

Understanding
Patronage Refunds and
Section 199A Pass
Through

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Agricultural Cooperatives

- Agricultural cooperatives are a special form of business that are owned by their farmer members
- Agricultural cooperatives are corporations, but they are chartered under separate statutes. Those enabling statutes required cooperatives to distribute profits to their users in proportion to use
- Agricultural cooperatives are taxed under Sub-Chapter T of the IRS code. Cooperatives are taxed similar to other corporations but are allowed to deduct certain distributions including patronage refunds from their taxable income
- Members are taxed on the tax deductible

More About Agricultural Cooperatives

- Agricultural cooperatives are sometimes considered an extension of the farm firm. That is the basic logic behind cooperative taxation. The profits and taxation are passed on to the producer.
- Cooperative members are impacted by both the prices on transactions and the profits generated and distributed.
- Most cooperative price inputs and purchase commodities at market rates
- Some marketing cooperatives operate under a special pooling system where the commodities are not purchased and after the pool closes the entire value of the commodity and added value from the cooperative is distributed to the pool participants in proportion to volume

Patronage Refunds

- Distribution of profits in proportion to use by a cooperative to its patrons in proportion to their business volume are termed "Patronage Refunds". The IRS uses the term "Patronage Dividends" but cooperative scholars prefer Patronage Refunds because it avoids confusion with dividends paid on the basis of ownership
- Patronage refunds can be in the form of cash or revolving equity (stock).
- There are two forms of revolving equity patronage refunds with different tax treatments

Revolving Equity

- Because cooperatives distribute profits in proportion to use there is no direct benefit to owning cooperative equity
- Due to that structure cooperatives create equity out of the profit stream by distributing a portion of profits in the form of equity
- There is no market value for cooperative equity (since profits are distributed in proportion to use) so cooperatives redeem equity into cash at a later date under a prescribed system.
- This creates the term "Revolving Equity"
- Cooperatives used the cash generated by distributing profits as revolving equity to reinvest in equipment and infrastructure and also

Qualified Revolving Equity Patronage

- Qualified stock patronage is deductible to the cooperative and taxable to the patron when issued
- The patron is therefore paying tax on both their cash patronage and the qualified stock patronage
- The IRS requires a cooperative distributing qualified stock patronage to pay at least 20% of total patronage in cash. The logic was for the member to have cash to pay the tax on the stock portion. Most cooperative feel they have to pay at least 35-40% in cash
- There is no tax effect when qualified stock is redeemed since the cooperative already received the deduction and the member received the taxable income when it was issued

Other Requirement of a Qualified Patronage Refund

- The word "Qualified" means that it qualifies to be deductible for the cooperative. Cash patronage is qualified since it is always deductible to the cooperative and taxable to the patron, but we don't refer to it that way
- A qualified patronage refund has to be distributed within 8 months of the cooperative's year end and the member has to receive written notice
- The member has to agree to accept the taxation of qualified refunds. This is typically part of the cooperative membership application

Non-qualified Revolving Equity Patronage Refund

- A non-qualified stock refund is not deductible to the cooperative or taxable to the patron until it is redeemed into cash
- The patron eventually receives the taxation but the taxation follows the cash event and not the stock receipt
- With non-qualified refunds the member is only being taxed on their cash patronage and, later, their cash redemption
- Non-qualified stock refunds effectively "park" the taxation at the cooperative until the stock is redeemed
- Cooperatives issues non-qualified stock refunds can reduce their cash percentages to be cash flow neutral. The member is also likely close to cash flow neutral since they are not paying taxes on the stock
- Non-qualified stock can, and should be redeemed by whatever system the board selects

The 2017 Tax Cut and Jobs Act (TCJA)

- Historically, corporate tax rates were much higher than farmer tax rates. That made it logical to pass on the taxation to the entity with the lower taxation
- The 2017 Act reduced the top corporate tax rate to 19% which resulted in cooperative corporations having lower tax rates relative to most of their patrons
- The 2017 Act therefore made non-qualified stock refunds more logical.
- Research conducted at OSU and by other cooperative specialist indicated that non-

Slow Transition to Non-qualified Stock

- There are mis-conceptions that non-qualified stock is not redeemed or that it is riskier. These result from situations and practices of regional cooperatives
- Many cooperative boards do not understand non-qualified and are reluctant to communicate a change to their membership
- Many agricultural cooperatives are transitioning to non-qualified stock and the member reaction is positive. The Section 199A deduction at the cooperative level, (which will be discussed later), can offset the cooperative's potentially higher taxes in the distribution year
- Members receiving non-qualified stock patronage will get some sort of notice from the cooperative

The Domestic Production Activities Deduction (DPAD) also referred to as Section

- ~~199~~1999 originated out of the American Jobs Creation Act of 2004
- Applied to domestic manufacturing firms which was eventually interpreted to include farmers
- The deduction was phased in but in 2010 it was calculated as the lesser of 9% of qualified production activities income or 50% of W-2 wages associated with the qualified production activities income.
- Most commodity producers did not have the W-2 wages to get the deduction. That created an incentive for the cooperative to treat commodity payments as pool payments and take the deduction at the cooperative level.
- Cooperatives could retain the deduction or pass some or all of it on to members

Pooling Cooperative and PURPIMs

- Marketing cooperatives can structure commodity payments such that the cooperative was considered to be collectively producing commodities on behalf of its members.
- This is logical when there is no apparent market price (example figs) and the cooperative sells a processed product
- The payments made by pooling cooperatives are termed Per Unit Retains Paid in Money (PURPIMs) by the IRS
- PURPIMs may be structured as an initial payment and a residual payment when the pool is closed but there is no distinction as to what part of the PURPIM represents the commodity value and

Grain Cooperatives Discover PURPIMs

- The Section 199 deduction was based on the qualified income of the cooperative which was similar to net profit
- Because cooperatives calculate net profit after patronage, cooperatives argued that qualified income should be calculated before patronage
- Pooling cooperatives convinced the IRS that their qualified income should be income before PURPIM payments
- Grain cooperatives realized that paying for commodities in the form of PURPIMs would significantly increase their Section 199 deduction.
- For example, rather than a qualifying income of \$.15/bushel (margin less operating expenses) the qualifying income would be \$5.15/bushel. (margin

The New Section 199A Emerged

- The Section 199 deduction, which applied to all US manufacturing firms became a large deduction. The elimination of Section 199 created much of the savings to implement the 2017 reduction in the corporate tax rate.
- Cooperatives argued that they did not benefit from the corporate tax rate cut and were successful in the creation of a new Section 199A deduction specific to cooperatives

Section 199A (after revision)

- All producers except those farming as a C-corporation get a 20% pass through entity deduction from qualified income.
- Marketing cooperatives can receive a Section 199A deduction at the cooperative level which they can keep or pass on.
- Farmers marketing commodities through cooperatives face a potential offset in their 20% pass through deduction.
- The offset is based on farm level calculations and is not linked to the actual pass through they received (or didn't receive) from their

The Section 199A Cooperative Level Deduction

- 9% of qualified production income less the costs of goods sold and other expenses associated with that income.
- Cooperative level deduction is capped at 50% of cooperative's W-2 wages associated with commodity sales
- The cooperative can retain the deduction or pass some or all of it on to the members
- To maximize the deduction the cooperative will want to recharacterize commodity payments as PURPIMs which keeps those payments out of cost of goods sold
- For many cooperatives the pass through portion is much greater than patronage refunds while the retained portion could significantly reduce or eliminate the cooperative's tax at the corporate

Producer's 20% Deduction

- All producers doing business in a form other than a C-corporation receive a deduction equaling 20% of their net income from commodity sales but not exceeding their taxable income. The deduction phases out when taxable income exceeds \$157,000.
- Producers marketing commodities through a cooperative face a possible offset in the deduction.
- The offset is not linked to the amount of the cooperative deduction that is passed through

Offset for Cooperative Delivering Producers

- Reduced by the lesser of 9% of the producer's income from commodity sales plus patronage or 50% of the producer's W-2 wages.
- The producer's offset has a similar structure to the cooperative's deduction but are calculated on different bases.
- A producer with no W-2 wages faces no offset but a producer with high W-2 wages could theoretically have their 20% deduction reduced to 11%

Your Man in Action!

- At the request of the National Council of Farmer Cooperatives our team of academic cooperative specialists undertook an effort to educate cooperative CEOs and boards on the impact of the TCJA.
- I did extensive research involving simulation with representative cooperative and developed information illustrating that non-qualified stock patronage increased member return and suggesting that cooperatives needed to pass on around 40% of their Section 199A deduction. The information was passed on in numerous state programs and national webinars
- The effort led to a national award from the American Agricultural Economics Association



Comparison for Producers Marketing through Cooperatives or Independents

- Producers marketing commodities through cooperatives face potential pass through from cooperative and potential offset of their 20% deduction
- The advantage or disadvantage of delivering to a cooperative depends on the balance of those two factors.

Take Home Points

- Agricultural cooperatives distribute profits in proportion to use in the form of cash, qualified and nonqualified revolving equity
- Cooperative patrons are taxed on cash and qualified stock when received and nonqualified stock when it is redeemed
- Most marketing cooperatives have restructured commodity payments as PURPIMs and calculate the producers manufacturing tax credit at the cooperative level
- Cooperative typically retain a portion of the tax deduction and pass on the remainder to the patrons
- Producers who market through a cooperative face a reduction in a separate 20% tax deduction

A New Role for Agricultural Cooperatives

- Agricultural cooperatives have historically focused on creating economies of scale and scope in input purchasing and commodity marketing and passed on the profits from those functions in the form of patronage refunds
- The 2017 tax reform act created a new role for agricultural cooperatives in pooling and distributing tax deductions.
- This added significant complexity for both cooperative boards of directors and members but also created very significant tax deduction benefits at both the cooperative and patron

Questions?

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