but in some instances, a farmer may see an advantage if the cooperative distributes out to its' members an additional deduction. For example, if John is selling to a cooperative, John may receive an additional deduction that he can add onto his IRC §199A deduction if the cooperative John sells to wishes to pass it through to him. The amount of the deduction that a cooperative may pass back through to its members, which will range from 0%-9% of the cooperative's qualified production activities income (QPAI), is attributed to that individual patron's grain sales to the cooperative. The deduction passed back through to the members of the cooperative operates in the same manner the old DPAD provision worked. The overall amount that the cooperative chooses to pass through to its members cannot exceed 50% of the value of the wages the cooperative pays to its employees, more detail on this aspect of the cooperatives deduction are noted below.

Let's now see what this could mean for John if the cooperative, he is a member of and sells to, decides to pass through an additional deduction.

				Potential QBI deduction
Sale of grain (co-op buyer)	$400,000			
Expenses	-$250,000			
Net Business Income	$150,000			$30,000 (a)
Less: Standard Deduction	-$12,000			
Taxable Income	$138,000			$27,600 (b)
Potential reduction of deduction pursuant to IRC §199A(b)(7)				
Subtract the lesser amount	9%	$12,420 (c)	50% of W-2 Wages	$0 (d)
Taxable Income after IRC §199A(b)(7) reduction	$110,400			
Additional deduction passed through from cooperative (IRC §199A(g)(2)(A)	$3,000			
Total IRC §199A deductions	$27,600 + $3,000 = $30,600			
Taxable Income after IRC §199A deductions	**$107,400**			

The cooperative that John sells to and is a member of has decided to allocate a $3,000 deduction[9] to him for John's portion of the cooperative's QPAI. John will be able to take this additional deduction so long as it does not exceed John's taxable income after his QBI deduction. John's total QBI deduction equals 22.17% of his taxable income, slightly more than the 20% deduction if John had sold to an independent purchaser.

The potential disadvantage of selling to a cooperative

Lastly, let's take a look at how the new Code section could affect farmers negatively if they were to sell to a cooperative rather than an independent purchaser. All of the facts that are noted above will remain the same, the only change is that John employed a W-2 employee. The W-2 employee was paid in the amount of $30,000 which was included in John's expenses for the 2018 tax year.

				Potential QBI deduction
Sale of grain (co-op buyer)	$400,000			
Expenses	-$250,000 ($30,000 W-2)			
Net Business Income	$150,000			$30,000 (a)
Less: Standard Deduction	-$12,000			
Taxable Income	$138,000			$27,600 (b)
Potential reduction of deduction pursuant to IRC §199A(b)(7)				
Subtract the lesser amount	9%	$12,420 (c)	50% of W-2 Wages	$15,000 (d)
Total QBI deductions	$27,600 - $12,420 = $15,180			
Taxable Income after IRC §199A(b)(7) reduction	$122,820			
Additional deduction passed through from cooperative (IRC §199A(g)(2)(A)	$3,000			
Total IRC §199A deductions	$15,180 + $3,000 = $18,180			
Taxable income after IRC §199A deductions	**$119,820**			

John's total deduction equals 13.17% of his taxable income, significantly less than the potential 20% deduction if John had sold to an independent purchaser.

It is important to note that the above calculation is only attributed to sales related to cooperatives, in regard to QBI deduction purposes. Individuals could still see a total QBI deduction affected by an individual's ability to receive rental income, or other qualified business income, allowing the individual to have the potential to still receive the maximum 20% deduction that a noncooperative seller could receive.

How do they compare?

	Cooperative-W-2 employee		Cooperative No W-2		Non-Cooperative	Potential QBI deduction
Sale of grain	$400,000		$400,000		$400,000	
Expenses	-$250,000 ($30,000 W-2)		-$250,000		-$250,000	
Net Business Income	$150,000		$150,000		$150,000	$30,000 (a)
Less: Standard Deduction	-$12,000		-$12,000		-$12,000	
Taxable Income	$138,000		$138,000		$138,000	$27,600 (b)
Potential reduction of deduction pursuant to IRC §199A(b)(7)						
Subtract the lesser amount	$12,420 (c)	$15,000 (d)	$12,420 (c)	$0 (d)	N/A	
Total QBI deductions	$15,180		$27,600			
Taxable Income after IRC §199A(b)(7) reduction	$122,820		$110,400		$110,400	
Additional deduction passed through from cooperative (IRC §199A(g)(2)(A)	$3,000		$3,000		N/A	
Total IRC §199A deductions	$18,180		$30,600			
Taxable income after IRC §199A deductions	**$119,820**		**$107,400**		**$110,400**	

As the above indicates, the results will vary depending on the farmer's particular circumstances. The new Code section does not appear to simplify choices for farmers when they decide to sell their product.

Cooperative patrons and other deductions

Although the above calculations may seem similar to the old 199A DPAD rules prior to 2018, a large distinction comes in the form of to whom this deduction now applies to. IRC §199A(g)(2)(D) restricts the deduction to "eligible taxpayer", specifically "(i) a taxpayer other than a corporation". This specification is strictly to exclude C-corporations and does not affect an S-corporation's ability to utilize this deduction. Also, the deduction that the cooperative is able to receive for itself is limited only by qualified payments attributed to those who qualify as a "eligible taxpayer" IRC §199A(g)(2)(C).

Another distinction from the old 199A DPAD rules is the manner in which agricultural cooperatives themselves receive a deduction. Under the new Code section, cooperatives can now take a deduction equal to 9% of QPAI. This amount is limited by taxable income and 50% of W-2 wages that are paid. If the cooperative chooses to pass through the deduction to its patrons, as in our example above, the cooperative must reduce, deductions it could normally take for payments to those patrons.

Planning considerations to discuss with trusted attorneys and accountants

Given the complexity of the new law there appear to be several areas where farmers may find advantages due to the structure of their operations. Below are a few questions to discuss with your trusted advisory team when considering how the new Code section will affect your taxes for the 2018 year and beyond.

- Should I consider separating my employees from my operations entity?
- How should I pay my employees?
- Should I consider placing my land into an entity?
- Should I switch from a C-corporation to a S-corporation?
- How will these new changes affect my FSA elections?
- Knowing that IRC §199A is temporary, should I even consider making changes to the manner in which I conduct my business operations?

Lastly, it is important to note that we are still waiting for guidance on how the provisions within the new tax law will be interpreted and administered. There are several other factors that should also be considered when addressing how and when farmers market their products and the new Code is just a piece to the puzzle. There will be more to come on this difficult area of the new tax act as the year progresses.

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[1] I.R.C. §199A(a)(1)
[2] I.R.C. §199A(a)(2)
[3] I.R.C. §199A(a)(1)
[4] I.R.C. §199A(b)(7)
[5] I.R.C. §199A(b)(7)
[6] I.R.C. §1385
[7] I.R.C. §199A(b)(7)
[8] I.R.C. §199A(b)(7)
[9] I.R.C. §199A(g)(2)

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