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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9947]

RIN 1545-B090

# Section 199A Rules for Cooperatives and their Patrons

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of final and temporary regulations.

SUMMARY: This document contains final regulations that provide guidance to cooperatives to which sections 1381 through 1388 of the Internal Revenue Code (Code) apply (Cooperatives) and their patrons regarding the deduction provided by section 199A(a) of the Code for qualified business income (QBI), as well as guidance to specified agricultural or horticultural cooperatives (Specified Cooperatives) and their patrons regarding the deduction provided by section 199A(g) of the Code for eligible domestic production activities undertaken by Specified Cooperatives. The final regulations also provide guidance on section 199A(b)(7), the statutory rule requiring patrons of Specified Cooperatives to reduce their QBI deduction under section 199A(a). In addition, the final regulations include a definition of patronage and nonpatronage sourced items under section 1388 of the Code, and revise existing regulations under section 1382 of the Code to reference this definition. Finally, this document removes the final and temporary regulations under former section 199. These final regulations affect Cooperatives as well as patrons that are individuals, partnerships, S corporations, trusts, and estates engaged in domestic trades or businesses.

DATES: Effective date: These regulations are effective on January 14, 2021.

Applicability dates: For dates of applicability, see §§1.199A-7(h), 1.199A-8(h), 1.199A-9(k), 1.199A-10(i), 1.199A-11(h), 1.199A-12(j), 1.1382-3(e), and 1.1388-1(g).

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SUPPLEMENTARY INFORMATION:

**Background**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A, 1382, and 1388 of the Code.

Section 199A was enacted on December 22, 2017, by section 11011 of Public Law 115-97, 131 Stat. 2054, 2063, commonly referred to as the Tax Cuts and Jobs Act (TCJA). Parts of section 199A were amended on March 23, 2018, effective as if included in the TCJA, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, 132 Stat. 348, 1151 (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026. Unless otherwise indicated, all references to section 199A are to section 199A as amended by the 2018 Act.

In addition, section 13305 of the TCJA repealed section 199 (former section 199), which provided a deduction for income attributable to domestic production activities (section 199 deduction). Public Law 115-97, 131 Stat. 2054, 2126. The repeal of former section 199 is effective for all taxable years beginning after 2017.

Section 199A(a) provides taxpayers a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income (section 199A(a) deduction). Section 199A(b)(7) requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive certain payments from Specified Cooperatives.

Section 199A(g) provides a deduction for Specified Cooperatives and their patrons (section 199A(g) deduction) that is based on the former section 199 deduction. Section 199A(g)(4)(A) defines a Specified Cooperative, in part, as an organization to which part I of subchapter T of chapter 1 of the Code (subchapter T) applies. Under section 1381(a)(2), subchapter T applies to any corporation operating on a cooperative basis, with certain exceptions not relevant here. Section 1382 provides rules regarding the taxable income of Cooperatives and section 1388 provides definitions applicable for purposes of subchapter T.

The Department of the Treasury (Treasury Department) and the IRS published proposed regulations (REG-107892-18) providing guidance on the section 199A(a) deduction in the **Federal Register** (83 FR 40884) on August 16, 2018. A second notice of proposed rulemaking providing guidance (REG-134652-18) and final regulations implementing the section 199A(a) deduction (TD 9847) were published in the **Federal Register** (84 FR 3015 and 84 FR 2952, respectively) on February 8, 2019, with corrections to TD 9847 published in the **Federal Register** (84 FR 15954) on April 17, 2019. TD 9847, which promulgated §§1.199A-1 through 1.199A-6 to implement the section 199A(a) deduction, does not include all the rules needed for patrons of Cooperatives to calculate their particular section 199A(a) deductions. Specifically, the rules included in TD 9847 do not address patrons' treatment of payments received from Cooperatives for purposes of section 199A(a) or the section 199A(g) deduction for Specified Cooperatives, though §1.199A-1(e)(7) restates the reduction to a patron's section 199A(a) deduction required under section 199A(b)(7).

To address these matters, on June 19, 2019, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-118425-18) in the **Federal Register** (84 FR 28668) containing proposed regulations under sections 199A and 1388, with corrections published in the **Federal Register** (84 FR 38148) on August 6, 2019 (together, Proposed Regulations). The Proposed Regulations set forth rules to address patrons' treatment of payments received from Cooperatives for purposes of section 199A(a) and the section 199A(g) deduction for Specified Cooperatives in proposed §§1.199A-7 through 1.199A-12, as well as proposed rules under section 1388 regarding patronage and nonpatronage sources of income of Cooperatives. The Proposed Regulations also withdrew all proposed regulations issued under former section 199 that had not been finalized and proposed to remove the final and temporary regulations under former section 199.

The Summary of Comments and Explanation of Revisions of the final regulations summarizes the provisions of the Proposed Regulations, which are explained in greater detail in the preamble to the Proposed Regulations. After full consideration of the comments received on the Proposed Regulations, this Treasury decision adopts the Proposed Regulations with modifications in response to such comments as described in the Summary of Comments and Explanation of Revisions.

**Summary of Comments and Explanation of Revisions**

The purpose and scope of the final regulations is limited to providing guidance regarding the application of sections 199A(a), 199A(b)(7), 199A(g), 1382, and 1388. Section 199A(a) is generally applicable to patrons of all Cooperatives, whereas sections 199A(b)(7) and 199A(g) apply only to Specified Cooperatives and their patrons. Section 1388 generally applies to all Cooperatives and their patrons.

The Treasury Department and the IRS received written comment submissions in response to the Proposed Regulations. All comments were considered and are available at *www.regulations.gov* or upon request. Most of the comments addressing the Proposed Regulations are summarized in this Summary of Comments and Explanation of Revisions. However, comments merely summarizing or interpreting the Proposed Regulations, recommending statutory revisions, or addressing issues which are outside the scope of the final regulations are not discussed in this Summary of Comments and Explanation of Revisions.

Commenters requested that the rules for section 199A as they apply to Cooperatives and patrons be simplified and clarified. Accordingly, while the final regulations adopt many of the rules described in the Proposed Regulations, they are revised in response to the comments received. Additionally, in response to the comments, the final regulations include clarifying language and additional examples.

Parts I through VII of this Summary of Comments and Explanation of Revisions discuss §§1.199A-7 through 1.199A-12, 1.1382-3, and 1.1388-1, respectively. Part VIII addresses the removal of all final and temporary regulations issued under former section 199. Part IX addresses comments on the proposed applicability date and the transition rule.

## I. §1.199A-7, Rules for Patrons of Cooperatives

### A. In General

As noted in the Background, the section 199A(a) deduction allows taxpayers to deduct up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified REIT dividends and PTP income. Patrons that are individuals (as described in §1.199A-1(a)(2)) are eligible for the section 199A(a) deduction. If patrons receive certain payments from Specified Cooperatives, then section 199A(b)(7) requires them to calculate a reduction to their section 199A(a) deduction. This part I.A provides a general outline of the rules of proposed §1.199A-7, and the remainder of this part I addresses the specific comments received on proposed §1.199A-7. Other than for modifications made in response to specific comments, the final regulations generally adopt the Proposed Regulations.

Proposed §1.199A-7(a) provides special rules and definitions for patrons of cooperatives in applying §§1.199A-1 through -6, including definitions of patron, patronage and nonpatronage, qualified payment, and Specified Cooperative. Proposed §1.199A-7(b) explains that patronage dividends or similar payments that a patron receives from a Cooperative are considered as generated from the trade or business the Cooperative conducts on behalf of the patron, and are therefore tested by the Cooperative at its trade or business level. Proposed §1.199A-7(c) provides special rules for patrons and Cooperatives relating to the definition of QBI, the determination of QBI by patrons, and the determination and reporting by Cooperatives of the amount of qualified items of income, gain, deduction, and loss (collectively, qualified items) for qualified trades or businesses in distributions made to patrons. Proposed §1.199A-7(d) provides special rules for patrons' determinations of specified service trades or businesses (SSTBs) and for Cooperatives' determination and reporting of SSTBs.

Under proposed §1.199A-7(c)(3) and (d)(3), Cooperatives are required to report the amount of qualified items related to non-SSTBs and SSTBs in distributions made to patrons on an attachment to or on the Form 1099-PATR (or any successor form), unless the form instructions provide otherwise. Under proposed §1.199A-7(c)(3), if a Cooperative fails to report the amount of qualified items from its non-SSTBs, then the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. Under proposed §1.199A-7(d)(3), if a Cooperative fails to report the amount of qualified items from an SSTB (SSTB items), then only the amount of qualified items the Cooperative reports under proposed §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative is presumed to not be included in the patron's QBI.

Proposed §1.199A-7(e) provides special rules for patrons relating to the statutory limitations based on W-2 wages and unadjusted basis immediately after acquisition

(UBIA) of qualified property. The Proposed Regulations provide that Cooperatives do not allocate their W-2 wages and UBIA of qualified property to patrons, and directs patrons to calculate the W-2 wage and UBIA of qualified property limitations at the patron level when calculating their section 199A(a) deduction.

Proposed §1.199A-7(f) provides special rules for Specified Cooperatives and their patrons relating to calculating the section 199A(b)(7) reduction, including a requirement that Cooperatives report the amount of qualified payments (as defined in proposed §1.199A-8(d)(2)(ii)) made to patrons on an attachment to or on the Form 1099-PATR (or any successor form). Proposed §1.199A-7(g) provides examples that illustrate the rules in §1.199A-7(a) through (f) for Specified Cooperatives and their patrons.

Lastly, proposed §1.199A-7(h) generally provides that taxpayers may rely on the proposed rules in their entirety and as applied in a consistent manner until final regulations are published in the **Federal Register**. Proposed §1.199A-7(h) also includes the transition rule relating to the repeal of the former section 199 deduction and the implementation of the new section 199A(a) deduction.

B. Comments related to proposed §§1.199A-7(c)(3) and (d)(3)

i. Requirements that Cooperative determines qualified items from non-SSTBs and qualified items from SSTBs

Under proposed §§1.199A-7(c)(3) and (d)(3), Cooperatives must separately determine the amounts of qualified items relating to non-SSTBs and qualified items relating to SSTBs in distributions made to patrons. Commenters asserted that whether income is a qualified item when earned at the Cooperative level should not be determinative of its treatment at the patron level, but that instead the determination of qualified items from non-SSTBs and SSTBs should be made by the patron based solely on whether a patronage dividend relates to a patron's trade or business. These commenters additionally asserted that the proposed rules burden Cooperatives by requiring additional information reporting and are not consistent with the provisions of subchapter T.

The final regulations do not adopt the commenters' suggestion for several reasons, including that the proposal does not comport with sections 199A(c)(3) and (d)(2). The rules of proposed §§1.199A-7(c)(3) and (d)(3) are consistent with the rules in TD 9847 implementing the section 199A(a) deduction generally. These rules arise from the statutory requirement that all items in the computation of the section 199A(a) deduction be qualified items as defined in section 199A(c)(3) and not derived from an SSTB as defined in section 199A(d)(2). TD 9847 generally provides that an item of income, gain, deduction and loss is determined and reported for each trade or business by the entity or individual that directly conducts the trade or business. Patronage dividends and similar payments are considered to be directly generated from the trade or business that the Cooperative conducts on behalf of or with its patrons. For example, an individual patron must determine QBI for each trade or business it directly conducts. To the extent a patron receives patronage dividends or similar payments from a Cooperative, such patronage dividends or similar payments are considered generated from the trade or business the Cooperative conducts on behalf of or with its patron and are tested by the Cooperative at the level of its trade or business.

Failure to determine whether items of income, gain, deduction, and loss that are distributed to patrons are qualified items at the Cooperative level could result in patrons' circumvention of the statutory requirements for qualified items under section 199A(c)(3)(A) and (B), for example, that items be effectively connected with the conduct of a trade or business within the United States. Section 199A(c)(3)(B) lists items that are not treated as qualified items defined in section 199A(c)(3). All dividends, income equivalent to dividends, or payments in lieu of dividends described in section 954(c)(1)(G) are not qualified items. However, section 199A(c)(3)(B)(ii) also specifically provides that patronage dividends are not treated as dividends, income equivalent to dividends, or payments in lieu of dividends described in section 954(c)(1)(G), which means a patronage dividend can be taken into account as a qualified item to the extent otherwise qualified. The Joint Committee on Taxation report titled "Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115-66)" (JCX-6-18, released March 22, 2018) (Joint Committee Report) further clarified that other similar amounts received from Cooperatives can be included in QBI, provided those amounts are otherwise a qualified item. JOINT COMMITTEE ON TAXATION, JCX-6-18, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE HOUSE AMENDMENT TO THE SENATE AMENDMENT TO H.R. 1625 (RULES COMMITTEE PRINT 115-66) 25 (March 22, 2018). As a result, the Proposed Regulations define a qualified item as including a distribution for which a Cooperative is allowed a deduction under section 1382(b) or (c)(2) (including patronage dividends and other similar payments, such as money, property, qualified written notices of allocation, and qualified per-unit retain certificates, as well as money or property paid in redemption of a nonqualified written notice of allocation), provided the distribution is otherwise a qualified item. Therefore, to be a qualified item under section 199A(c)(3), patronage dividends and other similar payments must still be effectively connected (section 199A(c)(3)(A)(i)), included or allowed in income (section 199A(c)(3)(A)(ii)), and not represent amounts described in section 199A(c)(3)(B)(i) and (iii)-(vii). Additionally, items of income, gain, deduction, and loss from an SSTB are not includable in QBI with respect to individuals above the threshold amount and subject to the phase-in range under section 199A(d)(3). Any potential burden to the Cooperatives in making these determinations is outweighed by the patrons' need for this information to determine their section 199A(a) deduction.

Based upon these statutory requirements and because the Cooperative is better positioned than a patron to determine whether a patronage dividend or other similar payment is a qualified item as determined under the rules of §199A(c)(3) and §1.199A-3(b) and whether it is derived from an SSTB as defined in §199A(d)(2) and §1.199A-5, these determination rules are adopted in the final regulations without substantive change. The patron then determines if the qualified item is includible in the patron's QBI under §1.199A-7(c)(2) and whether the qualified item from the SSTB is includible in the patron's QBI based on the threshold rules in §199A(d)(3) and §1.199A-5(a)(2)). There is no duplication in effort between the Cooperative and the patron with respect to these determinations. However, in response to commenters, the reporting requirements of Cooperatives have been modified to balance the burden on the Cooperatives and the patrons' need to receive information to determine their section 199A(a) deduction.

ii. Requirements that Cooperative report qualified items from non-SSTBs, qualified items from SSTBs, and qualified payments

Proposed §§1.199A-7(c)(3), (d)(3), and (f)(3) require Cooperatives to report qualified items from non-SSTBs, qualified items from SSTBs, and qualified payments (qualified payments are relevant only for Specified Cooperatives) to patrons. A commenter opposed these reporting requirements on the grounds that the requirements did not exist under former section 199 and do not exist under section 6044(b). In the commenter's view, Congress would have amended section 6044 to that effect if the reporting requirements were intended. The Treasury Department and the IRS agree that versions of Form 1099-PATR prior to the enactment of section 199A did not include a box for qualified payments and that section 6044(b) does not require reporting of these amounts. However, unlike former section 199, information concerning all of these amounts (qualified payments as applicable) are required for a patron to calculate its section 199A(a) deduction, including the reduction under section 199A(b)(7) for patrons of Specified Cooperatives, which did not exist under former section 199. Therefore, it is necessary for patrons to have this information, and it is most efficient for patrons to receive the information from Cooperatives on Form 1099-PATR (or any successor form). Additionally, section 199A(f)(4) authorizes the Treasury Department and the IRS to prescribe such regulations as are necessary to carry out the purposes of section 199A, including reporting requirements.

The commenter also requested removal of these reporting requirements on the grounds that Cooperatives should not be treated as relevant passthrough entities (RPEs). The Treasury Department and the IRS agree that Cooperatives are not RPEs. However, these reporting requirements emanate from the statutory requirements of section 199A and not the nature of the entities. These reporting requirements are imposed on Cooperatives because sections 199A(c) and (d) require that items of income, gain, deduction, and loss be of a certain character and from a qualified trade or business when determining the section 199A(a) deduction, and patrons need this information to determine their section 199A(a) deduction. Further, the reporting requirements applicable to Cooperatives are distinguishable from those imposed on RPEs because RPEs are required to engage in more detailed reporting, including reporting W-2 wages and UBIA of qualified property.

After consideration of the comments, the final regulations maintain a reporting requirement for Cooperatives, but the rules in proposed §1.199A-7(c)(3) and (d)(3) are revised to simplify the Cooperative's reporting obligation with respect to qualified items from non-SSTBs and qualified items from SSTBs. The proposed regulations required that the Cooperative report the amounts of qualified items with respect to each non-SSTB of the Cooperative, with a similar requirement for SSTBs. However, to reduce burden and clarify that Cooperatives do not make trade or business and corresponding aggregation determinations, the final regulations require the Cooperative to report the total net amount of qualified items from non-SSTBs in distributions to patrons without delineating these amounts business by business. A similar change was made to the reporting requirements for qualified items in distributions from SSTBs. Patrons then determine the extent that those payments are included in the QBI of the patrons' trade or business. For example, a patron will determine whether those payments are related to the patron's trade or business and whether any items in the SSTB distributions reported by the Cooperative are includible as qualified items of income, gain, deduction and loss at the patron's level after consideration of the threshold and phase-in amounts as applied to the patron's taxable income. In addition, the rules in proposed §1.199A-7(b) are revised for consistency with the revision to proposed §1.199A-7(c)(3) and (d)(3).

Commenter also suggested that the SSTB reporting requirements be revised to reflect that if a Cooperative provides services from SSTBs to patrons, the services are provided to patrons, not third parties. Therefore, any patronage dividends should be deemed a rebate, which would increase QBI of the patrons to its proper amount. Further, if the SSTBs conducted by the Cooperatives relate to personal expenses of a patron, then the SSTB patronage dividends should be excluded from the QBI calculation, but done so at the patron level, because only the patron would know whether the SSTB service is a personal expense.

Based on the commenter's suggestions, the Treasury Department and the IRS considered whether additional rules were needed and concluded that revisions are necessary to resolve certain questions raised by the commenter. Consider an example where a Cooperative provides a service to patrons as part of an SSTB of the Cooperative under section 199A(d)(2). Assume that a patron's use of that service is a deductible expense to its qualified trade or business. Patron pays the Cooperative $1,000 for the service. The Cooperative later pays the patron a patronage dividend of $50 related to the service. This patronage dividend is income under section 1385(a)(1) to the patron. Under the Proposed Regulations, assuming the patron's income is over the threshold amount (defined in section 199A(e)(2)), the patron would not be able to include the $50 in its calculation of QBI because it is SSTB income. Meanwhile, the patron would have a $1,000 expense that would reduce QBI. In substance, however, the patron would have only paid $950 for the service.

The Treasury Department and the IRS considered two approaches for resolving this asymmetry. One approach (suggested by a commenter) would permit a patron paying for services from an SSTB of the Cooperative for its trade or business to treat any patronage dividends related to those amounts as qualified items (or rebates that would reduce the expense), regardless of the threshold amounts, if the services were required or used in a qualified trade or business of the patron. A second approach would permit the allocation of part of the patron's expense to the non-qualified SSTB income. To reach the correct result, this second approach would limit the allocation of the expense to the amount of SSTB income of the Cooperative that relates to the patron's expense. Under the second approach, a patron could allocate expenses between its qualified trade or business income and the SSTB income up to the amount of the patronage dividend. Either approach reaches a similar end result with respect to the example—that is, the patron having a net $950 expense included within QBI. However, the first approach conflicts with section 199A(d)(2) in that SSTB income cannot be treated as QBI, unless the section 199A(d)(3) exception applies. The first approach also conflicts with section 1385(a)(1), which requires inclusion of patronage dividends in income, unless an exception is met under section 1385(b). In contrast, the second approach does not conflict with either the requirements of section 199A or section 1385(a)(1). Also, the commenter noted, the patron's exception to income from patronage dividends for personal, living, or family items is met under section 1385(b)(2). For clarification in that case, the patron will have to make that determination, and none of the expense or patronage dividend should be taken into account for purposes of QBI. Based on this analysis, the final regulations in §1.199A-7(d)(3)(ii) adopt the second approach, and include an example illustrating the application of this approach.

iii. Relief from zero-presumption rule

As discussed previously, if a Cooperative fails to timely report qualified items and SSTB items, proposed §§1.199A-7(c)(3) and (d)(3) provide that the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero (zero-presumption rule). Commenters requested relief from the zero-presumption rule on the basis that Cooperatives may not be aware of the reporting requirements and may negligently fail to issue Forms 1099-PATR in a timely manner. For tax year 2019 filing, Cooperatives can report qualified payments on the Form 1099-PATR and can attach a supplemental schedule disclosing qualified items and SSTB items to patrons. For future filing years, the Form 1099-PATR will be updated to include boxes for qualified items and SSTB items. The final regulations do not provide relief from the zero-presumption rule, since the zero-presumption rule is a presumption that the patron may rebut with appropriate evidence or documentation. One example of appropriate evidence or documentation would be a corrected Form 1099-PATR received by the patron from the Cooperative.

C. Comments related to proposed §1.199A-7(f), special rules for patrons of Specified Cooperatives

i. Requirement for patrons to compute the section 199A(b)(7) reduction

The section 199A(b)(7) reduction is a statutory rule requiring, in the case of any qualified trade or business of a patron of a Specified Cooperative, that the amount determined under section 199A(b)(2) with respect to the trade or business be reduced by the lesser of (A) 9 percent of so much of the QBI with respect to the trade of business as is properly allocable to qualified payments (as defined in section

199A(g)(2)(E) and §1.199A-8(d)(2)(ii)), or (B) 50 percent of so much of the W-2 wages with respect to the trade or business as are so allocable. Proposed §1.199A-7(f)(1) provides that a patron of a Specified Cooperative that receives a qualified payment must reduce its section 199A(a) deduction as provided in §1.199A-1(e)(7) (which follows the language of section 199A(b)(7)), and the reduction applies whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in the taxable year.

Commenters requested an opt-out provision whereby patrons and Specified Cooperatives could elect out of the rules under sections 199A(b)(7) and (g). The final regulations do not adopt this request. There is no statutory provision providing for an opt-out of these Code sections. In the parallel situation under former section 199, there also was no opt-out provision. Specifically, the no-double-counting rule under former §1.199-6(l) precluded farmers from including qualified payments in their own former section 199 deduction. Further, permitting patrons and Specified Cooperatives to elect out of the rules under sections 199A(b)(7) and (g) would be difficult to administer and could result in patrons and Specified Cooperatives taking conflicting positions.

Some commenters have reasoned that turning off the section 199A(b)(7) reduction is justified based on the part of the qualified payment definition in section 199A(g)(2)(E)(iii), whereby the payment must be attributable to qualified production activities income (QPAI) with respect to which a deduction is allowed to the Specified Cooperative under section 199A(g)(1). However, section 199A(b)(7) applies when qualified payments are received by a patron in a qualified trade or business. The determination of whether a qualified payment was received is a different issue and is addressed in part II of this Summary of Comments and Explanation of Revisions.

ii. <u>Comments on interaction of section 199A(b)(7) reduction and §1.199A-4</u>

Commenters requested clarification on how the section 199A(b)(7) reduction operates with the aggregation rules in §1.199A-4. In certain circumstances, an individual may aggregate two or more trades or businesses for purposes of the QBI component calculation in §1.199A-1(d)(2)(iv), which includes application of the W-2 wage and UBIA of qualified property limitations under section 199A(b)(2). Aggregation is permitted but not required. Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. As commenters point out, aggregation of two or more trades or businesses may be favored by a taxpayer because it may provide better results when applying the W-2 wage and UBIA of qualified property limitations.

Commenters asked for clarification in two situations. First, commenters asked whether a patron who aggregates a rental real estate business and a farming business conducted with or through a Specified Cooperative may exclude the rental income from the section 199A(b)(7) reduction. This question relates to clarifying the rule in proposed §1.199A-7(f)(2)(i), which provides that for purposes of calculating the section 199A(b)(7) reduction, a patron must use a reasonable method based on all the facts and circumstances to allocate between income that is from qualified payments and income that is not from qualified payments. As a clarification, income that is not related to qualified payments can be earned in transactions that do not involve Specified Cooperatives, for example, a grain sale to a noncooperative customer. This means that the rental income, which is not income related to qualified payments, should be excluded when calculating the section 199A(b)(7) reduction for the aggregated trade or business.

Second, commenters asked whether in that same situation a patron is permitted to allocate the rental expenses toward the income from the Specified Cooperative, thus possibly lowering the section 199A(b)(7) reduction. Proposed §1.199A-7(f)(2)(i) provides that for purposes of calculating the section 199A(b)(7) reduction, a patron must use a reasonable method to allocate income items and related deductions. Thus, it would be reasonable to allocate that expense against qualified payments when calculating the section 199A(b)(7) reduction only to the extent the rental expense is related to the qualified payments from the Specified Cooperative. These aggregation principles are applied throughout the rules and examples of the final regulations and are consistent with the Proposed Regulations.

Commenters also inquired as to how negative QBI allocable to qualified payments affects the section 199A(b)(7) reduction. The Treasury Department and the IRS considered this comment and determined that there would be no section 199A(b)(7) reduction in such a case. An example illustrating this is a farmer conducting two types of agricultural businesses (A and B). Assume the farmer treats A and B as one trade or business for purposes of the section 199A(a) deduction. The farmer conducts A with non-Specified Cooperatives and B through a Specified Cooperative. The farmer generates $100 of qualifying income through A and receives $100 of qualifying income from a Specified Cooperative in B, all of which is also a qualified payment. The farmer has $180 of qualified expenses. For purposes of the section 199A(a) deduction, the farmer's QBI ($20) from the trade or business is used to calculate the deduction, resulting in a $4 deduction (assuming there is no limitation under section 199A(b)(2)(B)). The farmer then must determine if there is any section 199A(b)(7) reduction to this amount. The farmer reasonably allocates its qualified expenses under §1.199A-7(f)(2)(i) for purposes of calculating the section 199A(b)(7) reduction, and determines $110 of the qualified expenses are allocable to B (and $70 to A). The farmer will use only QBI from B to calculate the section 199A(b)(7) reduction because that is the only QBI properly allocable to qualified payments. Farmer's QBI for purposes of section 199A(b)(7)(A) is negative $10, resulting in a $0 section 199A(b)(7) reduction (regardless of W-2 wages under section 199A(b)(7)(B)).

iii. Comments on safe harbor allocation method in proposed §1.199A-7(f)(2)(ii)

Proposed §1.199A-7(f)(2)(ii) is a safe harbor providing a reasonable method for patrons with income under the threshold amount (set forth in section 199A(e)(2)) to allocate deductions and W-2 wages between income or gain related to qualified payments and income or gain that is not related to qualified payments when determining the section 199A(b)(7) reduction with respect to a patron's qualified trade or business. The method allows patrons to apportion deductions and W-2 wages ratably between income related to qualified payments and income not related to qualified payments. This means, for example, that the amount of deductions in QBI allocable to qualified payments is equal to the proportion of the total deductions that the amount of income or gain related to qualified payments bears to total income or gain used to determine QBI. The same proportion also applies when determining the amount of W-2 wages allocable to the portion of the trade or business that received qualified payments. In addition to considering the specific comments concerning proposed §1.199A-7(f)(2)(ii) described in this preamble, revisions necessary to clarify the scope and application of the safe harbor were made in §1.199A-7(f)(2)(ii) of the final regulations.

Commenters requested clarification on whether QBI under the safe harbor allocation method in proposed §1.199A-7(f)(2)(ii) includes: gross receipts from the sale of farm equipment, farm program payments (i.e., Conservation Reserve Program, Market Facilitation Program, Dairy Program, etc.), section 1245 recapture, and commonly owned rental income. One commenter recommended that gross receipts from the sale of equipment and machinery should be included in the calculation and allocated based on past depreciation (in the case of section 1245 recapture), and that gross receipts from farm programs be considered not related to qualified payments.

Another commenter recommended that both gains from section 1245 recapture, crop insurance receipts, government subsidy payments, and income from aggregated rental income under §1.199A-4 be not allocable to qualified payments received from Specified Cooperatives for purposes of section 199A(b)(7).

Section 199A(b)(7)(A) requires determining the QBI with respect to a trade or business that is properly allocable to qualified payments received from a Specified Cooperative, §1.199A-7(f)(2)(i) requires a reasonable method be adopted for making this determination, and the safe harbor under §1.199A-7(f)(2)(ii) allows patrons under the threshold amount to allocate the deductions and W-2 wages of a business between income related to qualified payments and income that is not related to qualified payments based on a ratio. The determination of whether the amounts mentioned by commenters are included in QBI of a trade or business, subject to the section 199A(b)(7) reduction, and how these amounts are allocated may change based on a patron's individual facts and circumstances and is not addressed in the final regulations.

One commenter also requested that the safe harbor method in proposed §1.199A-7(f)(2)(ii) apply to patrons with a trade or business that has average annual total gross receipts equal to $25,000,000 or less. This amount is equal to the threshold for the small business simplified overall method under proposed §1.199A-10(f)(1). Under the small business simplified overall method, a qualifying small Specified Cooperative may apportion total costs for the current taxable year between domestic production gross receipts (DPGR) and non-DPGR based on relative gross receipts for purposes of calculating the section 199A(g) deduction. The safe harbor in proposed §1.199A-7(f)(2)(ii) is different from the safe harbor in proposed §1.199A-10(f)(1). Proposed §1.199A-7(f)(2)(ii) is applied as part of the patron's calculation of the section 199A(a) deduction. In calculating the section 199A(a) deduction, the threshold amount (described in section 199A(e)(2)) is used in other circumstances to determine when a taxpayer must engage in more complex calculations, specifically the W-2 wage and UBIA of qualified property limitations in section 199A(b)(2)(B). Thus, it is consistent with section 199A(e)(2) for the safe harbor in proposed §1.199A-7(f)(2)(ii) to adopt the threshold amount. This contrasts with the small business simplified overall method in §1.199A-10(f)(1), used to compute the section 199A(g) deduction by a Specified Cooperative, and for which the threshold amount in section 199A(e)(2) is not relevant. Therefore, the final regulations do not adopt this request.

The commenter also suggested cooperative and noncooperative farming expenses should be allocable based on sales. The commenter believes that if an allocation based on sales is not allowed, then it will be impossible for cash basis taxpayers to offset input expenses from the prior year to harvest revenues in the following year, because taxpayers would have already claimed the expenses in the prior year. Moreover, because farmers do not know if crops are sold to a Specified Cooperative or noncooperative until the crops are harvested, the potential exists for allocations to be understated/overstated as it relates to either Specified Cooperative/noncooperative revenues. The reasonable method approach in §1.199A-7(f)(2)(i) of the Proposed Regulations, which is the approach adopted in the final regulations, accommodates these timing issues. A reasonable method is based on the facts and circumstances of the taxpayer and should provide the needed flexibility to accommodate this fact pattern.

D. <u>Comments on examples in proposed §1.199A-7(g)</u>

Commenters requested corrections to proposed §1.199A-7(g)(1), Example 1, because the allocation of W-2 wage expense is not proportional to the total expense allocation. This example illustrates that a reasonable method of allocation does not necessarily have to be proportional between W-2 wages and other expenses. This example is consistent with Example 1 in the Joint Committee Report. The Joint

Committee Report in footnote 133 explains that example and the general rule by stating that "[w]hich expenses are properly allocable in a given case will depend on all the facts and circumstances. The example assumes that the fraction of properly allocable W-2 wages differs from the fraction of other properly allocable expenses." Thus, a modification to the allocation in Example 1 of the proposed §1.199A-7(g)(1) is not warranted.

## II. §1.199A-8, Deduction for Income Attributable to Domestic Production Activities of Specified Cooperatives

### A. In General

Section 199A(g) provides a deduction for Specified Cooperatives and their patrons. This deduction is similar in many respects to the former section 199 deduction and, as provided in section 199A(g)(6), these regulations are based on the regulations applicable to Specified Cooperatives and their patrons under former section 199. The section 199A(g) deduction is calculated by the Specified Cooperative and is equal to 9 percent of the lesser of the Specified Cooperative's QPAI or taxable income (as modified by section 199A(g)(1)(C)) for the taxable year. There is a further limitation on the deduction equal to 50 percent of the Specified Cooperative's W-2 wages for the taxable year that are properly allocable to DPGR. Proposed §1.199A-8 provides definitions relating to the section 199A(g) deduction, which includes establishing the criteria that a Specified Cooperative must satisfy to be eligible to claim the section 199A(g) deduction, and sets forth the necessary steps for a Specified Cooperative to calculate the section 199A(g) deduction. This part II.A provides a general outline of proposed §1.199A-8, and the remainder of this part II addresses specific comments on proposed §1.199A-8. Other than as described in response to the specific comments, the final regulations generally follow the Proposed Regulations.

Proposed §1.199A-8(a), for purposes of section 199A(g), defines the terms patron (cross references proposed §1.1388-1(e)), Specified Cooperative, and agricultural or horticultural products. The definition of Specified Cooperative is consistent with section 199A(g)(4) and the Joint Committee Report, and reflects the 2018 Act's amendment to the definition originally provided by section 11011(a) of the TCJA.; that is, a Specified Cooperative no longer includes a Cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other Specified Cooperatives. The definition of agricultural or horticultural products in the Proposed Regulations is based upon the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926).

Proposed §1.199A-8(b) provides the four steps a Specified Cooperative that is not qualified as a farmer's cooperative organization under section 521 (nonexempt Specified Cooperative) performs to calculate its section 199A(g) deduction and includes definitions of relevant terms. Step 1, under proposed §1.199A-8(b)(2)(i), requires a Specified Cooperative to identify its patronage and nonpatronage gross receipts, and related cost of goods sold (COGS), deductible expenses, W-2 wages, etc. (collectively, deductions) and allocate these deductions to the gross receipts from patronage and nonpatronage activity. Proposed §1.199A-8(b)(2)(ii) directs a nonexempt Specified Cooperative to use only patronage gross receipts and related deductions when calculating the section 199A(g) deduction. Step 2, under proposed §1.199A-8(b)(3), requires a nonexempt Specified Cooperative to determine the patronage gross receipts that qualify as DPGR. Proposed §1.199A-9 provides rules for determining whether gross receipts are DPGR. Step 3, under proposed §1.199A-8(b)(4), requires a Specified Cooperative to calculate QPAI (including oil-related QPAI) from only patronage DPGR and patronage deductions. Further rules for allocating COGS and other expenses, losses, or deductions to patronage DPGR are in proposed §1.199A-10. A nonexempt Specified Cooperative calculates the section 199A(g) deduction using step 4, under proposed §1.199A-8(b)(5). Proposed §1.199A-8(b) also provides a definition of taxable income (including how to take net operating losses (NOLs) into account), rules on the use of the patronage section 199A(g) deduction, and special rules for nonexempt Specified Cooperatives that have oil-related QPAI.

Proposed §1.199A-8(c) provides rules explaining the steps a Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 (exempt Specified Cooperative) performs to calculate its section 199A(g) deduction. Generally, exempt Specified Cooperatives follow the same steps as nonexempt Specified Cooperatives, except that exempt Specified Cooperatives are not disallowed a section 199A(g) deduction based on nonpatronage gross receipts and related deductions. Instead, exempt Specified Cooperatives performs step 1 to identify patronage and nonpatronage gross receipts and related deductions, and then performs steps 2 through 4 in proposed §1.199A-8(b) twice, to calculate a patronage section 199A(g) deduction and a nonpatronage section 199A(g) deduction. Proposed §1.199A-8(c)(4)(ii) explains that the nonpatronage section 199A(g) deduction can be used only against nonpatronage income and cannot be passed through to patrons.

Proposed §1.199A-8(d) provides rules for Specified Cooperatives passing through the section 199A(g) deduction to patrons. In general, under proposed §1.199A-8(d)(1), a Specified Cooperative may pass through all, some, or none of the section 199A(g) deduction to patrons who are eligible taxpayers as defined in section 199A(g)(2)(D), that is, (i) a patron that is other than a corporation defined in section 1361(a)(2) (C corporation) or (ii) a patron that is a Specified Cooperative. Proposed §1.199A-8(d)(2) limits the amount of the section 199A(g) deduction that a Specified Cooperative can pass through to the portion of the section 199A(g) deduction that is allowed with respect to the QPAI to which the qualified payments (defined in proposed §1.199A-8(d)(2)(ii)) made to the eligible taxpayer are attributable. Proposed §§1.199A-8(d)(3) through (7) further outlines the written notice requirement to pass through the deduction to a patron, the patron's ability to deduct the section 199A(g) passed through (generally limited to the patron's taxable income), that a Specified Cooperative that is passed through a section 199A(g) deduction as an eligible taxpayer is limited to taking the deduction only against patronage gross income and related deductions, that the W-2 wage limitation is applied only at the Specified Cooperative level, and that a Specified Cooperative must reduce its section 1382 deduction by an amount equal to the section 199A(g) deduction passed through to its eligible patrons.

The remainder of proposed §1.199A-8 covers a variety of issues. Proposed §1.199A-8(e) provides examples that illustrate the rules in proposed §1.199A-8(b) through (d). Proposed §1.199A-8(f) provides guidance for Specified Cooperatives that are partners in a partnership. Proposed §1.199A-8(g) provides guidance on the recapture of a claimed section 199A(g) deduction. Finally, proposed §1.199A-8(h) generally provides that taxpayers may rely on the proposed rules in their entirety and as applied in a consistent manner until final regulations are published in the **Federal Register**.

B. <u>Comments related to definition of "agricultural or horticultural products"</u>

i. <u>General comments on definition</u>

Section 199A(g)(3)(D) defines DPGR as the gross receipts of a taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition (collectively, disposition) of any agricultural or horticultural product that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or significant part within the United States. Proposed §1.199A-8(a)(4) defines <u>agricultural or horticultural products</u> as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802

(1926). Agricultural or horticultural products also include aquatic products that are farmed whether by an exempt or a nonexempt Specified Cooperative. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE by a Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property (other than as provided in the exception in §1.199A-9(b)(2)); for example, an agricultural or horticultural product includes a seed that is grown, but does not include the intangible property right to reproduce a seed for sale. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would all qualify as DPGR from the disposition of agricultural or horticultural products (assuming all other requirements of section 199A(g) are met). However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product.

One commenter requested that the definition be omitted on the premise that the meaning of farming and agricultural or horticultural product is generally understood by the agricultural community and their advisors, and argued that there was no current, comprehensive definition of these terms in the Code or regulations. Because section 199A(g) is focused solely on dispositions of agricultural or horticultural products, as opposed to the broader scope of former section 199, the Treasury Department and the IRS have determined a definition is necessary to provide guidance on the limits of the section 199A(g) deduction. As an alternative to removing the definition, the commenter recommended against referencing non-tax legislation or regulations because the definitions were developed independent of tax law. The Treasury Department and the IRS have determined that using the definition from the Proposed Regulations, based on a pre-existing definition from non-tax cooperative law specifically referencing the type of cooperative at issue here, is the best alternative, but have made some modifications based on the commenter’s suggested definition. The definition in the final regulations includes parts of the commenter’s suggested definition, by providing examples (without limitation) of products that are considered agricultural or horticultural products, including specific agricultural or horticultural products, livestock products, edible forestry products, and farmed aquatic products.

ii. Comments on exclusion of intangible property

A commenter requested that the definition of agricultural or horticultural products include intangible property. The commenter reasoned that because a license is a disposition under section 199A(g)(3)(D) for purposes of determining if gross receipts qualify as DPGR, an exploitation of intangible property is implied. However, the inclusion of the term license under section 199A(g)(3)(D) does not impact the definition of agricultural or horticultural products. The term license also appeared in former section 199(c)(4)(A)(i), which was the equivalent of section 199A(g)(3)(D) under former section 199. Under former section 199, DPGR generally meant the gross receipts of the taxpayer derived from qualifying production property (QPP) which was MPGE by the taxpayer in whole or significant part within the US. Income from the disposition of intangible property (with the specific exception of computer software, sound recordings under section 168(f)(4), and qualified films under former section 199(c)(6)) were generally excluded from DPGR. This was because intangible property was not QPP (as defined in former section 199(c)(5), also see former §1.199-3(j)(2)(iii)). The proposed definition and rules reach a similar result for purposes of section 199A(g).

Also related to intangible property, the commenter specifically requested that gross receipts qualify as DPGR from the disposition of an agricultural or horticultural product when a Specified Cooperative enters into a long-term arrangement with an unrelated third party, under which (1) the Specified Cooperative develops a finished retail product with the unrelated third party, (2) the finished retail product contains a patron's product as an ingredient, and (3) the Specified Cooperative receives a royalty or license fee based on the sale of the finished retail product irrespective of whether the Specified Cooperative's brand, label, and/or tradename is featured on the finished retail product. The situation described by the commenter is very fact specific and raises multiple possible issues for purposes of section 199A(g). Among the issues to consider are what property or properties the Specified Cooperative is deriving gross receipts from in the normal course of business, and which party is the producer of the property. Because of the fact specific nature of the comment, and multiple possible outcomes, there is no rule or example to address this specific situation in the final regulations.

After consideration of the comments, the final regulations maintain the approach in the Proposed Regulations that the definition of agricultural or horticultural products does not include intangible property, but also provide language further clarifying the exclusion. The clarifying language provides that intangible rights include the rights to MPGE and sell an agricultural or horticultural product with certain characteristics protected by a patent and the trademark of a brand. Further examples 9 and 10 have been added to §1.199A-8(e) to illustrate concepts related to intangible property transactions and the disposition of agricultural or horticultural products.

iii. Comments on "other supplies"

Included in the definition of agricultural or horticultural products are other supplies that are MPGE by the Specified Cooperative. A commenter suggested that the MPGE requirement be removed from "other supplies" on the basis that Joint Committee Report footnote 120 cites §1.199-6(f), which made no mention of a MPGE requirement as it pertained to "other supplies" being agricultural or horticultural products. However, footnote 120 explicitly mentions a MPGE requirement as it pertains to other supplies.

The Joint Committee Report also explains that after the amendments to section 199A(g) made by the 2018 Act, “[t]he definition of [specified agricultural or horticultural cooperative] no longer includes a [C]ooperative solely engaged in the provision of supplies, equipment, or services to farmers or other specified agricultural or horticultural cooperatives.” Joint Committee Report, 23. Based upon these considerations, subjecting “other supplies” to a MPGE requirement before being considered agricultural or horticultural products is appropriate.

Commenters also requested that “other supplies” be further illustrated with examples. The final regulations include more examples of “other supplies” such as seed, feed, herbicides, and pesticides.

Finally, one commenter requested that language be added to the definition of agricultural or horticultural products to include supplies used in activities under §1.199A-9(f)(2) and (3). Under proposed §1.199A-9(f)(2) and (3), if the Specified Cooperative performs packaging, repackaging, labeling, or installation with respect to an agricultural or horticultural product and engages in no other MPGE activity with respect to that agricultural or horticultural product, the Specified Cooperative’s activity does not qualify as MPGE with respect to that agricultural or horticultural product. Based on this rule, to the extent a Specified Cooperative performs MPGE activities with respect to an agricultural or horticultural product, and in conjunction performs a packaging, repackaging, labeling, or installation activity, the activities are treated as part of the MPGE of the agricultural production. The packaging or labeling materials used may also be treated as part of the agricultural or horticultural product. For example, if a Specified Cooperative packages an agricultural or horticultural product that the Specified Cooperative had MPGE, then the packaging activity is treated as part of the MPGE of the agricultural or horticultural product, and gross receipts from the sale of the packaged agricultural or horticultural product all qualify as DPGR, assuming all other requirements for such treatment are met. However, property packaged or offered with an agricultural or horticultural product that is not an agricultural or horticultural product (or packaging) is not considered part of the agricultural or horticultural product.

C. Identifying patronage items and exclusion of nonpatronage items for nonexempt Specified Cooperatives

As previously described, proposed §1.199A-8(b) outlines a four-step process for nonexempt Specified Cooperatives to use in calculating the section 199A(g) deduction. Step 1, in proposed §1.199A-8(b)(2)(i) and (ii), requires a nonexempt Specified Cooperative to identify its gross receipts, COGS, deductions, W-2 wages, etc. as patronage or nonpatronage, and allows only the patronage activities to be included in the calculation of the section 199A(g) deduction. One commenter described step 1 as burdensome and unnecessary, and suggested removal of that step. Further, the commenter asserted that both patronage and nonpatronage activities should be included in the section 199A(g) deduction calculation for nonexempt Specified Cooperatives. The commenter provided, as an alternative to removal of that step, that these rules be reserved until the conclusion of litigation under former section 199 relating to the calculation of the former section 199 deduction by Specified Cooperatives.

The Treasury Department and the IRS decline to adopt these comments in the final regulations for the reasons described in the following paragraphs. However, the final regulations make revisions to the proposed regulations to benefit and reduce complexity for Specified Cooperatives with de minimis gross receipts from nonpatronage activities.

Section 199A(g)(4)(A) defines a Specified Cooperative, in part, as an organization to which part I of subchapter T applies. Under section 1381(a)(2), subchapter T applies to any corporation operating on a cooperative basis, with certain exceptions not relevant here. In the commenter’s view, this means that if subchapter T applies, it applies to the entire corporation, and the benefits of the section 199A(g) deduction should follow that determination. In support of this position, the commenter argues that the plain language of the statute and the Joint Committee Report do not limit the deduction to patronage activities. The commenter's view fails to properly take into account how subchapter T applies to nonexempt Cooperatives that have both cooperative and noncooperative operations. This is an especially important consideration because of the exclusion of C corporations from the definition of eligible taxpayers under section 199A(g)(2)(D)(i), and the fact that section 199A as a general matter is not intended to benefit C corporations.

When a nonexempt Cooperative does not act entirely on a cooperative basis under subchapter T, its activities are characterized as patronage or nonpatronage, and accordingly, the tax items from these distinct activities receive different treatment. See Buckeye Countrymark, Inc. v. Comm'r, 103 T.C. 547, at 559 (1994) (explaining that "subchapter T requires nonexempt cooperatives to separate income and deductions into two categories or baskets, one for patronage income and deductions and one for nonpatronage income and deductions") and Farm Service Coop. v. Comm'r, 619 F.2d 718 (8th Cir. 1980) (subchapter T prohibits the netting of patronage losses against nonpatronage income). Cooperative activities generate patronage income and deductions and are taxed on a cooperative basis, generally resulting in a single-level of tax to the Cooperative or the patrons after application of the rules under subchapter T. See Joint Committee Report, 20 (explaining that "excluding patronage dividends and per-unit retain allocations paid by the cooperative from the cooperative's taxable income in effect allows the cooperative to be a conduit with respect to profits derived from transactions with its patrons"). In contrast, noncooperative activities of a Cooperative generate nonpatronage income and deductions and are taxed like a for-profit business of a C corporation, resulting in a double-level of tax, that is, at both the Cooperative and patron levels. See, for example, Farm Service at 723, and Conway Cty. Farmers Ass'n v. United States, 588 F.2d 592, 596 (8th Cir. 1978) (describing nonpatronage income as being taxed as a for-profit business in case where organization found to be operating on a cooperative basis with more than 50 percent of business done with nonmembers).

There is limited guidance as to how much of an organization's activities must be conducted on a cooperative basis for the organization to qualify as a Cooperative under subchapter T, but the available guidance suggests a low threshold in certain cases. To the extent this is true, it allows for the noncooperative activities to be of substantial value relative to the organization's cooperative activities. For example, in Columbus Fruit and Vegetable Coop. Ass'n, Inc. v. United States, 7 Cl. Ct. 561 (March 27, 1985), the court held that an agricultural organization whose sales of members' merchandise accounted for only about 24 percent of value of its total sales for the tax years in question was nevertheless a corporation operating on a cooperative basis within the meaning of the Code, and thus was entitled to deduct patronage dividends paid to its members.

The Treasury Department and IRS compared how application of the rules of subchapter T aligned with the commenter's proposal and with the Proposed Regulations and found the subchapter T rules align better with the Proposed Regulations. Among the scenarios considered were C corporations engaged in the following: (1) an agricultural business with no cooperative activities (scenario 1); (2) an agricultural business operating entirely on a cooperative basis considered a nonexempt Specified Cooperative (scenario 2); and, (3) an agricultural business with a mixed percentage of business from cooperative and noncooperative activities that qualifies as a nonexempt Specified Cooperative (scenario 3).

In the first and second scenarios, both the commenter's proposal and the Proposed Regulations reach the same conclusions. In the first scenario, because none of the organization's activities are conducted on a cooperative basis, subchapter T does not apply to the organization, and the organization receives no benefits from the section 199A(g) deduction. In the second scenario, because all the organization's activities are conducted on a cooperative basis, the benefits of subchapter T apply to all of the organization's activities, and the organization can calculate the section 199A(g) deduction based on all its activities.

It is the third scenario where the conclusions under the commenter's proposal and the Proposed Regulations differ. Under the commenter's proposal, subchapter T applies to the organization and so the organization should calculate a single section 199A(g) deduction by aggregating the patronage income, deductions, etc., resulting from cooperative activities and the nonpatronage income, deductions, etc., resulting from noncooperative activities. The commenter's proposal would permit a Specified Cooperative to calculate and take the section 199A(g) deduction on its business activities that are not operated on a cooperative basis (those activities that generate income that is taxed as that of a C corporation). This would be the case even where a substantial portion of the income of the Specified Cooperative is generated from business activities not operated on a cooperative basis. In contrast, the Proposed Regulations allow the organization to calculate the section 199A(g) deduction based only on the patronage income, deductions, etc., resulting from the organization's cooperative activities.

The Proposed Regulations, and not the commenter's proposal, align with subchapter T and the structure and intent of section 199A. Under subchapter T, a nonexempt Cooperative with both cooperative and noncooperative activities receives beneficial single-level tax treatment only on its patronage income, and its income from operating as a C corporation (that is, nonpatronage income) receives double-level tax treatment. <u>Farm Service</u> at 723. Generally, section 199A was structured to give businesses that are not operating as C corporations a deduction that corresponds to the TCJA's reduction of the top corporate rate of tax from 35 percent to 21 percent under section 11. Indeed, Congress needed to specifically clarify that Specified Cooperatives could benefit from the section 199A deduction because Cooperatives are C Corporations. See section 1382(a)(2). That is, Congress, in including section 199A(g), was making sure that Specified Cooperatives received a benefit when operating as Cooperatives. This also makes sense when considering that patronage distributions deductible under section 1382 to a Specified Cooperative, which enable the Specified Cooperative to act as a conduit for its patrons, are taxed to the patrons eligible for the section 199A(a) deduction at individual rates. The Proposed Regulations align with this intent because only the activities resulting in patronage income receive beneficial treatment under section 199A(g), and income arising from nonpatronage activities continues to be taxed as income from a C corporation. Were the result as requested by commenter, a C corporation conducting a portion of its business on a cooperative basis would receive the benefits of both the reduced corporate income tax rate and the section 199A(g) deduction with respect to its nonpatronage activities, giving it a competitive advantage relative to a regular C corporation.

The commenter also referred to section 199A(g)(6), which provides that the Secretary shall prescribe regulations as are necessary to carry out the purposes of section 199A(g), and that the regulations shall be based on the regulations applicable to Cooperatives and their patrons under section 199 (as in effect before its repeal). The commenter noted that the former section 199 regulations did not exclude nonpatronage income from the calculation of the former section 199 deduction. However, because there are material differences between former section 199 and section 199A, section 199A(g)(6) does not require that the section 199A(g) regulations replicate or duplicate the former section 199 regulations in their entirety. The former section 199 regulations did not specifically address an organization with cooperative and noncooperative operations because former section 199 applied to all categories of businesses, including C corporations, whether operating on a cooperative basis, noncooperative basis, or both. In contrast to the former section 199 deduction, the section 199A(g) deduction, which must be read in the context of section 199A, does not apply to C corporations generally. Unlike for the former section 199 regulations, clarification of this distinction is necessary to carry out the purposes of section 199A(g), which include providing the section 199A(g) deduction for the patronage activities of Specified Cooperatives. Clarification of this distinction is also necessary to assist taxpayers in complying with the law, as well as to aid the proper administration of section 199A(g).

The Treasury Department and the IRS also considered the recent opinions in Ag Processing, Inc. v. Comm'r, 153 T.C. No. 3 (2019), and Growmark, Inc. & Subsidiaries v. Comm'r, T.C. Memo. 2019-161. These cases are the litigation referred to by the commenter. In Ag Processing and Growmark, the Tax Court determined that under former section 199, a nonexempt agricultural Cooperative should calculate the section 199 deduction in the aggregate by combining patronage and nonpatronage items and then allocating the total section 199 deduction between the Cooperative's patronage and nonpatronage businesses. These cases do not support, and in fact, conflict with the commenter's proposal in that they require an allocation of the former section 199 deduction between patronage and nonpatronage businesses. At the same time, the Tax Court's approach in these cases allows the proceeds of the cooperative and noncooperative businesses to be combined to calculate an aggregate deduction before allocation. The allowance of an aggregate calculation highlights the difference between section 199A(g), benefitting solely cooperative activities, and former section 199, benefitting both cooperative and noncooperative activities. Thus, the cases do not necessitate that final regulations adopt an approach different from that of the Proposed

Regulations. Based on the commenter's proposal, the Treasury Department and IRS considered calculating the section 199A(g) deduction on an aggregate basis and then disallowing the nonpatronage portion, but this would require unnecessary calculations and likely prove less accurate than the straightforward calculation provided in the Proposed Regulations.

Finally, the Treasury Department and IRS considered how the commenter's proposal would align with the treatment of exempt Specified Cooperatives. The commenter's proposal would allow both exempt and nonexempt Specified Cooperatives to calculate their section 199A(g) deductions based on both cooperative and noncooperative activities. The Proposed Regulations permit only exempt Specified Cooperatives to calculate their section 199A(g) deductions based on both cooperative and noncooperative activities. Under subchapter T, exempt Cooperatives can receive the beneficial single-level tax treatment with respect to both types of business activities while nonexempt Cooperatives cannot. In effect, by meeting the requirements of section 521, the entirety of an exempt organization's operations can be treated as done on a cooperative basis. Exempt Specified Cooperatives, thus, are effectively equivalent to the described scenario 2 (a nonexempt Specified Cooperative operating entirely on a cooperative basis). The commenter's proposal would provide the same benefits of the section 199A(g) deduction to nonexempt Specified Cooperatives without requiring those Cooperatives to meet the requirements of section 521.

In summary, the Treasury Department and the IRS have determined that retaining step 1 in proposed §1.199A-8(b)(2)(i) and (ii) is the approach for calculating the section 199A(g) deduction that best reflects the law and is most consistent with the scope of section 199A(g) and the application of subchapter T to nonexempt Cooperatives.

The final regulations, however, revise the rule for applicable gross receipts in §1.199A-8(b)(2)(ii) to allow a Specified Cooperative to include all nonpatronage gross receipts in non-DPGR for purposes of the de minimis rules in §1.199A-9(c)(3), while also increasing the de minimis percentage in the de minimis rules in §1.199A-9(c)(3) from 5 percent to 10 percent. These revisions expand the type of gross receipts eligible for the de minimis rules and should increase the number of Specified Cooperatives that can apply the de minimis rules. Applying the de minimis rule in §1.199A-9(c)(3)(i) after these revisions means that a Specified Cooperative when calculating its patronage section 199A(g) deduction can treat all of its gross receipts as DPGR when the Specified Cooperative derives less than 10 percent of its total gross receipts from non-DPGR (with non-DPGR now possibly including all gross receipts from nonpatronage as well as other patronage non-DPGR). While this provides the benefit of increased DPGR, application of the de minimis rule in §1.199A-9(c)(3)(i) also reduces complexity by simplifying the allocations needed to calculate the section 199A(g) deduction. Under §1.199A-9(c)(3)(ii), the revisions also make it possible for any Specified Cooperative deriving less than 10 percent of their gross receipts from DPGR to treat all of their gross receipts as non-DPGR. The final regulations also update §1.199A-8(b)(5)(ii)(C), §1.199A-8(c)(2) and (4), and §1.199A-12(b)(1) to take these revisions into account.

D. Exempt Specified Cooperative calculation of nonpatronage section 199A(g) deduction

Rules for exempt Specified Cooperatives to calculate the section 199A(g) deduction were included in proposed §1.199A-8(c). Specifically, under proposed §1.199A-8(c)(2), an exempt Specified Cooperative calculates separate patronage and nonpatronage section 199A(g) deductions, as is consistent with the administration of former section 199. One commenter disputed that separate calculations were required under former section 199 and further stated that separate calculations are unnecessary since exempt Specified Cooperatives are permitted the section 199A(g) deduction on both their patronage and nonpatronage income. Contrary to the commenter's assertion, the instruction to line 25 for Agricultural and Horticultural Cooperatives on the Form 8903, Domestic Production Activities Deduction, makes clear that the calculations are made separately. This step is necessary because allowing an aggregate calculation and allocation results in less accurate patronage and nonpatronage deductions because alignment of the appropriate W-2 wages, COGS, and other expenses from an activity with the income from that activity is lost on aggregation, and difficult to rectify on allocation. For these reasons, the final regulations maintain the requirement of separate calculations of the patronage section 199A(g) deductions and nonpatronage section 199A(g) deductions by exempt Specified Cooperatives. However, the revisions in the final regulations to §1.199A-8(b)(2)(ii) and the increase in the de minimis percentage under §1.199A-9(c)(3) will simplify the allocations needed to calculate the section 199A(g) deduction for an exempt Specified Cooperative with de minimis nonpatronage gross receipts.

E. Definition of Taxable Income

i. General definition comments

Proposed §1.199A-8(b)(5)(ii)(C) provides that taxable income is defined in section 1382 and §1.1382-1 and §1.1382-2. For purposes of determining the amount of the deduction allowed under §1.199A-8(b)(5)(ii), taxable income is limited to taxable income and related deductions from patronage sources. Patronage NOLs reduce taxable income. Taxable income is determined without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Further, taxable income is determined using the same method of accounting used to determine distributions under section 1382(b) and qualified payments to eligible taxpayers.

One commenter stated that the definition of taxable income should refer to section 63, and take into account both patronage and nonpatronage income (including

NOLs) on an aggregate basis. The Treasury Department and the IRS agree that section 63 generally defines taxable income. In response, the definition of taxable income in the final regulations has been modified so that it also includes a reference to section 63. However, consistent with the exclusion of nonpatronage items from the calculation of the section 199A(g) deduction, the final regulations continue to limit the definition to patronage taxable items for purposes of the limitation.

The commenter also stated that the requirement that Specified Cooperatives use the same method of accounting to determine taxable income, distributions under section 1382(b), and qualified payments is in error. Specifically, commenter stated that patronage dividends or other similar payments to patrons can be calculated on a book basis because it is a more accurate economic measure of income over time. The commenter provided an example where accelerated depreciation and other book/tax items often cause timing differences that may disproportionately benefit longer-term patrons over shorter-term patrons. Commenter further maintained that Cooperatives have been allowed to determine payments to patrons pursuant to methods other than on tax basis. The commenter pointed to section 1388(a)(3), which in defining patronage dividends, references the net earnings of the organization. In the commenter’s view, the use of net earnings rather than taxable income means that net earnings do not necessarily correlate to taxable income. Further, the commenter pointed to Example 2 of former §1.199-6(m) that included language indicating patronage distributions could be paid based on book or Federal income tax net earnings, as well as the requirement on Form 1120-C (U.S. Income Tax Form for Cooperative Associations) that a cooperative disclose the method of accounting used to compute distributable patronage income, with the choices being “Book,” Tax,” and “Other.”

In reviewing this part of the definition, the Treasury Department and the IRS determined it is unnecessary for defining taxable income to include the requirement that taxable income is determined using the same method of accounting used to determine distributions under section 1382(b) and qualified payments to eligible taxpayers. Accordingly, the final regulations do not include this requirement in §1.199A-8(b)(5)(ii)(C) and also do not include a similar requirement in §1.199A-8(c)(4)(i). The commenter's example and reasoning, however, relate more to the deductibility under section 1382 of distributions to patrons calculated on a book basis when there are book/tax differences, which is outside of the scope of the final regulations. No inference as to the deductibility of distributions to patrons under section 1382 is intended by removing this language (regardless of the method used to determine the payments).

ii. Comments on net operating loss (NOL) ordering rules

Proposed §1.199A-8(b)(5)(ii)(C) provides that patronage NOLs reduce taxable income. However, taxable income does not take into account the section 199A(g) deduction or any deduction allowable under section 1382(b). A commenter requested clarification on ordering rules concerning the interplay of NOLs, section 1382(b), and section 199A(g) deductions. Specifically, the commenter requested that final regulations clarify that the amount of an NOL that is taken into account for purposes of calculating the section 199A(g) deduction is the amount that the Specified Cooperative actually used in computing taxable income on its tax return for the year. The commenter further suggested that NOLs should not be regarded as having been used against any patronage dividends or per-unit retain allocations that are disregarded in computing taxable income for purposes of the section 199A(g) deduction limitation. The commenter provided an example where a nonexempt Specified Cooperative generated $100 of QPAI and taxable income, without taking account any of its deductions under section 1382(b) or section 199A(g), or an NOL carryover of $500. In the commenter's example, the nonexempt Specified Cooperative was able to calculate and use a $9 section 199A(g) deduction, pay out a $91 patronage dividend, and avoid using any of the $500 NOL carryover.

In consideration of the commenter’s example, the Treasury Department and the IRS reviewed Examples 1 and 2 in former §1.199-1(b)(2), which illustrated that when calculating and using the former section 199 deduction, taxable income is reduced by any available NOL or NOL carryovers, before being reduced by the section 199 deduction. This avoided having the former section 199 deduction create or increase an NOL, but did not illustrate how section 1382 deductions impacted the calculation or use of the former section 199 deduction. Consistent with former section 199, taxable income for purposes of calculating the section 199A(g) deduction should take into account an NOL or NOL carryover. After calculation, the section 199A(g) deduction should not create or increase an NOL or NOL carryover. The section 199A(g) deduction also should not be used as a substitute for an NOL carryover when a Specified Cooperative has taxable income remaining after its section 1382 deductions, but before the section 199A(g) deduction is taken.

Using the facts of the commenter’s example, this means that for purposes of calculating the section 199A(g) deduction, the $500 NOL carryover should reduce taxable income by $9, which is the amount that remains after the section 1382(b) deduction. Taxpayer would calculate a section 199A(g) deduction based on $91 (the lesser of QPAI ($100) or taxable income ($91), without taking section 1382(b) deduction into account). As a result under these facts, taxpayer would have $0 of taxable income after taking a section 1382 deduction of $91 and using $9 of the $500 NOL carryover (leaving a $491 NOL carryover). The Specified Cooperative could pass through the section 199A(g) deduction to patrons and reduce its section 1382 deduction accordingly. However, if the Specified Cooperative did not pass through the section 199A(g) deduction it would be lost because the deduction cannot increase an NOL carryover.  In accordance with this analysis, the definition of taxable income in §1.199A-8(b)(5)(ii)(C) and the rules in §1.199A-8(b)(6) related to a Specified Cooperative using the section 199A(g) deduction have been updated.  To illustrate this ordering rule, example 5 has also been added under §1.199A-8(e).  Based on this ordering rule and its reasoning, the Treasury Department and the IRS decline to adopt the commenter's approach permitting Specified Cooperatives to reduce taxable income by taking the section 199A(g) deduction before using an NOL, but clarify that NOLs are not used against taxable income that is the result of not taking into account section 1382 deductions when calculating the section 199A(g) deduction.

The commenter also stated that the examples in the proposed regulation (Examples 6 and 7 of proposed §1.199A-8(e)) do not consider the more realistic case where the Specified Cooperative made payments to patrons that were deductible under section 1382(b).  The Treasury Department and the IRS agree with this statement, and the new example in §1.199A-8(e) replaces those examples from the Proposed Regulations.

F.  <u>Pass Through of Section 199A(g) Deduction</u>

Sections 1.199A-8(d)(1) and (2) of the Proposed Regulations allow a Specified Cooperative, at its discretion, to pass through all, some, or none of its patronage section 199A(g) deduction to an eligible taxpayer (i.e., a patron other than a C Corporation or a patron that is a Specified Cooperative), but the amount passed through to any eligible taxpayer is limited to the allowable portion of the section 199A(g) deduction with respect to the QPAI to which the qualified payments made to the eligible taxpayer are attributable.  The intent of the proposed rule was to allow the Specified Cooperative the benefit of retaining and using the amounts equal to the section 199A(g) deduction attributable to non-eligible taxpayers (who will not be able to use the deduction) at the Specified Cooperative level, even when the Specified Cooperative chooses to pass through all or some of the section 199A(g) deduction attributable to patrons that are eligible taxpayers. Consistent with section 199A(g)(2)(A)(ii), proposed §1.199A-8(d)(3) provides that a Specified Cooperative must identify in a written notice the amount of the deduction passed through to an eligible taxpayer, and the notice must be mailed by the Specified Cooperative to the eligible taxpayer no later than the 15th day of the ninth month following the close of the taxable year of the Specified Cooperative. The 15th day of the ninth month coincides with the end of the payment period as described in section 1382(d).

Commenters asked that the final regulations clarify that a Specified Cooperative will not be penalized if it passes through information relating to a section 199A(g) deduction to a non-eligible taxpayer, and that the ultimate determination of whether the deduction that is passed through can be used is the responsibility of the patron. One of these commenters indicated that section 199A(g)(2)(A) does not require the Specified Cooperative to determine the eligibility of all of its patrons. The Treasury Department and the IRS recognize that it may be difficult for a Specified Cooperative to determine the eligibility status of all patrons, and agree that the ultimate determination of eligibility should be made at the patron level. Therefore, the final regulations provide that a Specified Cooperative may pass through all, some, or none of the section 199A(g) deduction to all patrons, with appropriate adjustments to the section 1382 deduction depending on the amount passed through, but that only eligible taxpayers may claim the section 199A(g) deduction that is passed through. In considering this comment, the Treasury Department and the IRS also considered proposed §1.199A-8(d)(5), which provides special rules for eligible taxpayers that are Specified Cooperatives, and that provides a Specified Cooperative that receives a section 199A(g) deduction can take the deduction only against patronage gross income and related deductions. The final regulations clarify the rule to be consistent with the nonpatronage disallowance for nonexempt Specified Cooperatives and also provide that only an exempt Specified Cooperative can take a section 199A(g) deduction passed through from another Specified Cooperative if the deduction relates to the patron Specified Cooperative's nonpatronage gross income and related deductions.

In addition to requesting that Specified Cooperatives not be required to identify the eligibility of all patrons, commenters requested that if a Specified Cooperative does obtain the tax status of its patrons so as not to pass through the section 199A(g) deduction to an non-eligible taxpayer, then the Specified Cooperative should be allowed to retain and use the section 199A(g) deduction from patrons that are non-eligible taxpayers while passing through the section 199A(g) deduction to patrons that are eligible taxpayers, subject to the section 199A(g)(1)(A)(ii) limitation. The Treasury Department and the IRS intended this result in the Proposed Regulations and have revised §1.199A-8(d)(1) to clarify that if a Specified Cooperative obtains the tax status of a patron that is an non-eligible taxpayer, the Specified Cooperative may retain the section 199A(g) deduction attributable to that patron, even when passing through the deduction to other patrons. Example 11 under §1.199A-8(e) has also been added to illustrate allocation rules for situations in which a Specified Cooperative retains the section 199A(g) deduction attributable to non-eligible taxpayers.

Another commenter also requested relief from the notice requirements in proposed §1.199A-8(d)(3) in the event that a Specified Cooperative wishes to pass through the section 199A(g) deduction to patrons but does not send the notice before the payment period ends, or passes through an incorrect amount of the section 199A(g) deduction during the payment period. Specifically, the commenter asked if there is a way to issue a late notice or to void or otherwise reissue a notice after the payment period. The requirement of identifying the amount passed through during the payment period is from section 199A(g)(2)(A)(ii). Further, no administrative remedies of this type existed under former section 199. The former section 199 rules required the notice to be provided during the payment period, and this notice worked in conjunction with the recapture provision in former §1.199-6(k) and the no-double counting rule in former §1.199-6(l). Finally, the payment period is also used in determining whether a distribution is deductible under section 1382(b), so a consistent interpretation is appropriate. Thus, no changes were made with respect to this comment.

G. Comments on definition of qualified payments

Section 199A(g)(2)(E) defines qualified payment, with respect to any eligible taxpayer, as any amount which is (i) described in section 1385(a)(1) or (3), (ii) received by the taxpayer from a Specified Cooperative, and (iii) is attributable to QPAI with respect to which a deduction is allowed to the Specified Cooperative under section 199A(g)(1). Proposed §1.199A-8(d)(2)(ii) defines qualified payment as "any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a Specified Cooperative that is attributable to the portion of the Specified Cooperative's QPAI, for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the taxable year. A Specified Cooperative calculates its qualified payment using the same method of accounting it uses to calculate its taxable income." The inclusion of advances on patronage and per-unit retains paid in money during the taxable year is consistent with the definition in former §1.199-6(e).

The commenter asserted that when a Specified Cooperative's section 199A(g) deduction is W-2 wage-limited under section 199A(g)(1)(B), section 199A(g)(2)(E)(iii) requires qualified payments to reflect the limitation for purposes of the section 199A(b)(7) reduction. The commenter provided an example where the Cooperative's W-2 wage-limited section 199A(g) deduction is $50, but would have been $100 absent the W-2 wage limitation, and so the commenter proposed that only 50 percent of patronage dividends (or per-unit retain allocations) would be "qualified payments" under section 199A(g)(2)(E).

The definition of qualified payment in former section 199 and section 199A is almost identical. Under former section 199, the definition in section 199(d)(3)(E)(iii) provided that a qualified payment is an amount which is attributable to QPAI with respect to which a deduction is allowed to such cooperative under section 199(a). Section 199(A)(g)(2)(E)(iii) provides the same except that it refers to the deduction allowed to such cooperative under section 199A(g)(1). In former section 199, the amount allowed under former section 199(a) did not consider the W-2 wage limitation, which was in section 199(b). Section 199A(g)(1) is organized so that section 199A(g)(1)(A) is equivalent to former section 199(a) and section 199A(g)(1)(B) is equivalent to former section 199(b).

The Proposed Regulations interpreted the definition of qualified payment as referring to payments that relate to gross receipts that are allowable in the QPAI of a Specified Cooperative for which a deduction is allowed under section 199A(g)(1)(A). This is consistent with the language used in section 199A(g)(1)(A), which provides that there shall be allowed a deduction equal to 9 percent of the lesser of (i) QPAI of the taxpayer for the taxable year, or (ii) the taxable income of the taxpayer for the taxable year. As relevant, this language parallels former section 199(a). This interpretation is directly supported by Example 1 of the Joint Committee Report, which illustrates that payments to the patron are considered qualified payments for purposes of the section 199A(b)(7) reduction when the issuing Specified Cooperative's section 199A(g) deduction was W-2 wage-limited. This is also consistent with the regulations under former section 199, which did not have a proportionality rule for qualified payments. Therefore, the final regulations do not incorporate this comment.

Commenters also requested clarification that the definition of qualified payments does not include amounts paid to patrons by Specified Cooperatives with respect to activities that do not qualify as producing DPGR from the sale of agricultural or horticultural products. When gross receipts of a Specified Cooperative are non-DPGR, and thus, are not includable in QPAI, payments based on these amounts do not meet the definition of qualified payments. The Treasury Department and the IRS agree with this comment and view this as consistent with the interpretation of qualified payment described earlier, but do not consider additional regulatory language necessary to clarify this point.

Commenters also suggested that the last sentence of the definition, indicating that a Specified Cooperative calculates its qualified payment using the same method of accounting it uses to calculate its taxable income, was added in error and should be removed. This sentence was not in the definition of qualified payment in former §1.199-6(e), and the Treasury Department and the IRS have removed the sentence for consistency with former §1.199-6(e). Further, the definition of qualified payments already encompasses this concept with its references to patronage dividends and per-unit retain allocations, as a Specified Cooperative calculates patronage dividends and per-unit retain allocations when determining taxable income.

H. Comments on examples in proposed §1.199A-8(e)

Commenters requested clarification on Examples 1 and 2 of proposed §1.199A-8(e), asking how both examples are based on the same facts, but the payment in Example 1 is deemed a per-unit retain allocation, while the payment in Example 2 is deemed a purchase. Commenters indicated that without further explanation, the examples were confusing. Example 2 has been removed to eliminate any confusion as Example 1 is consistent with Example 1 from the Joint Committee Report. Example 1 has also been slightly modified for clarity and to more closely track Example 1 from the

Joint Committee Report. In general, the determination of whether a payment is a per-unit retain allocation is made based on the definition in section 1388(f). Section 1388(f) defines per-unit retain allocations as any allocation, by an organization to which part I of subchapter T apples, to a patron with respect to products marketed for the patron, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron. Per-unit retain allocations are qualified payments (to the extent all other requirements are met) under the definition in §1.199A-8(d)(2)(ii).

One commenter also requested clarification on whether it is possible for a Specified Cooperative and its patrons to contractually agree that a payment is not a qualified payment. The Treasury Department and the IRS believe that an agreement to treat a payment that otherwise meets the definition of qualified payment as something else would be inappropriate and ineffective. A payment meeting the definition of a qualified payment should be characterized as a qualified payment.

Commenters also asked that Examples 1-3 from former §1.199-6(m) be included in the final regulations. Similar to Example 2 of proposed §1.199A-8(e), the facts of Examples 1 and 2 from former §1.199-6(m) both treat the Cooperative payments to patrons as purchases rather than per-unit retain allocations. In order to avoid confusion, the examples were modified to be consistent with Example 1 from the Joint Committee Report. The final regulations include Examples 1-3 from former §1.199-6(m) as Examples 6, 7, and 8 under §1.199A-8(e).

I. <u>Comments on rules for Specific Cooperative partners in proposed §1.199A-8(f)</u>

Under proposed §1.199A-8(f), a Specified Cooperative that is a partner in a partnership must determine which Schedule K-1 allocations (i.e., gross receipts and related deductions) qualify as DPGR and use the items to calculate its corresponding section 199A(g) deduction. A commenter noted that W-2 wages generated by the partnership should be passed on to the Specified Cooperative partner, relying on section 199A(f)(1)(A)(iii) and former §1.199-5(b)(1)(i). The Treasury Department and the IRS agree and have amended §1.199A-8(f) accordingly. Section 1.199A-8(f) of the final regulations also includes the share of COGS to maintain consistency with former §1.199-5(b)(1)(i), which allowed for the allocation of COGS to partners.

A commenter also requested that if a partnership conducts MPGE activities that result in DPGR, then a Specified Cooperative partner in that partnership should be treated as if the activities were directly conducted by the Specified Cooperative. The Treasury Department and IRS agree with the comment and §1.199A-8(f) now allows for two-way attribution, meaning: 1) a partnership's activities alone with respect to an agricultural or horticultural product can qualify the gross receipts for the Specified Cooperative partner, and 2) a partnership can be attributed the activities of the Specified Cooperative partner (including those activities that a specified partner is attributed from patrons) so that the gross receipts can be DPGR.

## III. §1.199A-9, Domestic Production Gross Receipts

### A. In General

Section 199A(g)(3)(D) defines the term DPGR to mean gross receipts of a Specified Cooperative derived from any lease, rental, license, sale, exchange, or other disposition (collectively, a disposition) of any agricultural or horticultural product which was MPGE (determined after application of section 199A(g)(4)(B)) by the Specified Cooperative in whole or significant part within the United States. DPGR does not include gross receipts of the Specified Cooperative derived from a disposition of land or from services. Section 199A(g)(4)(B) treats marketing Specified Cooperatives as having MPGE any agricultural or horticultural product in whole or significant part within the United States if their patrons have done so. Proposed §1.199A-9 provides rules for determining whether gross receipts are DPGR, and provides methods of allocating gross receipts between DPGR and non-DPGR. Proposed §1.199A-9 was based on §1.199-3 of the former section 199 regulations, but also incorporated rules from former §1.199-1(d)(1) through (3) and §1.199-1(e). Former §1.199-1(d)(1) through (3) and §1.199-1(e) relate to the allocation of gross receipts between DPGR and non-DPGR, determining whether an allocation method is reasonable, treating de minimis gross receipts as DPGR or non-DPGR, and the use of historical data to allocate gross receipts for certain multiple-year transactions. The Proposed Regulations were intended to be interpreted in a manner consistent with the interpretation under former section 199. Other than as described in response to the specific comments, the final regulations generally follow the Proposed Regulations.

B. Reasonable Method of allocating gross receipts between DPGR and non-DPGR

Under proposed §1.199A-9(c)(1), Specified Cooperatives must use a reasonable method when allocating gross receipts between DPGR and non-DPGR. This reasonable method must be consistently applied from one taxable year to another, and must clearly reflect the portion of gross receipts for the taxable year that is DPGR and the portion of gross receipts that is non-DPGR. Proposed §1.199A-9(c)(2) provides that if a Specified Cooperative has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts are derived from an item as defined in proposed §1.199A-9(e)(1)(i) (and thus, are DPGR), then the Specified Cooperative must use that specific identification method to determine DPGR. If the Specified Cooperative does not have information readily available to specifically identify whether gross receipts are derived from an item or cannot, without undue burden or expense, specifically identify whether the gross receipts are derived from an item, then the Specified Cooperative can use a reasonable method. Among the seven factors listed for determining whether a method is reasonable is whether the Specified Cooperative applies the method consistently from year to year.

A commenter observed that former §1.199-8(a) did not prevent taxpayers from choosing a reasonable method on a year-to-year basis, and that former §1.199-8(a) provided that a taxpayer's change in allocating or apportioning items did not constitute a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under sections 446 and 481 apply. The Treasury Department and the IRS agree with the commenter that any change to an allocation or apportionment of items should not constitute a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under sections 446 and 481 apply. However, the final regulations maintain the rule from the Proposed Regulations. The Treasury Department and the IRS incorporated the "consistently applied" requirement into proposed §1.199A-9(c)(1) to be consistent with the section 199A(a) regulations, specifically §1.199A-3(b)(5). Further, if a method is not reasonable because it no longer clearly reflects the gross receipts from DPGR and non-DPGR, the method cannot continue to be used. The Specified Cooperative must choose a new method that is reasonable under the facts and circumstances and apply it consistently going forward.

The same commenter also claimed that former section 199 did not subject the "any reasonable method" determination to the §1.199A-9(c)(2) factors. This is incorrect, as the proposed §1.199A-9(c)(2) factors follow former §1.199-1(d)(2), including the factor of whether the taxpayer applies the method consistently from year to year. Therefore, the use of consistency as a factor (§1.199A-9(c)(2)) follows former §1.199-1(d)(2).

C. <u>Interaction of MPGE rules in proposed §1.199A-9(f)(1) with (f)(2) and (3)</u>

<u>MPGE</u> is defined under proposed §1.199A-9(f)(1) as manufacturing, producing, growing, extracting, installing, developing, improving, and creating agricultural or horticultural products; making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or

assembling two or more articles; and cultivating soil, raising livestock, and farming aquatic products. MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural or horticultural products only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative. The Specified Cooperative (or the patron if §1.199A-9(a)(2) applies) must have the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the MPGE activity occurs in order for the gross receipts derived from the MPGE of the agricultural or horticultural products to qualify as DPGR. Under proposed §1.199A-9(f)(2) and (3), if a Specified Cooperative engages in packaging, repackaging, labeling, or installation of an agricultural or horticultural product, and engages in no other MPGE activity with respect to the agricultural or horticultural product, then the activities of packaging, repackaging, labeling, or installation do not qualify as MPGE with respect to the agricultural or horticultural product.

A commenter suggested the removal of §1.199A-9(f)(2) and (3) on the grounds that "packaging, repackaging, or labelling, [and] installing" cannot be distinguished from "storage, handling, and other processing activities" mentioned in proposed §1.199A-9(f)(1).

The Joint Committee Report, in footnote 118, citing §1.199-3(e)(1), provides that gross receipts of a Specified Cooperative may qualify as DPGR so long as the Specified Cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided the products are consumed in connection with, or incorporated into, the MPGE of agricultural or horticultural products (whether or not by the Specified Cooperative). Thus, the Proposed

Regulations' definition of MPGE included that language. However, §1.199A-9(f)(2) and (3) effectively serve as minimum thresholds for purposes of MPGE qualification under §1.199A-9(f)(1). These requirements were also part of the former section 199 regulations at the time of repeal (see former §1.199-3(e)(2) and (3)). A logical reading of these paragraphs is that the storage, handling, and other processing activities that are described in §1.199A-9(f)(1) are activities that are more extensive than those described in §1.199A-9(f)(2) and (3). Thus, the final regulations do not adopt this suggestion.

Commenters requested the inclusion of Examples 1 and 2 of former §1.199-3(e)(5) to affirm that the storage of farm products qualifies as MPGE. These examples deal with relevant fact patterns, but required modification to apply to Specified Cooperatives as the examples in former §1.199-3(e)(5) explicitly state that all taxpayers are not Cooperatives. Therefore, Examples 1 and 2, with appropriate modifications, have been added under §1.199A-9(f)(5).

## IV. §1.199A-10, Costs Allocable to DPGR

Section 1.199A-10 provides guidance on the allocation of costs to DPGR. This section provides rules for allocating a taxpayer's COGS, as well as other expenses, losses, and deductions properly allocable to DPGR. The Proposed Regulations were based on and follow the former section 199 regulations in §1.199-4. No comments were received on this part of the Proposed Regulations, and so §1.199A-10 of the Proposed Regulations is adopted without change by the final regulations.

## V. §1.199A-11, Wage Limitation

Section 1.199A-11 provides guidance regarding the W-2 wage limitation on the section 199A(g) deduction. No comments were received on this part of the Proposed Regulations, and so §1.199A-11 of the Proposed Regulations is adopted without change by the final regulations.

A notice of proposed revenue procedure, Notice 2019-27, 2019-31 IRB, which proposed a draft revenue procedure providing three proposed methods that Specified Cooperatives may use for calculating W-2 wages, was issued concurrently with the Proposed Regulations. A revenue procedure is a statement of procedure that affects the rights or duties of taxpayers under the Code. Consistent with the general purpose of publishing revenue procedures in the Internal Revenue Bulletin, the methods that taxpayers may use for calculating W-2 wages are set forth in a revenue procedure to promote a uniform application of the laws administered by the IRS. The revenue procedure may be modified independently from the regulations under section 199A if, for example, changes unrelated to section 199A or the regulations thereunder are made to the underlying Form W-2, Wage and Tax Statement. No comments were received on Notice 2019-27. A revenue procedure that conforms with the draft, with one modification related to short taxable years, is being issued concurrently with the final regulations.

**VI. <u>§1.199A-12, Expanded Affiliated Group (EAG) Rules</u>**

Proposed §1.199A-12 provides guidance on the application of section 199A(g) to an expanded affiliated group (EAG) that includes a Specified Cooperative. Section 199A(g)(5)(A)(iii) defines an EAG as an "affiliated group as defined in section 1504(a)," except that the ownership threshold is "more than 50 percent" as opposed to "at least 80 percent." Section 1504(a)(1) defines an affiliated group as "1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation . . . ." Section 1504(b)(1) further provides that the term "includible corporation" excludes "[c]orporations exempt from taxation under section 501." Thus, the final regulations clarify that exempt Specified Cooperatives are not eligible to be members of an EAG. See §1.1381-2(a)(1) (treating farmers' cooperatives that are exempt from tax under section 521 (such as

Specified Cooperatives) as exempt organizations under section 501 "[f]or the purpose of any law that refers to organizations exempt from income taxes"). As a result, for purposes of section 199A(g), an EAG may include nonexempt Specified Cooperatives as well as other includible corporations.

The Proposed Regulations provide that the section 199A(g) deduction for an EAG is determined by separating patronage and nonpatronage gross receipts and related deductions of Specified Cooperatives that are members of the EAG. The section 199A(g) deduction is then computed solely with respect to patronage gross receipts and related deductions (patronage items). As explained in part VII of this Summary of Comments and Explanation of Revisions, patronage items are items of income or deduction produced by a transaction that actually facilitates the accomplishment of the Specified Cooperative's marketing, purchasing, or services activities. See Farmland Industries, Inc. v. Comm'r, 78 T.C.M. 846 (CCH) (1999); §1.1388-1(f).

Thus, the Proposed Regulations effectively have two specific rules addressing the computation of the section 199A(g) deduction for an EAG that includes a Specified Cooperative. First, the section 199A(g) deduction is computed using only patronage items (the EAG patronage limitation). Second, only members of an EAG that are Specified Cooperatives are taken into account in computing the section 199A(g) deduction (the Specified Cooperative limitation).

A commenter recommended that the final regulations eliminate the EAG patronage limitation. Specifically, as discussed in part II of this Summary of Comments and Explanation of Revisions, the commenter argued that the general requirement to distinguish income, deductions, and W-2 wages from patronage and nonpatronage activities conflicts with the policy of section 199A, and that such a requirement is equally inappropriate for EAGs that include Specified Cooperatives.

The Treasury Department and the IRS do not agree with the commenter's argument. Under subchapter T, patronage income of a nonexempt cooperative with both patronage and nonpatronage activities effectively receives single-level tax treatment, whereas nonpatronage income of such a cooperative is taxed at both the corporate level and the shareholder level. Farm Service Coop. v. Comm'r, 619 F.2d 718, 723 (8th Cir. 1980). Because the commenter's proposal would extend the benefits of the section 199A(g) deduction to nonpatronage activities, with respect to which a nonexempt cooperative is taxed as a C corporation, it is inconsistent with the purposes and structure of section 199A. Moreover, eliminating the patronage limitation solely in the context of an EAG would disadvantage nonexempt Specified Cooperatives that are not members of an EAG because such entities, unlike their counterparts in an EAG, would be prohibited from taking a section 199A(g) deduction on nonpatronage sourced gross receipts.

Thus, the final regulations do not adopt the commenter's recommendation to compute the section 199A(g) deduction using both patronage and nonpatronage items in either the standalone context (see part II of this Summary of Comments and Explanation of Revisions) or for EAGs. Instead, activities resulting in nonpatronage income continue to be taxed as income from a noncooperative C corporation.

The same commenter also recommended eliminating the Specified Cooperative limitation, specifically arguing that, because C corporations that are not Specified Cooperatives can be members of an EAG, such corporations also should be taken into account in computing the section 199A(g) deduction for an EAG. The commenter also stressed that the approach in proposed §1.199A-12 is different from the approach in the former section 199 EAG rules, which provide the basis for the rules in proposed §1.199A-12.

The final regulations also do not adopt this recommendation. Unlike the former section 199 deduction, which was broader in scope, section 199A(g) specifically provides that only a "taxpayer which is a specified agricultural or horticultural cooperative" (that is, a Specified Cooperative) may claim the section 199A(g) deduction. Moreover, as noted in part II of this Summary of Comments and Explanation of Revisions, C corporations are expressly prohibited under section 199A(a) from claiming a section 199A(a) deduction, and C corporations other than Specified Cooperatives under section 199A(g)(2)(D)(i) from claiming a section 199A(g) deduction as a patron of a Specified Cooperative. Although the statute does not expressly prohibit C corporations that are not Specified Cooperatives from being taken into account in computing an EAG's section 199A(g) deduction, the fact that the statute expressly limits this deduction to Specified Cooperatives, and the statute's general prohibition against C corporations that are not Specified Cooperatives benefiting from the section 199A(g) deduction, indicate that the Specified Cooperative limitation is consistent with the structure and intent of section 199A.

Additionally, eliminating the Specified Cooperative limitation would have no practical effect unless the EAG patronage limitation also were eliminated. Nonexempt Specified Cooperatives receive single-level tax treatment only to the extent of patronage income generated and distributed to their patrons; their nonpatronage income continues to be taxed at both the corporate level and the shareholder level. Accordingly, the net effect of the Specified Cooperative limitation is to exclude what otherwise would be nonpatronage income, because a C corporation that is not a Specified Cooperative cannot generate patronage income. Because the final regulations retain the EAG patronage limitation, removing the Specified Cooperative limitation would have no practical effect with respect to nonexempt Specified Cooperatives. As previously noted, removing the Specified Cooperative limitation would not affect the treatment of exempt

Specified Cooperatives because they are not eligible to be members of an EAG. See section 1504(b)(1); §1.1381-2(a)(1).

Finally, revisions necessary to clarify the scope and application of section 199A(g) to an EAG that includes a Specified Cooperative were made in §1.199A-12 of the final regulations.

## VII. §1.1382-3, Taxable income of cooperatives; special deductions for exempt farmers' cooperatives; and §1.1388-1, Definitions and special rules

### A. Comments on definition of "patronage and nonpatronage"

Section 1.1388-1 provides definitions and special rules applicable to Cooperatives. The Proposed Regulations added a definition of patronage and nonpatronage in proposed §1.1388-1(f). Proposed §1.1388-1(f) provides "[w]hether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test. The directly related use test provides that if the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or services activities, the income or deduction is from patronage sources. However, if the transaction producing the income or deduction does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income or deduction is from nonpatronage sources. Patronage and nonpatronage income or deductions cannot be netted unless otherwise permitted by the Internal Revenue Code or regulations issued under the relevant section of the Internal Revenue Code, or guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter)."

Commenters questioned the need for adopting a definition in connection with guidance under section 199A(g), as the definition will impact all Cooperatives. However, a common determination for all Cooperatives is identifying activities as patronage or nonpatronage. Prior to the Proposed Regulations, there was no single definition of patronage and nonpatronage. The definition of income derived from sources other than patronage in §1.1382-3(c)(2), which was often cited as part of the determination, is outdated. As it relates to section 199A(g), the requirement to identify patronage and nonpatronage to calculate the section 199A(g) deduction places additional importance on the determination. To assist taxpayers in distinguishing between patronage and nonpatronage, proposed §1.1388-1(f) was added. The intent in adding §1.1388-1(f) was to incorporate the "directly related" test, which is the current legal standard for making the determination.

Commenters requested citations relevant to the proposed definition to ensure the language complies with the current legal standard. Other than the last sentence, the language adopted in the Proposed Regulations closely follows the language used in Rev. Rul. 69-576, 1969-2 C.B. 166, which provides "[t]he classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources."

The language from Rev. Rul. 69-576 has been cited in numerous opinions, including Farmland Industries, Inc. v. Comm'r, 78 T.C.M. 846 (CCH) (1999), which provides a summary of published guidance and many of the cases relevant to the current legal standard. In the Farmland opinion, the court states that "the 'directly related test' applied by the courts is traceable to published rulings issued by the

Commissioner, such as Rev. Rul. 69–576, 1969-2 C.B. 166, and Rev. Rul. 74–160, 1974–1 C.B. 245, that interpreted patronage income broadly." Farmland at 865.

Commenters also suggested removal of §1.1388-1(f) on the basis that patronage/nonpatronage determinations necessitate a facts and circumstances analysis, and, therefore §1.1388-1(f) is inappropriate. Section 1.1388-1(f) provides a definition, it does not eliminate the necessity for factual analysis. Therefore, the final regulations do not adopt this comment.

Alternatively, one commenter requested that the definition in §1.1388-1(f) be modified to provide that income is from patronage sources if the underlying transaction is either directly related or actually facilitates the cooperative's purpose. The final regulations do not adopt this comment. The definitional language of §1.1388-1(f) follows the language from Rev. Rul. 69-576 and is also consistent with language in Farmland. However, revisions have been made to clarify the distinction between patronage and nonpatronage sourced items.

The commenter also suggested the removal of the last sentence of the definition, which prohibited the netting of patronage and nonpatronage items. The Treasury Department and the IRS agree that the "netting" rule is not needed to define patronage and nonpatronage. Therefore, the last sentence of proposed §1.1388-1(f) is removed from the definition in the final regulations.

B. Comments on removing the definition of "income from sources other than patronage"

The commenter also requested that if a definition was finalized, then the definition of income from sources other than patronage in §1.1382-3(c)(2) be removed. The Treasury Department and the IRS agree that this section should be revised. The final regulations revise this section so that it now cross-references the definition of patronage and nonpatronage in §1.1388-1(f).

## VIII. Removal of Section 199 Regulations

In light of the TCJA, the Treasury Department and the IRS proposed to remove the former section 199 regulations (§§1.199-0 through 1.199-9) and withdrew the 2015 proposed regulations because the regulations interpret a provision of the Code that has been repealed for taxable years beginning after December 31, 2017. No comments were received, and the final regulations remove the former section 199 final regulations (§§1.199-0 through 1.199-9, including expired temporary regulations published in the **Federal Register** as TD 9731).

The removal of these regulations is unrelated to the substance of the rules in the regulations, and no negative inference regarding the stated rules should be made. The regulations are removed from the Code of Federal Regulations (CFR) solely because they have no future applicability. Removal of these regulations is not intended to alter any non-regulatory guidance that cites to or relies upon these regulations. These regulations as contained in 26 CFR part 1, revised April 1, 2019, remain applicable to determining eligibility for the former section 199 deduction for any taxable year that began before January 1, 2018. The beginning date of the taxable year of a partnership, S corporation, or a non-grantor trust or estate, rather than the taxable year of a partner, shareholder, or beneficiary is used to determine items that are taken into account for purposes of calculating a former section 199 deduction.

## IX. Comments on proposed applicability date and transition rule

A commenter requested that the final regulations be made applicable to taxable years beginning after the publication date. The final regulations adopt the commenter's request.

Regarding the transition rule, proposed §1.199A-7(h)(2) provides that no deductions under section 199A are allowed to patrons for any qualified payments that are attributable to QPAI with respect to which a deduction is allowable to the Specified

Cooperative under former section 199 as in effect on and before December 31, 2017, for a taxable year of the Cooperative beginning before January 1, 2018. Additionally proposed §1.199A-7(h)(3) provides that if a patron of a Cooperative cannot claim a deduction under section 199A(a) for any qualified payments described in the transition rule of §1.199A-7(h)(2), the Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the form.

The commenter also requested omission of references to the transition rule and confirmation that any reasonable application of the transition rule will be deemed appropriate. This request was based on the presumption that these regulations would not be finalized until after 2019, when the time period covered by the transition rule has passed, thus requiring the amendment of Forms 1099-PATR (and corresponding Forms 1040, U.S. Individual Income Tax Return). The commenter also suggested that Cooperatives have a common understanding of the transition rule to the extent that payments described under proposed §1.199A-7(h)(2) would be properly identified and not included in patrons' section 199A(a) calculations. The commenter, however, did not identify a specific method that Cooperatives primarily used. The final regulations amend the rule from proposed §1.199A-7(h)(2) so that it now only cross-references section 101(c) of Division T of the 2018 Act. The final regulations also amend proposed §1.199A-7(h)(3) to allow Cooperatives to use a reasonable method to identify the payments, and state that the method from the Proposed Regulations of reporting on an attachment to or on Form 1099-PATR (or successor form) is one reasonable method.

**Applicability Dates**

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which the regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**.

Consistent with authority provided by section 7805(b)(1)(A), §§ 1.199A-7 through 1.199A-12, §1.1382-3(c)(2) as revised, and §1.1388-1(f) generally apply to taxable years beginning after [**INSERT DATE OF PUBLICATION IN FEDERAL REGISTER**]. However, taxpayers may choose to apply the rules set forth in §§1.199A-7 through 1.199A-12, §1.1382-3(c)(2) as revised**,** and §1.1388-1(f) for taxable years beginning on or before [**INSERT DATE OF PUBLICATION IN FEDERAL REGISTER**], provided, in each case, the taxpayers follow the rules in their entirety and in a consistent manner. Alternatively, taxpayers may rely on the proposed regulations under §§1.199A-7 through 1.199A-12 issued on June 19, 2019 for taxable years beginning on or before [**INSERT DATE OF PUBLICATION IN FEDERAL REGISTER**] and taxpayers may rely on the proposed regulations under §1.1388-1(f) issued on June 19, 2019 for taxable years beginning on or before [**INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, provided, in each case, taxpayers follow the proposed regulations in their entirety and in a consistent manner.

**Special Analyses**

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13771, 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the final rulemaking is significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement. Accordingly, the final regulations have been reviewed by the Office of Management and Budget.

A. Background and Overview

The TCJA repealed section 199 of the Code, which provided a deduction for income attributable to domestic production activities. In its place it created section 199A, which provides a deduction for qualified business income derived from passthrough businesses – such as sole proprietorships, partnerships, and S corporations – engaged in domestic trades or businesses. While the repealed section 199 deduction was generally available to all taxpayers, the section 199A(a) deduction is available only to taxpayers other than C corporations, including patrons of cooperatives to which sections 1381 through 1388 of the Code apply (Cooperatives). On March 23, 2018, section 101 of the 2018 Act amended section 199A(g) to provide deductions for Specified Cooperatives and their patrons that are substantially similar to the deductions allowed under the repealed section 199 deduction. Accordingly, these regulations generally formalize prior and current practices based on the rules under former section 199. The 2018 Act also added section 199A(b)(7), which requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive qualified payments from Specified Cooperatives.

The estimated number of Cooperatives affected by the 2018 Act and these final regulations is 9,200, including approximately 2,000 Specified Cooperatives, based on 2018 tax filings.

B. Need for Regulation

The final regulations provide guidance regarding the application of sections 199A(a), 199A(b)(7), and 199A(g) to Cooperatives, Specified Cooperatives, and their patrons. The final regulations are needed because the 2018 Act introduced a number of terms and calculations. Patrons, Cooperatives, and Specified Cooperatives would benefit from greater specificity regarding these and other items.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

2. Economic Rationale for Issuing Guidance for the 2018 Act

The Treasury Department and the IRS anticipate that the issuance of guidance pertaining to sections 199A(a), 199A(b)(7), and 199A(g) of the 2018 Act to Cooperatives, Specified Cooperatives, and their patrons will provide a marginal net economic benefit to the overall U.S. economy.

The final regulations clarify a number of concepts for Cooperatives and their patrons, regarding the deduction provided by section 199A(a) for qualified business income, as well as for Specified Cooperatives and their patrons regarding the section 199A(g) deduction on income attributable to the domestic production activities of Specified Cooperatives. Specifically, the final regulations (i) clarify how Specified Cooperatives should determine their section 199A(g) deduction; (ii) define "agricultural or horticultural products" to clarify which Cooperatives qualify as Specified Cooperatives eligible for the section 199A(g) deduction; (iii) provide de minimis rules reducing compliance costs for certain Specified Cooperatives; (iv) require reporting from Cooperatives; (v) provide a safe harbor permitting certain patrons of Specified Cooperatives to use a simpler method to calculate the section 199A(b)(7) reduction to the section 199A(a) deduction; (vi) permit patrons to allocate their expenses to calculate the correct amount of qualified business income and their section 199A(a) deduction; (vii) permit, but do not require, Specified Cooperatives to identify the eligibility status of patrons to pass through the section 199A(g) deduction to them; and (viii) permit partnerships to pass through W-2 wages and cost of goods sold (COGS) to Specified Cooperative partners and permit attribution of a partnership's activities to a Specified Cooperative partner and a Specified Cooperative's partner's activities to a partnership. In the absence of guidance, affected taxpayers would have to calculate their tax liability without the definitions and clarifications provided by the final regulations, a situation that is generally considered more burdensome and could lead to greater conflicts with tax administrators. Thus, the Treasury Department and the IRS project that the final regulations will marginally reduce taxpayer compliance burden and the costs of tax administration relative to not issuing any such guidance.

This guidance also ensures that section 199A deductions are calculated similarly across taxpayers, avoiding situations where one taxpayer receives preferential treatment over another for fundamentally similar economic activity. For example, in the absence of these final regulations, a Specified Cooperative may have uncertainty over what type of income is eligible for the section 199A(g) deduction. If a Specified Cooperative claimed the section 199A(g) deduction on income that is taxed similarly to a C corporation, this would confer an unintended economic benefit to the Specified Cooperative over other C corporations performing identical activities that only benefit from a lower corporate tax rate. As discussed further below, this guidance prevents the introduction of distortions of economic decisions in the agricultural or horticultural sector.

In the absence of these regulations, uncertainty over statutory interpretation could lead to economic losses to the extent that taxpayers interpret the statute in ways that are inconsistent with the statute's intents and purposes. For example, a Specified Cooperative may pursue a project involving a certain product that is only profitable if that product is deemed "agricultural or horticultural" and thus eligible for the section 199A(g) deduction. If, in fact, this product is ineligible for the deduction based on the intents and purposes of the statute, then the project should not have been pursued and this results in an economic loss. Alternatively, without a definition of "agricultural or horticultural," a Specified Cooperative may incorrectly assume that a project is not eligible for the deduction and not pursue the project, which could also result in an economic loss. In such cases, guidance provides value by supporting decision-making that is economically efficient, contingent on the overall Code. While no guidance can fully curtail all inaccurate interpretations of the statute, the final regulations significantly mitigate the chance for such interpretations and thereby increase economic efficiency. Due to the lack of readily available data, the Treasury Department and the IRS have not estimated the increase in United States economic activity that would arise from the guidance.

The Treasury Department further projects that the issuance of guidance will reduce taxpayer compliance burden and the costs of tax administration relative to a no-action baseline. Due to the lack of readily available data, the Treasury Department has not estimated the decrease in taxpayer compliance burden nor tax administration costs arising from the issuance of guidance.

No comments were received on the economic analysis provided in the proposed regulations.

3. Economic Analysis of Specific Provisions

The final regulations embody certain regulatory decisions that reflect necessary regulatory discretion. These decisions specify more fully how the 2018 Act is to be implemented.

i. Determining Section 199A(g) Deduction for Specified Cooperatives

The final regulations outline the process by which Specified Cooperatives calculate their section 199A(g) deductions. The rules concern two types of Specified Cooperatives, those that are exempt (qualified as a Cooperative under section 521) and those that are nonexempt (qualified under subchapter T of the Code), and two sources of income, patronage and nonpatronage. The patronage and nonpatronage income of Specified Cooperatives is taxed differently depending on whether the Specified Cooperative is exempt or nonexempt. In the case of exempt Specified Cooperatives, patronage and nonpatronage source income is subject to a single level of tax at the patron level. Whereas, for nonexempt Specified Cooperatives only patronage source income is subject to a single level of tax at the patron level; nonpatronage source income is subject to a double level of tax, similar to other C corporation income.

Because the Code does not define patronage and nonpatronage sourced items, §1.1388-1(f) of these final regulations sets forth a definition that is consistent with the current state of federal case law. Specifically, the definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. The final regulations also make revisions to clarify patronage versus nonpatronage items. In response to a commenter, the final regulations remove the last sentence in the proposed definition, because the Treasury Department and the IRS agree that the sentence is not needed to define patronage and nonpatronage. Specifying a definition that is consistent with current case law will help to minimize the economic impacts of these regulations that may arise from lack of clarity.

The final regulations adopt the proposed rule requiring Specified Cooperatives to identify gross receipts, COGS, deductions, W-2 wages, etc. as patronage or nonpatronage, and only allows the patronage activities of nonexempt Specified Cooperatives to be included in the calculation of the section 199A(g) deduction, unless the Specified Cooperative falls under the expanded de minimis rules, which are discussed later. The TCJA reduced the corporate tax rate for C corporations under section 11 and provided the section 199A deduction for domestic businesses operating as sole proprietorships or through partnerships, S corporations, trusts, or estates. The TCJA also repealed section 199, which did not preclude deductions on income earned by C corporations. The 2018 Act amended section 199A to address concerns that the TCJA created an unintended incentive for farmers to sell their agricultural or horticultural products to Specified Cooperatives over independent buyers. Specifically, the 2018 Act amended section 199A(g) to allow Specified Cooperatives and their patrons a deduction similar to the former section 199 deduction. Because the section 199A(g) deduction is not intended to benefit C corporations and their shareholders, in general, the final regulations specify that the section 199A(g) deduction can be claimed only on income that can be subject to tax only at the patron level. Under the final regulations, a non-exempt Specified Cooperative may not claim the section 199A(g) deductions on income that cannot be paid to patrons and deducted under section 1382(b) and exempt Specified Cooperatives may not claim section 199A(g) deductions on income that cannot be paid to patrons and deducted under sections 1382(b) or 1382(c)(2).

In the absence of these regulations, a Specified Cooperative may have uncertainty as to whether nonpatronage source income, which would be taxed in the same manner as a C corporation, could receive both the lower corporate tax rate and be further offset by a section 199A(g) deduction. Other C corporations performing identical activities would only benefit from the lower corporate tax rate. This would confer an unintended economic benefit to Specified Cooperatives over other C corporations and undermine the intent of the 2018 Act's amendments of section 199A to reduce competitive distortions between C corporations and Specified Cooperatives.

The Treasury Department and the IRS have determined that this potential uncertainty as to tax treatment could distort economic decisions in the agricultural or horticultural sector. The final regulations avoid this outcome, promoting a more efficient allocation of resources by providing more uniform incentives across taxpayers.

ii. Definition of Agricultural or Horticultural Products

The section 199A(g) deduction is focused solely on dispositions of agricultural or horticultural products. As a result, the Treasury Department and the IRS determined that it was necessary to provide a definition. Because there is no definition of agricultural or horticultural products in the Code or Income Tax Regulations, the Treasury Department and the IRS looked to the United States Department of Agriculture (USDA) for definitions because the USDA has expertise concerning Specified Cooperatives, and Specified Cooperatives are likely familiar with USDA law. The proposed regulations defined agricultural or horticultural products within the meaning of the Cooperative Marketing Act of 1926 as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof. Agricultural or horticultural products also include aquatic products that are farmed as well as fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property, since agricultural or horticultural products were considered a subset of tangible property under former section 199. Intangible property (defined in §1.199-3(j)(2)(iii)) was a separate category of property and gross receipts from intangible property did not qualify as domestic production gross receipts (DPGR).

The final regulations made clarifying changes to the definition of agricultural or horticultural products in response to commenters. The final regulations provide examples (without limitation) of products that are considered agricultural or horticultural products, including specific agricultural or horticultural products, livestock products, edible forestry products, and farmed aquatic products. The final regulations also provide language further clarifying that agricultural or horticultural products do not include intangible property. Finally, the final regulations include more examples of "other supplies" being agricultural or horticultural products.

The Treasury Department and the IRS considered a similar but alternative definition of agricultural or horticultural products within the meaning of the Agricultural Marketing Act of 1946 as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof. While very similar to the definition in the rules adopted in these final regulations, the rules under the Agricultural Marketing Act of 1946 concern the marketing and distribution of agricultural products without reference to Cooperatives.

The Treasury Department and the IRS also considered an alternative definition of agricultural or horticultural products based on the definition of agricultural commodities within the meaning of general regulations under the Commodity Exchange Act. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities. The use of this narrow definition would have restricted the range of products for which the section 199A(g) deduction would be otherwise available.

The Treasury Department and the IRS did not attempt to provide quantitative estimates of the economic consequences of different designations of agricultural or horticultural products because suitable data are not readily available at this level of detail.

iii. De Minimis Threshold for Domestic Production Gross Receipts of Specified Cooperatives

In general, §1.199A-9 of the final regulations requires that Specified Cooperatives allocate gross receipts between DPGR and non-DPGR. However, §1.199A-9(c)(3) of the proposed regulations includes a de minimis provision that allows Specified Cooperatives to allocate total gross receipts to DPGR if less than 5 percent of total gross receipts are non-DPGR or to allocate total gross receipts to non-DPGR if less than 5 percent of total gross receipts are DPGR. The thresholds provided in the proposed regulations are based on the thresholds set forth in §1.199-1(d)(3) under former section 199. The Treasury Department and the IRS chose to include a de minimis rule to reduce compliance costs and simplify tax filing relative to an alternative of no de minimis rule.

The Treasury Department and the IRS considered changes to the de minimis provisions in the proposed regulations, but determined that materially changing these rules from provisions that were previously available would lead to taxpayer confusion. The final regulations generally maintain the rules of the proposed regulations, but increase the threshold. Thus, under §1.199A-9(c)(3) of the final regulations, Specified Cooperatives when calculating the patronage section 199A(g) deduction may allocate total gross receipts to DPGR if less than 10 percent of total gross receipts are non-DPGR (which now can include nonpatronage gross receipts as well as patronage non-

DPGR pursuant to §1.199A-8(b)(2)(ii)), or alternatively, may allocate total gross receipts to non-DPGR if less than 10 percent of total gross receipts are DPGR. The de minimis threshold modestly reduces compliance costs for businesses with relatively small amounts of non-DPGR or DPGR by allowing them to avoid allocating receipts between DPGR and non-DPGR activities. The de minimis threshold is unlikely to create any substantial effects on market activity because any change in the ratio of DPGR to non-DPGR will be localized around the threshold, meaning that the movement will be a small fraction of receipts to get below the de minimis threshold. Because the de minimis provision exempts taxpayers from having to perform certain allocations and therefore reporting these allocations, the Treasury Department and the IRS do not have information on taxpayers' use of this exemption under former section 199 to perform a quantitative analysis of the impacts of the de minimis provision.

iv. Reporting Requirements for Cooperatives

Final regulations §1.199A-7(c) and (d) provide that, when a patron conducts a trade or business that receives distributions from a Cooperative, the Cooperative is required to provide the patron with qualified items of income, gain, deduction, and loss and specified service trade or business (SSTB) determinations with respect to those distributions. This increases the compliance burden on such Cooperatives. However, in the absence of these regulations, the burden for determining of the amount of distributions from a Cooperative that constitute qualified items of income, gain, deduction, and loss from a non-SSTB and an SSTB would lie with the patron. Because patrons are less well positioned to acquire the relevant information to determine whether distributions from a Cooperative are qualified items of income, gain, deduction, and loss and whether items that would otherwise qualify are from an SSTB, the Treasury Department and the IRS expect that these regulations will reduce overall compliance costs relative to an alternative approach of not introducing a reporting requirement. After consideration of comments, the reporting requirements of Cooperatives have been modified to simplify the Cooperatives' reporting obligations in order to balance the burden on the Cooperatives and the patrons' need to receive information to determine their section 199A(a) deduction.

v. Allocation Safe Harbor

If a patron receives both income or gain related to qualified payments and income or gain that is not related to qualified payments in a qualified trade or business, the patron must allocate those items and related deductions, losses, and W-2 wages using a reasonable method based on all of the facts and circumstances. The final regulations provide a safe harbor that allows patrons who receive income or gain related to qualified payments in addition to income or gain that is not related to qualified payments to use a simpler method to allocate deductions, losses, and W-2 wages between income or gain related to qualified payments and income or gain that is not related to qualified payments to calculate the section 199A(b)(7) reduction to the section 199A(a) deduction. The safe harbor allocation method allows patrons to allocate by ratably apportioning deductions, losses, and W-2 wages based on the proportion that the amount of income or gain related to qualified payments bears to the total income or gain used to determine QBI. This safe harbor is available to patrons with taxable incomes below the threshold amounts set forth in section 199A(e)(2).

The Treasury Department and the IRS considered an alternative of not allowing a safe harbor but determined that a safe harbor could reduce compliance costs and simplify tax filing. The threshold was set at amounts set forth in section 199A(e)(2) to avoid a proliferation of thresholds applicable to taxpayers claiming a section 199A(a) deduction. Because the threshold amounts are relatively low, the Treasury Department and the IRS expect that the safe harbor would not distort business decisions or reduce revenue to any meaningful extent.

### i. Patrons May Allocate Expenses to Specified Service Trade or Business Items of Income Reported by Cooperative

A commenter asked the Treasury Department and the IRS to revise proposed reporting requirements in circumstances where a Cooperative engages in a specified service trade or business (SSTB) business with patrons. In response to the commenter's request, the final regulations allow patrons to allocate expenses between qualified trade or business income and any SSTB income received from the Cooperative up to the amount of the income from the SSTB. The final regulations more accurately track the substance of the transaction. In the absence of these regulations, the patron may calculate lower qualified business income, resulting in a lower section 199A(a) deduction.

### ii. Specified Cooperatives May Pass Through All, Some, or None of the Section 199A(g) Deduction

Section 199A(g) permits Specified Cooperatives to pass through their section 199A(g) deduction, and allows eligible taxpayers to claim the deduction passed through. The proposed regulations required Specified Cooperatives to identify whether the patrons are eligible taxpayers and only pass through the deduction to those patrons. Commenters requested that the rule be modified so that patrons, and not Specified Cooperatives, have to identify whether the patrons are eligible taxpayers for purposes of using the section 199A(g) deduction. The rules have been modified in the final regulations to provide Specified Cooperatives with maximum flexibility. If a Specified Cooperative does not identify the eligibility status of all of its patrons, it may pass through all, some, or none of the section 199A(g) deduction. Only patrons that are eligible taxpayers may use the section 199A(g) deduction passed through to them. If a Specified Cooperative does determine the eligibility status of its patrons, it has the discretion to retain the section 199A(g) deduction attributable to any ineligible taxpayer, and pass out the remainder to eligible taxpayers.

In the absence of these regulations, a Specified Cooperative may have uncertainty as to whether to distribute the section 199A(g) deduction to eligible taxpayers.  The final regulations provide Specified Cooperatives with the option of retaining and using the amounts equal to the section 199A(g) deduction attributable to ineligible taxpayers, or passing out the deduction, which only eligible taxpayers may claim.  This allows Specified Cooperatives to choose whether to engage in information gathering regarding patrons' eligibility to use the deduction.  The Treasury Department and the IRS have determined that this increased flexibility promotes a more efficient allocation of resources by allowing Specified Cooperatives to choose the extent to which they engage in information gathering in relation to the use of the section 199A(g) deduction at the Specified Cooperative level or the patron level.

iii. Special Rule for Specified Cooperative Partners

The final regulations provide special rules for Specified Cooperatives that are partners in a partnership.  A commenter recommended that the proposed regulations be modified to permit partnerships to pass through W-2 wages to Specified Cooperative partners, thereby increasing the Specified Cooperatives' section 199A(g) deduction.  A commenter also recommended that, to the extent a partnership conducts activities that result in gross receipts, a Specified Cooperative partner in that partnership should be permitted to treat those activities as conducted directed by the Specified Cooperative.  The Treasury Department and the IRS agree with these comments.  The final regulations permit the partnerships to pass through W-2 wages and COGS to Specified Cooperative partners.  Additionally, the final regulations allow for two-way attribution, meaning: (1) a partnership's activities alone with respect to an agricultural or horticultural product can qualify as gross receipts for the Specified Cooperative partner and (2) a partnership can be attributed the activities of the Specified Cooperative partner.  These rules permit additional activities and the resulting income, as well as additional W-2 wages and COGS, to be considered in the calculation of the section 199A(g) deduction.

This stipulation allows for greater flexibility in determining deductions when Specified Cooperatives are partners. Flexibility will increase economic efficiency by making it more likely that Specified Cooperatives comply with regulations by lowering the compliance burden.

The Treasury Department and the IRS anticipate that these regulations in aggregate will have a marginal impact on economic activity. Compared to the economic impacts resulting from the 2018 Act, the final regulations' primary impact will be through increasing comprehension of the tax code. Increased understanding will reduce the risk that firms and the IRS will disagree on tax reporting and allocation and therefore engage in costly legal transactions. Increased comprehension will also reduce the possibility that firms will engage in activities that would yield negative economic impacts if clarity were stronger. These final regulations also respond to commenters by adding additional examples to further increase comprehension.

II. Paperwork Reduction Act

The collection of information contained in these regulations has been revised and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control numbers 1545-0118 and 1545-0123.

Regulations in §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as §1.199A-8(d)(3) and (f), require the collection of information. The collections of information in §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as §1.199A-8(d)(3) will be conducted through Form 1099-PATR, Taxable Distributions Received From Cooperatives, while the collection of information in §1.199A-8(f) will be conducted through Schedule K-1 to Form 1065, U.S. Return of Partnership Income.

A. <u>Collections of information conducted through Form 1099-PATR</u>

Section 1.199A-7(c)(3) requires the Cooperative to inform its patron of the amount of any distribution to the patron that constitutes qualified items of income, gain, deduction, and loss from a non-specified service trade or business (SSTB) conducted directly by the Cooperative. Not all distributions to patrons are qualified items of income, gain, deduction, and loss because the source of the distribution may not be effectively connected with the conduct of a trade or business within the United States or may include interest income that is not properly allocable to the patron's trade or business. The Cooperative directly conducting the trade or business from which the distribution to the patron originates is in the best position to know how much of the distribution is qualified items of income, gain, deduction, and loss. The Cooperative is also in the best position to know if it is generating income from an SSTB. Accordingly, the collection of information is necessary for the patron to calculate correctly the patron's section 199A(a) deduction for the patron's trade or business.

Section 1.199A-7(d)(3) requires the Cooperative to inform its patron of the amount of any distributions to the patron that constitutes qualified items of income, gain, deduction, and loss from an SSTB conducted directly by the Cooperative. Accordingly, the collection of information is necessary for the patron to correctly calculate the patron's section 199A(a) deduction for the patron's qualified trade or business.

The collection of information in §1.199A-7(f)(3) is essential for the eligible taxpayer's calculation of the reduction in the eligible taxpayer's section 199A(a) deduction for the eligible taxpayer's trade or business that is required by section 199A(b)(7). Section 199A(g)(2)(A) requires the Specified Cooperative to identify the amount of qualified payments being distributed to an eligible taxpayer and identify the portion of the section 199A(g) deduction allowed in a notice mailed to the eligible taxpayer during the payment period described in section 1382(d). Section 199A(b)(7) provides that an eligible taxpayer who receives qualified payments from a Specified Cooperative must reduce the eligible taxpayer's section 199A(a) deduction by an amount set forth in this section. Without the notice described in §1.199A-7(f)(3), the eligible taxpayer cannot calculate the reduction required by section 199A(b)(7).

The collection of information in §1.199A-8(d)(3) is necessitated by section 199A(g)(2)(A). Section 199A(g)(2)(A) permits a Specified Cooperative to pass through an amount of its section 199A(g) deduction to an eligible taxpayer. The amount of the section 199A(g) deduction that the Specified Cooperative is permitted to pass through is an amount that is allocable to the qualified production activities income (QPAI) generated from qualified payments distributed to the eligible taxpayer and identified by such cooperative in a written notice mailed to such taxpayer during the payment period described in section 1382(d). Without the notice required in §1.199A-8(d)(3) the eligible taxpayer would not know that the Specified Cooperative is passing a portion of its section 199A(g) deduction to the eligible taxpayer.

The collections of information in §1.199A-7(h)(3) are necessitated by a special transition rule in section 101 of the 2018 Act. Under this transition rule, the repeal of former section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a Specified Cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to QPAI with respect to which a deduction is allowable to the Specified Cooperative under former section 199 for a taxable year of the Specified Cooperative beginning before January 1, 2018. Such qualified payment remains subject to former section 199 and no deduction is allowed under section 199A(a) or (g) with respect to such qualified payment. Without these collections of information by the Specified Cooperative, the patron has no way of knowing that the patron is barred by the transition rule from using a qualified payment received that is QBI for the patron's trade or business to claim a section 199A(a) deduction for the patron's trade or business.

The collections of information in §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as §1.199A-8(d)(3) are satisfied by providing information about qualified items of income, SSTB determinations, qualified payments, the section 199A(g) deduction, and the use of qualified payments tied to the former section 199 deduction, as applicable, on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

For purposes of the Paperwork Reduction Act of 1995, (44 U.S.C. 3507(d)) (PRA), the reporting burden associated with proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §1.199A-8(d)(3) will be reflected in the PRA Submission associated with Form 1099-PATR (OMB control number 1545-0118). As further discussed in this section, the estimated number of respondents for the reporting burden associated with these information collections is 9,200 based on 2018 tax filings.

B. Collections of information conducted through Schedule K-1, Form 1065

The collection of information in §1.199A-8(f) is required by section 199A(g)(5)(B). This section allows a Specified Cooperative that is a partner in a partnership to use its allocable share of gross receipts and related deductions, W-2 wages, and cost of goods sold to calculate its section 199A(g) deduction. Under these regulations, the partnership must separately identify and report the allocable share of gross receipts and related deductions, W-2 wages, and cost of goods sold on or attached to the Schedule K-1 to the Form 1065 (or any successor form) issued to a Specified Cooperative partner, unless otherwise provided by the instructions to the Form. Without this reporting, the Specified Cooperative partner would not have the information necessary to calculate its section 199A(g) deduction from its activities with the partnership.

The Schedule K-1 to the Form 1065 will be modified to include a mechanism to report the Specified Cooperative partner's allocable share of gross receipts and related deductions. The collection of information in §1.199A-8(f) is satisfied when the partnership provides the required information to its Specified Cooperative partners on or attached to the Schedule K-1 of Form 1065 (or any successor form), unless otherwise provided by the instructions to the Form. For purposes of the PRA, the reporting burden associated with proposed §1.199A-8(f) will be reflected in the PRA Submission associated with Form 1065 (OMB control number 1545-0123). As provided in this section, the estimated number of respondents for the reporting burden associated with these information collections is 750 based on 2018 tax filings.

C. Revised tax forms

The revised tax forms are as follows:

| | **OMB Number** | **New** | **Revision of existing form** | **Number of respondents** |
|---|---|---|---|---|
| Form 1099-PATR | 1545-0118 | | ✓ | 9,200 |
| Schedule K-1 (Form 1065) | 1545-0123 | | ✓ | 750 |

The current status of the PRA submissions related to the tax forms that will be revised as a result of the information collections in the final regulations is provided in the accompanying table. As described previously, the burdens associated with §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as §1.199A-8(d)(3) will be included in the aggregated burden estimates for OMB control number 1545-0118, which represents a new total estimated burden time of 564,200 hours and total estimated monetized costs of $49.497 million ($2018). The burdens associated with the information collection in §1.199A-8(f) will be included in the aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules of 3.344 billion hours and total estimated monetized costs of $61.558 billion

($2018).  The overall burden estimates provided for 1545-0118 and 1545-0123 are aggregate amounts that relate to all information collections associated with the applicable OMB control number.  These estimates are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations.  To guard against over-counting the burden imposed, the Treasury Department and the IRS urge readers to recognize that these burden estimates are aggregates for the applicable types of filers.  With respect to the final regulations, the only relevant burden estimates are those associated with OMB control number 1545-0118.  Future estimates under OMB control number 1545-0123 would capture both changes made by the 2018 Act and those that arise out of discretionary authority exercised in the regulations.  In addition, when available, drafts of IRS forms are posted for comment at www.irs.gov/draftforms.

One comment on the burden related to the Form 1099-PATR reporting requirements suggested the Proposed Regulations may have understated the regulatory burden, but provided no specific estimates.  Without an alternative estimate to evaluate, the final regulations will rely on the new aggregated burden estimates for OMB control number 1545-0118.  The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden.

<table>
<tr><th>Form</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="2">Form 1099-PATR</td><td>[Business (Legacy Model)]</td><td>1545-0118</td><td>Approved by OIRA through 6/30/2023.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201602-1545-024</td></tr>
<tr><td rowspan="2">Form 1065, Schedule K-1</td><td>Business (NEW Model)</td><td>1545-0123</td><td>Approved by OIRA through 1/31/2021.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
</table>

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

III. Regulatory Flexibility Act

As described in more detail in this section, pursuant to the Regulatory Flexibility Act (RFA), 5 U.S.C. chapter 6, the Treasury Department and the IRS hereby certify that these regulations will not have a significant economic impact on a substantial number of small entities. In addition to the economic impact described, affected taxpayers, regardless of size will also need to spend time and resources to read and understand these regulations.

A. §1.199A-7(c)(3) and (d)(3)

Although §1.199A-7(c)(3) and (d)(3) will have an impact on a substantial number of small entities, the economic impact will not be significant. The IRS creates the Business Master File which contains data from Form 1120-C, U.S. Income Tax Return for Cooperative Associations. According to the Business Master File data, in 2018, the

IRS received approximately 9,200 Forms 1120-C from Cooperatives. The small business size standards of the U.S. Small Business Association (SBA) under 13 CFR §121.201 matched to the North American Industry Classification System (NAICS) were used in estimating the number of Cooperatives that are considered small businesses. Approximately 8,200 (90 percent) of the 9,200 filers of Forms 1120-C were estimated to be small businesses. Therefore, a substantial number of small entities are affected by the requirements in §1.199A-7(c)(3) and (d)(3).

Section 1.199A-7 provides rules similar to those provided in §1.199A-6. In §1.199A-6, relevant passthrough entities (RPEs) are not permitted to take the section 199A deduction but are required to determine and report the information necessary for their direct and indirect owners to determine their individual section 199A(a) deductions. Section 1.199A-6 requires RPEs to determine and report on or attach to the RPEs' Schedule K-1s to the Form 1065 for each trade or business in which the RPE was directly engaged four items: (1) The amount of QBI, (2) W-2 wages, (3) UBIA of qualified property, and (4) SSTBs.

Although Cooperatives are not RPEs, Cooperatives make distributions to patrons that such patrons are permitted to include in calculating their individual section 199A(a) deductions. Section 1.199A-7(c) and (d) require the Cooperatives to determine and report to their patrons whether the distributions for which the Cooperatives take deductions under section 1382(b) and/or (c)(2), as applicable, constitute qualified items of income, gain, deduction, and loss and whether they are from an SSTB in which the Cooperative was directly engaged.

In TD 9847 the Treasury Department and the IRS determined that the reporting burden in §1.199A-6 was estimated at 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours for all affected entities, regardless of size. The burden on entities with business receipts below $10 million was expected to be at the lower end of the range (30 minutes to 2.5 hours). The estimated compliance burden for passthrough entities that issue Schedules K-1 is $53 per hour. This estimate was derived from the Business Taxpayer Burden model developed by the IRS's Office of Research, Applied Analytics, and Statistics (RAAS), which relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables. See Tax Compliance Burden (John Guyton, et al., July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. Thus, the annual aggregate burden on businesses with gross receipts below $10 million was estimated to be between $19.50 and $132.50 per business. The Treasury Department and the IRS determined in TD 9847 that the requirements in §1.199A-6 imposed no significant economic impact on affected entities.

The reporting requirements under §1.199A-7(c)(3) and (d)(3) require Specified Cooperatives to report only two of the four pieces of information RPEs are required to report under §1.199A-6: the amount of qualified items of income, gain, deduction, and loss and whether the distributions are from an SSTB in which the Cooperative was directly engaged. In addition, these final regulations, in response to comments, revise the proposed reporting requirements under §1.199A-7(c)(3) and (d)(3) to reduce the Specified Cooperative's burden by requiring the Cooperative to report the total net amount of qualified items from non-SSTBs and SSTBs in distributions to patrons without delineating these amounts business by business.

Furthermore, the burden imposed by §1.199A-7(c)(3) and (d)(3) only occurs when a Cooperative has net income that it may distribute to its patrons such that the income will qualify for the income tax deductions under section 1382(b) and/or (c), as applicable. With respect to this net income, Cooperatives already know the source of their income and deductions without which information they would not be able to determine the correct distributions to their patrons and to claim the income tax deduction for these distributions under section 1382(b) and/or (c)(2), as applicable. Finally, assuming that the approximately 8,200 filers of Forms 1120-C were estimated to be small businesses in 2018 and that each business incurred half of the higher figure of $132.50 ($66.25) determined for the §1.199A-6 regulations to satisfy the reporting requirements under §1.199A-7(c)(3) and (d)(3), the annual burden imposed by the reporting requirements would not exceed $66.25 per business. Accordingly, the Treasury Department and the IRS conclude that the requirements in §1.199A-7(c)(3) and (d)(3) will not impose a significant economic impact on small entities.

B. §1.199A-7(h)(3)

Although §1.199A-7(h)(3) will have an impact on a substantial number of small entities, this economic impact will not be significant. As previously noted, in 2018, approximately 90 percent of Cooperatives filing Form 1120-C were estimated to be small businesses. Therefore, a substantial number of small entities are affected by §1.199A-7(h)(3).

Section 1.199A-7(h)(3) requires Cooperatives to notify patrons if, pursuant to the transition rule in section 101 of the 2018 Act, the patron is barred from using certain qualified payments from a Cooperative to claim a section 199A(a) deduction in a taxable year because these qualified payments are attributable to QPAI with respect to which a deduction is allowable to the Cooperative under former section 199 in a taxable year beginning before January 1, 2018. The Cooperative knows which patrons are impacted since, in order to claim its deduction under former section 199, the Cooperative must identify which qualified payments to use. The Treasury Department and the IRS estimate that the annual burden imposed by the requirement in §1.199A-7(h)(3) will be far less than the $66.25 per business estimated for the requirements in §1.199A-7(c)(3) and (d)(3) discussed above, since the Cooperatives know which patrons are impacted and the reporting is limited to informing these patrons that they cannot use such qualified payments to calculate their section 199A(a) deduction. Further, the requirements under §1.199A-7(h)(3), in response to a comment, have been revised to allow more flexibility by allowing the reporting to be made using any reasonable method.

In addition, absent notice from the Cooperatives, patrons would have no way of determining whether they were barred from claiming the section 199A(a) deduction using such qualified payments. Finally, Cooperatives are not able to claim a deduction under former section 199 for taxable years beginning after December 31, 2017. Therefore, the reporting required by §1.199A-7(h)(3) will be for a short duration and have a limited impact on Cooperatives. Accordingly, for all these reasons, the requirements in §1.199A-7(h)(3) will not impose a significant economic impact on small entities.

C. §§1.199A-7(f)(3) and 1.199A-8(d)(3)

Sections 1.199A-7(f)(3) and 1.199A-8(d)(3) will not have a significant economic impact on a substantial number of small entities. According to the Business Master File filing data from the transcribed fields from the Forms 1120-C for 2018, of the approximately 9,200 Forms 1120-C filed by Cooperatives, approximately 2,000 filers identified their Cooperatives as involving agriculture or horticulture using the NAICS codes. Of the 2,000 filers of Forms 1120-C identifying as Specified Cooperatives, approximately 1,600 filers (80 percent) would qualify as small business under the SBA thresholds. However, the requirement under §1.199A-7(f)(3) involving reporting of qualified payments should not impose a significant burden because qualified payments overlap with the section 1382 distributions a Cooperative uses to calculate the section 199A(g) deduction. Further, the notice requirement in §1.199A-8(d)(3), which is imposed under section 199A(g)(2)(A)(ii), follows the same procedures that Cooperatives used under former section 199 so Cooperatives should already have a process in place.

Accordingly, §§1.199A-7(f)(3) and 1.199A-8(d)(3) will not impose a significant economic impact on a substantial number of small entities.

D. §1.199A-8(f)

Although §1.199A-8(f) will have an impact on a substantial number of small entities, this impact will not be economically significant. According to the Business Master File filing data from the transcribed fields from the Forms 1065 for 2018, the IRS estimates that there were 4,100,000 partnerships reporting their partners' share of partnership items on Schedules K-1 (Form 1065). The IRS also identified 763 different partnerships that issued a Schedule K-1 to 654 different Cooperatives in 2018. The IRS does not have information as to whether the 654 Cooperatives all qualified as Specified Cooperatives.

Of the 763 different partnerships, the IRS estimated that 215 of the partnerships conducted activities in 2018 that would have required the partnerships to file under §1.199A-8(f). The IRS does not have sufficient data to determine the type of business activities of the remaining partnerships. To be as comprehensive and transparent as possible in analyzing the potential impact of the final regulations, it is assumed that all of these partnerships would be required to file under §1.199A-8(f) and would be considered small entities.

Of the 215 partnerships identified as having both issued a Schedule K-1 to a Cooperative and conducting eligible activities in 2018, the IRS determined that 158 of these partnerships conducted activities for which the SBA uses the number of employees to determine if an entity is a small entity using the NAICS. The IRS determined that 95 of these 97 partnerships would be small entities, while two would not be small entities based on the reported number of Forms W-2 filed in connection with the Forms 1065 the partnerships filed in 2018.

The SBA uses income to determine if an entity is a small entity for the reported business activities of the remaining 118 partnerships using the NAICS. Based upon the reported income for 2018, 84 of the remaining 118 partnerships are small entities, while 34 partnerships are not small entities. Therefore, a substantial number of small entities are affected by requirements in §1.199A-8(f).

The economic impact of §1.199A-8(f), however, will not be significant because the information required to be reported is gross receipts and related deductions. This information is readily available to each partnership and already known for the purpose of determining Federal income and other tax obligations. A commenter also requested that the partnerships be allowed to report further information, and the rules in §1.199A-8(f) were broadened consistent with the request. Because the information required to be reported is already available and familiar to each partnership, the reporting required by §1.199A-8(f) will not impose a significant economic impact on small entities.

Accordingly, the Treasury Department and the IRS hereby certify that these regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Code, the Proposed Regulation preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately $154 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (titled Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These rules do not have federalism implications, and do not impose substantial direct compliance costs on state and local governments or preempt state law, within the meaning of the Executive Order.

VI. Congressional Review Act

Pursuant to the Congressional Review Act (5 U.S.C. 801 et seq.), the Office of Information and Regulatory Affairs designated this rule as not a 'major rule', as defined by 5 U.S.C. 804(2).

**Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, Notices and other guidance cited in this document are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

**Drafting Information**

The principal author of these regulations is Jason Deirmenjian, Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Amendments to the Regulations**

Accordingly, 26 CFR parts 1 is amended as follows:

**PART 1 – INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by:

1. Removing the entries for §§ 1.199-0 through 1.199-9.

2. Adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805

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Section 1.199A-7 also issued under 26 U.S.C. 199A(f)(4) and (g)(6).

Section 1.199A-8 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-9 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-10 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-11 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-12 also issued under 26 U.S.C. 199A(g)(6).

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**§§1.199-0 through 1.199-9 [Removed]**

Par. 2. Sections 1.199-0 through 1.199-9 are removed.

Par. 3. Sections 1.199A-7 through 1.199A-12 are added to read as follows:

* * * * *

**§1.199A-7 Section 199A(a) Rules for Cooperatives and their Patrons.**

(a) Overview--(1) In general. This section provides guidance and special rules on the application of the rules of §§1.199A-1 through 1.199A-6 regarding the deduction for qualified business income (QBI) under section 199A(a) (section 199A(a) deduction) of the Internal Revenue Code (Code) by patrons (patrons) of cooperatives to which Part I of subchapter T of chapter 1 of the Code (subchapter T) applies (Cooperatives). Unless otherwise provided in this section, all the rules in §§1.199A-1 through 1.199A-6 relating to calculating the section 199A(a) deduction apply to patrons and Cooperatives. Paragraph (b) of this section provides special rules for patrons relating to trades or businesses. Paragraph (c) of this section provides special rules for patrons and Cooperatives relating to the definition of QBI. Paragraph (d) of this section provides special rules for patrons and Cooperatives relating to specified service trades or businesses (SSTBs). Paragraph (e) of this section provides special rules for patrons relating to the statutory limitations based on W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property. Paragraph (f) of this section provides special rules for specified agricultural or horticultural cooperatives (Specified Cooperatives) and paragraph (g) of this section provides examples for Specified Cooperatives and their patrons. Paragraph (h) of this section sets forth the applicability date of this section and a special transition rule relating to Specified Cooperatives and their patrons.

(2) At patron level. The section 199A(a) deduction is applied at the patron level, and patrons who are individuals (as defined in §1.199A-1(a)(2)) may take the section 199A(a) deduction.

(3) Definitions. For purposes of section 199A and §1.199A-7, the following definitions apply--

(i) Individual is defined in §1.199A-1(a)(2).

(ii) Patron is defined in §1.1388-1(e).

(iii) Patronage and nonpatronage is defined in §1.1388-1(f).

(iv) Relevant Passthrough Entity (RPE) is defined in §1.199A-1(a)(9).

(v) Qualified payment is defined in §1.199A-8(d)(2)(ii).

(vi) Specified Cooperative is defined in §1.199A-8(a)(2) and is a subset of Cooperatives defined in §1.199A-7(a)(1).

(b) Trade or business. A patron (whether the patron is an RPE or an individual), and not a Cooperative, must determine whether it has one or more trades or businesses that it directly conducts as defined in §1.199A-1(b)(14). To the extent a patron operating a trade or business has income directly from that business, the patron must follow the rules of §§1.199A-1 through 1.199A-6 to calculate the section 199A(a) deduction. Patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron. A Cooperative that distributes patronage dividends or similar payments, as described in paragraph (c)(1) of this section, must determine and report information to its patrons relating to qualified items of income, gain, deduction, and loss in accordance with paragraphs (c)(3) and (d)(3) of this section. A patron that receives patronage dividends or similar payments, as described in paragraph (c)(1) of this section, from a Cooperative must follow the rules of paragraphs (c) through (e) of this section to calculate the section 199A(a) deduction.

(c) Qualified Business Income--(1) In general. QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §199A(c)(3) and §1.199A-3(b). A qualified item of income includes distributions for which the Cooperative is allowed a deduction under section 1382(b) and (c)(2) (including patronage dividends or similar payments, such as money, property, qualified written notices of allocations, and qualified per-unit retain certificates, as well as money or property paid in redemption of a nonqualified written notice of allocation (collectively patronage dividends or similar payments)), provided such distribution is otherwise a qualified item of income, gain, deduction, or loss. <u>See</u> special rule in paragraph (d)(3) of this section relating to SSTBs that may affect QBI.

(2) <u>QBI determinations made by patron</u>. A patron must determine QBI for each trade or business it directly conducts. In situations where the patron receives distributions described in paragraph (c)(1) of this section, the Cooperative must determine whether those distributions include qualified items of income, gain, deduction, and loss as determined under rules of §199A(c)(3) and §1.199A-3(b). These distributions may be included in the QBI of the patron's trade or business to the extent that:

(i) The distributions are related to the patron's trade or business as defined in §1.199A-1(b)(14);

(ii) The distributions are qualified items of income, gain, deduction, and loss as determined under rules of §199A(c)(3) and §1.199A-3(b) at the Cooperative's trade or business level;

(iii) The distributions are not items from an SSTB as defined in §199A(d)(2) at the Cooperative's trade or business level (except as permitted by the threshold rules in §199A(d)(3) and §1.199A-5(a)(2)); and

(iv) Certain information is reported by the Cooperative about these payments as provided in paragraphs (c)(3) and (d)(3) of this section.

(3) <u>Qualified items of income, gain, deduction, and loss determinations made and reported by Cooperatives</u>. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss as determined under the rules of §199A(c)(3) and §1.199A-3(b) in those distributions. A patron must determine whether these qualified items relate to one or more trades or businesses that it directly conducts as defined in §1.199A-1(b)(14). Pursuant to this

paragraph (c)(3), the Cooperative must report the net amount of qualified items with respect to non-SSTBs of the Cooperative in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives, (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report on or before the due date of the Form 1099-PATR the amount of such qualified items of income, gain, deduction, and loss in the distributions to the patron, the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. See special rule in paragraph (d)(3) of this section relating to reporting of qualified items of income, gain, deduction, and loss with respect to SSTBs of the Cooperative.

(d) Specified Service Trades or Businesses--(1) In general. This section provides guidance on the determination of SSTBs as defined in §199A(d)(2) and §1.199A-5. Unless otherwise provided in this section, all of the rules in §1.199A-5 relating to SSTBs apply to patrons of Cooperatives.

(2) SSTB determinations made by patron. A patron (whether an RPE or an individual) must determine whether each trade or business it directly conducts is an SSTB.

(3) SSTB determinations made and reported by Cooperatives—(i) In general. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss as determined under the rules of §199A(c)(3) and §1.199A-3(b) with respect to SSTBs directly conducted by the Cooperative. A patron must determine whether these qualified items relate to one or more trades or businesses that it directly conducts as defined in §1.199A-1(b)(14). The Cooperative must report the net amount of qualified items with respect to the SSTBs of the

Cooperative in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received from Cooperatives, (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099-PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero.

(ii) Patron allocation of expenses paid to Cooperative for SSTB items of income reported by Cooperative--(A) In general. When a Cooperative reports SSTB items to a patron, a patron may allocate a deductible expense that was paid to the Cooperative in connection with the patron's qualified trade or business between a patron's qualified trade or business income and the SSTB income reported to it by the Cooperative only if the SSTB income directly relates to the deductible expense. A patron can allocate the deductible expense paid by the patron to the Cooperative only up to the amount of SSTB income reported by the Cooperative.

(B) Example. Patron allocating expenses between qualified trade or business and SSTB income from a Cooperative. (1) Cooperative provides to its patrons a service that is an SSTB under section 199A(d)(2). P, a patron, runs a qualified trade or business under section 199A(d)(1) and incurs expenses for the service from the Cooperative in P's qualified trade or business. P pays the Cooperative $1,000 for the service. Cooperative later pays P a patronage dividend of $50 related to the service.

(i2) Cooperative reports the $50 as SSTB income on the Form 1099-PATR issued to P.

(3) Since P's deductible expense for services from the Cooperative was in connection with a qualified trade or business and the SSTB income directly relates to

that expense, P may allocate the expense under paragraph (d)(3)(ii) of this section. Accordingly, $50 of the $1,000 expense is allocated to P's SSTB income, and $950 of the expense is allocated to P's qualified trade or business and is included in P's QBI calculation.

(e) W-2 wages and unadjusted basis immediately after acquisition of qualified property--(1) In general. This section provides guidance on calculating a trade or business's W-2 wages and the UBIA of qualified property properly allocable to QBI.

(2) Determinations made by patron. The determination of W-2 wages and UBIA of qualified property must be made for each trade or business by the patron (whether an RPE or individual) that directly conducts the trade or business before applying the aggregation rules of §1.199A-4. Unlike RPEs, Cooperatives do not compute and allocate their W-2 wages and UBIA of qualified property to patrons.

(f) Special rules for patrons of Specified Cooperatives--(1) Section 199A(b)(7) reduction. A patron of a Specified Cooperative that receives a qualified payment must reduce its section 199A(a) deduction as provided in §1.199A-1(e)(7). This reduction applies whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year. The rules relating to the section 199A(g) deduction can be found in §§1.199A-8 through 1.199A-12.

(2) Reduction calculation--(i) Allocation method. If in any taxable year, a patron receives income or gain related to qualified payments and income or gain that is not related to qualified payments in a trade or business, the patron must allocate the income or gain and related deductions, losses and W-2 wages using a reasonable method based on all the facts and circumstances for purposes of calculating the reduction in §1.199A-1(e)(7). Different reasonable methods may be used for different items and related deductions of income, gain, deduction, and loss. The chosen

reasonable method for each item must be consistently applied from one taxable year of the patron to another, and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (f)(2)(i).

(ii) Safe harbor. A patron with taxable income under the threshold amount set forth in section 199A(e)(2) is eligible to use the safe harbor set forth in this paragraph (f)(2)(ii) to apportion its deductions, losses and W-2 wages instead of the allocation method set forth in paragraph (f)(2)(i) of this section for any taxable year in which the patron receives income or gain related to qualified payments and income or gain not related to qualified payments in a trade or business. Under the safe harbor the patron may apportion its deductions, losses and W-2 wages ratably between income or gain related to qualified payments and income or gain that is not related to qualified payments for purposes of calculating the reduction in paragraph (f)(1) of this section. Accordingly, the amount of deductions and losses apportioned to determine QBI allocable to qualified payments is equal to the proportion of the total deductions and losses that the amount of income or gain related to qualified payments bears to total income or gain used to determine QBI. The same proportion applies to determine the amount of W-2 wages allocable to the portion of the trade or business that received qualified payments.

(3) Qualified payments notice requirement. A Specified Cooperative must report the amount of the qualified payments made to the eligible taxpayer, as defined in section 199A(g)(2)(D), on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

(g) Examples. The following examples illustrate the provisions of paragraph (f) of this section. For purposes of these examples, assume that the Specified Cooperative has satisfied the applicable written notice requirements in paragraphs (c)(3), (d)(3) and (f)(3) of this section.

(1) Example 1. Patron of Specified Cooperative with W-2 wages. (i) P, a grain farmer and patron of nonexempt Specified Cooperative C, delivered to C during 2020 2% of all grain marketed through C during such year. During 2021, P receives $20,000 in patronage dividends and $1,000 of allocated section 199A(g) deduction from C related to the grain delivered to C during 2020.

(ii) P has taxable income of $75,000 for 2021 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business for 2021 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per-unit retain allocations received from C during 2021 of $80,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2021 is $10,000, which consists of per-unit retain allocations received from C during 2021 of $80,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $20,000, and properly allocable expenses of $90,000 (including $25,000 of W-2 wages).

(iv) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($12,500), or $9,100. As P does not have any other trades or businesses, the combined QBI amount is also $9,100.

(v) P's deduction under section 199A for 2021 is $10,100, which consists of the combined QBI amount of $9,100, plus P's deduction passed through from C of $1,000.

(2) Example 2. Patron of Specified Cooperative without W-2 wages. (i) C and P have the same facts for 2020 and 2021 as Example 1, except that P has expenses of $200,000 that include zero W-2 wages during 2021.

(ii) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($0), or $10,000.

(iii) P's deduction under section 199A for 2021 is $11,000, which consists of the combined QBI amount of $10,000, plus P's deduction passed through from C of $1,000.

(3) Example 3. Patron of Specified Cooperative – Qualified Payments do not equal QBI and no section 199A(g) passthrough. (i) P, a grain farmer and a patron of a nonexempt Specified Cooperative C, during 2020, receives $60,000 in patronage dividends, $100,000 in per-unit retain allocations, and $0 of allocated section 199A(g) deduction from C related to the grain delivered to C. C notifies P that only $150,000 of the patronage dividends and per-unit retain allocations are qualified payments because $10,000 of the payments are not attributable to C's QPAI.

(ii) P has taxable income of $90,000 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business is $45,000, which consists of gross receipts of $95,000 from sales to an independent grain elevator, plus $160,000 from C (all payments from C qualify as qualified items of income, gain, deduction, and loss), less expenses of $210,000 (including $30,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C is $25,000, which consists of the qualified payments received from C of $150,000, less the properly allocable expenses of $125,000 (including $18,000 of W-2 wages), which were determined using a reasonable method under paragraph (f)(2)(ii) of this section.

(iv) P's patron reduction is $2,250, which is the lesser of 9% of QBI related to qualified payments received from C, $2,250 (9% x $25,000), or 50% of W-2 wages related to qualified payments received from C, $9,000 (50% x $18,000). As P does not have any other trades or businesses, the combined QBI amount is $6,750 (20% of P's total QBI, $9,000 (20% x $45,000), reduced by the patron reduction of $2,250).

(v) P's deduction under section 199A is $6,750, which consists of the combined QBI amount of $6,750.

(4) <u>Example 4</u>. <u>Patron of Specified Cooperative – Reasonable Method under paragraph (f)(2)(i) of this section</u>. P is a grain farmer that has $45,000 of QBI related to P's grain trade or business in 2020. P's QBI consists of $105,000 of sales to an independent grain elevator, $100,000 of per-unit retain allocations, and $50,000 of patronage dividends from a nonexempt Specified Cooperative C, for which C reports $150,000 of qualified payments to P as required by paragraph (f)(3) of this section. P's grain trade or business has $210,000 of expenses (including $30,000 of W-2 wages). P delivered 65x bushels of grain to C and sold 35x bushels of comparable grain to the independent grain elevator. To allocate the expenses between qualified payments ($150,000) and other income ($105,000), P compares the bushels of grain delivered to C (65x) to the total bushels of grain delivered to C and sold to the independent grain elevator (100x). P determines $136,500 (65% x $210,000) of expenses (including $19,500 of W-2 wages) are properly allocable to the qualified payments. The portion of QBI from P's grain trade or business related to qualified payments received from C is $13,500, which consists of qualified payments of $150,000 less the properly allocable

expenses of $136,500 (including $19,500 of W-2 wages). P's method of allocating expenses is a reasonable method under paragraph (f)(2)(i) of this section.

(5) Example 5. Patron of Specified Cooperative using safe harbor to allocate. (i) P is a grain farmer with taxable income of $100,000 for 2021 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to P's grain trade or business for 2021 is $50,000, which consists of gross receipts of $180,000 from sales to an independent grain elevator, per-unit retain allocations received from a Specified Cooperative C during 2021 of $15,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $5,000, and expenses of $150,000 (including $50,000 of W-2 wages). C also passed through $1,800 of the section 199A(g) deduction to P, which related to the grain delivered by P to the Specified Cooperative during 2020. P uses the safe harbor in paragraph (f)(2)(ii) of this section to determine the expenses (including W-2 wages) allocable to the qualified payments.

(ii) Using the safe harbor to allocate P's $150,000 of expenses, P allocates $15,000 of the expenses to the qualified payments ($150,000 of expenses multiplied by the ratio (0.10) of qualified payments ($20,000) to total gross receipts ($200,000)). Using the same ratio, P also determines there are $5,000 of W-2 wages allocable ($50,000 multiplied by 0.10) to the qualified payments.

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2021 is $5,000, which consists of per-unit retain allocations received from C during 2021 of $15,000, patronage dividends of $5,000, and properly allocable expenses of $15,000 (including $5,000 of W-2 wages).

(iv) P's QBI related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($450) or 50% of W-2 wages related to qualified payments received from C ($2,500), or

$9,550. As P does not have any other trades or businesses, the combined QBI amount is also $9,550.

(v) P's deduction under section 199A for 2021 is $11,350, which consists of the combined QBI amount of $9,550, plus P's deduction passed through from C of $1,800.

(h) Applicability date--(1) General rule. Except as provided in paragraph (h)(2) of this section, the provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided taxpayers apply the rules in their entirety and in a consistent manner.

(2) Transition rule for qualified payments of patrons of Cooperatives. See the transition rule for qualified payments of patrons of Cooperatives for a taxable year of a Cooperative beginning before January 1, 2018 in the Consolidated Appropriations Act, 2018 (Public Law 115-141, 132 Stat. 348) Division T, section 101(c).

(3) Notice from the Cooperative. If a patron of a Cooperative cannot claim a deduction under section 199A for any qualified payments described in the transition rule set forth in paragraph (h)(2) of this section, the Cooperative must use a reasonable method to identify the qualified payments to its patrons. A reasonable method includes reporting this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

**§1.199A-8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives**

(a) Overview--(1) In general. This section provides rules relating to the deduction for income attributable to domestic production activities of a specified agricultural or horticultural cooperative (Specified Cooperative). This paragraph (a) provides an overview and definitions of certain terms. Paragraph (b) of this section provides rules explaining the steps a nonexempt Specified Cooperative performs to calculate its section 199A(g) deduction and includes definitions of relevant terms. Paragraph (c) of this section provides rules explaining the steps an exempt Specified Cooperative performs to calculate its section 199A(g) deduction. Paragraph (d) of this section provides rules for Specified Cooperatives passing through the section 199A(g) deduction to patrons. Paragraph (e) of this section provides examples that illustrate the provisions of paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section provides guidance for Specified Cooperatives that are partners in a partnership. Paragraph (g) of this section provides guidance on the recapture of a claimed section 199A(g) deduction. Paragraph (h) of this section provides effective dates. For additional rules addressing an expanded affiliated group (EAG), to which the principles of this section apply, see §1.199A-12. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) Specified Cooperative--(i) In general. Specified Cooperative means a cooperative to which Part I of subchapter T of chapter 1 of the Code applies and which--

(A) Manufactures, produces, grows, or extracts (MPGE) in whole or significant part within the United States any agricultural or horticultural product, or

(B) Is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the United States by the patrons of the cooperative.

(C) See §1.199A-9 for rules to determine if a Specified Cooperative has MPGE an agricultural or horticultural product in whole or significant part within the United States.

(ii) Types of Specified Cooperatives. A Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 is an exempt Specified

Cooperative, while a Specified Cooperative not so qualified is a nonexempt Specified Cooperative.

(3) Patron is defined in §1.1388-1(e).

(4) Agricultural or horticultural products are agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural products also include aquatic products that are farmed. Some examples of agricultural or horticultural products include, but are not limited to, fruits, grains, oilseeds, rice, vegetables, legumes, grasses (including hay), plants of all kinds, flowers (including hops), seeds, tobacco, cotton, sugar cane and sugar beets. Some examples of livestock products include, but are not limited to, wool, fur, hides, eggs, down, honey, and silk. Some examples of edible forestry products include, but are not limited to, fruits, nuts, berries and mushrooms. Some examples of aquatic products include, but are not limited to, fish, crustaceans, shellfish and seaweed. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies (for example, seed, feed, herbicides, and pesticides) used in agricultural or horticultural production that are MPGE by a Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property other than when incorporated into a tangible agricultural or horticultural product (other than as provided in the exception in §1.199A-9(b)(2)). Intangible property for this purpose includes, for example, the rights to MPGE and sell an agricultural or horticultural product with certain characteristics protected by a patent, or the rights to a trademark or tradename. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges

would be considered from the disposition of agricultural or horticultural products. However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product.

(b) Steps for a nonexempt Specified Cooperative in calculating deduction--(1) In general. Except as provided in paragraph (c)(3) of this section, this paragraph (b) applies only to nonexempt Specified Cooperatives.

(2) Step 1 - Gross receipts and related deductions--(i) Identify. To determine the section 199A(g) deduction, a Specified Cooperative first identifies its patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W-2 wages, etc. (deductions) and allocates them between patronage and nonpatronage. A single definition for the term patronage and nonpatronage is found in §1.1388-1(f).

(ii) Applicable gross receipts and deductions. Except as described in this paragraph (b)(ii), for all purposes of the section 199A(g) deduction, a Specified Cooperative can use only patronage gross receipts and related deductions to calculate qualified production activities income (QPAI) as defined in paragraph (b)(4)(ii) of this section, oil-related QPAI as defined in paragraph (b)(7)(ii) of this section, the W-2 wage limitation in paragraph (b)(5)(ii)(B) of this section, or taxable income as defined in paragraph (b)(5)(ii)(C) of this section. A Specified Cooperative cannot use its nonpatronage gross receipts and related deductions to calculate its section 199A(g) deduction, other than treating all of its nonpatronage gross receipts as patronage non-DPGR for purposes of applying the de minimis rules in §1.199A-9(c)(3). If a Specified Cooperative treats all nonpatronage gross receipts as DPGR under §1.199A-9(c)(3)(i), then a Specified Cooperative shall also treat its deductions related to the nonpatronage gross receipts as patronage in calculating QPAI, oil-related QPAI, the W-2 wage limitation, or taxable income for purposes of the section 199A(g) deduction.

(iii) Gross receipts are the Specified Cooperative's receipts for the taxable year that are recognized under the Specified Cooperative's methods of accounting used for Federal income tax purposes for the taxable year. See §1.199A-12 if the gross receipts are recognized in an intercompany transaction within the meaning of §1.1502-13. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (except interest under section 103 but including original issue discount), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the Specified Cooperative's trade or business. Gross receipts are not reduced by COGS or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Finally, gross receipts do not include amounts received by the Specified Cooperative with respect to sales tax or other similar state or local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the Specified Cooperative merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the Specified Cooperative under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(3) Step 2 – Determine gross receipts that are DPGR--(i) In general. A Specified Cooperative examines its patronage gross receipts to determine which of these are DPGR. A Specified Cooperative does not use nonpatronage gross receipts to determine DPGR.

(ii) DPGR are the gross receipts of the Specified Cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is MPGE by the Specified Cooperative or its patrons in whole or significant part within the United States. DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. See §1.199A-9 for additional rules on determining if gross receipts are DPGR.

(4) Step 3 – Determine QPAI--(i) In general. A Specified Cooperative determines QPAI from patronage DPGR and patronage deductions identified in paragraphs (b)(3)(ii) and (b)(2)(i) of this section, respectively. A Specified Cooperative does not use nonpatronage gross receipts or deductions to determine QPAI.

(ii) QPAI for the taxable year means an amount equal to the excess (if any) of--

(A) DPGR for the taxable year, over

(B) The sum of--

(1) COGS that are allocable to DPGR, and

(2) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR.

(C) QPAI computational rules. QPAI is computed without taking into account the section 199A(g) deduction or any deduction allowed under section 1382(b). See §1.199A-10 for additional rules on calculating QPAI.

(5) Step 4 – Calculate deduction--(i) In general. From QPAI and taxable income, a Specified Cooperative calculates its section 199A(g) deduction as provided in paragraph (b)(5)(ii) of this section.

(ii) Deduction--(A) In general. A Specified Cooperative is allowed a deduction equal to 9 percent of the lesser of--

(1) QPAI of the Specified Cooperative for the taxable year, or

(2) Taxable income of the Specified Cooperative for the taxable year.

(B) W-2 wage limitation. The deduction allowed under paragraph (b)(5)(ii)(A) of this section for any taxable year cannot exceed 50 percent of the patronage W-2 wages attributable to DPGR for the taxable year. See §1.199A-11 for additional rules on calculating the patronage W-2 wage limitation.

(C) Taxable income. Taxable income is defined in section 63, and adjusted under section 1382 and §1.1382-1 and §1.1382-2. For purposes of determining the amount of the deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from patronage sources, other than as allowed under paragraph (b)(2)(ii) of this section. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Patronage net operating losses (NOLs) reduce taxable income in the amount that the Specified Cooperative would use to reduce taxable income (no lower than zero) before using the section 199A(g) deduction, but do not reduce taxable income that is the result of not taking into account any deduction allowable under section 1382(b).

(6) Use of patronage section 199A(g) deduction. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the patronage section 199A(g) deduction cannot create or increase a patronage or nonpatronage NOL or the amount of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A patronage section 199A(g) deduction can be applied only against patronage income and deductions. A patronage section 199A(g) deduction that is not used in the appropriate taxable year is lost. To the extent that a Specified Cooperative passes through the section 199A(g) deduction to patrons and appropriately adjusts the section 1382 deduction under §1.199A-8(d), the amount passed through is not considered to create or increase a patronage or nonpatronage NOL or the amount

of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172.

(7) Special rules for nonexempt Specified Cooperatives that have oil-related QPAI--(i) Reduction of section 199A(g) deduction. If a Specified Cooperative has oil-related QPAI for any taxable year, the amount otherwise allowable as a deduction under paragraph (b)(5)(ii) of this section must be reduced by 3 percent of the least of--

(A) Oil-related QPAI of the Specified Cooperative for the taxable year,

(B) QPAI of the Specified Cooperative for the taxable year, or

(C) Taxable income of the Specified Cooperative for the taxable year.

(ii) Oil-related QPAI means, for any taxable year, the patronage QPAI that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year. Oil-related QPAI for any taxable year is an amount equal to the excess (if any) of patronage DPGR derived from the production, refining or processing of oil, gas, or any primary product thereof (oil-related DPGR) over the sum of--

(A) COGS of the Specified Cooperative that is allocable to such receipts; and

(B) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to such receipts.

(iii) Special rule for patronage oil-related DPGR. Oil-related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof. However, to the extent that the nonexempt Specified Cooperative treats gross receipts derived from transportation or distribution of oil, gas, or any primary product thereof as part of DPGR under §1.199A-9(c)(3)(i), or under §1.199A-9(j)(3)(i)(B), then the Specified Cooperative must treat those patronage gross receipts as oil-related DGPR.

(iv) Oil includes oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. The primary product from oil includes all products derived from the destructive distillation of oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. The primary product from gas means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. The primary products from oil and gas provided in this paragraph (b)(7)(iv) are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.

(c) Exempt Specified Cooperatives--(1) In general. This paragraph (c) applies only to exempt Specified Cooperatives.

(2) Two section 199A(g) deductions. The Specified Cooperative must calculate two separate section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced, unless a Specified Cooperative treats all of its nonpatronage gross receipts and related deductions as patronage as described in paragraph (b)(2)(ii) of this section. Patronage and nonpatronage gross receipts, related COGS that are allocable to DPGR, and other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR (deductions), DPGR, QPAI, NOLs, W-2 wages, etc. are not netted to calculate these two separate section 199A(g) deductions.

(3) Exempt Specified Cooperative patronage section 199A(g) deduction. The Specified Cooperative calculates its patronage section 199A(g) deduction following steps 1 through 4 in paragraphs (b)(2) through (5) of this section as if it were a nonexempt Specified Cooperative.

(4) Exempt Specified Cooperative nonpatronage section 199A(g) deduction--(i) In general. The Specified Cooperative calculates its nonpatronage section 199A(g) deduction following steps 2 through 4 in paragraphs (b)(2) through (5) of this section using only nonpatronage gross receipts and related nonpatronage deductions, unless a Specified Cooperative treats all of its nonpatronage gross receipts and related deductions as patronage as described in paragraph (b)(2)(ii) of this section. For purposes of determining the amount of the nonpatronage section 199A(g) deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from nonpatronage sources. Nonpatronage NOLs reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(c).

(ii) Use of nonpatronage section 199A(g) deduction. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the nonpatronage section 199A(g) deduction cannot create or increase a nonpatronage NOL or the amount of nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A Specified Cooperative cannot pass through its nonpatronage section 199A(g) deduction under paragraph (d) of this section and can apply the nonpatronage section 199A(g) deduction only against its nonpatronage income and deductions. As is the case for the patronage section 199A(g) deduction, the nonpatronage section 199A(g) deduction that a Specified Cooperative does not use in the appropriate taxable year is lost.

(d) Discretion to pass through deduction--(1)(i) In general. A Specified Cooperative may, at its discretion, pass through all, some, or none of its patronage section 199A(g) deduction to all patrons. Only eligible taxpayers as defined in section 199A(g)(2)(D) may claim the section 199A(g) deduction that is passed through. A Specified Cooperative member of a federated cooperative may pass through the patronage section 199A(g) deduction it receives from the federated cooperative to its member patrons.

(ii) Specified Cooperative identifies eligibility of patron. If a Specified Cooperative determines that a patron is not an eligible taxpayer, then the Specified Cooperative may, at its discretion, retain any of the patronage section 199A(g) deduction attributable to the patron that would otherwise be passed through and lost under the general rule in paragraph (d)(1)(i) of this section.

(2) Amount of deduction being passed through--(i) In general. A Specified Cooperative is permitted to pass through an amount equal to the portion of the Specified Cooperative's section 199A(g) deduction that is allowed with respect to the portion of the cooperative's QPAI that is attributable to the qualified payments the Specified Cooperative distributed to the patron during the taxable year and identified on the notice required in §1.199A-7(f)(3) on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR), (or any successor form) issued by the Specified Cooperative to the patron, unless otherwise provided by the instructions to the Form. The notice requirement to pass through the section 199A(g) deduction is in paragraph (d)(3) of this section.

(ii) Qualified payment means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a Specified Cooperative that is attributable to the portion of the Specified Cooperative's QPAI, for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the taxable year.

(3) Notice requirement to pass through deduction. A Specified Cooperative must identify in a written notice the amount of the section 199A(g) deduction being passed through to its patrons. This written notice must be mailed by the Specified Cooperative to the patron no later than the 15th day of the ninth month following the close of the taxable year of the Specified Cooperative. The Specified Cooperative may use the same written notice, if any, that it uses to notify the patron of the patron's respective allocations of patronage distributions, or may use a separate timely written notice(s) to comply with this section. The Specified Cooperative must report the amount of section 199A(g) deduction passed through to the patron on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Specified Cooperative to the patron, unless otherwise provided by the instructions to the Form.

(4) Section 199A(g) deduction allocated to eligible taxpayer. An eligible taxpayer may deduct the lesser of the section 199A(g) deduction identified on the notice described in paragraph (d)(3) of this section or the eligible taxpayer's taxable income in the taxable year in which the eligible taxpayer receives the timely written notice described in paragraph (d)(3) of this section. For this purpose, the eligible taxpayer's taxable income is determined without taking into account the section 199A(g) deduction being passed through to the eligible taxpayer and after taking into account any section 199A(a) deduction allowed to the eligible taxpayer. Any section 199A(g) deduction the eligible taxpayer does not use in the taxable year in which the eligible taxpayer receives the notice (received on or before the due date of the Form 1099-PATR) is lost and cannot be carried forward or back to other taxable years. The taxable income limitation for the section 199A(a) deduction set forth in section 199A(b)(3) and

§1.199A-1(a) and (b) does not apply to limit the deductibility of the section 199A(g) deduction passed through to the eligible taxpayer.

(5) Special rules for eligible taxpayers that are Specified Cooperatives. Any Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction against patronage gross income and related deductions to the extent it relates to its patronage gross income and related deductions. Only a patron that is an exempt Specified Cooperative may take a section 199A(g) deduction passed through from another Specified Cooperative if the deduction relates to the patron Specified Cooperative's nonpatronage gross income and related deductions.

(6) W-2 wage limitation. The W-2 wage limitation described in paragraph (b)(5)(ii)(B) of this section is applied at the cooperative level whether or not the Specified Cooperative chooses to pass through some or all of the section 199A(g) deduction. Any section 199A(g) deduction that has been passed through by a Specified Cooperative to an eligible taxpayer is not subject to the W-2 wage limitation a second time at the eligible taxpayer's level.

(7) Specified Cooperative denied section 1382 deduction for portion of qualified payments. A Specified Cooperative must reduce its section 1382 deduction by an amount equal to the portion of any qualified payment that is attributable to the Specified Cooperative's section 199A(g) deduction passed through. This means the Specified Cooperative must reduce its section 1382 deduction in an amount equal to the section 199A(g) deduction passed through.

(8) No double counting. A qualified payment received by a Specified Cooperative that is a patron of a Specified Cooperative is not taken into account by the patron for purposes of section 199A(g).

(e) Examples. The following examples illustrate the application of paragraphs (a), (b), (c), and (d) of this section. The examples of this section apply solely for purposes of section 199A of the Code. Assume for each example that the Specified Cooperative sent all required notices to patrons on or before the due date of the Form 1099-PATR.

(1) Example 1. Nonexempt Specified Cooperative calculating section 199A(g) deduction. (i) C is a grain marketing nonexempt Specified Cooperative, with $5,250,000 in gross receipts during 2020 from the sale of grain grown by its patrons. C paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations and another $1,000,000 in patronage dividends after the close of the 2020 taxable year. C has other expenses of $250,000 during 2020, including $100,000 of W-2 wages.

(ii) C has DPGR of $5,250,000 and QPAI as defined in §1.199A-8(b)(4)(ii) of $5,000,000 for 2020. C's section 199A(g) deduction is equal to the least of 9% of QPAI ($450,000), 9% of taxable income ($450,000), or 50% of W-2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $5,000,000 deduction allowable under section 1382(b) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000.

(2) Example 2. Nonexempt Specified Cooperative determines amounts included in QPAI and taxable income. (i) C, a nonexempt Specified Cooperative, offers harvesting services and markets the grain of patrons and nonpatrons. C had gross receipts from harvesting services and grain sales, and expenses related to both. All of C's harvesting services were performed for their patrons, and 75% of the grain sales were for patrons.

(ii) C identifies 75% of the gross receipts and related expenses from grain sales and 100% of the gross receipts and related expenses from the harvesting services as patronage sourced. C identifies 25% of the gross receipts and related expenses from grain sales as nonpatronage sourced.

(iii) C does not include any nonpatronage gross receipts or related expenses from grain sales in either QPAI or taxable income when calculating the section 199A(g) deduction. C's QPAI includes the patronage DPGR, less related expenses (allocable COGS, wages and other expenses). C's taxable income includes the patronage gross receipts, whether such gross receipts are DPGR or non-DPGR.

(iv) C allocates and reports patronage dividends to its harvesting patrons and grain marketing patrons. C also notifies its grain marketing patrons (in accordance with the requirements of §1.199A-7(f)(3)) that their patronage dividends are qualified payments used in C's section 199A(g) computation. The patrons must use this information for purposes of computing their section 199A(b)(7) reduction to their section 199A(a) deduction (see §1.199A-7(f)).

(3) Example 3. Nonexempt Specified Cooperative with patronage and nonpatronage gross receipts and related deductions. (i) C, a nonexempt Specified Cooperative, markets corn grown by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. Such gross receipts qualify as DPGR. Assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction allowed under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500, and has nonpatronage deductions in the amount of $400 (including COGS, other expenses, and $100 of W-2 wages).

(ii) C does not include any gross receipts or deductions from nonpatronage sources when calculating the deduction under paragraph (b)(5)(ii) of this section. C's QPAI and taxable income both equal $1,000 ($1,800 – 800). C's deduction under paragraph (b)(5)(ii) of this section for the taxable year is equal to $90 (9% of $1,000), which does not exceed $200 (50% of C's W-2 wages properly allocable to DPGR). C passes through $90 of the deduction to patrons and C reduces its section 1382(b) deduction by $90.

(4) Example 4. Exempt Specified Cooperative with patronage and nonpatronage income and deductions. (i) C, an exempt Specified Cooperative, markets corn MPGE by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. For this activity assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500. Assume the gross receipts qualify as DPGR. For this activity assume C has $400 of expenses (including COGS, other expenses, and $20 of W-2 wages) properly allocable to DPGR and no deduction under section 1382(c).

(ii) C calculates two separate section 199A(g) deduction amounts. C's section 199A(g) deduction attributable to patronage sources is the same as the deduction calculated by the nonexempt Specified Cooperative in Example 1 in paragraph (e)(1) of this section.

(iii) C's nonpatronage QPAI and taxable income is equal to $100 ($500 – $400). C's deduction under paragraph (c)(4) of this section that directs C to use paragraph (b)(5)(ii) of this section attributable to nonpatronage sources is equal to $9 (9% of $100), which does not exceed $10 (50% of C's W-2 wages properly allocable to DPGR). C cannot pass through any of the nonpatronage section 199A(g) deduction amount to its patrons.

(5) Example 5. NOL. (i) In 2021, E, a nonexempt Specified Cooperative that is not part of an EAG, generates QPAI and taxable income of $100 (without taking into account any section 1382(b) deductions, NOLs, or the section 199A(g) deduction). E pays out patronage dividends of $91 that are deductible under section 1382(b). E has

an NOL carryover of $500 attributable to losses incurred prior to 2018. While taxable income and QPAI do not take into account the section 1382(b) deduction, taxable income does take into account NOLs. When calculating its section 199A(g) deduction, E must take into account the NOL carryover when calculating taxable income, unless the taxable income is the result of not taking into account any deduction allowable under section 1382(b). In this case $91 of taxable income is the result of not taking into account the deduction allowed under section 1382(b) and the remaining $9 should be reduced by the NOL carryover so that taxable income equals $91. E calculates a section 199A(g) deduction of $8.19 (.09 x $91 (which is the lesser of $100 QPAI or $91 taxable income)).

(ii) E may pass through the entire $8.19 of section 199A(g) deduction to patrons (which will reduce its section 1382(b) deduction from $91 to $82.81). However, if E does not pass the deduction through, paragraph (b)(6) of this section prohibits E from claiming any of the section 199A(g) deduction in 2021.

(iii) If E passes through the deduction to patrons, E’s taxable income under section 172(b)(2) for NOL absorption purposes is $9 ($100 - $82.81 - $9 NOL - $8.19 section 199A(g) deduction). If E does not pass through the deduction, then E’s taxable income under section 172(b)(2) for NOL absorption purposes is $9 ($100 - $91 - $9 NOL).

(iv) Assuming E passes through the deduction to patrons, E would use $9 of the NOL carryover and have a $491 NOL carryover remaining. To the extent E does not pass through the deduction, E would still use $9 of the NOL carryover and have a $491 NOL carryover remaining.

(6) Example 6. Nonexempt Specified Cooperative not passing through the section 199A(g) deduction to patrons. (i) D, a nonexempt Specified Cooperative, markets corn grown by its patrons within the United States. For its calendar year ended

December 31, 2020, D has gross receipts of $1,500,000, all derived from the sale of corn grown by its patrons within the United States. D pays $300,000 for its patrons' corn at the time the grain was delivered in the form of per-unit retain allocations and its W-2 wages (as defined in §1.199A-11)) for 2020 total $200,000. D has no other costs. Patron A is a patron of D. Patron A is a cash basis taxpayer and files Federal income tax returns on a calendar year basis. All corn grown by Patron A in 2020 is sold through D and Patron A is eligible to share in patronage dividends paid by D for that year.

(ii) All of D's gross receipts from the sale of its patrons' corn qualify as DPGR (as defined paragraph (8)(b)(3)(ii) of this section). D's QPAI and taxable income is $1,300,000. D's section 199A(g) deduction for its taxable year 2020 is $117,000 (.09 x $1,300,000). Because this amount is less than 50% of Cooperative X's W-2 wages, the entire amount is allowed as a section 199A(g) deduction. D decides not to pass any of its section 199A(g) deduction to its patrons. The section 199A(g) deduction of $117,000 is applied to, and reduces, D's taxable income.

(7) Example 7. Nonexempt Specified Cooperative passing through the section 199A(g) deduction to patrons paid a patronage dividend. (i) The facts are the same as in Example 6 except that D decides to pass its entire section 199A(g) deduction through to its patrons. D declares a patronage dividend for its 2020 taxable year of $1,000,000, which it pays on March 15, 2021. Pursuant to paragraph (d)(3) of this section, D notifies patrons in written notices that accompany the patronage dividend notification that D is allocating to them the section 199A(g) deduction D is entitled to claim in the calendar year 2020. On March 15, 2021, Patron A receives a $10,000 patronage dividend that is a qualified payment under paragraph (d)(2)(ii) of this section from D. In the notice that accompanies the patronage dividend, Patron A is designated a $1,170 section 199A(g) deduction. Under paragraph (a) of this section, Patron A may claim a $1,170 section 199A(g) deduction for the taxable year ending December 31,

2021, subject to the limitations set forth under paragraph (d)(4) of this section. D must report the allowable amount of Patron A's section 199A(g) deduction on Form 1099-PATR, "Taxable Distributions Received From Cooperatives," issued to Patron A for the calendar year 2021.

(ii) Under paragraph (d)(7) of this section, D is required to reduce its section 1382 deduction of $1,300,000 by the $117,000 section 199A(g) deduction passed through to patrons (whether D pays patronage dividends on book or Federal income tax net earnings). As a consequence, D is entitled to a section 1382 deduction for the taxable year ending December 31, 2020, in the amount of $1,183,000 ($1,300,000 - $117,000) and to a section 199A(g) deduction in the amount of $117,000 ($1,300,000 x .09). Its taxable income for 2020 is $0.

(8) <u>Example 8</u>. <u>Nonexempt Specified Cooperative passing through the section 199A(g) deduction to patrons paid a patronage dividend and advances on expected patronage net earnings</u>. (i) The facts are the same as in Example 6 except that D paid out $500,000 to its patrons as advances on expected patronage net earnings. In 2020, D pays its patrons a $500,000 ($1,000,000–$500,000 already paid) patronage dividend in cash or a combination of cash and qualified written notices of allocation. Under paragraph (d)(7) of this section and section 1382, D is allowed a deduction of $1,183,000 ($1,300,000 – $117,000 section 199A(g) deduction), whether patronage net earnings are distributed on book or Federal income tax net earnings.

(ii) The patrons will have received a gross amount of $1,300,000 in qualified payments under paragraph (d)(2)(ii) of this section from Cooperative D ($300,000 paid as per-unit retain allocations, $500,000 paid during the taxable year as advances, and the additional $800,000 paid as patronage dividends). If D passes through its entire section 199A(g) deduction to its patrons by providing the notice required by paragraph (d)(3) of this section, then the patrons will be allowed a $117,000 section 199A(g) deduction, resulting in a net $1,183,000 taxable distribution from D. Pursuant to paragraph (d)(8) of this section, any of the $1,300,000 received by patrons that are Specified Cooperatives from D is not taken into account for purposes of calculating the patrons' section 199A(g) deduction. Patrons that are not Specified Cooperatives must include those payments in the section 199A(b)(7) reduction when calculating a section 199A(a) deduction as applicable.

(9) Example 9. Intangible property transaction as part of disposition of agricultural or horticultural products. F, a Specified Cooperative, markets patrons' oranges by processing the oranges into orange juice, and then bottling and selling the orange juice to customers. F markets the orange juice under its own brand name, but F also licenses from G, an unrelated third party, the rights to use G's brand name on the bottled orange juice. F's gross receipts from the sale of both brands of orange juice qualify as DPGR, assuming all other requirements of this section are met.

(10) Example 10. Intangible property transaction that is not a disposition of an agricultural or horticultural product. H, a Specified Cooperative, licenses H's brand name to J, an unrelated third party. J purchases oranges, produces orange juice, and then bottles and sells the orange juice to customers. Gross receipts that H derives from the license of the brand name to J are not DPGR from the disposition of an agricultural or horticultural product.

(11) Example 11. Allocation rules when Specified Cooperative retains the section 199A(g) deduction attributable to non-eligible taxpayers. K, a Specified Cooperative, for the taxable year has $200 of taxable income and QPAI ($100 is attributable to business done for patrons that are C corporation patrons and $100 is attributable to business done for patrons that are eligible taxpayers). K calculates an $18 section 199A(g) deduction. K passes through $9 to its patrons that are eligible taxpayers, distributes $191 to patrons in distributions that are deductible under section

1382(b)(including patronage dividends that were paid out in the same amounts to C corporation patrons and eligible taxpayer patrons because the value of their business,$100 each, was the same), and adjusts its deduction under section 1382 by $9 (the amount of the section 199A(g) deduction passed through). K's taxable income after the section 199A deduction and distributions is $0.

(f) Special rule for Specified Cooperative partners. In the case described in section 199A(g)(5)(B), where a Specified Cooperative is a partner in a partnership, the partnership must separately identify and report on the Schedule K-1 of the Form 1065, U.S. Return of Partnership Income (or any successor form) issued to the Specified Cooperative partner the cooperative's share of gross receipts and related deductions, unless otherwise provided by the instructions to the Form. The Specified Cooperative partner determines what gross receipts reported by the partnership qualify as DPGR and includes these gross receipts and related deductions, W-2 wages, and COGS to calculate one section 199A(g) deduction (in the case of a nonexempt Specified Cooperative) or two section 199A(g) deductions (in the case of an exempt Specified Cooperative) using the steps set forth in paragraphs (b) and (c) of this section. For purposes of determining whether gross receipts are DPGR, the MPGE activities of the Specified Cooperative partner may be attributed to the partnership, and the partnership's MPGE activities may be attributed to the Specified Cooperative partner.

(g) Recapture of section 199A(g) deduction. If the amount of the section 199A(g) deduction that was passed through to eligible taxpayers exceeds the amount allowable as a section 199A(g) deduction as determined on examination or reported on an amended return, then recapture of the excess will occur at the Specified Cooperative level in the taxable year the Specified Cooperative took the excess section 199A(g) deduction.

(h) Applicability date. Except as provided in paragraph (h)(2) of §1.199A-7, the provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

**§1.199A-9 Domestic production gross receipts.**

(a) Domestic production gross receipts--(1) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance to determine what gross receipts (defined in §1.199A-8(b)(2)(iii)) are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)). DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. Partners, including partners in an EAG partnership described in §1.199A-12(i)(1), may not treat guaranteed payments under section 707(c) as DPGR.

(2) Application to marketing cooperatives. For purposes of determining DPGR, a Specified Cooperative (defined in §1.199A-8(a)(2)) will be treated as having manufactured, produced, grown, or extracted (MPGE) (defined in paragraph (f) of this section) in whole or significant part (defined in paragraph (h) of this section) any agricultural or horticultural product (defined in §1.199A-8(a)(4)) within the United States (defined in paragraph (i) of this section) marketed by the Specified Cooperative which its patrons (defined in §1.1388-1(e)) have so MPGE.

(b) Related persons--(1) In general. Pursuant to section 199A(g)(3)(D)(ii), DPGR does not include any gross receipts derived from agricultural or horticultural products leased, licensed, or rented by the Specified Cooperative for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). Any other person is an unrelated person for purposes of the section 199A(g) deduction.

(2) Exceptions. Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any agricultural or horticultural product leased or rented by the Specified Cooperative to a related person may qualify as DPGR if the agricultural or horticultural product is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from a license of the right to reproduce an agricultural or horticultural product to a related person for reproduction and sale, exchange, lease, or rental to an unrelated person for the ultimate use of the unrelated person are treated as gross receipts from a disposition of an agricultural or horticultural product and may qualify as DPGR.

(c) Allocating gross receipts--(1) In general. A Specified Cooperative must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR using a reasonable method based on all the facts and circumstances. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR, whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a Specified Cooperative sells an agricultural or horticultural product and, in connection with that sale, also provides services, the Specified Cooperative must allocate its gross receipts from the transaction using a reasonable method based on all the facts and circumstances that accurately identifies the gross receipts that constitute DPGR and non-DPGR in accordance with the requirements of §1.199A-8(b) and/or (c). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts for the taxable year that is DPGR and the portion of gross receipts that is non-DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (c)(1).

(2) Reasonable method of allocation. If a Specified Cooperative has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts are derived from an item (and thus, are DPGR), then the Specified Cooperative must use that specific identification to determine DPGR. If the Specified Cooperative does not have information readily available to specifically identify whether gross receipts are derived from an item or cannot, without undue burden or expense, specifically identify whether gross receipts are derived from an item, then the Specified Cooperative is not required to use a method that specifically identifies whether the gross receipts are derived from an item but can use a reasonable allocation method. Factors taken into consideration in determining whether the Specified Cooperative's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year.

(3) De minimis rules--(i) DPGR. A Specified Cooperative's applicable gross receipts as provided in §1.199A-8(b) and/or (c) may be treated as DPGR if less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR (after

application of the exceptions provided in §1.199A-9(j)(3)). If the amount of the Specified Cooperative's gross receipts that are non-DPGR equals or exceeds 10 percent of the Specified Cooperative's total gross receipts, then, except as provided in paragraph (c)(3)(ii) of this section, the Specified Cooperative is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (c)(1) of this section. If a Specified Cooperative is a member of an expanded affiliated group (EAG) (defined in §1.199A-12), but is not a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the consolidated group level. <u>See</u> §1.199A-12(d).

(ii) <u>Non-DPGR</u>. A Specified Cooperative's applicable gross receipts as provided in §§1.199A-8(b) and/or (c) may be treated as non-DPGR if less than 10 percent of the Specified Cooperative's total gross receipts are DPGR. If a Specified Cooperative is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are DPGR is made at the consolidated group level.

(d) <u>Use of historical data for multiple-year transactions</u>. If a Specified Cooperative recognizes and reports gross receipts from upfront payments or other similar payments on a Federal income tax return for a taxable year, then the Specified Cooperative's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a

Specified Cooperative makes allocations using historical data, and subsequently updates the data, then the Specified Cooperative must use the more recent or updated data, starting in the taxable year in which the update is made.

(e) Determining DPGR item-by-item--(1) In general. For purposes of the section 199A(g) deduction, a Specified Cooperative determines, using a reasonable method based on all the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts that is DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (e)(1).

(i) The term item means the agricultural or horticultural product offered by the Specified Cooperative in the normal course of its trade or business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (e), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such product qualify as DPGR; or

(ii) If paragraph (e)(1)(i) of this section does not apply to the product, then any component of the product described in paragraph (e)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the product described in paragraph (e)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (e)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (e)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) Special rules. (i) For purposes of paragraph (e)(1)(i) of this section, in no event may a single item consist of two or more products unless those products are

offered for disposition, in the normal course of the Specified Cooperative's trade or business, as a single item (regardless of how the products are packaged).

(ii) In the case of agricultural or horticultural products customarily sold by weight or by volume, the item is determined using the most common custom of the industry (for example, barrels of oil).

(3) Exception. If the Specified Cooperative MPGE agricultural or horticultural products within the United States that it disposes of, and the Specified Cooperative leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the agricultural or horticultural products (or a portion thereof), and the Specified Cooperative cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original agricultural or horticultural products MPGE by the Specified Cooperative, then the Specified Cooperative is not required to determine whether any portion of the acquired property qualifies as an item for purposes of paragraph (e)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences apply if the Specified Cooperative can reasonably determine that the acquired property contains agricultural or horticultural products (or a portion thereof) MPGE by the Specified Cooperative, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the agricultural or horticultural MPGE by the Specified Cooperative the acquired property contains.

(f) Definition of manufactured, produced, grown, or extracted (MPGE)--(1) In general. Except as provided in paragraphs (f)(2) and (3) of this section, the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating agricultural or horticultural products; making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, and farming aquatic products. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural or horticultural products only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative. The Specified Cooperative (or the patron if §1.199A-9(a)(2) applies) must have the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the MPGE activity occurs for the gross receipts derived from the MPGE of the agricultural or horticultural products to qualify as DPGR.

(2) Packaging, repackaging, or labeling. If the Specified Cooperative packages, repackages, or labels agricultural or horticultural products and engages in no other MPGE activity with respect to those agricultural or horticultural products, the packaging, repackaging, or labeling does not qualify as MPGE with respect to those agricultural or horticultural products.

(3) Installing. If a Specified Cooperative installs agricultural or horticultural products and engages in no other MPGE activity with respect to the agricultural or horticultural products, the Specified Cooperative's installing activity does not qualify as an MPGE activity. Notwithstanding paragraph (j)(3)(i)(A) of this section, if the Specified Cooperative installs agricultural or horticultural products MPGE by the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the agricultural or horticultural products is an MPGE activity.

(4) Consistency with section 263A. A Specified Cooperative that has MPGE agricultural or horticultural products for the taxable year must treat itself as a producer

under section 263A with respect to the agricultural or horticultural products unless the Specified Cooperative is not subject to section 263A.  A Specified Cooperative that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2015-13, 2015-5 IRB 419, or any applicable subsequent guidance (see §601.601(d)(2) of this chapter)).

(5) Examples.  The following examples illustrate the application of paragraphs (f)(1), (2), and (3) of this section.

(i) Example 1. MPGE activities conducted within United States.  A, B, and C are unrelated persons.  A is a Specified Cooperative, B is an individual patron of A, and C is a C corporation.  B grows agricultural products outside of the United States and A markets those agricultural products for B.  A stores the agricultural products in agricultural storage bins in the United States and has the benefits and burdens of ownership under Federal income tax principles of the agricultural products while they are being stored.  A sells the agricultural products to C, who processes them into refined agricultural products in the United States.  The gross receipts from A's activities are DPGR from the MPGE of agricultural products.

(ii) Example 2. MPGE activities conducted within and outside United States.  The facts are the same as in Example 1 except that B grows the agricultural products outside the United States and C processes them into refined agricultural products outside the United States.  Pursuant to paragraph (f)(1) of this section, the gross receipts derived by A from its sale of the agricultural products to C are DPGR from the MPGE of agricultural products within the United States.

(g) By the taxpayer. With respect to the exception of the rules applicable to an EAG and EAG partnerships under §1.199A-12, only one Specified Cooperative may claim the section 199A(g) deduction with respect to any qualifying activity under paragraph (f) of this section performed in connection with the same agricultural or horticultural product. If an unrelated party performs a qualifying activity under paragraph (f) of this section pursuant to a contract with a Specified Cooperative (or its patron as relevant under paragraph (a)(2) of this section), then only if the Specified Cooperative (or its patron) has the benefits and burdens of ownership of the agricultural or horticultural product under Federal income tax principles during the period in which the qualifying activity occurs is the Specified Cooperative (or its patron) treated as engaging in the qualifying activity.

(h) In whole or significant part defined--(1) In general. Agricultural or horticultural products must be MPGE in whole or significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) and in whole or significant part within the United States to qualify under section 199A(g)(3)(D)(i). If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE agricultural or horticultural products for the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under applicable Federal income tax principles during the period the MPGE activity occurs, then, pursuant to paragraph (g) of this section, the Specified Cooperative is considered to MPGE the agricultural or horticultural products under this section. The unrelated person must perform the MPGE activity on behalf of the Specified Cooperative in whole or significant part within the United States in order for the Specified Cooperative to satisfy the requirements of this paragraph (h)(1).

(2) Substantial in nature. Agricultural or horticultural products will be treated as MPGE in whole or in significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) within the United States for purposes of paragraph (h)(1) of this section. However, MPGE of the agricultural or horticultural products by the Specified Cooperative within the United States must be substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the Specified Cooperative's MPGE within the United States, the nature of the agricultural or horticultural products, and the nature of the MPGE activity that the Specified Cooperative performs within the United States. The MPGE of a key component of an agricultural or horticultural product does not, in itself, meet the substantial-in-nature requirement with respect to an agricultural or horticultural product under this paragraph (h)(2). In the case of an agricultural or horticultural product, research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of the agricultural or horticultural product is substantial in nature.

(3) Safe harbor--(i) In general. A Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) will be treated as having MPGE an agricultural or horticultural product in whole or in significant part within the United States for purposes of paragraph (h)(1) of this section if the direct labor and overhead of such Specified Cooperative to MPGE the agricultural or horticultural product within the United States account for 20 percent or more of the Specified Cooperative's COGS of the agricultural or horticultural product, or in a transaction without COGS (for example, a lease, rental, or license), account for 20 percent or more of the Specified Cooperative's unadjusted depreciable basis (as defined in paragraph (h)(3)(ii) of this section) in property included in the definition of agricultural or horticultural products. For Specified Cooperatives subject to section 263A, overhead is all costs required to be capitalized

under section 263A except direct materials and direct labor. For Specified Cooperatives not subject to section 263A, overhead may be computed using a reasonable method based on all the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the Specified Cooperative were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any agricultural or horticultural product. In the case of agricultural or horticultural products, research and experimental expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from COGS or unadjusted depreciable basis for purposes of determining whether the Specified Cooperative meets the safe harbor under this paragraph (h)(3). For Specified Cooperatives not subject to section 263A, the chosen reasonable method to compute overhead must be consistently applied from one taxable year to another and must clearly reflect the Specified Cooperative's portion of overhead not subject to section 263A. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for overhead must be consistent with any allocations under this paragraph (h)(3)(i).

(ii) Unadjusted depreciable basis. The term unadjusted depreciable basis means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for--

(A) Any portion of the basis the Specified Cooperative properly elects to treat as an expense under sections 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(4) Special rules--(i) Contract with an unrelated person. If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE an agricultural or horticultural product within the United States for the Specified Cooperative, and the Specified Cooperative is considered to MPGE the agricultural or horticultural product pursuant to paragraph (f)(1) of this section, then, for purposes of the substantial-in-nature requirement under paragraph (h)(2) of this section and the safe harbor under paragraph (h)(3)(i) of this section, the Specified Cooperative's MPGE activities or direct labor and overhead must include both the Specified Cooperative's MPGE activities or direct labor and overhead to MPGE the agricultural or horticultural product within the United States as well as the MPGE activities or direct labor and overhead of the unrelated person to MPGE the agricultural or horticultural product within the United States under the contract.

(ii) Aggregation. In determining whether the substantial-in-nature requirement under paragraph (h)(2) of this section or the safe harbor under paragraph (h)(3)(i) of this section is met at the time the Specified Cooperative disposes of an agricultural or horticultural product--

(A) An EAG member must take into account all the previous MPGE activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership as defined in §1.199A-12(i)(1) must take into account all of the previous MPGE activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE activities of any other EAG partnerships owned by members of the same EAG); and

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE activities of any other EAG partnerships owned by members of the same EAG).

(i) United States defined. For purposes of section 199A(g), the term United States includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Consistent with its definition in section 7701(a)(9), the term United States does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(j) Derived from the lease, rental, license, sale, exchange, or other disposition--(1) In general--(i) Definition. The term derived from the lease, rental, license, sale, exchange, or other disposition is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products even if the Specified Cooperative has already recognized receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same agricultural or horticultural products. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) Lease income. The financing and interest components of a lease of agricultural or horticultural products are considered to be derived from the lease of such agricultural or horticultural products. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (j)(3) of this section is not derived from the lease of agricultural or horticultural products.

(iii) Income substitutes. The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent they are substitutes for gross receipts that would qualify as DPGR.

(iv) Exchange of property--(A) Taxable exchanges. The value of property received by the Specified Cooperative in a taxable exchange of agricultural or horticultural products MPGE in whole or in significant part by the Specified Cooperative within the United States is DPGR for the Specified Cooperative (assuming all the other requirements of this section are met). However, unless the Specified Cooperative meets all of the requirements under this section with respect to any additional MPGE by the Specified Cooperative of the agricultural or horticultural products received in the taxable exchange, any gross receipts derived from the sale by the Specified Cooperative of the property received in the taxable exchange are non-DPGR, because the Specified Cooperative did not MPGE such property, even if the property was an agricultural or horticultural product in the hands of the other party to the transaction.

(B) Safe harbor. For purposes of paragraph (j)(1)(iv)(A) of this section, the gross receipts derived by the Specified Cooperative from the sale of eligible property (as defined in paragraph (j)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the Specified Cooperative in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the Specified Cooperative, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the Specified Cooperative. In addition, if the Specified Cooperative engages in any further MPGE activity with respect to the eligible property received in the taxable exchange, then, unless the Specified Cooperative meets the in-whole-or-in-significant-part requirement under paragraph (h)(1) of this section with respect to the property sold, for purposes of this paragraph (j)(1)(iv)(B), the Specified Cooperative must also value the property sold without taking into account the gross receipts attributable to the further MPGE activity.

(C) Eligible property. For purposes of paragraph (j)(1)(iv)(B) of this section, eligible property is--

(1) Oil, natural gas, or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(2) Any other property or product designated by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(3) For this purpose, the term natural gas includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(2) Hedging transactions--(i) In general. For purposes of this section, if a transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221-2(b), is properly identified as a hedging transaction in accordance with §1.1221-2(f), and the risk being hedged relates to property described in section 1221(a)(1) that gives rise to DPGR or to property described in section 1221(a)(8) that is consumed in an activity that gives rise to DPGR, then--

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining COGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) Allocation. The income, deduction, gain and loss from hedging transactions described in paragraph (j)(2) of this section must be allocated between the patronage and nonpatronage (defined in §1.1388-1(f)) sourced income and related deductions of the Specified Cooperatives consistent with the cooperative's method for determining patronage and nonpatronage income and deductions.

(iii) Effect of identification and nonidentification. The principles of §1.1221-2(g) apply to a Specified Cooperative that identifies or fails to identify a transaction as a hedging transaction, except that the consequence of identifying as a hedging transaction a transaction that is not in fact a hedging transaction described in paragraph (j)(2) of this section, or of failing to identify a transaction that the Specified Cooperative has no reasonable grounds for treating as other than a hedging transaction described in paragraph (j)(2) of this section, is that deduction or loss (but not income or gain) from the transaction is taken into account under paragraph (j)(2) of this section.

(iv) Other rules. See §1.1221-2(e) for rules applicable to hedging by members of a consolidated group and §1.446-4 for rules regarding the timing of income, deductions, gains or losses with respect to hedging transactions.

(3) Allocation of gross receipts to embedded services and non-qualified property--(i) Embedded services and non-qualified property--(A) In general. Except as otherwise provided in paragraph (j)(3)(i)(B) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded

service, that is, a service the price of which, in the normal course of the business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products, DPGR includes only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products (assuming all the other requirements of this section are met) and not any receipts attributable to the embedded service. In addition, DPGR does not include gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property.

(B) Exceptions. There are five exceptions to the rules under paragraph (j)(3)(i)(A) of this section regarding embedded services and non-qualified property. A Specified Cooperative may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of agricultural or horticultural products to which the embedded services or non-qualified property relate, the gross receipts derived from--

(1) A qualified warranty, that is, a warranty that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The warranty is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the warranty);

(2) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The delivery or distribution service is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the delivery or distribution service).

(3) A qualified operating manual, that is, a manual of instructions that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products;

(ii) The manual is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the manual); and

(iii) The manual is not provided in connection with a training course for customers.

(4) A qualified installation, that is, an installation service for agricultural or horticultural products that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The installation is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the installation service).

(5) A de minimis amount of gross receipts from embedded services and non-qualified property for each item of agricultural or horticultural products may qualify. For purposes of this exception, a de minimis amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of agricultural or horticultural products. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if a Specified Cooperative treats gross receipts as DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the Specified Cooperative treats as DPGR under paragraphs (j)(3)(i)(B)(1) through (4) of this section are treated as DPGR for purposes

of applying this de minimis exception. This de minimis exception does not apply if the price of a service or non-qualified property is separately stated by the Specified Cooperative, or if the service or non-qualified property is separately offered or separately bargained for with the customer (that is, the customer can purchase the agricultural or horticultural products without the service or non-qualified property).

(ii) Non-DPGR. Applicable gross receipts as provided in §§1.199A-8(b) and/or (c) derived from the lease, rental, license, sale, exchange or other disposition of an item of agricultural or horticultural products may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR (taking into account embedded services and non-qualified property included in such disposition, but not part of the item). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (j)(5)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if the Specified Cooperative treats gross receipts as non-DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(k) Applicability date. The provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

**§1.199A-10 Allocation of cost of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.**

(a) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide additional guidance on determining qualified production activities income (QPAI) as described and defined in §1.199A-8(b)(4)(ii).

(b) COGS allocable to DPGR--(1) In general. When determining its QPAI, the Specified Cooperative (defined in §1.199A-8(a)(2)) must subtract from its DPGR (defined in §1.199A-8(b)(3)(ii)) the COGS allocable to its DPGR. The Specified Cooperative determines its COGS allocable to DPGR in accordance with this paragraph (b)(1) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, COGS is equal to beginning inventory of the Specified Cooperative plus purchases and production costs incurred during the taxable year and included in inventory costs by the Specified Cooperative, less ending inventory of the Specified Cooperative. In determining its QPAI, the Specified Cooperative does not include in COGS any payment made, whether during the taxable year, or included in beginning inventory, for which a deduction is allowed under section 1382(b) and/or (c), as applicable. See §1.199A-8(b)(4)(ii)(C). COGS is determined under the methods of accounting that the Specified Cooperative uses to compute taxable income. See sections 263A, 471, and 472. If section 263A requires the Specified Cooperative to include additional section 263A costs (as defined in §1.263A-1(d)(3)) in inventory, additional section 263A costs must be included in determining COGS. COGS also include the Specified Cooperative's inventory valuation adjustments such as write-downs under the lower of cost or market method. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) by the

Specified Cooperative of non-inventory property, COGS for purposes of this section includes the adjusted basis of the property.

(2) Allocating COGS--(i) In general. A Specified Cooperative must use a reasonable method based on all the facts and circumstances to allocate COGS between DPGR and non-DPGR. Whether an allocation method is reasonable is based on all the facts and circumstances, including whether the Specified Cooperative uses the most accurate information available; the relationship between COGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts (defined in §1.199A-8(b)(2)(iii)), number of units sold, number of units produced, or total production costs. Ordinarily, if a Specified Cooperative uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate COGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a Specified Cooperative has information readily available to specifically identify COGS allocable to DPGR and can specifically identify that amount without undue burden or expense, COGS allocable to DPGR is that amount irrespective of whether the Specified Cooperative uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A Specified Cooperative that does not have information readily available to specifically identify COGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies COGS allocable to

DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of COGS between DPGR and non-DPGR. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for COGS must be consistent with any allocations under this paragraph (b)(2).

(ii) <u>Gross receipts recognized in an earlier taxable year</u>. If the Specified Cooperative (other than a Specified Cooperative that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs COGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the Specified Cooperative must allocate the COGS to--

(A) DPGR if the Specified Cooperative identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the Specified Cooperative identified the related gross receipts as non-DPGR in the prior taxable year or if the Specified Cooperative recognized under the Specified Cooperative's methods of accounting those gross receipts in a taxable year to which section 199A(g) does not apply.

(iii) <u>COGS associated with activities undertaken in an earlier taxable year</u>--(A) <u>In general</u>. A Specified Cooperative must allocate its COGS between DPGR and non-DPGR under the rules provided in paragraphs (b)(2)(i) and (iii) of this section, regardless of whether certain costs included in its COGS can be associated with activities undertaken in an earlier taxable year (including a year prior to the effective date of section 199A(g)). A Specified Cooperative may not segregate its COGS into component costs and allocate those component costs between DPGR and non-DPGR.

(B) <u>Example</u>. The following example illustrates an application of paragraph (b)(2)(iii)(A) of this section.

(1) Example 1. During the 2020 taxable year, nonexempt Specified Cooperative X grew and sold Horticultural Product A. All of the patronage gross receipts from sales recognized by X in 2020 were from the sale of Horticultural Product A and qualified as DPGR. Employee 1 of X was involved in X's production process until he retired in 2013. In 2020, X paid $30 directly from its general assets for Employee 1's medical expenses pursuant to an unfunded, self-insured plan for retired X employees. For purposes of computing X's 2020 taxable income, X capitalized those medical costs to inventory under section 263A. In 2020, the COGS for a unit of Horticultural Product A was $100 (including the applicable portion of the $30 paid for Employee 1's medical costs that was allocated to COGS under X's allocation method for additional section 263A costs). X has information readily available to specifically identify COGS allocable to DPGR and can identify that amount without undue burden and expense because all of X's gross receipts from sales in 2020 are attributable to the sale of Horticultural Product A and qualify as DPGR. The inventory cost of each unit of Horticultural Product A sold in 2020, including the applicable portion of retiree medical costs, is related to X's gross receipts from the sale of Horticultural Product A in 2020. X may not segregate the 2020 COGS by separately allocating the retiree medical costs, which are components of COGS, to DPGR and non-DPGR. Thus, even though the retiree medical costs can be associated with activities undertaken in prior years, $100 of inventory cost of each unit of Horticultural Product A sold in 2020, including the applicable portion of the retiree medical expense cost component, is allocable to DPGR in 2020.

(3) Special allocation rules. Section 199A(g)(3)(C) provides the following two special rules--

(i) For purposes of determining the COGS that are allocable to DPGR, any item or service brought into the United States (defined in §1.199A-9(i)) is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to DPGR.

(ii) In the case of any property described in paragraph (b)(3)(i) of this section that has been exported by the Specified Cooperative for further manufacture, the increase in cost or adjusted basis under paragraph (b)(3)(i) of this section cannot exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. For the purposes of this paragraph (b)(3), the value of property is its customs value as defined in section 1059A(b)(1).

(4) Rules for inventories valued at market or bona fide selling prices. If part of COGS is attributable to the Specified Cooperative's inventory valuation adjustments, then COGS allocable to DPGR includes inventory adjustments to agricultural or horticultural products that are MPGE in whole or significant part within the United States. Accordingly, a Specified Cooperative that values its inventory under §1.471-4 (inventories at cost or market, whichever is lower) or §1.471-2(c) (subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, write-downs) to DPGR based on a reasonable method based on all the facts and circumstances. Factors taken into account in determining whether the method is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the adjustment and the allocation base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. If the Specified Cooperative has information readily available to specifically identify the proper

amount of inventory valuation adjustments allocable to DPGR, then the Specified Cooperative must allocate that amount to DPGR. The Specified Cooperative that does not have information readily available to specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuation adjustments to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect inventory adjustments. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for inventory adjustments must be consistent with any allocations under this paragraph (b)(4).

(5) Rules applicable to inventories accounted for under the last-in, first-out inventory method--(i) In general. This paragraph (b)(5) applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains agricultural or horticultural products that produce DPGR and goods that do not, the Specified Cooperative must allocate COGS attributable to that grouping or pool between DPGR and non-DPGR using a reasonable method based on all the facts and circumstances. Whether a method of allocating COGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a Specified Cooperative may use to allocate COGS for a Specified Cooperative's inventories accounted for using the LIFO method. If the Specified Cooperative uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, then the Specified Cooperative must use that method for all of the Specified Cooperative's inventory accounted for under the

LIFO method. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the inventory method. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for the inventory method must be consistent with any allocations under this paragraph (b)(5).

(ii) LIFO/FIFO ratio method. The LIFO/FIFO ratio method is applied with respect to the LIFO inventory on a grouping-by-grouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a Specified Cooperative computes the COGS of a grouping or pool allocable to DPGR by multiplying the COGS of agricultural or horticultural products (defined in §1.199A-8(a)(4)) in the grouping or pool that produced DPGR computed using the FIFO method by the LIFO/FIFO ratio of the grouping or pool. The LIFO/FIFO ratio of a grouping or pool is equal to the total COGS of the grouping or pool computed using the LIFO method over the total COGS of the grouping or pool computed using the FIFO method.

(iii) Change in relative base-year cost method. A Specified Cooperative using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method for a Specified Cooperative using the dollar-value LIFO method is applied to all LIFO inventory on a pool-by-pool basis. The change in relative base-year cost method determines the COGS allocable to DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of agricultural or horticultural products that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of agricultural or horticultural products that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6) Specified Cooperative using a simplified method for additional section 263A costs to ending inventory. A Specified Cooperative that uses a simplified method specifically described in the section 263A regulations to allocate additional section 263A costs to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in the Specified Cooperative's beginning inventory as well as additional section 263A costs incurred during the taxable year by the Specified Cooperative. Ordinarily, if the Specified Cooperative uses a simplified method specifically described in the section 263A regulations to allocate its additional section 263A costs to its ending inventory, the additional section 263A costs must be allocated in the same proportion as section 471 costs are allocated.

(c) Other deductions properly allocable to DPGR or gross income attributable to DPGR--(1) In general. In determining its QPAI, the Specified Cooperative must subtract from its DPGR (in addition to the COGS), the deductions that are properly allocable and apportioned to DPGR. A Specified Cooperative generally must allocate and apportion these deductions using the rules of the section 861 method provided in paragraph (d) of this section. In lieu of the section 861 method, an eligible Specified Cooperative may apportion these deductions using the simplified deduction method provided in paragraph (e) of this section. Paragraph (f) of this section provides a small business simplified overall method that may be used by a qualifying small Specified Cooperative. A Specified Cooperative using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A Specified Cooperative eligible to use the small business simplified overall method may choose at any time for any taxable year to use the small business simplified overall method or the simplified deduction method for a taxable year.

(2) Treatment of net operating losses. A deduction under section 172 for a net operating loss (NOL) is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(3) W-2 wages. Although only W-2 wages as described in §1.199A-11 are taken into account in computing the W-2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in the taxable year are taken into account in computing QPAI for that taxable year.

(d) Section 861 method. Under the section 861 method, the Specified Cooperative must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations under which section 199A(g) is treated as an operative section described in §1.861-8(f). Accordingly, the Specified Cooperative applies the rules of the section 861 regulations to allocate and apportion deductions (including, if applicable, its distributive share of deductions from passthrough entities) to gross income attributable to DPGR. If the Specified Cooperative applies the allocation and apportionment rules of the section 861 regulations for section 199A(g) and another operative section, then the Specified Cooperative must use the same method of allocation and the same principles of apportionment for purposes of all operative sections. Research and experimental expenditures must be allocated and apportioned in accordance with §1.861-17 without taking into account the exclusive apportionment rule of §1.861-17(b). Deductions for charitable contributions (as allowed under section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(e) Simplified deduction method--(1) In general. An eligible Specified Cooperative (defined in paragraph (e)(2) of this section) may use the simplified deduction method to apportion business deductions between DPGR and non-DPGR. The simplified deduction method does not apply to COGS. Under the simplified deduction method, the business deductions (except the NOL deduction) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the proportion of the total business deductions for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) Eligible Specified Cooperative. For purposes of this paragraph (e), an eligible Specified Cooperative is--

(i) A Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A Specified Cooperative that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3) Total assets.--(i) In general. For purposes of the simplified deduction method, total assets mean the total assets the Specified Cooperative has at the end of the taxable year.

(ii) Members of an expanded affiliated group. To compute the total assets of an expanded affiliated group (EAG) at the end of the taxable year, the total assets at the end of the taxable year of each member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member (as described in §1.199A-12(g)) are aggregated.

(4) Members of an expanded affiliated group--(i) In general. Whether the members of an EAG may use the simplified deduction method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (e)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(f) Small business simplified overall method--(1) In general. A qualifying small Specified Cooperative may use the small business simplified overall method to apportion COGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a Specified Cooperative's total costs for the current taxable year (as defined in paragraph (f)(3) of this section) are apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) Qualifying small Specified Cooperative. For purposes of this paragraph (f), a qualifying small Specified Cooperative is a Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $25,000,000 or less.

(3) Total costs for the current taxable year. For purposes of the small business simplified overall method, total costs for the current taxable year means the total COGS and deductions for the current taxable year. Total costs for the current taxable year are

determined under the methods of accounting that the Specified Cooperative uses to compute taxable income.

(4) Members of an expanded affiliated group--(i) In general. Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $25,000,000 then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (f)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(g) Average annual gross receipts--(1) In general. For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the Specified Cooperative for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199A(g). In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts of the Specified Cooperative are annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) Members of an expanded affiliated group--(i) In general. To compute the average annual gross receipts of an EAG, the gross receipts for the entire taxable year of each member that is a member of the EAG at the end of its taxable year that ends with or within the taxable year are aggregated. For purposes of this paragraph (g)(2), a consolidated group is treated as one member of an EAG.

(ii) Exception. Notwithstanding paragraph (g)(1)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(h) Cost allocation methods for determining oil-related QPAI--(1) Section 861 method. A Specified Cooperative that uses the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to DPGR must use the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to oil-related DPGR.

(2) Simplified deduction method. A Specified Cooperative that uses the simplified deduction method to apportion deductions between DPGR and non-DPGR must determine the portion of deductions allocable to oil-related DPGR by multiplying the deductions allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(3) Small business simplified overall method. A Specified Cooperative that uses the small business simplified overall method to apportion total costs (COGS and deductions) between DPGR and non-DPGR must determine the portion of total costs allocable to oil-related DPGR by multiplying the total costs allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(i) Applicability date. The provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

**§1.199A-11 Wage limitation for the section 199A(g) deduction.**

(a) Rules of application--(1) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance on determining the W-2 wage limitation as defined in §1.199A-8(b)(5)(ii)(B). Except as provided in paragraph (d)(2) of this section, the Form W-2, Wage and Tax Statement, or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the taxable year of the Specified Cooperative (defined in §1.199A-8(a)(2)) for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative.  Employees are limited to employees defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules).  See paragraph (a)(5) of this section for the requirement that W-2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return.  See also section 199A(a)(4)(C).

(2)  Wage limitation for section 199A(g) deduction.  The amount of the deduction allowable under section 199A(g) to the Specified Cooperative for any taxable year cannot exceed 50 percent of the W-2 wages (as defined in section 199A(g)(1)(B)(ii) and paragraph (b) of this section) for the taxable year that are attributable to domestic production gross receipts (DPGR), defined in §1.199A-8(b)(3)(ii), of agricultural or horticultural products defined in §1.199A-8(a)(4).

(3)  Wages paid by entity other than common law employer.  In determining W-2 wages, the Specified Cooperative may take into account any W-2 wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the Specified Cooperative for employment by the Specified Cooperative.  In such cases, the entity paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that entity.  For purposes of this paragraph (a)(4), entities that pay and report W-2 wages on behalf of or with respect to other taxpayers can include, but are not limited to, certified professional employer

organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(4) Requirement that wages must be reported on return filed with the Social Security Administration--(i) In general. Pursuant to section 199A(g)(1)(B)(ii) and section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, Transmittal of Wage and Tax Statements, together constitute an information return to be filed with SSA. Similarly, each Form W-2c, Corrected Wage and Tax Statement, and the transmittal Form W-3 or W-3c, Transmittal of Corrected Wage and Tax Statements, together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 is considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c is considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under §31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(ii) Corrected return filed to correct a return that was filed within 60 days of the due date. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(5)(iii) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, such increase (or increases) on Return D is disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) Corrected return filed to correct a return that was filed later than 60 days after the due date. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then this Form W-2c is not to be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W-2c, regardless of when the Form W-2c is filed.

(b) Definition of W-2 wages--(1) In general. Section 199A(g)(1)(B)(ii) provides that the W-2 wages of the Specified Cooperative must be determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B) and after application of section 199A(b)(5)). Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and the amount of designated Roth contributions (as defined in section 402A).

(2) Section 199A(g) deduction. Pursuant to section 199A(g)(3)(A), W-2 wages do not include any amount which is not properly allocable to DPGR for purposes of calculating qualified production activities income (QPAI) as defined in §1.199A-8(b)(4)(ii). The Specified Cooperative may determine the amount of wages that is properly allocable to DPGR using a reasonable method based on all the facts and circumstances. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the wages allocable to DPGR for purposes of QPAI. The books and records maintained for wages allocable to DPGR for purposes of QPAI must be consistent with any allocations under this paragraph (b)(2).

(c) Methods for calculating W-2 wages. The Secretary may provide for methods that may be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter).

(d) Wage limitation -- acquisitions, dispositions, and short taxable years--(1) In general. For purposes of computing the deduction under section 199A(g) of the Specified Cooperative, in the case of an acquisition or disposition (as defined in section 199A(b)(5) and paragraph (d)(3) of this section) that causes more than one Specified Cooperative to be an employer of the employees of the acquired or disposed of Specified Cooperative during the calendar year, the W-2 wages of the Specified Cooperative for the calendar year of the acquisition or disposition are allocated between or among each Specified Cooperative based on the period during which the employees of the acquired or disposed of Specified Cooperatives were employed by the Specified Cooperative, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, Wage and Tax Statement.

(2) Short taxable year that does not include December 31. If the Specified Cooperative has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by the Specified Cooperative during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (a) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(3) Acquisition or disposition. For purposes of paragraph (d)(1) and (2) of this section, the terms acquisition and disposition include an incorporation, a liquidation, a reorganization, or a purchase or sale of assets.

(e) Application in the case of a Specified Cooperative with a short taxable year. In the case of a Specified Cooperative with a short taxable year, subject to the rules of paragraph (a) of this section, the W-2 wages of the Specified Cooperative for the short taxable year can include only those wages paid during the short taxable year to employees of the Specified Cooperative, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the Specified Cooperative, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the Specified Cooperative.

(f) Non-duplication rule. Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year. Also, an amount cannot be treated as W-2 wages by more than one taxpayer. Finally, an amount cannot be treated as W-2 wages by the Specified Cooperative both in determining patronage and nonpatronage W-2 wages.

(g) Wage expense safe harbor--(1) In general. A Specified Cooperative using either the section 861 method of cost allocation under §1.199A-10(d) or the simplified deduction method under §1.199A-10(e) may determine the amount of W-2 wages that are properly allocable to DPGR for a taxable year by multiplying the amount of W-2 wages determined under paragraph (b)(1) of this section for the taxable year by the ratio of the Specified Cooperative's wage expense included in calculating QPAI for the taxable year to the Specified Cooperative's total wage expense used in calculating the Specified Cooperative's taxable income for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A Specified Cooperative that uses either the section 861 method of cost allocation or the simplified deduction method to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (g)(1), the term wage expense means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the Specified Cooperative's method of accounting.

(2) Wage expense included in cost of goods sold. For purposes of paragraph (g)(1) of this section, a Specified Cooperative may determine its wage expense included in cost of goods sold (COGS) using a reasonable method based on all the facts and circumstances, such as using the amount of direct labor included in COGS or using section 263A labor costs (as defined in §1.263A-1(h)(4)(ii)) included in

COGS. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of wage expense included in COGS. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for wage expense included in COGS must be consistent with any allocations under this paragraph (g)(2).

(3) Small business simplified overall method safe harbor. The Specified Cooperative that uses the small business simplified overall method under §1.199A-10(f) may use the small business simplified overall method safe harbor for determining the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR. Under this safe harbor, the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR is equal to the same proportion of W-2 wages determined under paragraph (b)(1) of this section that the amount of DPGR bears to the Specified Cooperative's total gross receipts.

(h) Applicability date. The provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

**§1.199A-12 Expanded affiliated groups.**

(a) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). Except as otherwise provided in the Code or regulations issued under the relevant section of the Code (for example, sections 199A(g)(3)(D)(ii) and 267, §1.199A-8(c), paragraph (a)(3) of this section, and the consolidated return regulations under section 1502), each nonexempt Specified Cooperative (defined in §1.199A-8(a)(2)(ii)) that is a member of an expanded affiliated group (EAG) (defined in paragraph (a)(1) of this section) computes its own taxable income or loss, qualified production activities income (QPAI) (defined in §1.199A-8(b)(4)(ii)), and W-2 wages (defined in §1.199A-11(b)). For purposes of this section unless otherwise specified, the term Specified Cooperative means a nonexempt Specified Cooperative. If a Specified Cooperative is also a member of a consolidated group, see paragraph (d) of this section.

(1) Definition of an expanded affiliated group. An EAG is an affiliated group as defined in section 1504(a), determined by substituting “more than 50 percent” for “at least 80 percent” in each place it appears and without regard to section 1504(b)(2) and (4).

(2) Identification of members of an expanded affiliated group--(i) In general. Each Specified Cooperative must determine if it is a member of an EAG on a daily basis.

(ii) Becoming or ceasing to be a member of an expanded affiliated group. If a Specified Cooperative becomes or ceases to be a member of an EAG, the Specified Cooperative is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(3) Attribution of activities--(i) In general. Except as provided in paragraph (a)(3)(iv) of this section, if a Specified Cooperative that is a member of an EAG (disposing member) derives gross receipts (defined in §1.199A-8(b)(2)(iii)) from the lease, rental, license, sale, exchange, or other disposition (defined in §1.199A-9(j)) of agricultural or horticultural products (defined in §1.199A-8(a)(4)) that were manufactured, produced, grown or extracted (MPGE) (defined in §1.199A-9(f)), in whole or significant part (defined in §1.199A-9(h)), in the United States (defined in §1.199A-9(i)) by another Specified Cooperative, then the disposing member is treated as conducting the previous activities conducted by such other Specified Cooperative with respect to the agricultural or horticultural products in determining whether its gross

receipts are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)) if--

(A) Such property was MPGE by such other Specified Cooperative, and

(B) The disposing member is a member of the same EAG as such other Specified Cooperative at the time that the disposing member disposes of the agricultural or horticultural products.

(ii) Date of disposition for leases, rentals, or licenses. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a lease, rental, or license, the disposing member described in paragraph (a)(3)(i) of this section is treated as having disposed of the agricultural or horticultural products on the date or dates on which it takes into account the gross receipts derived from the lease, rental, or license under its methods of accounting.

(iii) Date of disposition for sales, exchanges, or other dispositions. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the agricultural or horticultural products on the date on which it ceases to own the agricultural or horticultural products for Federal income tax purposes, even if no gain or loss is taken into account.

(iv) Exception. A Specified Cooperative is not attributed nonpatronage activities conducted by another Specified Cooperative. See §1.199A-8(b)(2)(ii).

(4) Marketing Specified Cooperatives. A Specified Cooperative is treated as having MPGE in whole or significant part any agricultural or horticultural product within the United States marketed by the Specified Cooperative which its patrons have so MPGE. Patrons are defined in §1.1388-1(e).

(5) Anti-avoidance rule. If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the

amount of, the section 199A(g) deduction of the EAG or the portion of the section 199A(g) deduction allocated to one or more members of the EAG, the Secretary may make adjustments to eliminate the effect of the transaction on the computation of the section 199A(g) deduction.

(b) Computation of EAG's section 199A(g) deduction.--(1) In general. The section 199A(g) deduction for an EAG is determined by separately computing the section 199A(g) deduction from the patronage sources of Specified Cooperatives that are members of the EAG. The section 199A(g) deduction from patronage sources of Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W-2 wages, if any, of each patronage source of a Specified Cooperative that is a member of the EAG. For purposes of this determination, a member's QPAI may be positive or negative. A Specified Cooperative's taxable income or loss and QPAI is determined by reference to the Specified Cooperative's method of accounting. For purposes of determining the section 199A(g) deduction for an EAG, taxable income or loss, QPAI, and W-2 wages of a Specified Cooperative from nonpatronage sources are considered to be zero, other than as allowed under §1.199A-8(b)(2)(ii).

(2) Example. The following example illustrates the application of paragraph (b)(1) of this section.

(i) Facts. Nonexempt Specified Cooperatives X, Y, and Z, calendar year taxpayers, are the only members of an EAG and are not members of a consolidated group. X has patronage source taxable income of $50,000, QPAI of $15,000, and W-2 wages of $0. Y has patronage source taxable income of ($20,000), QPAI of ($1,000), and W-2 wages of $750. Z has patronage source taxable income of $0, QPAI of $0, and W-2 wages of $3,000.

(ii) Analysis. In determining the EAG's section 199A(g) deduction, the EAG aggregates each member's patronage source taxable income or loss, QPAI, and W-2 wages. Thus, the EAG has patronage source taxable income of $30,000, the sum of X's patronage source taxable income of $50,000, Y's patronage source taxable income of ($20,000), and Z's patronage source taxable income of $0. The EAG has QPAI of $14,000, the sum of X's QPAI of $15,000, Y's QPAI of ($1,000), and Z's QPAI of $0. The EAG has W-2 wages of $3,750, the sum of X's W-2 wages of $0, Y's W-2 wages of $750, and Z's W-2 wages of $3,000. Accordingly, the EAG's section 199A(g) deduction equals $1,260, 9% of $14,000, the lesser of the QPAI and patronage source taxable income, but not greater than $1,875, 50% of its W-2 wages of $3,750. This result would be the same if X had a nonpatronage source income or loss, because nonpatronage source income of a nonexempt Specified Cooperative is not taken into account in determining the section 199A(g) deduction.

(3) Net operating loss carryovers/carrybacks. In determining the taxable income of an EAG, if a Specified Cooperative has a net operating loss (NOL) from its patronage sources that may be carried over or carried back (in accordance with section 172) to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the patronage source of that Specified Cooperative.

(4) Losses used to reduce taxable income of an expanded affiliated group. The amount of an NOL sustained by a Specified Cooperative member of an EAG that is used in the year sustained in determining an EAG's taxable income limitation under §1.199A-8(b)(5)(ii)(C) is not treated as an NOL carryover to any taxable year in determining the taxable income limitation under §1.199A-8(b)(5)(ii)(C). For purposes of this paragraph (b)(4), an NOL is considered to be used if it reduces an EAG's aggregate taxable income from patronage sources or nonpatronage sources, as the case may be, regardless of whether the use of the NOL actually reduces the amount of the section 199A(g) deduction that the EAG would otherwise derive. An NOL is not

considered to be used to the extent that it reduces an EAG's aggregate taxable income from patronage sources to an amount less than zero. If more than one Specified Cooperative has an NOL used in the same taxable year to reduce the EAG's taxable income from patronage sources, the respective NOLs are deemed used in proportion to the amount of each Specified Cooperative's NOL.

(5) Example. The following example illustrates the application of paragraph (b)(4) of this section.

(i) Facts. Nonexempt Specified Cooperatives A and B are the only two members of an EAG. A and B are both calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. Neither A nor B had taxable income or loss prior to 2020. In 2020, A has patronage QPAI and patronage taxable income of $1,000 and B has patronage QPAI of $1,000 and a patronage NOL of $1,500. A also has nonpatronage income of $3,000. B has no activities other than from its patronage activities. In 2021, A has patronage QPAI of $2,000 and patronage taxable income of $1,000 and B has patronage QPAI of $2,000 and patronage taxable income prior to the NOL deduction allowed under section 172 of $2,000. Neither A nor B has nonpatronage activities in 2021. A's and B's patronage activities have aggregate W-2 wages in excess of the section 199A(g)(1)(B) wage limitation in both 2020 and 2021.

(ii) Section 199A(g) deduction for 2020. In determining the EAG's section 199A(g) deduction for 2020, A's $1,000 of QPAI and B's $1,000 of QPAI are aggregated, as are A's $1,000 of taxable income from its patronage activities and B's $1,500 NOL from its patronage activities. A's nonpatronage income is not included. Thus, for 2020, the EAG has patronage QPAI of $2,000 and patronage taxable income of ($500). The EAG's section 199A(g) deduction for 2020 is 9% of the lesser of its patronage QPAI or its patronage taxable income. Because the EAG has a taxable loss from patronage sources in 2020, the EAG's section 199A(g) deduction is $0.

(iii) Section 199A(a) deduction for 2021. In determining the EAG's section 199A deduction for 2021, A's patronage QPAI of $2,000 and B's patronage QPAI of $2,000 are aggregated, resulting in the EAG having patronage QPAI of $4,000. Also, $1,000 of B's patronage NOL from 2020 was used in 2020 to reduce the EAG's taxable income from patronage sources to $0. The remaining $500 of B's patronage NOL from 2020 is not considered to have been used in 2020 because it reduced the EAG's patronage taxable income to less than $0. Accordingly, for purposes of determining the EAG's taxable income limitation under §1.199A-8(b)(5) in 2021, B is deemed to have only a $500 NOL carryover from its patronage sources from 2020 to offset a portion of its 2021 taxable income from its patronage sources. Thus, B's taxable income from its patronage sources in 2021 is $1,500, which is aggregated with A's $1,000 of taxable income from its patronage sources. The EAG's taxable income limitation in 2021 is $2,500. The EAG's section 199A(g) deduction is 9% of the lesser of its patronage sourced QPAI of $4,000 and its taxable income from patronage sources of $2,500. Thus, the EAG's section 199A(g) deduction in 2021 is 9% of $2,500, or $225. The results for 2021 would be the same if neither A nor B had patronage sourced QPAI in 2020.

(c) Allocation of an expanded affiliated group's section 199A(g) deduction among members of the expanded affiliated group--(1) In general. An EAG's section 199A(g) deduction from its patronage sources, as determined in paragraph (b) of this section, is allocated among the Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage taxable income or W-2 wages for the taxable year. For these purposes, if a Specified Cooperative has negative patronage QPAI, such QPAI is treated as zero. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions.

(2) Use of section 199A(g) deduction to create or increase a net operating loss. If a Specified Cooperative that is a member of an EAG has some or all of the EAG's section 199A(g) deduction allocated to it under paragraph (c)(1) of this section and the amount allocated exceeds patronage taxable income, determined as described in this section and prior to allocation of the section 199A(g) deduction, the section 199A(g) deduction will create an NOL for the patronage source. Similarly, if a Specified Cooperative that is a member of an EAG, prior to the allocation of some or all of the EAG's section 199A(g) deduction to the member, has a patronage NOL for the taxable year, the portion of the EAG's section 199A(g) deduction allocated to the member will increase such NOL.

(d) Special rules for members of the same consolidated group--(1) Intercompany transactions. In the case of an intercompany transaction between consolidated group members S and B (as the terms intercompany transaction, S, and B are defined in §1.1502-13(b)(1)), S takes the intercompany transaction into account in computing the section 199A(g) deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under §1.1502-13.

(2) Application of the simplified deduction method and the small business simplified overall method. For purposes of applying the simplified deduction method under §1.199A-10(e) and the small business simplified overall method under §1.199A-10(f), a Specified Cooperative that is part of a consolidated group determines its QPAI using its members' DPGR, non-DPGR, cost of goods sold (COGS), and all other deductions, expenses, or losses (hereinafter deductions), determined after the application of §1.1502-13.

(3) Determining the section 199A(g) deduction--(i) Expanded affiliated group consists of consolidated group and non-consolidated group members. In determining the section 199A(g) deduction, if an EAG includes Specified Cooperatives that are members of the same consolidated group and Specified Cooperatives that are not members of the same consolidated group, the consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the consolidated group (and not the separate taxable income or loss, QPAI, and W-2 wages from patronage sources of the members of the consolidated group), are aggregated with the taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the non-consolidated group members. For example, if A, B, C, S1, and S2 are Specified Cooperatives that are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), then the A consolidated group is treated as one member of the EAG. Accordingly, the EAG is considered to have three members—the A consolidated group, B, and C. The consolidated taxable income or loss, QPAI, and W-2 wages from patronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from patronage sources, QPAI, and W-2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction from patronage sources. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions.

(ii) Expanded affiliated group consists only of members of a single consolidated group. If all of the Specified Cooperatives that are members of an EAG are also members of the same consolidated group, the consolidated group's section 199A(g) deduction is determined using the consolidated group's consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources rather than the separate taxable income or loss, QPAI, and W-2 wages from patronage sources of its members.

(4) Allocation of the section 199A(g) deduction of a consolidated group among its members. The section 199A(g) deduction from patronage sources of a consolidated group (or the section 199A(g) deduction allocated to a consolidated group that is a member of an EAG) is allocated among the patronage sources of Specified Cooperatives in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage separate taxable income or W-2 wages for the taxable year. In allocating the section 199A(g) deduction of a patronage source of a Specified Cooperative that is part of a consolidated group among patronage sources of other members of the same group, any redetermination of a member's patronage receipts, COGS, or other deductions from an intercompany transaction under §1.1502-13(c)(1)(i) or (c)(4) is not taken into account for purposes of section 199A(g). Also, for purposes of this allocation, if a patronage source of a Specified Cooperative that is a member of a consolidated group has negative QPAI, the QPAI of the patronage source is treated as zero.

(e) Examples. The following examples illustrate the application of paragraphs (a) through (d) of this section.

(i) Example 1. Specified Cooperatives X, Y, and Z are members of the same EAG but are not members of a consolidated group. X, Y, and Z each files Federal income tax returns on a calendar year basis. None of X, Y, or Z have activities other than from its patronage sources. Prior to 2020, X had no taxable income or loss. In 2020, X has taxable income of $0, QPAI of $2,000, and W-2 wages of $0, Y has taxable income of $4,000, QPAI of $3,000, and W-2 wages of $500, and Z has taxable income of $4,000, QPAI of $5,000, and W-2 wages of $2,500. Accordingly, the EAG's patronage source taxable income is $8,000, the sum of X's taxable income of $0, Y's taxable income of $4,000, and Z's taxable income of $4,000. The EAG has QPAI of $10,000, the sum of X's QPAI of $2,000, Y's QPAI of $3,000, and Z's QPAI of $5,000.

The EAG's W-2 wages are $3,000, the sum of X's W-2 wages of $0, Y's W-2 wages of $500, and Z's W-2 wages of $2,500. Thus, the EAG's section 199A(g) deduction for 2020 is $720 (9% of the lesser of the EAG's patronage source taxable income of $8,000 and the EAG's QPAI of $10,000, but no greater than 50% of its W-2 wages of $3,000, that is $1,500). Pursuant to paragraph (c)(1) of this section, the $720 section 199A(g) deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is $144 to X ($720 × $2,000/$10,000), $216 to Y ($720 × $3,000/$10,000), and $360 to Z ($720 × $5,000/$10,000). Although X's patronage source taxable income for 2020 determined prior to allocation of a portion of the EAG's section 199A(g) deduction to it was $0, pursuant to paragraph (c)(2) of this section, X will have an NOL from its patronage source for 2020 equal to $144, which will be a carryover to 2021.

(ii) Example 2. (A) Facts. Corporation X is the common parent of a consolidated group, consisting of X and Y, which has filed a consolidated Federal income tax return for many years. Corporation P is the common parent of a consolidated group, consisting of P and S, which has filed a consolidated Federal income tax return for many years. The X and P consolidated groups each file their consolidated Federal income tax returns on a calendar year basis. X, Y, P, and S are each Specified Cooperatives, and none of X, Y, P, or S has ever had activities other than from its patronage sources. The X consolidated group and the P consolidated group are members of the same EAG in 2021. In 2020, the X consolidated group incurred a consolidated net operating loss (CNOL) of $25,000. Neither P nor S (nor the P consolidated group) has ever incurred an NOL. In 2021, the X consolidated group has (prior to the deduction under section 172) taxable income of $8,000 and the P consolidated group has taxable income of $20,000. X's QPAI is $8,000, Y's QPAI is ($13,000), P's QPAI is $16,000 and S's QPAI is $4,000. There are sufficient W-2 wages to exceed the section 199A(g)(1)(B) limitation.

(B) Analysis. The X consolidated group uses $8,000 of its CNOL from 2020 to offset the X consolidated group's taxable income in 2021. None of the X consolidated group's remaining CNOL may be used to offset taxable income of the P consolidated group under paragraph (b)(3) of this section. Accordingly, for purposes of determining the EAG's section 199A(g) deduction for 2021, the EAG has taxable income of $20,000 (the X consolidated group's taxable income, after the deduction under section 172, of $0 plus the P consolidated group's taxable income of $20,000). The EAG has QPAI of $15,000 (the X consolidated group's QPAI of ($5,000) (X's $8,000 + Y's ($13,000)), and the P consolidated group's QPAI of $20,000 (P's $16,000 + S's $4,000)). The EAG's section 199A(g) deduction equals $1,350, 9% of the lesser of its taxable income of $20,000 and its QPAI of $15,000. The section 199A(g) deduction is allocated between the X and P consolidated groups in proportion to their respective QPAI. Because the X consolidated group has negative QPAI, all of the section 199A(g) deduction of $1,350 is allocated to the P consolidated group. This $1,350 is allocated between P and S, the members of the P consolidated group, in proportion to their QPAI. Accordingly, P is allocated $1,080 ($1,350 x ($16,000/$20,000) and S is allocated $270 ($1,350 x $4,000/$20,000)).

(f) Allocation of patronage income and loss by a Specified Cooperative that is a member of the expanded affiliated group for only a portion of the year--(1) In general. A Specified Cooperative that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year that the Specified Cooperative is a member of the EAG and the portion of the taxable year that the Specified Cooperative is not a member of the EAG. This allocation of items is made by using the pro rata allocation method described in this paragraph (f)(1). Under the pro rata allocation method, an equal portion of patronage taxable income or loss, QPAI, and W-2 wages is assigned to each day of the Specified Cooperative's taxable year. Those items assigned to those days that the Specified Cooperative was a member of the EAG are then aggregated.

(2) Coordination with rules relating to the allocation of income under §1.1502-76(b). If §1.1502-76(b) (relating to items included in a consolidated return) applies to a Specified Cooperative that is a member of an EAG, then any allocation of items required under this paragraph (f) is made only after the allocation of the items pursuant to §1.1502-76(b).

(g) Total section 199A(g) deduction for a Specified Cooperative that is a member of an expanded affiliated group for some or all of its taxable year--(1) Member of the same EAG for the entire taxable year. If a Specified Cooperative is a member of the same EAG for its entire taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year is the amount of the section 199A(g) deduction allocated to it by the EAG under paragraph (c)(1) of this section.

(2) Member of the expanded affiliated group for a portion of the taxable year. If a Specified Cooperative is a member of an EAG for only a portion of its taxable year and is either not a member of any EAG or is a member of another EAG, or both, for another portion of the taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year is the sum of its section 199A(g) deductions for each portion of the taxable year.

(3) Example. The following example illustrates the application of paragraphs (f) and (g) of this section.

(i) Facts. Specified Cooperatives X and Y, calendar year taxpayers, are members of the same EAG for the entire 2020 taxable year. Specified Cooperative Z, also a calendar year taxpayer, is a member of the EAG of which X and Y are members for the first half of 2020 and not a member of any EAG for the second half of 2020. None of X, Y, or Z have activities other than from its patronage sources. Assume that

X, Y, and Z each has W-2 wages in excess of the section 199A(g)(1)(B) wage limitation for all relevant periods. In 2020, X has taxable income of $2,000 and QPAI of $600, Y has taxable loss of $400 and QPAI of ($200), and Z has taxable income of $1,400 and QPAI of $2,400.

(ii) Analysis. Pursuant to the pro rata allocation method, $700 of Z's 2020 taxable income and $1,200 of its QPAI are allocated to the first half of the 2020 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2020 taxable income and $1,200 of its QPAI are allocated to the second half of the 2020 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2020, the EAG has taxable income from patronage sources of $2,300 ($2,000 + ($400) + $700) and QPAI of $1,600 ($600 + ($200) + $1,200). The EAG's section 199A(g) deduction for 2020 is $144 (9% of the lesser of the EAG's taxable income of $2,300 or QPAI of $1,600). Pursuant to §1.199A-12(c)(1), this $144 deduction is allocated to X, Y, and Z in proportion to their respective QPAI. Accordingly, X is allocated $48 of the EAG's section 199A(g) deduction ($144 x ($600/($600 + $0 + $1,200))), Y is allocated $0 of the EAG's section 199A(g) deduction ($144 x ($0 / ($600 + $0 + $1,200))), and Z is allocated $96 of the EAG's section 199A(g) deduction ($144 x ($1,200 / ($600 + $0 + $1,200))). For the second half of 2020, Z has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2020, Z has a section 199A(g) deduction of $63 (9% of the lesser of its taxable income of $700 or its QPAI of $1,200). Accordingly, X's 2020 section 199A(g) deduction is $48 and Y's 2020 section 199A(g) deduction is $0. Z's 2020 section 199A(g) deduction is $159, the sum of $96, the portion of the EAG's section 199A(g) deduction allocated to Z for the first half of 2020 and Z's $63 section 199A(g) deduction for the second half of 2020.

(h) Computation of section 199A(g) deduction for members of an expanded affiliated group with different taxable years--(1) In general. If Specified Cooperatives that are members of an EAG have different taxable years, in determining the section 199A(g) deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages of each other group member that are both--

(i) Attributable to the period that each other member of the EAG and the computing member are members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199A(g) and ends with or within the taxable year of the computing member with respect to which the section 199A(g) deduction is computed.

(2) Example. The following example illustrates the application of this paragraph (h).

(i) Facts. Specified Cooperatives X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Z came into existence on July 1, 2020. None of X, Y, or Z have activities other than from its patronage sources. Each Specified Cooperative has taxable income that exceeds its QPAI and W-2 wages in excess of the section 199A(g)(1)(B) wage limitation. For the taxable year ending December 31, 2020, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2021, Z's QPAI is $2,000.

(ii) 2020 Computation. In computing X's and Y's respective section 199A(g) deductions for their taxable years ending December 31, 2020, X's taxable income or loss, QPAI and W-2 wages and Y's taxable income or loss, QPAI, and W-2 wages from their respective taxable years ending December 31, 2020, are aggregated. The EAG's QPAI for this purpose is $2,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000)). Accordingly, the EAG's section 199A(g) deduction is $180 (9% × $2,000). The $180 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199A(g) deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being $0. Accordingly, X's section 199A(g) deduction for its taxable year ending December 31, 2020, is $180 ($180 × $8,000/($8,000 + $0)). Y's section 199A(g) deduction for its taxable year ending December 31, 2020, is $0 ($180 × $0/($8,000 + $0)).

(iii) 2021 Computation. In computing Z's section 199A(g) deduction for its taxable year ending June 30, 2021, X's and Y's items from their respective taxable years ending December 31, 2020, are taken into account. Therefore, X's taxable income or loss and Y's taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages from their taxable years ending December 31, 2020, are aggregated with Z's taxable income or loss, QPAI, and W-2 wages from its taxable year ending June 30, 2021. The EAG's QPAI is $4,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000) + Z's QPAI of $2,000). The EAG's section 199A(g) deduction is $360 (9% × $4,000). A portion of the $360 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the $360 deduction to Z, Y's QPAI is treated as being $0 because Y's QPAI is negative. Z's section 199A(g) deduction for its taxable year ending June 30, 2021, is $72 ($360 × ($2,000/($8,000 + $0 + $2,000))).

(i) Partnership owned by expanded affiliated group--(1) In general. For purposes of section 199A(g)(3)(D) relating to DPGR, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of such partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer during such period.

(2) Attribution of activities--(i) In general. If a Specified Cooperative which is a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease,

rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(ii) Attribution between expanded affiliated group partnerships. If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE activities previously conducted by the producing partnership with respect to that property, provided that each of these partnerships (the producing partnership and the disposing partnership) is owned for its entire taxable year in which the disposing partnership disposes of such property by members of the same EAG. With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(j) Applicability date. The provisions of this section apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of §§1.199A-7 through 1.199A-12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

Par. 5. Section 1.1382-3 is amended by

1. Revising paragraph (c)(2).

2. Adding paragraph (e).

The revisions and additions read as follows:

**§1.1382-3 Taxable income of cooperatives; special deductions for exempt farmers' cooperatives.**

* * * * *

(c) * * *

(2) <u>Definition</u>. The term <u>income derived from sources other than patronage</u> used in this paragraph (c) means income from nonpatronage sources within the meaning of §1.1388-1(f)(3).

* * * * *

(e) <u>Applicability date</u>. Paragraph (c)(2) of this section applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, taxpayers, however, may choose to apply the rules of paragraph (c)(2) of this section, provided the taxpayers apply the rules in their entirety and in a consistent manner.

Par. 6. Section 1.1388-1 is amended by adding paragraphs (f) and (g).

The additions read as follows:

**§1.1388-1 Definitions and special rules.**

* * * * *

(f) <u>Patronage and nonpatronage sourced items</u>--(1) <u>Directly related use test</u>. Whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test.

(2) <u>Patronage sourced income or deductions</u>. If the income or deduction is produced by a transaction that actually facilitates the accomplishment of the

cooperative’s marketing, purchasing, or services activities, the income or deduction is from patronage sources.

(3) Nonpatronage sourced income or deductions. If the transaction producing the income or deduction does not actually facilitate the accomplishment of the cooperative’s marketing, purchasing, or services activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association’s cooperative operation, the income or deduction is from nonpatronage sources.

(g) Applicability date. Paragraph (f) of this section applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers, however, may choose to apply the rules of paragraph (f) of this section for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

**Sunita Lough,**

*Deputy Commissioner for Services and Enforcement.*

Approved: January 8, 2021.

**David J. Kautter,**

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