Section 199A - Where We Are and Might Be?
Tax Reform for Farmers

Paul Neiffer, Principal
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Speaker Introduction

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- Frequent national speaker on taxation, agricultural, farm bill and estate tax topics
- Current chair of the AICPA National Agriculture Conference committee.
- Past President of Farm Financial Standards Council
- Author of the “FarmCPA” Top Producer column
- Primary source for nationally recognized blog “FarmCPAToday.com”
What Does the Cooperative Distribution Deduction Mean?

December 10, 2017 | by Paul Weffer

The Senate Tax Bill has a special 23% deduction for business income. However, there are two limits to the deduction. First, the deduction is limited to 50% of wages paid by the farm. Second, there is a limit based on taxable income. Therefore, even if a farm has net farm income, if their net income from all sources is negative, then they will not receive the deduction.

However, there is a special provision in the proposed bill that says if a farmer receives distributions from cooperatives, then the farmer is allowed to take the 23%
Quick History of Section 199
Section 199 (DPAD)

• Former Section 114 of the IRC
  – Provided an incentive for taxpayers to export goods
  – WTO ruled it was an export subsidy and violated international trade agreements

• In response, Congress enacted Section 199
  – Provided a Domestic Production Activities Deduction (DPAD) based on net Qualified Productions Activities Income (QPAI)
    ◊ 3% of QPAI in 2005-2006
    ◊ 6% of QPAI in 2007-2009
    ◊ 9% thereafter
Section 199 and Farmers

• Farmers could receive a 9% of net farm income deduction limited to:
  – 50% of cash wages paid by the farmer

• Could group all of the businesses together and take a net 9% deduction on all qualified income
Section 199 and Cooperatives

• Based on several IRS Private Letter Rulings, cooperatives were able to:
  – To compute their taxable income without deducting payments made to patrons (PURPIM)
  – Receive a DPAD equal to the lessor of 9% of taxable income or 50% of wages paid
  – Could elect to keep all or part of DPAD or pass it through to the patron

• In almost all cases, DPAD was limited to 50% of wages
# Example of Cooperative DPAD

<table>
<thead>
<tr>
<th></th>
<th>High Wage Cooperative</th>
<th>Low Wage Cooperative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$500,000,000</td>
<td>$500,000,000</td>
</tr>
<tr>
<td>Wages</td>
<td>$40,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>9% of taxable income</td>
<td>$36,000,000</td>
<td>$43,000,000</td>
</tr>
<tr>
<td>Actual DPAD allowed</td>
<td>$20,000,000</td>
<td>$2,500,000</td>
</tr>
</tbody>
</table>

Farmer in a high wage cooperative would be allowed to offset about 4% of sales to the cooperative, whereas a farmer in the low wage cooperative could only offset about .5% of sales to the cooperative.
Cooperative DPAD and Farmers

• If farmers sold to cooperatives:
  – Then they could only deduct the DPAD from the cooperative (if any) on the net income from cooperative sales
  – Plus could receive 9% on the net farm income from private sales subject to 50% of wage limitation
  – Required a bifurcation of net income between cooperatives and privates
    ◇ Although many farmers took 9% on 100% of net farm income plus the DPAD from the cooperative
DPAD and Grain Farmers

• For the majority of grain farmers, the DPAD was primarily either the DPAD from the cooperative or limited to 50% of wages paid
  – The DPAD from the cooperative was in most cases less than 1% of sales
  – No great incentive to sell to a cooperative to capture the DPAD
Section 199A Enters Into Law
Timing of New Code

• Cooperatives lobbied to keep the benefits of Section 199 as part of the new tax law
• Section 199A provided for a net 20% of Qualified Business Income, but cooperatives felt retaining Section 199 for the benefit of their patrons and the cooperative was important
• As part of the last minute negotiations with Senator Thune (R-SD) and Hoeven (R-ND), Section 199A(a)(2) was placed into the Code to achieve that goal
• However, it was never vetted by tax professionals
New Section 199A Pass-Through Deduction - General

• 20% deduction on net farm income
• Plus 20% of REIT and PTP income
  – Limited to 20% of taxable income minus capital gains minus cooperative payments

Plus

• 20% of cooperative payments as a patron
  – Limited to 100% of taxable income minus capital gains
Possible Limits

• If taxable income before Section 199A is greater than threshold:
  – Single - $157,500 – $207,500
  – Married - $315,000 to $415,000

• Then limited to greater of:
  – 50% of wages paid by business, or
  – 25% of wages paid by business plus 2.5% of qualified business property

◊ Depreciable property owned less than 10 years, plus
◊ Any land improvements or buildings where depreciation is still ongoing
◊ Must be owned at end of year to qualify
◊ Commodity wages do not qualify, must be subject to Medicare tax
Example – Threshold Limit

- Example
  - Farmer Ben nets $400,000, but has taxable income of $365,000. Wages paid are $65,000 and QP is $1 million.
  - Tentative Deduction is $80,000 ($400,000 X 20%)
  - Limit is greater of $32,500 or $41,250 (25% of $65,000 plus 2.5% of $1 million)
  - Phase-out is 50% of ($80,000 - $41,250) or $19,375
  - Tentative deduction is $60,625 ($80,000 - $19,375)
  - Final limit is 20% of $365,000 or $73,000
  - Actual Section 199A deduction allowed $60,625
Example – Taxable Income and Capital Gains

• Same facts as previous example, except taxable income includes $200,000 of Section 1231 gains
• $60,625 calculated deduction is now limited to:
  – 20% of ($365,000 - $200,000) or $33,000
Dairy Cooperatives and Farmers

• Most dairy farmers report most of their taxable income as capital gains (sale of raised breeding stock)

• Under old Section 199, they could offset capital gains with DPAD

• Under new Section 199A, they can not

• Therefore, not happy with Section 199A
Section 199A Example

Farmer has sales of $5 million and $1 million total taxable income.

Net Farm Income is $1 million, wages of $500,000.

If he sells his grain to a NON-CO-OP then deduction is $200,000.

If he sells all his grain to a CO-OP then 20% deduction equals $1 million and eliminates taxable income.
Section 199A Example

Farmer has sales of $5 million and $1 million total taxable income.

Net farm income is zero.

If he sells his grain to a NON-CO-OP then NO 20% deduction.

If he sells all his grain to a CO-OP then $1 million deduction wiping out taxable income.
Section 199A Example

Farmer has sales of $5 million and $1 million total taxable income which includes $500k of capital gains.

Net Farm Income is $1 million, wages of $500,000.

If he sells his grain to a NON-CO-OP, $100,000 due to 20% of TI – CG limitation.

If he sells all his grain to a CO-OP, then deduction is limited to $500k due to TI-CG limitation.
Section 199A Example – Qualified Property

Rental Apartments with $5 million of qualified property

Net Income from rentals of $1 million

Section 199A deduction of $200,000

Limited to $125,000 ($5 million times 2.5%)
A Possible Flowchart – No Cooperative Sales

Determining The Section 199A Deduction

Are you a taxpayer other than a C corporation that owns a:
1. Sole Proprietorship
2. Stand Alone Rental Property
3. S Corporation
4. Partnership

YES

Is the business for which the deduction is being claimed a "specified service business"? FN1

NO

Is the taxable income of the taxpayer claiming the deduction less than:
$315,000 if MFJ
$157,500 for all other taxpayers?

YES

Is the taxable income of the taxpayer claiming the deduction greater than:
$415,000 if MFJ
$207,500 for all other taxpayers?

NO

NO

Is the taxable income of the taxpayer claiming the deduction less than:
$415,000 if MFJ
$207,500 for all other taxpayers?

NO

NO

Taxpayer is eligible for a partial deduction
Example 2, FN2

Deduction = 20% of qualified business income, subject to limitation
Example 6, FN6

NO

Taxpayer is eligible for a partial deduction
Example 4, FN4

No deduction
Example 1

Is the taxable income of the taxpayer claiming the deduction less than:
$315,000 if MFJ
$157,500 for all other taxpayers?
Unintended Consequences
List of the Major Unintended Consequences

- New Section 199A created a major incentive for farmers to sell to cooperatives
- All other non-farm businesses now want to set up cooperatives
  - Doctors, Attorneys, CPAs
- Result, unless changed, likely to have 1,000s of new cooperatives created, drastic changes to farmer sales and major reduction in tax revenue to US Government
- Plus dairy farmers hurt by new law
Appointment of Committee to “Fix” the Law

• Congress reached out to the National Council of Farmer Cooperatives (NCFC) and the National Grain and Feed Association (NGFA) to fix the law

• The Mandate was to
  – Retain old Section 199 for cooperatives and farmers, and
  – Level the playing field between privates and cooperatives
    ◊ e.g. maintain uncertainty in most situation as to whether it is better to sell to either like old Section 199

• At no point was the 20% of gross sales deduction to remain
Committee

• Several members from both the NCFC and NGFA plus certain CLA staff had numerous phone conferences to work-out a possible solution
• Staff from both the Senate and House were actively involved
• Last week, a final proposal was reached and agreement made by Senate and House committees
• Likely included with the Budget bill due March 23
The Proposal
New Section 199A and Cooperatives

• Cooperatives would calculate a Section 199A DPAD similar to old Section 199 rules
• Could elect to either keep all or part or pass it out to their patrons
New Section 199A and Farmers

- Farmers can deduct:
  - 20% of net farm income from sales to privates, plus
  - DPAD received from cooperative, if any, plus
  - 20% of net farm income from sales to cooperatives, minus
    the lessor of:
      ◊ 9% of net farm income, or
      ◊ 50% of wages paid by farmer
## Example

<table>
<thead>
<tr>
<th></th>
<th>Farmer With Wages Paid</th>
<th>Farmer No Wages Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Wages paid</td>
<td>$100,000</td>
<td>0</td>
</tr>
<tr>
<td>Net Farm Income</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>DPAD from cooperative</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Regular Section 199A</td>
<td>$22,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Total Section 199A deduction</td>
<td>$32,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
# New Deduction for Sales to Privates or Co-ops

<table>
<thead>
<tr>
<th></th>
<th>No Coop Sales</th>
<th>Co-op Sales - Wages</th>
<th>Co-op – No Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Net Farm income</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Wages Paid</td>
<td>$75,000</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Coop DPAD</td>
<td>0</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Reg. Section 199A</td>
<td>$40,000</td>
<td>$22,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Total Section 199A</td>
<td>$40,000</td>
<td>$32,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Delta Coop Sales</td>
<td>-</td>
<td>($8,000)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Bottom Line

• Proposal
  – Levels playing field
  – Hard to know if selling to cooperative or private is better
  – Small farmers with no wages no worse off and could be better off with DPAD from cooperative
  – Larger farmers with lots of wages may be better selling to privates but have flexibility to restructure to increase deduction similar to selling to privates or exceed
  – Every situation will have some uncertainty

• Not like current Section 199A
Three Things You Don’t Expect to See in the Same Article
SECTION 199A
SECTION 199A
SECTION 199A
Tax Reform for Farmers
Summary

- Overall tax rates decrease
- New Section 199A 20% farm deduction
- Limitations on itemized deductions
- Double of lifetime estate/gift tax exemption
- All of above reverts back to current law in 2026
- Increased Section 179 and bonus depreciation
- Other provisions
# Comparison of MFJ Rates: Old 2018 Rates vs. TCJA

<table>
<thead>
<tr>
<th>Income range</th>
<th>Scheduled 2018 rate</th>
<th>TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 to $19,050</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>$19,051 to $77,400</td>
<td>15%</td>
<td>12%</td>
</tr>
<tr>
<td>$77,401 to $156,150</td>
<td>25%</td>
<td>22%</td>
</tr>
<tr>
<td>$156,150 to $165,000</td>
<td>28%</td>
<td>22%</td>
</tr>
<tr>
<td>$165,001 to $237,950</td>
<td>28%</td>
<td>24%</td>
</tr>
<tr>
<td>$237,951 to $315,000</td>
<td>33%</td>
<td>24%</td>
</tr>
<tr>
<td>$315,001 to $400,000</td>
<td>33%</td>
<td>32%</td>
</tr>
<tr>
<td>$400,001 to $424,950</td>
<td>33%</td>
<td>35%</td>
</tr>
<tr>
<td>$424,950 to $480,050</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>$480,051 to $600,000</td>
<td>39.6%</td>
<td>35%</td>
</tr>
<tr>
<td>Over $600,000</td>
<td>39.6%</td>
<td>37%</td>
</tr>
</tbody>
</table>
Capital Gains and Kiddie Tax

• Capital Gains – No changes
  – Still retain **Zero Tax Rate** on effectively same income levels
    ◇ Up to about $100,000 tax free for MFJ
    ◇ Up to about $50,000 tax free for singles
  – Maximum rate still 20%
  – Retains Net Investment Income Tax of **3.8%**

• Kiddie tax no longer tied to parent’s income
  – Makes grain gifts taxed at Trust and Estate Tax Rates
    ◇ Essentially 37% on gifts over $12,500
Standard Deduction: 2018

Standard Deduction
• MFJ = $24,000
• Single = $12,000
• H of H = $18,000

Personal Exemptions
• Repealed

Zero tax amount:
Joint
Single

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint</td>
<td>$20,800</td>
<td>$24,000</td>
</tr>
<tr>
<td>Single</td>
<td>$10,400</td>
<td>$12,000</td>
</tr>
</tbody>
</table>
Child and Family Tax Credits

• Child credit: increase from $1,000 to $2,000
  – No change to “qualifying child” definition: < age 17
• Plus $500 credit for dependent not a qualifying child for $2,000 credit
• Refundable portion = $1,400 & indexed
• Phase-out begins at MFJ of $400,000 AGI (up from $110K); Single at $200,000 (up from $75K)
Itemized Deductions: Taxes

- Allow aggregate deduction of $10,000 for income or sales tax, plus real property tax.
- Does not affect payments for farmers, crop-share landlords and cash-rent landlords on their operations.
- This is only for Schedule A personal taxes.
Estate, Gift, and GST Tax

• Doubled exclusion: $5M to $10M + indexing for estates between 1-1-18 and 12-31-25
  – Deaths in 2017: Present exclusion is $5,490,000
  – Will be $11.2 million for 2018

• Retain annual gift tax exclusion ($15K)

• Reverts back to current law in 2026
AMT

- Retained for individuals
- Higher exemption amount
  - $109,400 up from $78,750 (MFJ)
  - $70,300 up from $50,600 (Single)
- Higher thresholds for phase-out
  - $1 million for MFJ, up from $160,900
  - $500,000 for singles, up from $120,700
- Likely eliminates AMT for most farmers, but not all
Corporate Taxes

• Flat 21% rate
• Corporate AMT repealed
• May be an actual 40% tax increase for most farmers who kept corporate taxable income under $50,000
Farm C Corporation Tax Example

Farm partnership with four equal C corporation owners

Partnership income of $200,000

Under old law, the corporations each paid $7,500 or $30,000 of total taxes

Under new law, each corporation pays $10,500 or $42,000 total, a 40% increase
Fiscal Year Calculation Example

ABC Farm Corp with a March 31, 2018 Year-End

Taxable income of $50,000

Pre 2018 Tax - $7,500 times $\frac{3}{4}$ (rounded) = $5,650

Post 2017 Tax - $2,590 for total tax of $8,240
Section 199 (DPAD) Repealed

- 9% Sec. 199 DPAD repealed 1/1/18
- Fiscal year S corporations lose deduction
  - Consider switching to calendar year-end
  - Get full deduction in 2017
  - Don’t lose 2018 Section 199A deduction
- Need IRS guidance
Employer-provided Housing and Meals

• House proposed cap of $50,000 on exclusion with phase-out
• Not available to ≥5% owners
  – Must be reported as income to owner
  – C Corporation still allowed the deduction
• This did not get included in final bill
• Employer provided meals now deductible at 50% 1-1-18 to 12-31-25
• After 12-31-25, no deduction for employer provided meals on business premises, etc.
Section 179

- Bumps to $1 million in 2018 (indexed to inflation)
  - Phase-out starts at $2.5 million (indexed)
  - Adds roofs, HVAC, Sec. Systems

- Can be used to optimize taxable income if farmer elects out of bonus depreciation
Bonus Depreciation

- Expense 100% acquired and placed in service >9/27/17 and before 1/1/2023
  - Includes new and **used**
- Phased-out beginning in 2023
  - 80% in 2023
  - 60% in 2024
  - 40% in 2025
  - 20% in 2026
  - Zero thereafter
Bonus Depreciation Examples

- Farmer purchases $500,000 of used equipment, $350,000 of tiling, and buys land with a machine shed worth $500,000
  - Under old law, could only deduct $175,000 on the new tiling using 50% bonus depreciation.
  - Under the new law, the farmer can fully depreciate all $1,350,000 using 100% bonus depreciation
  - Or can elect out of bonus on any of the assets on an asset by asset basis (7, 15 and 20 year property)
## Depreciation Example – Old and New Law

<table>
<thead>
<tr>
<th>Depreciation Calculation</th>
<th>Old Law</th>
<th>New Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Machine shed</td>
<td>750,000</td>
<td>750,000</td>
</tr>
<tr>
<td>New Farm Equipment</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Used Farm Equipment</td>
<td>675,000</td>
<td>675,000</td>
</tr>
<tr>
<td>New Pivots</td>
<td>1,250,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Purchased well and mainline on land</td>
<td>750,000</td>
<td>750,000</td>
</tr>
<tr>
<td><strong>Total purchases</strong></td>
<td>3,575,000</td>
<td>3,575,000</td>
</tr>
</tbody>
</table>

| Section 179 allowed                     |          | 325,000  |
| Bonus depreciation allowed              | 1,075,000| 3,250,000|
| Regular depreciation                    | 198,884  |          |
| **Total depreciation allowed**          | 1,273,884| 3,575,000|
## Larger Farmer Taxes – Old Law & New Law

<table>
<thead>
<tr>
<th></th>
<th>Old Law</th>
<th>New Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>10,000,000</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Normal Costs</td>
<td>(6,000,000)</td>
<td>(6,000,000)</td>
</tr>
<tr>
<td>Section 179</td>
<td>-</td>
<td>(325,000)</td>
</tr>
<tr>
<td>Bonus Depreciation</td>
<td>(1,075,000)</td>
<td>(3,250,000)</td>
</tr>
<tr>
<td>Regular Depreciation</td>
<td>(198,884)</td>
<td>-</td>
</tr>
<tr>
<td>Net farm income</td>
<td>2,726,117</td>
<td>425,000</td>
</tr>
<tr>
<td>Other income</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Section 199/199A deduction</td>
<td>(245,350)</td>
<td>(85,000)</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>(12,700)</td>
<td>(24,000)</td>
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<tr>
<td>Taxable Income</td>
<td>2,968,067</td>
<td>816,000</td>
</tr>
<tr>
<td>Income Tax</td>
<td>1,120,585</td>
<td>241,299</td>
</tr>
<tr>
<td></td>
<td>Savings</td>
<td>879,286</td>
</tr>
<tr>
<td></td>
<td>Savings if income is exactly the same</td>
<td>83,021</td>
</tr>
</tbody>
</table>
Business Interest Expense

- Disallowed: *excess of 30% of business adjusted taxable income*
  - Determined without interest expense, interest income, NOL, depreciation, amortization, depletion (EBIDTA)
    - ◊ EBIT is used beginning in 2022 (depreciation is deducted)
  - Determined at tax filer level (1065, 1120-S)
  - Excess carried forward

- No disallowance for businesses with average gross receipts ≤$25 million
Special Farmer Interest Provision

- If gross revenue over $25 million, then farmer can elect to deduct 100% of business interest expense
  - Must use ADS for depreciation of 10 year + assets (longer lives)
  - Farm equipment still enjoy shorter life
  - Can’t take bonus depreciation on 10 year or longer life assets
Sec. 263A Exemption

- If farmer’s gross revenues less than $25 million:
  - Can expense all preproductive costs
  - Take 100% bonus on cost of plants
  - Take 100% bonus on all other costs

- Not sure if farmers who elected out under old law can now “elect” back in

- Need IRS guidance
Loss Limit Provisions

- Maximum Business Loss in one year - $500,000
- Net Operating Loss: limited to 80% of pre-NOL taxable income
- Pre 2018 NOLs still allowed at 100% (FIFO)
- Repeal carrybacks for non-farmers
- Allows two-year carryback for farms
- However, carryback can only offset 80% of taxable income on both carrybacks and forwards
Other Business Changes

• Section 1031 exchanges for only real property
  – Personal property exchanges taxable; but asset expensing offsets the gain

• Drops NEW farm machinery from 7 years to 5

• Allows for 200%db method for farm equipment, etc.
  – Was 150%db since 1987
Section 1031 Equipment Exchange Example

Farmer has old combine worth $200,000
Trades it in on new combine worth $500,000

Old law – no gain, $300k cost basis (Section 179 or bonus)

New Law - $200k gain, $500k combine fully deducted
Section 1031 Equipment Exchange Example – State Law

Farmer has old combine worth $200,000

Trades it in on new combine worth $500,000

Old law – no gain, $300k cost basis depreciated over 7 years

New Law - $200k gain, $500k depreciated over 5-7 years (large tax hit in year of sale)
Questions?

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