

# ISSUE BRIEF

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## Why the Harmful “Grain Glitch” in the New Tax Law Must Be Fixed

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On December 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act into law.<sup>1</sup> This sweeping legislation made major improvements to existing tax policy. As is common with legislation of this complexity and magnitude, technical errors and minor unintended consequences are expected. However, there is one major problem in the law—it concerns a specific part of a new pass-through business deduction, the “grain glitch,” and it must be fixed immediately.

The grain glitch refers to a problem with the new deduction (Section 199A) that makes it possible for some farmers to avoid paying federal tax altogether. It also creates major distortions in agricultural markets by incentivizing farmers to sell to cooperatives instead of other private businesses. This glitch may have ramifications well beyond agriculture.

The root of the problem is the U.S. tax code’s disparate treatment of business income, treating similar businesses differently depending on their legal structure. This *Issue Brief* provides important background information, explains the problem, and identifies recommendations on how Congress can fix the glitch in the cooperative deduction. However, addressing the inequities in business taxation and the broader problems with the new 20 percent

deduction will require a more fundamental re-imagination of how business income is taxed.

### Background

In order to understand the grain glitch, it helps to go back to the American Jobs Creation Act of 2004, which created the Section 199 deduction.<sup>2</sup> This deduction provided a tax break for domestic manufacturers and other businesses engaged in production activities (including cooperatives).<sup>3</sup> By enacting this special tax subsidy, Congress used the tax code to pick winners and losers, creating an unwarranted special interest benefit and entrenching an entire industry against any tax reform that would eliminate its subsidy.

In tandem with a steep reduction to the corporate tax rate and a new pass-through deduction, Congress was able to eliminate Section 199 in the Tax Cuts and Jobs Act. The elimination of Section 199, which should never have existed in the first place, concerned farmer cooperatives who had come to enjoy their subsidy.<sup>4</sup> Cooperatives, called co-ops, are member-owned businesses operated for the benefit of members, and are prevalent in agriculture.<sup>5</sup> Many farmers belong to farmer cooperatives, which provide services such as marketing commodities.<sup>6</sup>

Instead of just eliminating Section 199 deductions and lowering tax rates for all businesses, Congress decided to address the concerns of farmer co-ops by developing a new privilege. As a result, Congress added language to the new tax law that created the grain glitch.

The new cooperative deduction was likely not an *unintended* glitch, at least to the legislators who pushed the specific language. As reported by *Politico*,

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“[T]hough that’s been dubbed the ‘grain glitch,’ it was included in the legislation at the insistence of multiple senators despite warnings of its implications.”<sup>7</sup>

## What Is the Grain Glitch?

The *new* Section 199A created a 20 percent deduction to help all pass-through businesses. Pass-throughs are businesses, such as sole proprietorships, partnerships, and S corporations, which pass their income through to the owners of the businesses. They do not include traditional C corporations. Instead of treating all pass-through businesses equally, Section 199A created special rules for members of cooperatives selling to cooperatives.<sup>8</sup>

**Net v. Gross Calculations.** The new deduction applies in two different situations. First, it allows households to deduct 20 percent of their “qualified business income,” calculated based on *net* business income, meaning they must account for business costs. Second, it allows households to deduct 20 percent of their “qualified cooperative dividends,” which include *gross* sales—business costs are not factored into the calculus.<sup>10</sup>

This distinction creates a major benefit for cooperative members selling to cooperatives, and as a

result, a major benefit to any business organized as a cooperative. For example, assume a business has \$200,000 in revenue, \$100,000 in expenses, and therefore has a net business income of \$100,000. The allowed deduction is \$20,000 (20 percent of the net business income).

If instead of applying to net business income, the deduction is based on *gross* cooperative dividends, the 20 percent deduction applies to \$200,000 (total revenue) not \$100,000 (the net amount). Therefore, the available deduction is \$40,000. For farmers selling commodities, they now have a major incentive to sell to cooperatives as opposed to other private businesses, such as grain operators.

**Other Preferences for Co-ops.** There are two other important preferences for cooperatives included in the new Section 199A:

- **Taxable ordinary income.** The 20 percent deduction for standard pass-throughs, based on qualified business income, is limited to 20 percent of taxable ordinary income. The 20 percent deduction for qualified cooperative dividends can be applied to 100 percent of taxable ordinary income.<sup>11</sup>

1. H.R. 1, Public Law 115-97, 115th Congress, 2018, <https://www.congress.gov/bill/115th-congress/house-bill/1> (accessed March 6, 2018). The 2017 tax reform law H.R. 1 is known as the Tax Cuts and Jobs Act. In a last-minute procedural change, the act’s name was stripped from the bill and it remains officially nameless.
2. American Jobs Creation of 2004, Public Law 108-357, 108th Congress, 2004, <https://www.gpo.gov/fdsys/pkg/PLAW-108publ357/html/PLAW-108publ357.htm> (accessed March 6, 2018).
3. See, for example, Internal Revenue Service webpage on Form 8903, <https://www.irs.gov/instructions/i8903> (accessed March 6, 2018).
4. Cooperatives were able to pass the deduction from the old-law Section 199 on to their members. See, e.g., “Special Rules for Cooperatives—Section 199 Planning, the Pass Through Provision, and Wage Limitation,” Baker Tilly, <http://bakertilly.com/insights/special-rules-for-cooperatives-section-199-planning-the-pass-through-provis/> (accessed March 7, 2018).
5. U.S. Department of Agriculture, “Co-ops: A Key Part of Rural America,” <https://www.usda.gov/topics/rural/co-ops-key-part-fabric-rural-america> (accessed March 6, 2018).
6. See, for example, National Council on Farmer Cooperatives, <http://ncfc.org/about-ncfc/> (accessed March 6, 2018).
7. Brian Faler, “‘This Is Not Normal’: Glitches Mar New Tax Law,” *Politico*, February 24, 2018, <https://www.politico.com/story/2018/02/24/tax-law-glitches-gop-423434> (accessed March 6, 2018).
8. Paul Neiffer, “How Much Is the Co-op Deduction Really Worth?” CliftonLarsonAllen, January 7, 2018, <http://blogs.claconnect.com/agribusiness/how-much-is-the-co-op-deduction-really-worth/> (accessed March 6, 2018). Members must sell to the cooperative *and* be a patron of the cooperative to receive the deduction.
9. A qualified cooperative dividend includes patronage dividends and per unit retains paid in money. See Section 11011(e)(4), H.R. 1, Public Law 115-97, 115th Congress, 2018, <https://www.congress.gov/bill/115th-congress/house-bill/1> (accessed March 6, 2018). See also Keri L. Jacobs, “A Discussion of the Sec 199A Deduction and Its Potential Impacts on Producers and Grains Marketing Firms,” University of Illinois at Urbana-Champaign, January 26, 2018, <http://farmdocdaily.illinois.edu/2018/01/a-discussion-of-the-sec-199a-deduction.html> (accessed March 6, 2018).
10. See, for example, Jacqui Fatka, “Work on Fixing Section 199A Continues on Capitol Hill,” *Feedstuffs*, January 29, 2018, <http://www.feedstuffs.com/news/work-fixing-section-199a-continues-capitol-hill> (accessed March 6, 2018).
11. Scott Greenberg, “The ‘Grain Glitch’ Needs to Be Fixed,” Tax Foundation, February 8, 2018, <https://taxfoundation.org/grain-glitch-needs-fixed/> (accessed March 6, 2018).

- **Wages and investments.** The qualified business income deduction is also limited by the greater of either 50 percent of wages paid or 25 percent of wages plus 2.5 percent of qualified property.<sup>12</sup> The qualified cooperative dividends deduction has no such limitation.<sup>13</sup>

## Eliminating All Federal Income-Tax Liability

This special treatment allows farmers to avoid paying federal income tax altogether. The Tax Foundation provides a useful illustration of this point:

Imagine a farmer that sells \$2 million worth of grain a year to a co-op, earns no other income, and incurs \$1.6 million worth of expenses throughout the year. The farmer would end the year with \$400,000 of income, which presumably ought to be subject to federal taxes. However, the farmer would also be able to claim a deduction of \$400,000 (or 20 percent of the \$2 million in cooperative dividends the farmer receives). As a result, the farmer would be able to wipe out his entire taxable income using the section 199A deduction, ending up with no federal tax liability whatsoever.

This result is a direct consequence of the design of the deduction for businesses that sell to cooperatives. Because the size of the deduction is determined by a gross measure, and is only limited to 100 percent of a household's taxable ordinary income, there's nothing stopping the deduction from being large enough to wipe out a household's entire tax bill.<sup>14</sup>

## Impact of the Grain Glitch

As should be expected, private businesses that are not cooperatives want to compete and are therefore looking into the possibility of reorganizing their businesses. If farmers are only willing to sell to cooperatives, this could be devastating to those companies that are not cooperatives.<sup>15</sup>

In a February 21, 2018, letter to congressional leadership, 87 Republican Members explained that Section 199A "has resulted in a dramatic competitive imbalance impacting numerous agricultural value chain stakeholders including grain handlers, feed mills, seed companies, ag retailers, biofuels producers, banks, livestock marketers, and dairy processors. Left unchecked, Section 199A's uncompetitive impacts will ripple across many industries."<sup>16</sup>

Section 199A may also have a direct impact on industries outside agriculture. The special provision for cooperatives was not limited to agricultural cooperatives. There is a possibility that other industries could form cooperatives to take advantage of the benefits, including setting up worker cooperatives for lawyers, accountants, and other professionals.<sup>17</sup>

## What Congress Should Do

Congress needs to take immediate action, such as in the upcoming omnibus spending bill expected to be passed in March.<sup>18</sup> Timely action is necessary to head off strategic tax planning that encourages businesses to change their legal structures and further harms those businesses that have been put at an artificial disadvantage. This harm may very well result in private companies going out of business and lost jobs.

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12. See, for example, William G. Gale and Aaron Krupkin, "Navigating the New Pass-Through Provisions: A Technical Explanation," The Brookings Institution, February 12, 2018, <https://www.brookings.edu/research/navigating-the-new-pass-through-provisions-a-technical-explanation/> (accessed March 6, 2018).

13. Greenberg, "The 'Grain Glitch' Needs to Be Fixed."

14. Ibid.

15. Jacob Bunge and Richard Rubin, "Agriculture Firms Warn of Unintended Impact of Tax Law," *The Wall Street Journal*, January 9, 2018, <https://www.wsj.com/articles/agriculture-firms-decry-provision-in-new-tax-law-1515529022> (accessed March 6, 2018).

16. Section 199A letter from Representative David Young (R-IA) et al. to the House Speaker and Senate Majority Leader, February 21, 2018, <https://davidyoung.house.gov/sites/davidyoung.house.gov/files/Section%20199A%20Letter.pdf> (accessed March 6, 2018).

17. Peter J. Reilly, "Cooperative Glitch in Tax Bill May Mean Food Fight in Congress," *Forbes*, February 11, 2018, <https://www.forbes.com/sites/peterjreilly/2018/02/11/cooperative-glitch-in-tax-bill-may-mean-food-fight-in-congress/2/#e4482d03e00a> (accessed March 6, 2018).

18. There appears to be support for addressing the glitch in the upcoming omnibus spending bill. For example, according to Tax Analysts, House Ways and Means Committee Chair Kevin Brady (R-TX) "said it's likely the legislative fix will be considered when lawmakers negotiate the omnibus spending package, which they hope to pass before the government runs out of funding on March 23." Dylan F. Moroses, "Brady Suggests 'Grain Glitch' Fix May Ride on Spending Bill," Tax Analysts, February 27, 2018, <http://www.taxanalysts.org/content/brady-suggests-grain-glitch-fix-may-ride-spending-bill> (accessed March 6, 2018).

Fortunately, there is wide recognition<sup>19</sup> of the problem and the need to fix it. The question is really *how* to fix the glitch not *whether* to fix it. Even Senators John Hoeven (R–ND) and John Thune (R–SD), who reportedly pushed for a special cooperative benefit,<sup>20</sup> have recognized the need to limit the deduction.

Specifically, Congress should:

- **Treat those who benefit under Section 199A equally.** The pass-through deduction for qualified business income is poor tax policy on its own merits; the addition of the cooperative deduction makes it that much worse. If Section 199A deductions are to exist, they should be applied as equally as possible. This means that cooperatives, farmers, and other agricultural businesses should be treated just like other pass-through businesses.<sup>21</sup> It also means that Section 199A should be applied equally within the agricultural sector, instead of creating market distortions and favoritism as it does now.

Congress should repeal the special treatment of cooperative dividends. The deduction for those selling to cooperatives should be based on net income, not gross sales.

- **Apply any fix retroactively.** Regardless of when a fix becomes law, it should apply to the beginning of this year. Members of Congress quickly determined, albeit after the fact, that this provision was a mistake and it never should have existed in the tax bill in the first place. Nobody should benefit or suffer from this mistake.
- **Refuse to reinsert the old-law Section 199 just for cooperatives, or otherwise seek to provide cooperatives with pre-Tax Cuts and Jobs Act favoritism.** Some have proposed reinserting Section 199 for cooperatives, as it existed before tax

reform. Such a move would be a major substantive change that would be far from a “fix.” It also would ignore the will of Congress in passing the Tax Cuts and Jobs Act: Congress sought to eliminate the Section 199 deduction. Reintroducing a special subsidy for a politically favored industry would perpetuate a culture of using the tax code to support industries that have political power in Washington.

Instead of reinserting Section 199 for cooperatives, some legislators may seek to manipulate the recently enacted tax reforms so that cooperatives have a level of benefits equivalent to what they had in the old Section 199. Actually determining the value of an equivalent benefit and then designing a new system for cooperatives to access the new subsidy will only create additional complexity and could result in additional glitches.

## Conclusion

The grain glitch is the most high-profile problem stemming from the new Section 199A deduction for pass-through businesses. Narrowing the cooperative deduction to net income is really only a patch, not a fix, in a new system that is rife with similar inconsistencies. The broader 20 percent deduction is itself a tax privilege, which has no consistent policy rationale and arbitrarily favors certain types of businesses over others. A true fix will have to wrestle with the inherent inequities that arise from having two different business tax schemes. Holistic business tax reform should remove the 20 percent deduction in favor of a system that equalizes business taxation by integrating the corporate and individual tax codes.<sup>22</sup>

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19. The U.S. Department of Agriculture issued a statement calling for a fix: “[W]hile the goal was to preserve benefits in Section 199A for cooperatives and their patrons, the unintended consequences of the current language disadvantage the independent operators in the same industry. The federal tax code should not pick winners and losers in the marketplace.” Statement of Under Secretary Greg Ibach on Section 199A Tax Code Fix,” U.S. Department of Agriculture, January 12, 2018, <https://www.usda.gov/media/press-releases/2018/01/12/statement-under-secretary-greg-ibach-section-199a-tax-code-fix> (accessed March 6, 2018).

20. Asha Glover, “Lawmakers Working to Fix Tax Law’s Grain Glitch,” Tax Analysts, February 6, 2018, <https://www.taxanalysts.org/content/lawmakers-working-fix-tax-laws-grain-glitch> (accessed March 6, 2018).

21. Eliminating favoritism toward cooperatives should not be done by merely making it possible for all farmers to waive all federal tax liability.

22. David R. Burton, “Tax Reform: Eliminating the Double Taxation of Corporate Income,” Heritage Foundation *Backgrounder* No. 3216, May 18, 2017, <https://www.heritage.org/taxes/report/tax-reform-eliminating-the-double-taxation-corporate-income>.