

Impact of Tax Reform on Agricultural Cooperatives

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Brian C. Briggeman, Ph.D.
Professor and Arthur Capper Cooperative Center (ACCC), Director
Department of Agricultural Economics
Kansas State University

Philip Kenkel, Ph.D.
Professor and Bill Fitzwater Cooperative Chair
Department of Agricultural Economics
Oklahoma State University

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Disclaimer: It should be noted that this is an initial examination of the proposed tax reform plan as of 12-18-2017. At the time of writing this fact sheet, the tax reform plan has not been passed into law. The analysis starts a discussion on how tax reform could impact a cooperative's distribution of member profits. Individual cooperative directors and managers should consider their own situation before altering their distribution decisions.

Tax reform could have significant implications for how agricultural cooperatives distribute patronage back to their members. Under the proposed tax plan, there are three key changes for cooperatives – (1) elimination of the domestic production activities deduction or Section 199; (2) lower corporate tax rates; and (3) lower member taxes on qualified patronage distributions. Many cooperative directors, managers, farmer-owners, and policymakers are trying to figure out how all of this will impact taxes in rural America. Some aspects will raise taxes, such as removing Section 199, and some will lower taxes. What does all of this mean for directors and managers of agricultural cooperatives?

The purpose of this fact sheet is to examine the implications of the proposed tax reform plan for agricultural cooperatives. A simulation model of a hypothetical grain marketing cooperative is applied to the current tax situation and the proposed tax plan. Results show that members of cooperatives not using Section 199 will benefit from the proposed plan. While members of a cooperative that has been fully utilizing Section 199, will likely see a reduction in after tax benefits. Taxation affects the optimal structure of distributing profits to members. Our analysis shows a slight advantage of distributing equity in patronage in nonqualified (not immediately taxable) form. Finally, the tax reform plan will benefit those agricultural cooperatives that did not qualify to use Section 199 such as farm supply cooperatives.

Brief Explanation of Tax Changes for Agricultural Cooperatives

Cooperative directors and managers are able to respond to changes in the tax code in unique ways. Under the Sub-Chapter T of the IRS code, cooperatives can deduct certain distributions of profits to their patrons. While certain deductions like Section 199 are proposed to be removed under the new tax reform plan, other aspects should benefit the cooperative and its members. The ability of cooperatives to manage their taxes via different distribution strategies could mitigate the impact of the proposed tax reform changes.

The tax treatment of member-based profits is important to this discussion. In order for a cooperative to maintain single taxation, all member-based profits must be allocated and distributed to the members in the form of patronage distributions. Patronage distributions can be qualified or nonqualified. Qualified distributions are tax deductible to the cooperative and taxable to the member. Cash patronage is one form of qualified distribution. The cooperative can also distribute profits in the form of qualified equity. When profits are distributed in a combination of cash and qualified equity the patron pays the tax on the entire amount received. The IRS requires cooperatives to pay at least 20% of the entire qualified, patronage distribution in cash.

While qualified cash and equity patronage distributions have been the historical choice of agricultural cooperatives, the firm can also distribute profits as nonqualified equity. For nonqualified distributions, the cooperative pays tax on the profits in the current year and receives a deduction in a future year when the nonqualified equity is redeemed. When the member receives the nonqualified equity in cash, they will then pay the tax. Both qualified and nonqualified equity are eventually redeemed according to the cooperative's equity retirement plan.

Cooperatives can also retain both member-based and non-member based profits as unallocated retained earnings. These profits are taxed at the regular corporate rate, and the cooperative pays the tax. Cooperatives typically retain non-member profits as unallocated equity since those profits cannot be distributed as patronage. Retaining member based profits as unallocated retained earnings does not achieve pass through taxation and, in the absence of a tax credit, increases taxes at the cooperative level. Unallocated retained earnings are only realized by the member if the cooperative is liquidated.

The Section 199 deduction allows cooperatives to offset some of their taxable income or their members' taxable income. Without getting into details, the amount of the Section 199 deduction is often limited to 50 percent of the cooperative's W2 wages. Section 199 became available at a time when many cooperatives needed to retain funds to replace infrastructure. Many cooperatives used the Section 199 deduction to retain funds without creating taxable

income to the members. This increased the member's after tax cash flows since they did not have to pay taxes on qualified equity patronage. In addition to using the deduction at the cooperative level, cooperatives had the ability to pass through all or part of this deduction to its members. Given these wide range of possible uses, there is no one universal use of Section 199 by individual cooperatives.

While the elimination of Section 199 removes one potential tax deduction for cooperatives other aspects of the tax reform package could benefit cooperatives and members. Corporate tax rates, which are paid by cooperatives, are proposed to fall from 35 percent to 21 percent. Additionally, farmers (not the cooperative) will have the ability to deduct 20 percent on qualified patronage distributions. In addition to reducing the member's tax burden on cash and qualified equity, the proposed qualified patronage deduction highlights the value of agricultural cooperatives because farmers conducting business with non-cooperatives would not receive the same treatment.

Examining the Tax Reform Package for Agricultural Cooperatives

In order to estimate the effect of the tax reform package, a simulation model of a hypothetical grain marketing cooperative was constructed. The case study cooperative had \$280 million total sales, which are primarily from grain; 85 percent member business; 5 percent annual asset growth; 24 percent debt-to-asset ratio; 15 year revolving equity retirement plan; and 44 percent of total equity is allocated.

Three tax scenarios are applied to the simulation model. The first is the "Baseline" tax scenario prior to the availability of the Section 199 deduction. Here the cooperative does not use Section 199, assumed to have a 41 percent corporate tax rate (federal and state), and its membership has a tax rate equal to 35 percent (federal, state, and self-employment). The next scenario is similar to the Baseline, except the cooperative utilizes Section 199. Finally, the Tax Reform Plan is used, which has no Section 199, an assumed 27 corporate tax rate, a 35 percent member tax rate, and a 20 percent deduction on qualified patronage distributions.

In order to provide a fair comparison, the cash patronage distributions were adjusted to keep the cooperative's cash flow constant across the profit distribution choices. This is an important assumption because the analysis aims to capture the ability of a cooperative to adjust to changes within the tax code. Doing so will provide cooperative directors and managers an indication of how they could respond to tax reform. The impact of tax reform will vary across cooperatives so this analysis provides insights into how a cooperative might adjust their current patronage distributions.

Prior to Section 199, members received the highest return when the cooperative distributed qualified patronage. Table 1 shows that the baseline scenario of 50% cash and 50% qualified equity provides the cooperative with just over \$4.5M in cash flow and only the taxation associated with its non-member profits. Members receive cash patronage of about \$3.7M but have an after tax annual cash flow of nearly \$1.4M. This results in an internal rate of return for the members of 26% over the simulated 30-year lifespan of cooperative usage. Because the cooperative is issuing allocated qualified equity, the ratio of allocated equity to total equity increases from the beginning level of 44% to 71% by year 10. Alternative profit distribution choices resulted in lower returns to member because the cooperative must reduce cash patronage to 15% keep its cash flow constant.

With Section 199, cooperatives had a strong incentive to create taxable income to take advantage of the deduction. The reason is because section 199 essentially removes the tax impact on the cooperative when retaining funds as nonqualified equity or unallocated retained earnings. As a result, the cooperative can keep their cash patronage payments at 50% but not have a significant increase in their cash outflow. In the scenarios of 50% cash and 50% nonqualified or unallocated retained earnings, members benefit from higher member after-tax cash flow (\$2.7M) and higher member return (41%).

Baseline 41% corporate tax rate 35% member tax rate

Patronage Income Distribution	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	26.0%	70.7%
15% cash 85% Nonqualified	\$4,523,660	\$3,092,501	\$1,123,333	\$1,004,290	22.1%	79.9%
15% cash 85% Unallocated	\$4,523,660	\$3,092,501	\$1,123,333	\$1,004,290	19.0%	4.6%

Section 199 with 41% corporate tax rate and 35% member tax rate

Patronage Income Distribution	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	26.0%	70.7%
50% cash 50% Nonqualified	\$4,523,660	\$532,960	\$3,683,057	\$2,668,111	41.7%	66.0%
50% cash 50% Unallocated	\$4,523,660	\$532,960	\$3,683,057	\$2,668,111	41.4%	4.6%

Tax Reform No section 199 27% corporate tax rate; 35% member tax rate; 20% deduction on qualified patronage

Patronage Income Distribution	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	\$4,705,646	\$350,974	\$3,683,057	\$1,821,008	31.2%	68.4%
37% Cash 63% Nonqualified	\$4,706,014	\$1,713,337	\$2,320,326	\$1,921,556	32.4%	74.5%
37% Cash 63% Unallocated	\$4,706,014	\$1,713,337	\$2,320,326	\$1,921,556	31.5%	4.5%

Table 1. Tax Scenarios and Patronage Income Distribution Results for a Hypothetical Agricultural Cooperative

Many agricultural cooperatives, including farm supply-only cooperatives, have not been eligible to use Section 199. Not all marketing cooperatives have chosen to use Section 199. Members of a cooperative not currently using Section 199 clearly stand to benefit from tax reform which has provisions to lower both the cooperative’s corporate tax rate and the member’s effective tax rate on qualified distributions. That advantage can be seen by comparing the results under our baseline scenario with the results under tax reform. The tax reform equivalent distribution shows a slightly higher cash flow (due to a lower corporate tax rate on nonmember business), higher member after-tax cash flow (due to the 20% deduction), and higher member rate of return. It should be noted that our analysis did not consider any impacts of Section 199 credits passed through to the member.

Other agricultural marketing cooperatives have been making use of Section 199 which involved a change in their profit distribution structure. Our analysis suggests that the major benefit has been an increase in the member's after tax cash flow from the cooperative. Members of those cooperatives are likely to find that tax reform results in lower after tax cash flows from the cooperative relative to Section 199. However, they will still find their post-tax reform cash flows an improvement over their historical, per-Section 199 situation. These effects can be observed by comparing our tax reform table results with the two previous tables. Our analysis continues to show an advantage of retaining funds by issuing nonqualified equity relative to qualified equity. Due to the lower corporate tax rate, the cooperative only has to reduce cash patronage to 37 percent when retaining profits as nonqualified equity to maintain the same cash flow as a 50% qualified equity distribution.

The largest impact of the profit distribution choice is on the cooperative's balance sheet. Retaining funds as unallocated retained earnings rapidly creates a balance sheet with a small portion of revolving equity and a high portion of retained earnings. Our analysis suggests that if a cooperative retaining funds in the form of unallocated retained earnings the ratio of allocated equity to total equity may fall below 5% in as little as 10 years. Cooperative directors and managers need to be aware of balance sheet implications as they consider the best way to distribute member profits.

Conclusions

There are several conclusions from our analysis. First, if a cooperative is fully utilizing Section 199, its members are likely currently experiencing higher after tax cash flows than they will experience under tax reform. However, tax reform is beneficial relative to their pre-Section 199 situation. The impact of tax reform on cooperative members depends on whether the cooperative used Section 199 and how they adjusted and continue to adjust their profit distribution choices. It is important to note that while cooperatives and their members lost the Section 199 deduction they gained from lower corporate tax rates and the partial deduction of qualified distributions.

The second conclusion is that after tax reform, there continues to be an advantage to retaining funds as nonqualified equity rather than qualified equity. Nonqualified equity was the optimal choice under Section 199. However, few local cooperatives issued nonqualified. If a cooperative board is not considering nonqualified equity distributions, tax reform provides another opportunity to consider member profit distribution options. The board should consider whether their members would prefer receiving slightly less cash patronage (37% as opposed to 50% in the example) in exchange for eliminating the immediate taxation on the equity patronage.

Finally, cooperatives that use Section 199 to retain funds as unallocated retained earnings restructured their balance sheets by shrinking the portion of revolving equity. 'Cooperative purest' view allocated equity as highly desirable, giving members a tangible and personal measure of ownership. If a cooperative board concludes that allocated equity is under emphasized on their balance sheet, tax reform provides a good opportunity to return to retaining profits as allocated equity. The results favor nonqualified allocated equity but the differential over qualified allocated equity is minimal.

In summary, the recent tax reform package will have implications for agricultural cooperatives. Individual cooperatives and individual producers have different tax situations so the conclusions of the above analysis will likely not hold in every situation. While there is always great interest in determining the winners and losers from any change in tax policy, the more useful response is to consider whether the policy changes justify changes in financial decisions. Cooperative directors and managers should view tax reform as an opportunity to reconsider how they distribute patronage income and the resulting impacts on member's return, the cooperative's cash flow, and the cooperative's balance sheet. Cooperatives continue to enjoy a great business model and it appears that the value is not lost in this tax reform package.