New Federal Tax Bill Includes Helpful Provisions for Farmers, Especially Those Marketing Through Cooperatives

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Following fierce debate, extensive negotiations, and votes - then re-votes - in Congress, on December 20, 2017, the U.S. Senate and U.S. House of Representatives approved the Tax Cuts and Jobs Act ("Tax Reform"), and sent a final bill to President Trump for his signature. The Tax Reform was signed into law by the president on December 22, 2017, and became effective on January 1, 2018.

The Tax Reform bill marks the most extensive overhaul of the U.S. income tax law in over 30 years. The bill includes significant cuts to the corporate tax rate and creates new deductions for other businesses, including pass-through businesses like cooperatives.

When the dust settled, farmers and cooperatives came out as winners, although certain provisions will have limited value to some producers.

As the legislation developed, cooperatives and their farmer-members were particularly concerned that the Domestic Production Activities Deduction ("DPAD") under Section 199 of the U.S. Internal Revenue Code would be repealed. Section 199 was repealed for future tax years.

Prior to its repeal, Section 199 gave businesses, including marketing cooperatives, additional income tax deductions based upon their income and W-2 wages paid to employees. Cooperatives are often viewed as collective activities of their member-farmers, and were subject to special tax rules under Section 199. Specifically, cooperatives could either use their Section 199 deductions or pass the deductions through to patron-farmers. In recent years, marketing cooperatives across nearly all commodities relied upon Section 199 and passed through substantial income tax deductions to patron-farmers. This often resulted in substantial income tax benefits to for these farmers.

The tax reform legislation replaces Section 199 with a new deduction for cooperatives and a new deduction for farmers who market their crops through cooperatives. These provisions are simpler and provide

tax benefits to both cooperatives and farmers. In doing so, these provisions create substantial incentives for many farmers to join and market their crops through cooperatives rather than non-cooperative firms.

Unsurprisingly, many non-cooperative firms and trade groups are disappointed by the new rules. They argue that the law was not intended to affect farmers' marketing decisions, and that the new law gives their cooperative competitors an unfair advantage. On the other hand, some cooperatives and their supporters point out that the cooperative provisions expire in 2025, while other changes that benefit many non-cooperatives, such as a lower corporate tax rate, are permanent. Some non-cooperative firms have already asked their legislators to change the new law, and there appears to be legislative efforts under way to do so. Many farmers, cooperatives, and non-cooperative agricultural businesses hope that legislators will extend the same benefits that cooperative members enjoy under the new law to those farmers who market through non-cooperative firms, instead of "leveling the playing field" by simply taking valuable tax benefits away from cooperatives and their members.

Despite these concerns, it is important to remember that the IRS has not issued regulations implementing the new law, so its real impact is not yet clear. The IRS is expected to issue new regulations later this year, which should provide more detail and certainty.

The new deductions for farmers and cooperatives are set forth in new Section 199A of the U.S. Internal Revenue Code. As currently enacted, new Section 199A provides:

1. Farmer-Level Deduction. A farmer who markets crops through agricultural cooperatives of which he or she is a member will receive a 20% deduction on all payments from the cooperatives.[1] This includes qualified per-unit retains, qualified patronage, and written notices of allocation. The deduction is limited to the amount of the farmer's taxable income, less net capital gain. To take the deduction, the farmer must not be taxed as a C corporation. In simple terms, if a farmer is a member of a cooperative, he or she will receive an additional income tax deduction equal to 20% of his or her gross check (payment for crops delivered before qualified capital retains are deducted), plus qualified patronage dividends for the year.
2. Cooperative-Level Deduction. Cooperatives will receive a 20% deduction, less payments to farmers/patrons, limited to (A) the greater of the 50% of the cooperative's share of W-2 wages or (B) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property. This formula seems complicated. However, it is simpler than cooperative's current Section 199 calculation. More importantly, it applies *in addition to* the farmers' deduction. Unlike under Section 199, cooperatives are not required to choose between using it or passing it through to members.

Let's look at a simple example. Assume a farmer grows corn and pays $400,000 for seed, chemicals, and custom planting and harvesting, and receives a gross payment of $500,000 from his or her cooperative. Without new Section 199A, the farmer would owe income tax on $100,000. With new Section 199A, the farmer gets an additional $100,000 deduction (20% of the gross payment), and pays no tax. Certainly, the farmer might have reduced his income tax bill by prepaying future expenses, but that simply pushes the tax liability into the future. The new law eliminates the tax liability altogether. As a practical matter, this frees up additional cash for other uses, such as paying down principal on land debt (which is not tax-deductible).

Under an even more interesting variation on this scenario, assume the farmer paid $500,000 for seed, chemicals, and custom work, and received a $500,000 check as payment for the crop. If the farmer's only income is from farming, the new 20% deduction is lost. However, if the farmer or the farmer's spouse has other ordinary income (e.g., from an off-farm job, selling seed or fertilizer, etc.), as the new law is currently written, the Section 199A deduction appears to be available to offset tax on that other ordinary income. That strategy is not available to farmers who market their crops through non-cooperatives.

The bottom-line of new Section 199A is that it should reduce the overall tax burden of most farmers selling farm products to cooperatives as well as farmer-owned cooperatives themselves. Unless congress changes the new law (which is possible), the tax benefits are attractive enough that many farmers should seriously consider joining a cooperative, and some non-cooperative firms should consider whether to change their organizational structure, perhaps by affiliating with a new or existing farmer-owned cooperative. For some farmers, joining an existing cooperative isn't a viable marketing option. These farmers may want to consider whether to create new farmer-owned cooperatives to handle marketing activities, even if their crops are ultimately sold by the cooperatives to many of the same customers. In addition to providing tax benefits, these new cooperatives could provide other substantial non-tax benefits, such as giving farmers increased buying power and providing a platform for new services to members.

However, until we know whether congress will revise the new law, and until the IRS issues regulations, guidance or further clarification, it is impossible to know exactly how Section 199A will be treated, especially with some more aggressive strategies.

This article only discusses the cooperative provisions of the new tax law. However, there are many other provisions that benefit farmers, such as lowering tax rates, doubling the federal estate tax exclusion amount (allowing married couples to shelter roughly $22,000,000 from death tax), increased Section 179 expensing, changes to bonus depreciation rules, and limiting interest deductions. Many of these changes can be carefully combined to create advantages for individual farms. Accordingly, before taking any actions to make structural changes to farm and cooperative operations based on the tax bill, farmers should consult with an experienced tax professional to understand the associated tax implications.

[1] *Farmers who do not market through cooperatives get a similar deduction, but much like the former DPAD, that deduction is phased out based upon W-2 wages and the cost of certain fixed assets if the farmer's taxable income is over $315,000 (married filing jointly, or $157,500 for single filers) before applying the deduction. Given volatility in commodity prices, this deduction may have limited value. Unlike the deduction for payments from cooperatives, it also will not help offset other non-farm income.*

The information in this article has been updated from the original as of February 14, 2018.