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National Council of Farmer Cooperatives

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April 14, 2015

The Honorable John Thune
Dirksen Senate Office Building, Room 511
Washington, DC 20510

The Honorable Ben Cardin
Hart Senate Office Building, Room 509
Washington, DC 20510

Dear Senator Thune and Senator Cardin:

On behalf of the more than two million farmers and ranchers who belong to farmer cooperatives, the National Council of Farmer Cooperatives (NCFC) appreciates this opportunity to provide comments to the Senate Finance Committee Tax Reform Working Group on Business Income Tax.

Farmer cooperatives are owned and governed by their farmer members. Earnings from business conducted with or for a cooperative's members are subject to tax as income of the farmer members, provided the cooperative pays or allocates the earnings to its members based on patronage. Earnings not so paid or allocated are retained to support the cooperative's capital funding or other needs and are taxed at regular corporate rates. They are then taxed a second time at individual rates when distributed to the farmer members. Earnings from sources other than business with or for the cooperative's members also are taxed at corporate rates when earned and individual rates when distributed. The cooperative tax regime has been a feature of the Internal Revenue Code since its inception and was codified formally in Subchapter T in 1962. Subchapter T and the related regulations should be retained because they properly reflect the unique relationship between a cooperative and its farmer members.

NCFC is concerned that several tax reform proposals under discussion could negatively impact farmer cooperatives and their members, and that a lowered corporate rate would not help to offset those negative impacts.

The Section 199 Deduction for Domestic Production Activity. Section 199 is very beneficial to farmer cooperatives and rural economies. The deduction applies to proceeds from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives. It also applies to products marketed through cooperatives, including dairy, grains, fruits, nuts, soybeans, sugar beets, and livestock. For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production.

Cooperatives may choose to keep the deduction at the cooperative level, or pass it through to their farmer members, making it extremely beneficial to both. Section 199 benefits are returned to the economy through job creation, increased spending on agricultural production, and increased spending in rural communities. In the agricultural sector, Section 199 is serving the purpose intended by Congress – encouraging domestic job creation and investment – and we urge you to maintain the deduction as you work toward reform of the tax code.

Repeal of LIFO Accounting Method. Reform proposals put forth by former Senate Finance Committee Chairman Baucus and former House Ways and Means Committee Chairman Camp and others have suggested eliminating the last-in, first-out (LIFO) accounting method. LIFO is a widely accepted accounting method under which taxpayers assume for accounting purposes that inventory most recently acquired is sold first. If the LIFO method is repealed, farmer cooperatives and other businesses using this method would be required to restate inventories at their first-in, first-out (FIFO) value, and be subject to tax as if they had been using the FIFO method all along. This would create a significant tax liability even though the taxpayers have received no cash to pay the tax. Obtaining the funds necessary to pay the tax on this deemed sale would cause severe strain on cooperatives' capital budgets.

Taxation of LIFO reserves would be the equivalent of a retroactive tax on the savings of a cooperative. In addition, LIFO repeal will burden a class of patrons that did not enjoy the benefits of the build-up of the LIFO reserves and will instead place the burden of taxation on current patrons of the cooperative.

Repeal of Lower of Cost or Market Accounting Method. Eliminating the lower of cost or market (LCM) accounting method has also been proposed in conjunction with LIFO repeal. Using this method, a taxpayer determines an inventory's value using either the original cost or the current replacement cost, whichever is lower. Like LIFO, LCM is a widely accepted method of accounting, and is important to cooperatives that acquire farm commodities from their members to be sold or processed at a later date.

The repeal of the LCM accounting method also would harm supply cooperatives because their inventories consist largely of commodities susceptible to large variations in value. When commodity prices decline, supply cooperatives must drastically devalue those commodities to reflect a proper carrying value for financial reporting purposes. The repeal of the LCM accounting method would result in supply cooperatives effectively pre-paying substantially higher income taxes as a result of the disallowed deduction. Key commodities for supply cooperatives include fertilizer; pesticides, herbicides, and other agricultural chemicals; grains; feeds; and petroleum products, including diesel, propane, and heating oil.

In addition, any proposal to disallow "any method valuing inventory at a bona fide selling price" (as under the Baucus proposal) would prohibit the long-standing and accepted industry practice of grain companies valuing their grain inventories and all open grain positions at market at year-end for book and tax purposes.

Changes to Depreciation Rules. Some tax reform proposals would replace the current depreciation rules with a new set of rules for all business taxpayers. Under the approach proposed by former Chairman Baucus, taxpayers would use a pooling method for most tangible personal property rather than calculating depreciation for each separate asset, and real property would be depreciated on a straight-line basis over 43 years. The result is a slowing of depreciation for agricultural property. In fact, taxpayers would never fully recover all costs associated with some assets. Former Chairman Camp also introduced a tax reform proposal (the "Tax Reform Act of 2014," H.R. 1) that would have slowed the current depreciation allowances for property, including agricultural property.

The new, slower methods of depreciation in the Baucus and Camp proposals, and their application to old as well as new assets in the Baucus proposal, would impose significant new costs on taxpayers and would discourage farmer cooperatives and their members from investing in new buildings, plants, and equipment.

Capitalization Provisions. Other proposed changes would impose additional tax burdens on farmer cooperatives' members. For example, the Baucus and Camp proposals would have required farmers to capitalize the cost of fertilizer, an annual ordinary and necessary cost we believe should be more properly expensed. Further, determining the proper method of recovering the cost of capitalized fertilizer would increase tax complexity under such a proposal.

The Baucus proposal also would require farmers to amortize soil and water conservation expenditures over a 28-year period. Farmers should neither be discouraged from voluntarily making conservation expenditures, nor be subject to additional tax burdens in a time of increasing federal and state conservation requirements.

Accrual Method of Accounting. Various reform proposals have included eliminating the cash method of accounting for those taxpayers with $10 million or more in receipts. For farmers and ranchers, cash accounting is crucial due to the number and scale of up-front costs associated with farming and the uncertainty of crop yields and market prices. Farmers need to be able to buy inputs when they have income in hand, not when earned for book purposes.

Farmers and ranchers also need the flexibility and simplicity of cash accounting (in part) because annual revenues often differ drastically from one year to the next. By eliminating the cash method of accounting for some farms, the proposal may impose a tax bill on farmers before they have the cash to pay it, and would increase the complexity and cost of tax compliance.

Conclusion. Some have suggested that lowering corporate rates would offset the loss of Section 199, the changes to depreciation rules, and the repeal of accounting method changes. However, because farmer cooperatives' income can flow through to farmer members and is then taxed at individual rates, a corporate rate reduction generally would not benefit cooperatives and their members. We urge you to consider the negative impacts of these changes and to consider appropriate adjustments and transition rules to lessen these negative impacts.

Once again, NCFC appreciates the opportunity to comment on tax reform and would be happy to answer any questions you may have about farmer cooperatives and their taxation. Please contact Marlis Carson, Senior Vice President and General Counsel, at 202-879-0825 or mcarson@ncfc.org.

Sincerely,

Charles F. Conner
President & CEO
National Council of Farmer Cooperatives