SECTION 199A RESOURCE: "Fix" to Grain Glitch is Now Law

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President Trump signed the Consolidated Appropriations Act, 2018, H.R. 1625, on March 23, 2018. At the end of the 2,232-page legislation, Congress included a section written to "fix" the "grain glitch." This is, of course, the provision in the Tax Cuts and Jobs Act that provided significantly higher tax deductions (in most cases) to patrons who sold commodities to cooperatives rather than to non-cooperatives.

The 17-page "fix," while attempting to level the playing field, adds even more complexity to an already convoluted section of the new tax law, IRC § 199A. The fix retroactively takes effect, beginning January 1, 2018. This wipes from existence the provision giving cooperative patrons a 20-percent deduction based upon *gross* sales.

Non-Coop Sales

Under the fix, the tax benefit to farmers who sell grain, for example, to a non-cooperative does not change. They are generally entitled to the new 20 percent 199A(a) qualified business income (QBI) deduction, calculated based upon their *net* income from the sale. Their overall 199A deduction is limited to 20 percent of taxable income (minus capital gains). It is also restricted by a wages/capital limitation if their income exceeds $157,500 for singles and $315,000 for those who are married filing jointly.

Coop-Sales by Patrons

The fix completely changes, however, the tax benefit offered to patrons who sell grain, for example, to their cooperative. Instead of the 20-percent deduction calculated based upon their gross sales, the cooperative patron is subject to a new bifurcated calculation and a hybrid 199A deduction. Essentially, the fix gives the cooperative patron a deduction that blends the new 199A deduction with the old 199 DPAD deduction (all within the new 199A).* Depending upon their individual situations, cooperative patrons may be advantaged, disadvantaged, or essentially treated the same by selling to a cooperative rather than selling to a non-cooperative. While the significant advantage is gone, the complexity certainly is not.

First, patrons calculate the 20 percent 199A(a) QBI deduction that would apply if they had sold the commodity to a non-cooperative. But they don't stop there. The patron must then, pursuant to 199A(b)(7), subtract from that initial 199A(a) deduction amount whichever of the following is smaller:

- 9 percent of net income attributable to cooperative sale(s) OR
- 50 percent of W-2 wages they paid to earn that income from the cooperative

Note that if the patron does not pay W-2 wages to any employees, no reduction is required. But we are still not done. Once that amount is backed out, patrons get to add an additional "DPAD-like" deduction (if any) passed through to them by the cooperative. The determination of the amount of this new "DPAD-like" deduction, which will generally range from 0 to 9 percent of the cooperative's qualified production activities income (QPAI) atrributable to that patron's grain. The final amount passed through to the patron is at the discretion of the cooperative. It is governed by language copied directly from the old DPAD provision. In any event, the overall amount a cooperative can choose to pass through to its members cannot exceed 50 percent of the value of the wages the cooperative pays to its employees. The farmer's deduction cannot exceed taxable income (subtracting the 20 percent QBI deduction detailed above, but not subtracting capital gain).

Pretty straightforward, huh? Let's look at some basic examples.

EXAMPLE ONE

Pat Patron, a single taxpayer, is a member patron of Farm Coop. In 2018, he sells all of his grain through Farm Coop.

Pat receives $250,000 from Farm Coop in 2018 for his grain sales. He receives $230,000 of this as a per unit retain paid in money (PURPIM) and $20,000 as an end-of-year patronage dividend. Pat also has $200,000 in expenses, which does not include any W-2 wages in 2018. Pat has no capital gain income in 2018, but he receives wages from an outside job, leaving him with taxable income of $75,000 (after the

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$12,000 standard deduction is subtracted).

Pat's 2018 qualified business income (QBI) is $50,000, which equals his net income from his grain marketing activities. Under 199A(a), Pat calculates a tentative QBI deduction of $10,000, which is .20 of his QBI. Because Pat's taxable income is below $157,500, his QBI deduction is not limited by the wages / capital limitation.

Because all of Pat's tentative QBI deduction is attributable to qualified payments he received from Big Coop, Pat must determine what portion of that deduction must be reduced under 199A(b)(7). He must reduce his QBI deduction by the lesserof:

- 9 percent of QBI allocable to qualified payments from cooperative ($50,000 * .09 = OR $4,500) OR
- 50 percent of W-2 wages attributable to Pat's coop payments ($0)

Because Pat paid no wages for his grain business, he is not required to reduce his QBI deduction at all. He is therefore entitled to the full 20 percent 199A(b) deduction.

Assume that in 2018, Farm Coop also allocates a $2,500 199A(g)(2)(A) deduction to Pat for his portion of the Coop's QPAI. This deduction is limited only by Pat's taxable income (after subtracting his QBI deduction).

Pat's final 199A deduction for 2018 is $10,000 (QBI) + $2,500 (199(g)) = $12,500 (25 percent of QBI)

Pat's final taxable income in 2018 is therefore $75,000 - $12,500 = $62,500.

EXAMPLE TWO

We will now change only one fact from Example One. Here, we assume that $25,000 of Pat's $200,000 in expenses were W-2 wages that he paid to an employee.

Here, Pat's tentative 199A(a) QBI deduction will remain $10,000 (20 percent of QBI). However, he must now reduce his QBI deduction by the lesser of the following:

- 9 percent of QBI allocable to qualified payments from cooperative ($50,000 * .09 = OR $4,500) OR
- 50 percent of W-2 wages attributable to Pat's coop payments ($25,000 * .5 = $12,500)

Here, Pat must subtract $4,500 from his $10,000 tentative deduction for a final QBI deduction of $5,500. Pat thus gets only an 11 percent QBI deduction in this example. However, Pat also get to take his $2,500 199A(g) deduction from Farm Coop, for a final 199A deduction of $8,000 (16 percent of QBI).

Pat's final taxable income in this example is $67,000.

Deduction for Agricultural Cooperative

The fix significantly changes the deduction allowed to agricultural cooperatives themselves. Under the original 199A, the cooperative would have received its own 20-percent deduction, calculated based upon gross income minus qualified cooperative dividends paid. This deduction was also limited by a wages/capital restriction. Under the fix, this approach is replaced by the "DPAD-like" regime discussed above. As noted, the cooperative can take a new 199A(g) deduction in an amount equal to 9 percent of "QPAI" (which includes PURPIM), limited by taxable income and 50 percent of W-2 wages paid. If the cooperative passes the 199A(g) deduction through to its patrons, it must reduce, in a corresponding amount, the deductions it could normally take for its payments to the patrons.

Corporate Patrons

The 199A deduction, including the new 199A(g) does not apply to taxpayers who are C Corporations. Specifically, the 199A(g)(A) deduction, although modeled after the old DPAD, is now restricted to "eligible taxpayers," which are taxpayers "other than a corporation." 199A(g)(2)(D). Likewise, 199A(g)(2)(C) limits the cooperatives' own deduction only by qualified payments attributed to "eligible taxpayers." This is because the new 199A(g) can only be passed through to non-corporate taxpayers (including shareholders of S Corporations).

Transition Rule

The new law also includes a transition rule for farmers who receive a cooperative payment in 2018 that is attributable to QPAI for which the old DPAD deduction was applicable. This will include any QPAI attributable to a cooperative tax year beginning before 2018. See Section 101(c)(2). With the original DPAD gone in 2018, taxpayers were left to wonder how to report such DPAD allocations. The law clarifies that such farmers will still be able to take the old DPAD deduction in 2018, as long as it is attributable to QPAI which was allowed to the cooperative for a tax year beginning before 2018. No 199A deduction will be allowed for such payments.

So it appears that some farmers in 2018 will have an old DPAD deduction, a "DPAD-like" 199A deduction, and a straight-up 199A deduction. Allocating expenses among the three may be interesting.

*It should be remembered that the 199A deduction only applies to pass-throughs and sole proprietors. Talk of a "DPAD-like" deduction does not mean that corporations are now eligible for this deduction.