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Section 199A Deduction

The New 20% Deduction

The word of the new Section 199A Deduction that is part of the Tax Reform Bill passed in December of 2017 has been spreading quickly and not all the information out there is 100% accurate. Part of the reason for the inaccuracies is that it will affect different taxpayers differently and also because this is a new tax law, which means until IRS writes the regulations concerning the law, no one really knows exactly how it's going to impact your tax return. It has also been promised by the Senators who wrote this section of the bill that a correction will take place because it was not the intent of the law to give such a significant advantage to cooperatives. That being said, it is really important to understand that any analysis or advice given on this law is someone's interpretation and the only interpretation that counts is IRS's. Since that is not available, we can only do the best we can with limited information.

While I definitely think the right answer is we have to "wait and see" what the final law will be and then what the interpretation by IRS will be, we also need to address it now due to all the information that is out there. The reality is that the way the law was originally written, some operations will benefit greatly from selling their crops to a cooperative in 2018, but other won't so it's important to know if you will be affected.

History & Definitions

Cooperatives have been receiving a deduction called the Domestic Production Activities Deduction (DPAD) for many years. This was I.R.C. Section 199 and was eliminated as part of the tax reform simplification. The cooperatives were concerned about the significant impact the elimination of Section 199 would have on their business so they were lobbying for a replacement of some kind.

C-Corporations were given a flat 21% tax rate in the Tax Reform Bill which significantly reduced their tax liability. There was a lot of concern that this would cause many more operations to need to incorporate to be competitive.

To solve the concern over the advantages to C-Corps, the Senate introduced the Section 199a deduction to give pass-through entities a deduction of 20% of net income which would start to even the benefits that the corporations would receive from their rate reduction. During the last few days of discussion, there was a provision added to the Section 199a rules that allowed the 20% calculation to be applied to distributions from cooperatives and the language clearly states

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a "qualified cooperative dividend" is any patronage dividend, any per-unit retain allocation and any qualified written notice of allocation that is included in gross income.

We need a few definitions to understand all this.

- Pass-through entities include Partnerships, S-Corporations, Schedule C and Schedule F filers. If you have an LLC, your tax status is based on the election you made when you formed the LLC. It could be one of these entities or it could be taxed as a c-corporation. Schedule C is for all business income that is not from farming or fishing. Schedule F is for business income from farming and fishing. If you have trade or business income on one of these forms, you qualify for the 20% deduction.
- If your operation is a C-corporation, you do not qualify for the 20% deduction so it doesn't matter where you sell your grain.
- Per-Unit Retain Allocations are the amount paid to you by a cooperative for products sold to them. This is different than a patronage dividend which is your distributive share of the cooperative's net income. Both of these added together are considered your "Qualified Cooperative Dividend" and would be eligible for a 20% deduction.

Calculation Options

Somehow simplification of the tax code got lost by the time they got to the calculations for this new deduction. There are a couple different ways we need to look at and this will be interesting to see how the code is interpreted and applied to the tax forms.

1. If you file married filing joint and your taxable income is less than $315,000 ($157,500 for single filiers) your deduction is 20% of your Qualified Business income plus 20% of your Qualified Cooperative Dividends
2. If your income is above the threshold, you must also apply a test which would include a limit based on wages paid. There are (of course) two options there as well.
    a. Your deduction could be limited to 50% of the wages you paid. (This is wages you paid to employees, not wages you received as an employee.) The wages must be subject to social security taxes which means commodity wages and wages paid to your children under the age of 18 (sole-proprietors only) do not count.
    b. Or your deduction could be limited to 25% of wages plus 2.5% of the "Unadjusted basis immediately after acquisition of all qualified property". There will be some interpretation on this but looks like in general it will be the total costs basis of your equipment purchased in the last 10 years without regard to depreciation taken.
3. At no time, can this deduction be used to make taxable income less than zero so there is also a limit of your taxable income.

To Sell to A Cooperative or Not…

With all that said, there are several groups of people who can forget this discussion and sell to whoever you want.

1. If you operate in a c-corporation, you don't have to worry about this since you don't qualify.

2. If you do not have taxable income on your tax return, you don't have to about this deduction.
3. If your total income will be over $315,000, your deduction will likely be limited more by wages paid than by whether you sell your crop to a coop or a private grain company unless you have significant wages.

If I haven't eliminated you, we need to start looking at some examples to see just how this may affect you.

Example 1: High Profit Percentage, Less than $315,000 of Taxable Income

	Selling to Cooperative	Selling to Private Company
Grain Sales	$600,000	$600,000
Other Farm Income	$30,000	$30,000
Total Farm Income	$630,000	$630,000
Farm Expenses	$475,000	$475,000
Net Farm Income	$155,000	$155,000
Non-Farm Income	$150,000	$150,000
Total Income	$305,000	$305,000
Adjustment to Income	$15,000	$15,000
Adjusted Gross Income	$290,000	$290,000
Section 199A Deduction	$120,000	$31,000
Standard Deduction	$24,000	$24,000
Taxable Income	$146,000	$235,000
Tax Due	$24,000	$45,000
Difference	$21,000	

Let's assume the $600,000 of grain sales was a split between corn and soybeans.

Corn	85,000 bu.	$285,000	47.5%	12 cents/bu
Soybeans	36,000 bu.	$315,000	52.5%	31 cents/bu.
Total Grain Sales	121,000 bu.	$600,000		

This example is probably the perfect example for how to maximize the deduction by selling to a coop. In reality, an operation with a profit percentage this high is rare in my experience. Let's look at another example that may be more "average".

Example 2: Average Operation, Less than $315,000 of Income

	Selling to Cooperative	Selling to Private Company
Grain Sales	$900,000	$900,000
Other Farm Income	$100,000	$100,000
Total Farm Income	$1,000,000	$1,000,000
Farm Expenses	$900,000	$900,000
Net Farm Income	$100,000	$100,000
Non-Farm Income	$20,000	$20,000
Total Income	$120,000	$120,000
Adjustment to Income	$7,000	$7,000
Adjusted Gross Income	$113,000	$113,000
Section 199A Deduction	$89,000	$20,000
Standard Deduction	$24,000	$24,000
Taxable Income	$0	$69,000
Tax Due	$0	$7,900
Difference	$7,900	

Again we can assume a similar split between corn and bean sales.

Corn	165,000 bu.	$580,000	47.5%	2 cents/bu
Soybeans	35,000 bu.	$320,000	52.5%	12 cents/bu.
Total Grain Sales	200,000 bu.	$900,000		

The savings is not nearly as large with this example for a couple of reason. The first is the profit percentage. In example 1, the producer was recognizing almost 26% of gross income as net. In example 2, it was only 10%. Since it was less than 20%, selling 100% of the grain to the cooperative was more than he needed. Let's go back to the example. The maximum 199A deduction we can get is $89,000 because that takes his taxable income to $0. The producer would only need to sell $445,000 of grain to the coop to get an $89,000 deduction ($89,000

/0.20 = $445,000). So he could sell the rest to a private company and still max out his deduction. The second reason is because the total taxable income in Example 2 is lower. This means that the deduction is offsetting income in a lower tax bracket, so it won't add up as fast as in Example 1.

Example 3: Low Income

	Selling to Cooperative	Selling to Private Company
Grain Sales	$650,000	$650,000
Other Farm Income	$85,000	$85,000
Total Farm Income	$735,000	$735,000
Farm Expenses	$725,000	$725,000
Net Farm Income	$10,000	$10,000
Non-Farm Income	$25,000	$25,000
Total Income	$35,000	$35,000
Adjustment to Income	$12,000	$12,000
Adjusted Gross Income	$23,000	$23,000
Section 199A Deduction	$0	$0
Standard Deduction	$24,000	$24,000
Taxable Income	$0	$0
Tax Due	$0	$0
Difference	$0	

This producer does not qualify for a Section 199A deduction because it would have taken his taxable income below zero. For this producer, it doesn't matter if he sells to a cooperative or a private grain company

Obviously, these are three very simple examples but they illustrate the main points of the decision of whether you need to change who you sell your grain to. For most operations, it seems your profit percentage will tell you a lot. To calculate your profit percentage, divide your net income on Schedule F by your Gross income on Schedule F. If your profit percentage is above 20%, you may want to consider selling 100% of your crop to a cooperative. If your profit percentage is near zero, you probably don't need to worry about selling any grain to a specific type of merchandiser. If you're in between, you may want to consider selling at least some grain to a cooperative.

What does this mean for livestock?

Livestock will be treated the same as grain if you sell to a cooperative. Since fewer livestock buyers are organized as a cooperative, it will not apply the same to a livestock operation the same as it will to grain operations.

Conclusion:

So what should you do? It's really hard to give a blanket advice to producers that they should or shouldn't worry about this. For some producers, like those in Example 1 it will make a significant difference. For others, like those in Example 3, it will make no difference. As with most things related to tax law, this deduction is not as simple as I've laid it out here as we have the impact of the sale of business property, the potential impact of the elimination of tax free treatment of trade for personal property, how self-rental income will apply, as well as the impact to share-rent landlords. Add to those questions that this is one interpretation of the law and we will not know specific procedures for this law until IRS issues regulations.

My hope in writing this is point out that there are several groups of producers who do not need to worry about where they should sell their crop in 2018. For others, there may be some real reason to at least spread your sales around at least until we hear more from IRS and Congress. There is hope that Congress will act sooner rather than later, but it's really impossible to know when either the IRS or Congress will act to clarify these issues.

It may feel like farmers are losing something big if Congress does correct the language of the law, but it's important to remember that just getting a 20% of net income deduction is going to be a significant savings to many producers. For example, an average producer (like in Example 2) will see a tax cut of almost $3,500 by the 20% of net deduction so whether the cooperative provision stays or not, the Section 199a deduction will have a significant impact for all businesses' 2018 tax returns.

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