

# The Impact of the “Transition Rule” on Grain Sales to a Cooperative and a Farmer’s Section 199A Deduction

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*Disclaimer: The purpose of this ACCC Fact Sheet is to start a discussion on how the transition rule could impact a cooperative patron’s Section 199A deduction. Cooperatives and farmers should consult a tax and/or legal professional before filing any tax and/or legal documents.*

The “transition rule” in Section 199A could significantly impact a cooperative patron’s 199A deduction. In March 2018, provisions to Section 199A of the Tax Cuts and Jobs Act of 2017 were amended to effectively remove the tax incentive to sell grain to a cooperative or what had become known as the “fix to the grain glitch” (Tidgren, 2018; Kenkel and Briggeman, 2018). These provisions also created a transition rule that essentially states that when a farmer calculates their 199A deduction in 2018, they cannot include grain sold to a cooperative if that cooperative accounted for those sales when calculating their domestic production activities deduction (DPAD) under the old 199 rules on their 2018 tax return. While this reduction in a patron’s 199A deduction is not because of a decision the cooperative made, it is a reality that could affect many patrons and could lead to questions posed by patrons to their local cooperative. In this ACCC Fact Sheet, we discuss the potential implications of the “transition rule” on a farmer’s Section 199A deduction.

The Joint Committee on Taxation published their Bluebook in December 2018. In it, they provided additional comments about the Section 199A’s transition rule:

“The provision clarifies that the repeal of section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a specified agricultural or horticultural cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to qualified production activities income with respect to which a deduction is allowable to the cooperative under former section 199 for a taxable year of the cooperative beginning before January 1, 2018. Such qualified payment remains subject to former section 199 and any section 199 deduction allocated by the cooperative to its patrons related to such qualified payment may be deducted by such patrons in accordance with former section 199. In addition, no deduction is allowed under section 199A for such qualified payments.” – Joint Committee on Taxation *General Explanation of Public Law 115-97*

In other words, patrons that received qualified payments from cooperatives with fiscal years that begin in 2017 and end in 2018 are subject to this transition rule. For these patrons, the former or old section 199 DPAD can be claimed if the cooperative passed through the DPAD. However, these qualified payments cannot be considered in the calculation of 2018 qualified business income deduction or QBID. Calculating QBID has created quite the discussion among tax advisers (Nieffer 2018).

Let’s go through a straightforward example to illustrate this potential issue. Assume a farmer is not a C-corporation; is under the \$315,000 income limit; has zero W-2 wages; sells all of his grain to a local cooperative that issues per-unit retains paid in money (PURPIM) on all grain sales. Furthermore, assume in 2018 the farmer sold \$900,000 of grain to the cooperative, received \$100,000 of government payments, and had \$150,000 of net income or qualified production activities income (QPAI). Finally, the cooperative the farmer sells his grain to has a fiscal year end in February.

With that as background, let’s vary the timing of when the farmer sold his grain to see how the farmer’s Section 199A QBID is affected:

**Table 1. Simplified Section 199A QBID Calculation of a Farmer Selling Grain to a Cooperative in FY2018 and FY2019**

| Variables                      | Scenario 1: Sell 100% of Grain in January (FY18) | Scenario 2: Sell 50% of Grain in January (FY18) and 50% in April (FY19) | Scenario 3: Sell 100% of Grain in April (FY19) |
|--------------------------------|--|---|--|
| Grain Sold in Month:           |  |   |  |
| January                        | \$900,000  | \$450,000   | \$0  |
| April                          | \$0  | \$450,000   | \$900,000                                      |
| Government Payments            | \$100,000  | \$100,000   | \$100,000                                      |
| Gross Income                   | \$1,000,000                                      | \$1,000,000   | \$1,000,000                                    |
| Expenses                       | \$850,000  | \$850,000   | \$850,000                                      |
| Net Income                     | \$150,000  | \$150,000   | \$150,000                                      |
| QPAI <sup>1</sup>              | \$15,000   | \$82,500  | \$150,000                                      |
| Section 199A QBID <sup>2</sup> | \$3,000  | \$16,500  | \$30,000                                       |

Notes: <sup>1</sup>Qualified Production Activities Income.

<sup>2</sup>Qualified Business Income Deduction.

Cooperative's fiscal year-end is assumed to be February.

Table 1 shows that the transition rule and the timing of grain sales has a significant impact on the amount of Section 199A QBID a farmer can claim on their 2018 tax return. QBID is calculated by taking QPAI times 20 percent. Calculating QPAI depends on when the grain was sold and the cooperative's fiscal year end. In Scenario 1, the transition rule applies because \$900,000 of grain was sold in the cooperative's FY18. In this case, only 10 percent of Net Income can be used in calculating QPAI. This percentage is found by taking the amount of Gross Income available for QPAI divided by Gross Income ( $\$100,000 \div \$1,000,000 = 10$  percent). So scenario 1's Section 199A QBID is \$15,000 times 20 percent, which equals \$3,000.

Grain sales in FY19 can be included in QPAI, which increases the Section 199A QBID. Scenario 2 shows \$450,000 of total grain sales were in FY19. So these grain sales can be included in the QPAI calculation (55 percent of Net Income or \$82,500), which increases the QBID in this scenario to \$16,500. The largest Section 199A QBID in this hypothetical example occurs in scenario 3. If all \$900,000 of grain sales occurred in FY19, then the QBID is \$30,000.

Note that the transition rule does not apply to non-cooperatives. So if the farmer had sold their \$900,000 of grain, in 2018, to a non-cooperative, the QBID calculation would have been \$30,000. The timing of grain sales to a non-cooperative does not matter when calculating QBID.

It should be noted that the calculation of QBID in Table 1 is based on our interpretation of the transition rule. More guidance is needed to know for sure how this transition rule will and should be calculated on farmer's 2018 tax returns.

The transition rule presents a challenge to cooperatives, farmers, and farmer income tax preparers. In the simple example shown in table 1, the farmer's Section 199A QBID could be as low as \$3,000 or as high as \$30,000. It all depends on the farmer being able to show his or her tax accountant when the grain was sold to the cooperative. Knowing this adds another layer of reporting for cooperatives because the 1099 PATR form that cooperatives send to their patrons does not state when the grain was sold. It is possible patrons could be contacting their local cooperative to find out (1) when is the cooperative's fiscal year end; and (2) when was their grain sold.

It is important to remember that the transition rule only affects 2018 farm income tax returns. So the timing of grain sales to a cooperative will not impact the calculation of QBID for the 2019 tax period and beyond. Also, farmers may ask additional questions about their total tax deduction from the cooperative. Given that, it is also important to remember that:

- The cooperative could pass through a portion of their deduction to the patron, which could raise the patron's 199A deduction above 20 percent.
- The cooperative could issue non-qualified equity that provides (1) a tax benefit to the patron, and (2) the non-qualified equity would be redeemed to the patron at a later date.
- Cash patronage paid to the patron is not in the QBID calculation.

The purpose of this fact sheet is to familiarize cooperatives with the "transition rule" and its potential impact on their patron-owners. Next year, the transition rule will not be an issue because it only applies to farmers' 2018 tax returns. For now, cooperatives need to aware of this rule and continue to provide value to their patron-owners.

## References

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Joint Committee on Taxation *General Explanation of Public Law 115-97*