The Section 199A Deduction: Potential Impacts on Farm Prices and Income

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The beginning of 2018 was a rollercoaster ride for agricultural producers and tax professionals paying attention to tax law changes in the Tax Cuts and Jobs Act (TCJA) that passed in late 2017. One of the key changes that will make doing taxes in the foreseeable future challenging is Section 199A (Sec 199A) of the Consolidated Appropriations Act that followed the TCJA in March 2018. Sec 199A is a deduction for agricultural producers and their producer associations (cooperatives), and it replaces a prior deduction these taxpayers used—the Domestic Production Activities Deduction (DPAD). Though Sec 199A was written to restore many features of DPAD for producers and co-ops, it sets-up for producers an explicit trade-off in deductions between marketing grain through a cooperative versus a non-cooperative firm.

Sec 199A is a temporary deduction (expiring after 2025) based on "qualified business income" (QBI) for pass-through organizations (e.g., partnerships, LLCs taxed as partnerships, S-corps, cooperatives) and sole proprietors.[1] The deduction is an attempt to align non-C Corporation rates with the permanent flat 21% corporate tax rate. Sec 199A has two main parts: Sec 199A(a) deals with the producer-level deduction, and Sec 199A(g) sets up a deduction for agricultural and horticultural cooperatives.

The producer-level provisions in Sec 199A(a) establish a different deduction depending on whether the producer markets grain to a non-cooperative firm or to a cooperative. A non-C corporation producer selling grain to a non-cooperative firm generates a deduction equal to 20% of QBI, limited to 20% of taxable income minus capital gains (additional wage/capital restrictions apply). However, the same producer marketing their grain through a cooperative calculates a deduction that depends on their farm wages: the deduction is 20% of QBI minus the smaller of 50% of W2 wages or 9% of QBI, in both cases using values attributable to the sales to the cooperative. Farmers who have no on-farm W2 wages will not reduce their 20% QBI deduction, but those with significant W2 wages may end up with a deduction that is 11% of QBI: 20% QBI less 9% of QBI. But the deduction for farmers marketing through a cooperative does not stop there—there may be a co-op level deduction for producers to consider.

Section 199A(g) establishes the deduction that agricultural and horticultural cooperatives can generate due to sales from eligible taxpayers (non-C corporation members). Generally, that deduction is 9% of the cooperative's "qualified production activities income" based on the sales of patrons' products, limited to 50% of the co-op's wages. Cooperatives are pass-through organizations, and as with the old DPAD, the co-op can elect to pass through any portion of its deduction to its eligible taxpayers: 0% - 9%, limited by 50% of W2 wages. Any pass-through that the cooperative gives to its eligible members is added to the deduction that the producer generates through Sec 199A(a), and the total deduction for a producer marketing through a cooperative is limited only by taxable income (not subject to capital gains).

What does this mean for producers selling to a cooperative?

In many (not all) cases, the cooperative will not be able to utilize the full amount of the deduction it generates and will likely pass through the remainder of its deduction to eligible members. Producers who sold to a cooperative and have no on-farm W2 wages will likely have a deduction

[1] *The Center for Agricultural Law and Taxation (CALT) at Iowa State University has resources for producers and tax professionals who need to understand Section 199A, www.calt.iastate.edu/blogpost/fix-grain-glitch-now-law-examples-included.*

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of 20% of QBI plus some portion of the co-op's 9% qualified production activities income (QPAI) deduction that was attributable to that producer's sales. Early estimates suggest that the pass-through from a grain-marketing cooperative is likely to be 30% - 50% of the co-op's deduction, which equates to 3% - 4.5% of its QPAI attributable to the producer. For producers with farm W2 wages, the co-op's deduction pass-through represents an opportunity to increase their total tax deduction.

The bottom line: producers marketing their 2018 production (and beyond) should take care to understand that where they market their grain may affect their deduction under Sec 199A of the TCJA. Producers with no or little on-farm W2 wages will likely be able to take a higher deduction by selling to a cooperative because of the deduction pass-through from the cooperative. Producers have always been cognizant that patronage from the cooperative adds to their net marketing prices for grain. The TCJA's new Section 199A deduction is another compelling factor for weighing carefully the decision of where to market grain, as it will ultimately affect net grain marketing prices and farm incomes. Producers are encouraged to seek a tax professional's input in deciding the impact of all tax laws on their operations.

For more information about cooperatives, visit the Ag Decision Maker Cooperatives webpage, www.extension.iastate.edu/agdm/cooperatives.html.

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