Impact of Tax Reform on Agricultural Cooperatives

Thanks to Our Sponsors

- NCREA-210 Research Committee on Cooperatives
- Cooperatives Community of Practice on eXtension
- All of you who helped us get the word out!

Housekeeping

- We will send link to recording and any updates to materials
- Please type your questions into the Chat Box and we will answer as many as time allows. We will email answers to any questions we do not get to
- Let us know if you have information or additional resources to share with the group or if you would like to be added to our research group listserv to receive notice of future programs and information

Our Panel

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Tax Cuts and Jobs Act of 2017

- Signed into law on December 22nd, 2017
- Sweeping changes to the tax code
  - Individuals
  - Estates
  - Foreign income
  - And a lot more
- The focus here is on the impact to agricultural cooperatives and their members
  - In particular, four key changes are the focus in this presentation
    - There are other items of interest for cooperatives such as limitation on business interest and expensing depreciable assets

Tax Cuts and Jobs Act of 2017

- (1) Lower federal corporate tax rates
  - Previously, federal corporate tax rates were up to 35%
  - Now, they are 21%
  - For cooperatives to receive this benefit, they must generate taxable income
    - Patronage income distributed as non-qualified equity
    - Patronage income retained as unallocated equity
    - Non-patronage income

Tax Cuts and Jobs Act of 2017

- (2) Elimination of the domestic production activities deduction or DPAD
  - DPAD was originally part of the American Jobs Creation Act of 2004 (Bush Tax Cuts)
    - Spur manufacturing job creation
  - Agricultural marketing cooperatives were able to use it
    - Primarily grain marketing in the Midwest and Great Plains
  - Tax deduction that could be held at the cooperative level or passed through to patrons
    - The pass-through was used if the co-op could not use the entire deduction or it benefitted the members due to differential tax rates

Tax Cuts and Jobs Act of 2017

- (3) Creation of Section 199A
  - Replacement for DPAD for cooperatives only
  - Tax deduction for the cooperative and patron
  - 20% deduction for qualified business income
    - Grain, farm supply, equipment, and services to farmers…for all agricultural cooperatives, not just grain marketing
  - Limited by the greater of
    - 50% of W2 wages
    - 25% of W2 wages plus 2.5% of qualified property of the cooperative

Tax Cuts and Jobs Act of 2017

- (4) Lower member taxes
  - Qualified patronage distributions
    - 20% tax deduction on all qualified dividends (qualified patronage. i.e. cash and qualified equity)
  - Effectively lower member tax rate
    - A Schedule F farmer in the 35% tax bracket would have an effective tax rate on cash and qualified equity distributions of 28%
  - If per-unit retain payments are included as "qualified distributions from the cooperative" the impact on member taxes would be much greater. (We do not consider this potential effect in our simulation analysis)

Calculation of tax deductions for the Simulation Model

Cooperative Deduction – Section 199A

Qualified Business Income
– Patronage Dividends
Applicable Deduction Amount
x 20%
Preliminary Deduction

Limited by greater of:
50% all co-op W2 wages
or
25% all co-op W2 wages PLUS
2.5% qualified property

Patron Deduction

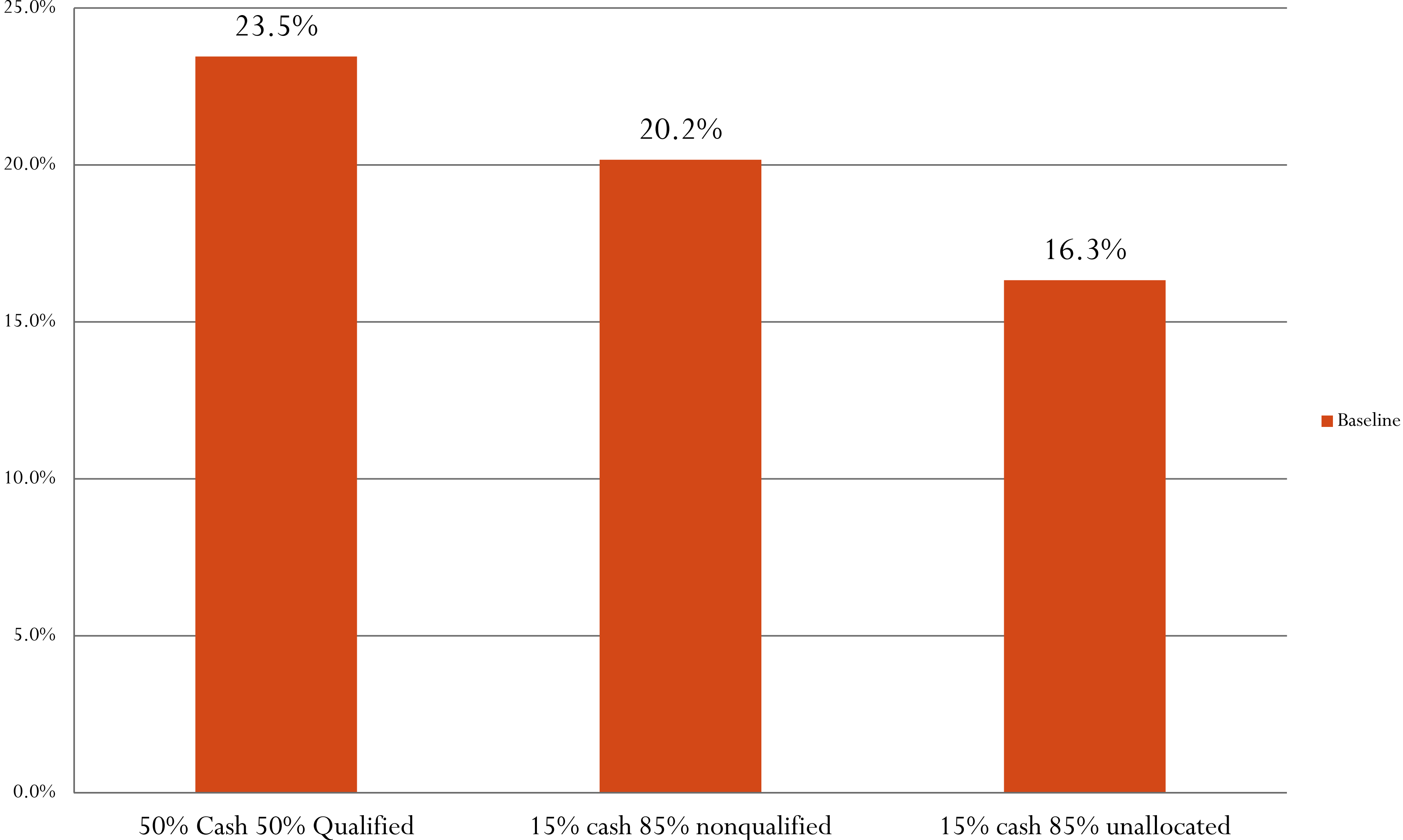
Cash Patronage Paid
+Qualified Retained Patronage
Applicable Deduction Amount
x 20%
Tax Deduction

Hypothetical Grain and Farm Supply Cooperative

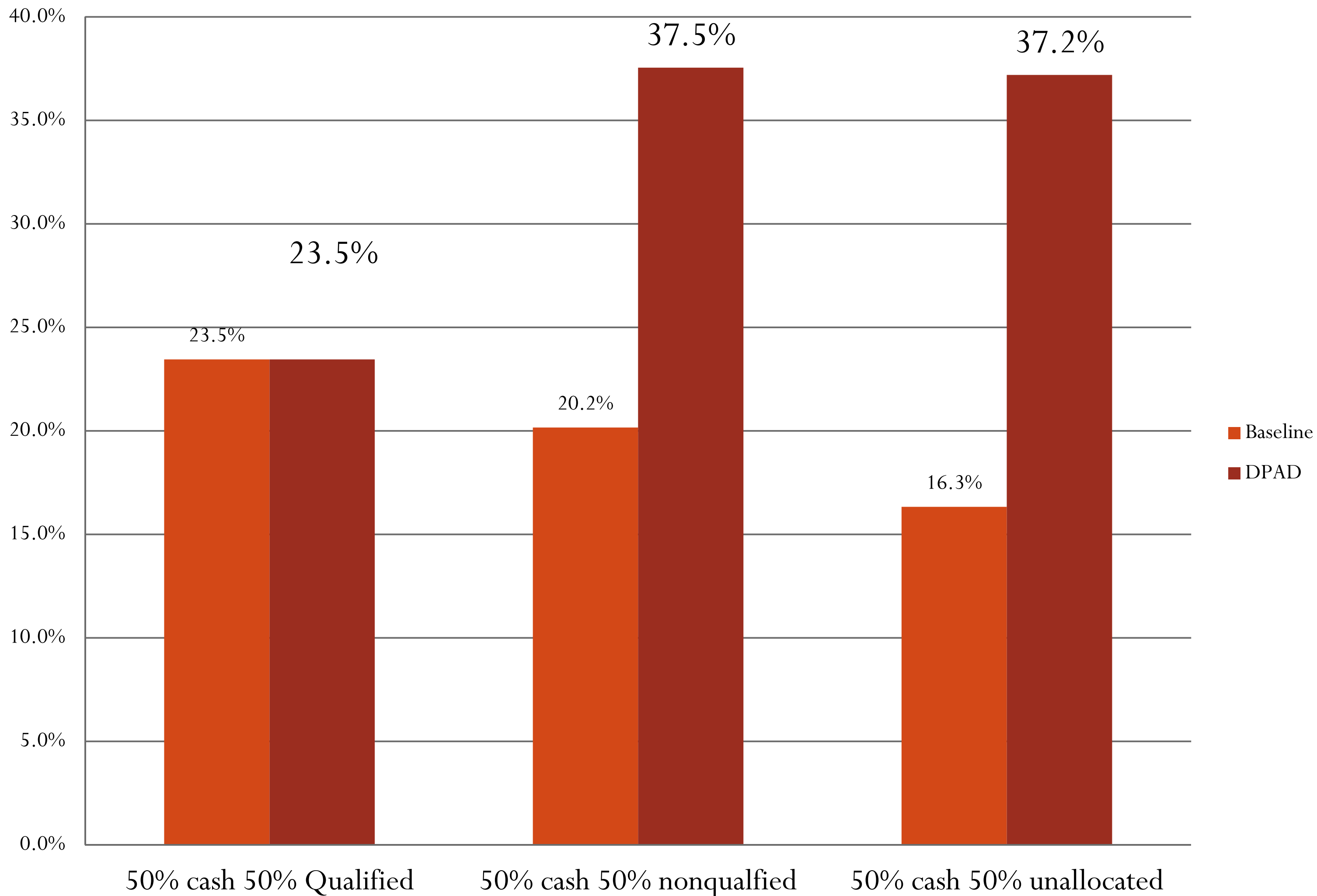
- $280M Total Sales – 55% grain
- 85% member business
- Debt/asset = 24%
- 15 year equity revolving period
- Allocated equity/total equity = 44%
- $4.7M wage expense (32% of gross margin, 1.6% of sales)
- Baseline tax rates: 41% corporate (35% federal + 6% state), 35% member (federal, state and self employment)
- Calculate the member's internal rate of return (IRR) which represents their rate of return from all cash patronage and redeemed equity over a 30 year life span of using the cooperative)

Base Line Results

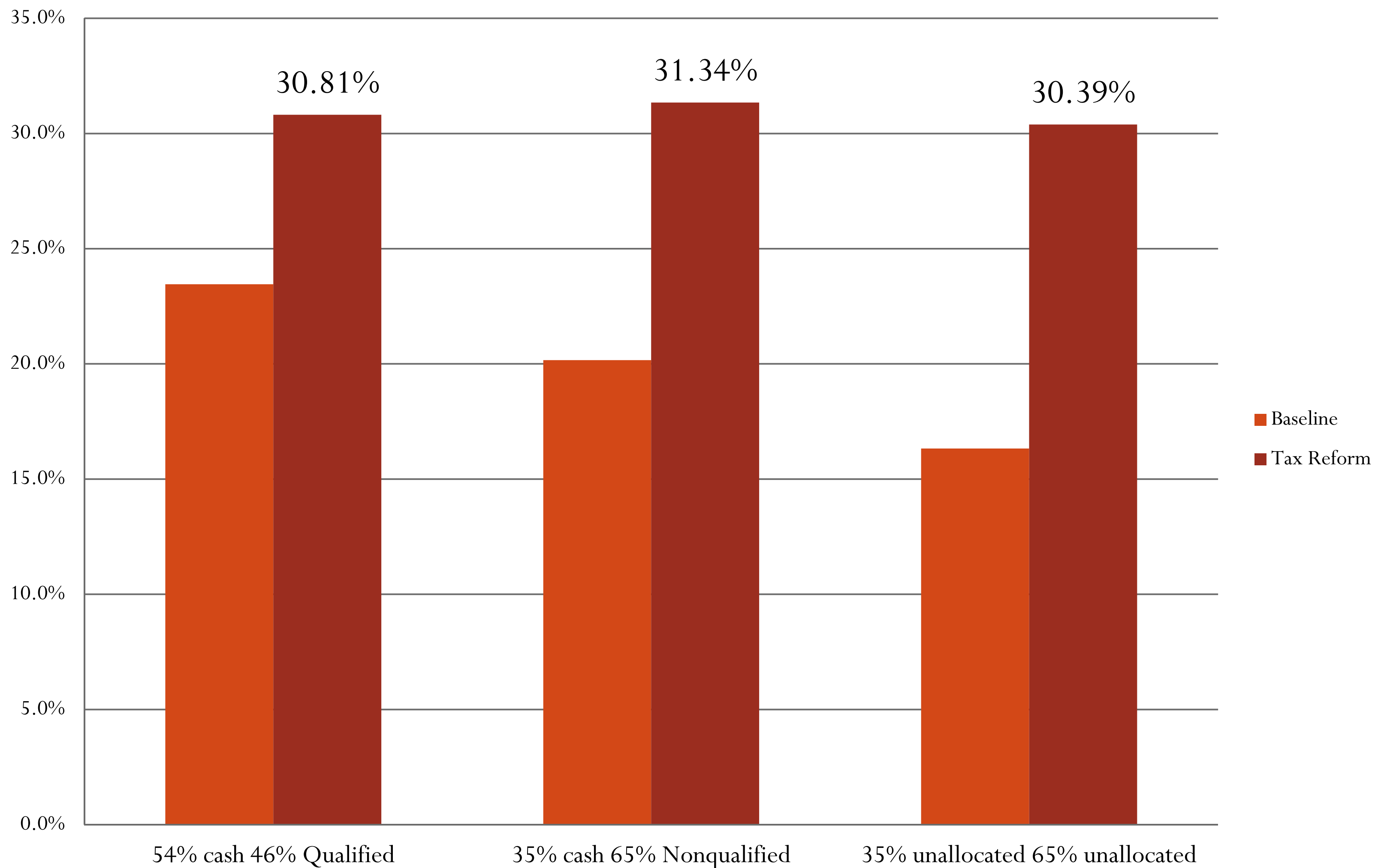
Table 1: Baseline 41% corporate tax 35% member tax rate						
	Cooperative's Year 1 Cash flow	Cooperative's Year 1 Tax	Member Year 1 Cash Patronage	Member Year 1 After Tax Cash Flow	Member IRR	Allocated Equity to Total Equity in Year 10
50% Cash 50% Qualified	$ 4,523,660	$ 532,960	$ 3,683,057	$ 1,379,041	23.5%	68.9%
15% cash 85% nonqualified	$ 4,523,660	$ 3,092,501	$ 1,123,333	$ 1,004,290	20.2%	78.4%
15% cash 85% unallocated	$ 4,523,660	$ 3,092,501	$ 1,123,333	$ 1,004,290	16.3%	5.3%



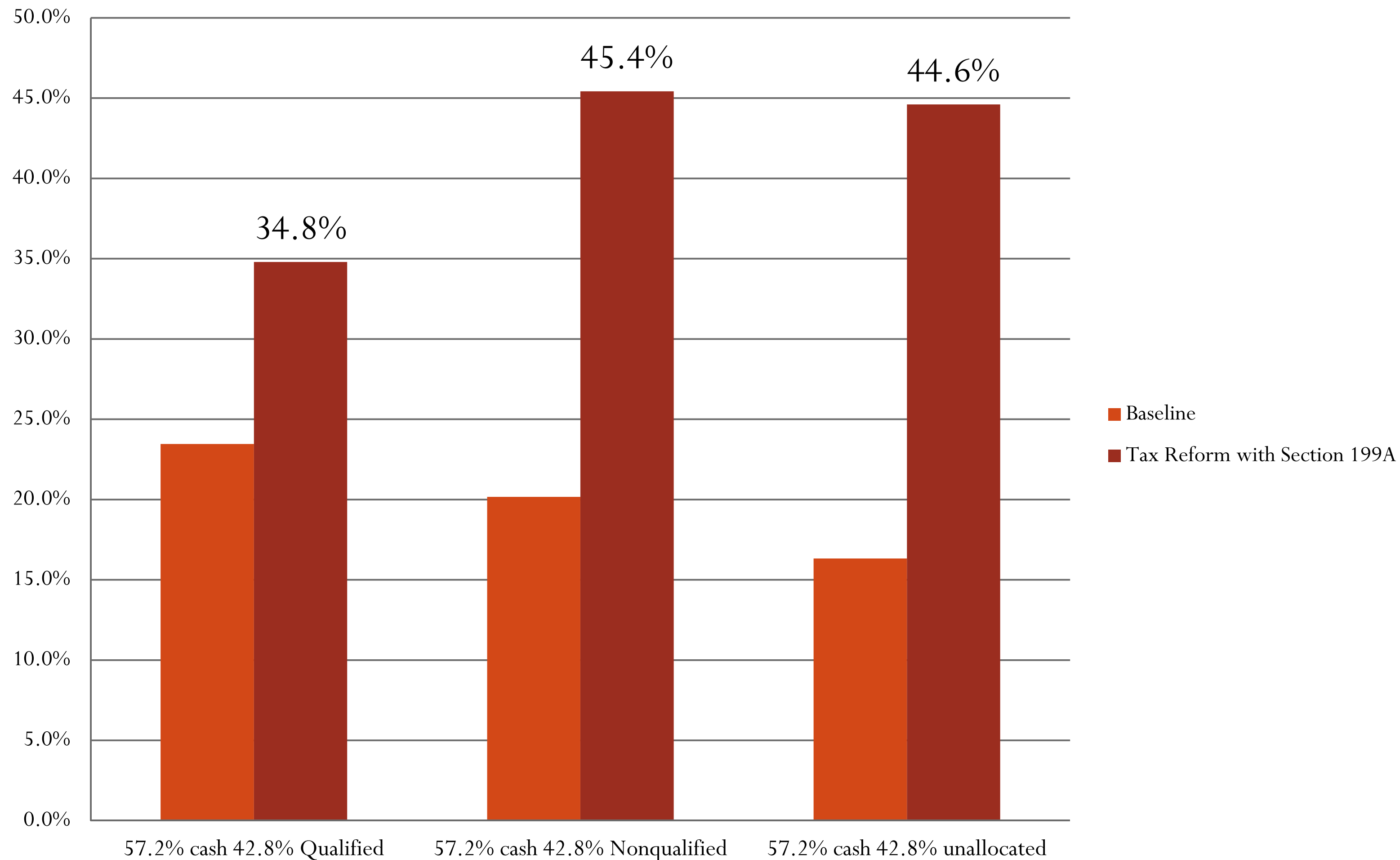
Baseline: Member IRR
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
23.5%
20.2%
16.3%
50% Cash 50% Qualified
15% cash 85% nonqualified
15% cash 85% unallocated
Baseline



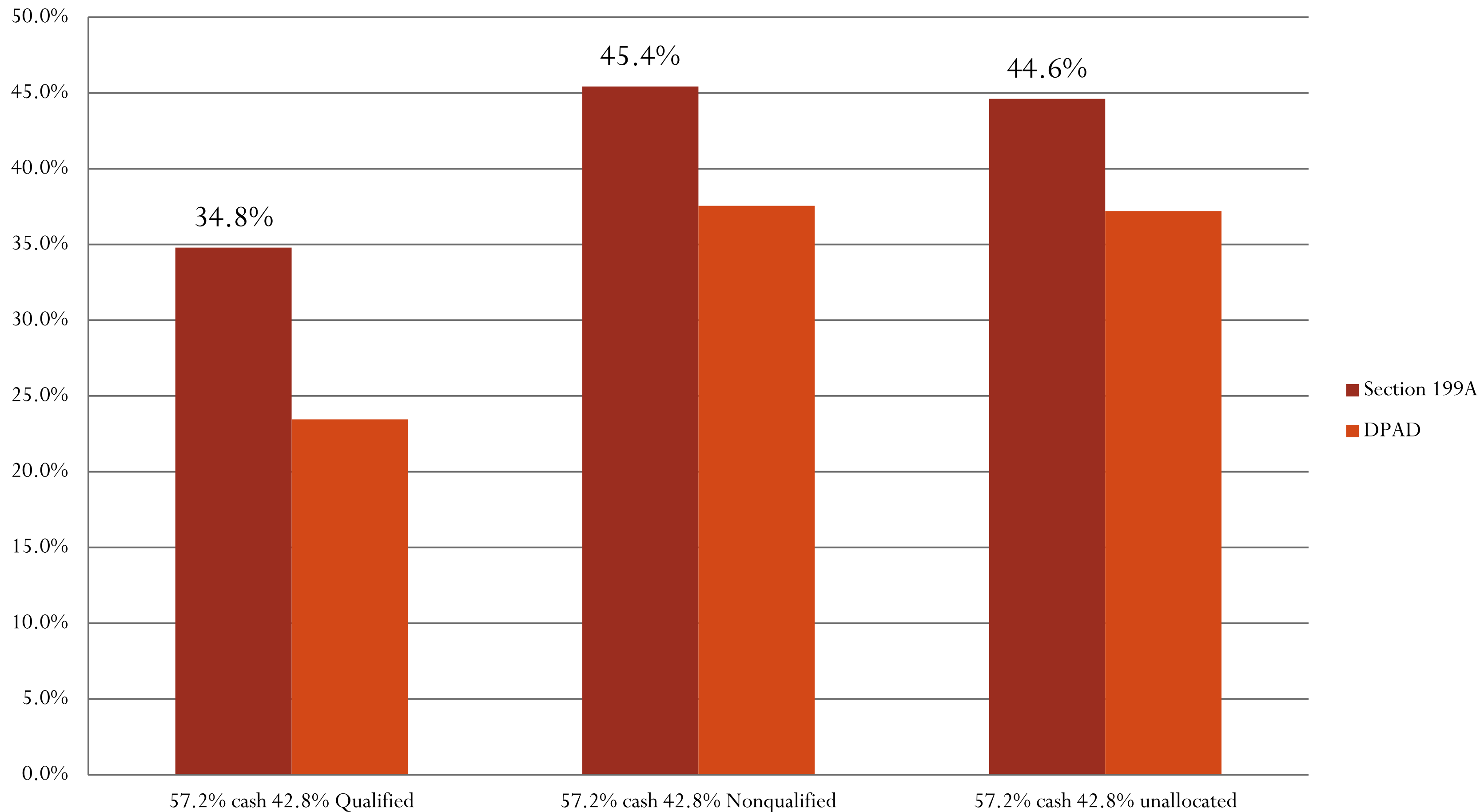
DPAD allowed the cooperative to maintain the qualified cash patronage rate, while issuing nonqualified or retaining unallocated equity and maintaining the same cash flow as in the baseline scenario.



- Lower tax on non-member business increases cash patronage with cooperative
- Cash flow is constant and allowed the cooperative to pay 35% cash with NQ or UE
- Member receives 20% deduction on cash and qualified equity



Section 199A eliminates taxation on non-member profits and allows same cash percentage with NQ and unallocated, with constant cash flow as in the baseline scenario



Section 199A can potentially also eliminate taxation on non-member profits allowing for slightly higher cash patronage. Both DPAD and Section 199A allow the cooperative to keep the cash patronage percentage constant while switching to nonqualified retained equity or unallocated equity.

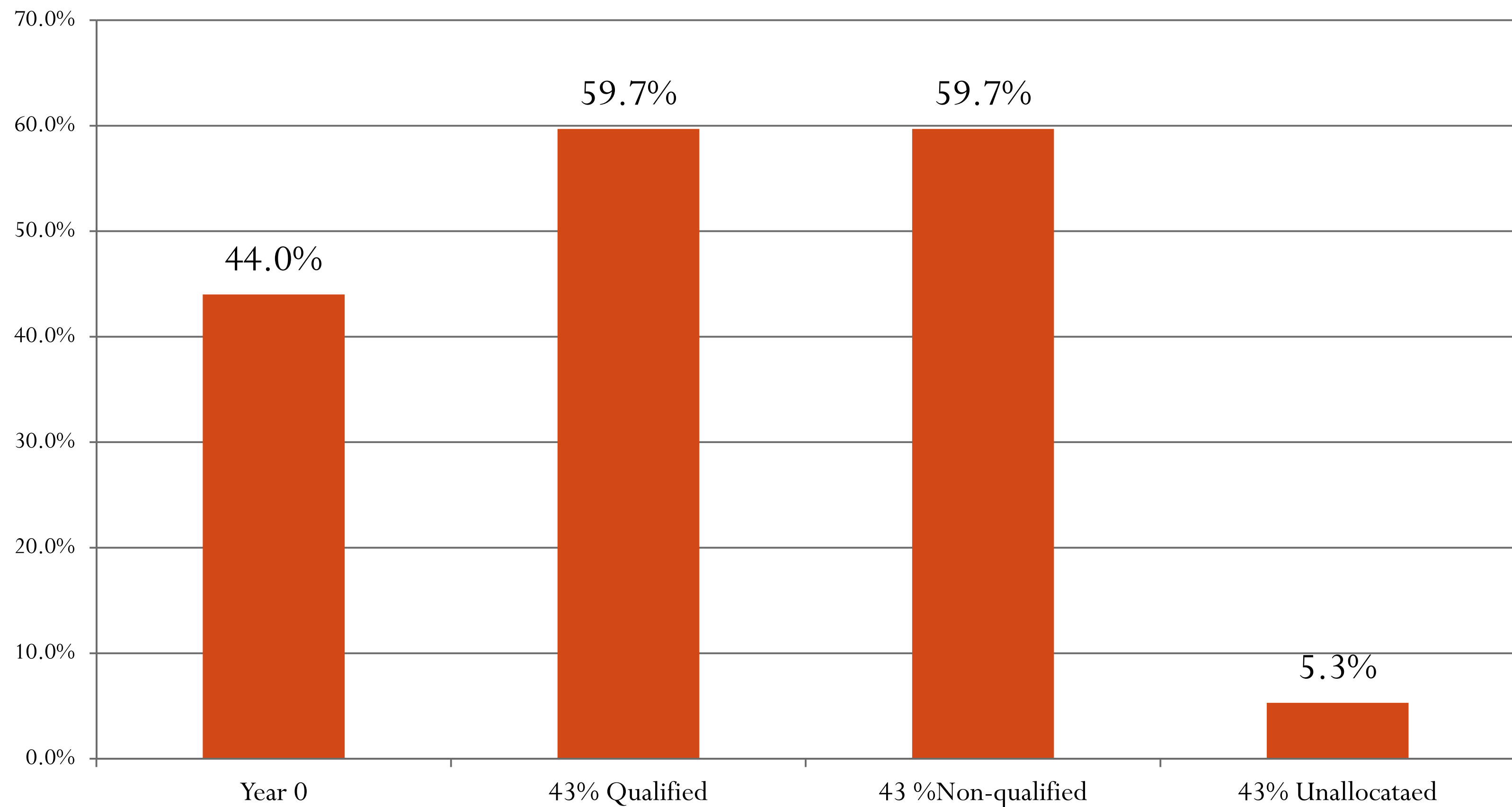
Conclusions

- Prior to DPAD the logical choice was to distribute profits in a combination of cash and qualified retained patronage
- DPAD allowed the cooperative to retain the same cash patronage rate using non-qualified (NQ) and/or unallocated equity (UE)
- Tax reform allows the cooperative to increase cash patronage from 50% to 54% with qualified or from 15% to 35% with NQ or UE
- Section 199A allows for further increase to 57.2% cash with either Q, NQ or UE.

Optimal Profit Distribution Choices

- Prior to DPAD: 50% Cash, 50%Qualified, 23.5% IRR
- DPAD: 50% Cash, 50% NQ, 37.5% IRR
- Tax reform w/out Sec 199A: 54% Cash, 46% NQ, 30.8% IRR
- Tax reform w/ Sec 199A: 57.2% Cash, 43.8% NQ, 45.4% IRR
- What is the big difference between nonqualified and unallocated equity?

Impact on Balance Sheet



Producer-Member Impacts and Unknowns

Producer Impacts Discussed So Far

- The 20% deduction on cash and qualified equity patronage should increase member-producers' after tax return from the cooperative.
- Co-op can use tax savings on non-member profits and its Sec 199A deduction to increase cash patronage.
- Co-ops may capitalize by transitioning to non-qualified equity (NQ), and members may prefer receiving equity allocations not taxed until redemption.
- These effects would be viewed as beneficial by co-ops and their members since they may not significantly benefit from reduction in the corporate tax rate.

Section 199 A "Clarifications"

- NGFA and NCFC working through potential "clarifications" to Section 199A.
- Clarification could impact the benefits we have discussed but are most likely to focus on the treatment of Per Unit Retain payments by cooperatives.
- We will need to wait for clarification before we can completely analyze producer impacts.

Per Unit Retain Payments

****Discussion of implications of per unit retains is premature, BUT…**

- Defined as payments based on amount of commodity handled without reference to profit.
- In the current Sec 199A language, per unit retains are included in the types of cooperative distributions that qualify for the 20% deduction at the member level.
- As defined, this permits marketing co-ops to pay for commodities in the form of per unit retains, increasing members' 20% deduction from the qualified allocation in that year to include the commodity payment.
- Estimates of the tax savings for a typical grain farmer ranges $0.07 - $0.20/bushel, but dissipates as farm income weakens.

Other Possible Producer Impacts

- Cooperatives could also choose to use tax savings to accelerate equity redemption and investments, and improve infrastructure.
- Accelerated equity redemption increases the member-level returns from using the co-op but may reduce the proportion of equity allocated to members (balance sheet effect).
- Infrastructure investments benefit members indirectly and improve the system's efficiency.

Other Common Questions

****Discussion of implications of tax code is premature, BUT…**

- How will the tax code change producers' marketing?
- Will there be capacity and grain flow issues, including on local prices?
- How does this impact specialty forms of co-ops, like pooling, and co-ops in other sectors?
- Will this encourage formation of closed cooperatives, condominium and co-op commodity handling assets?
- Will producers restructure farm businesses?

Questions?