

# INTERNAL REVENUE BULLETIN



## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### ADMINISTRATIVE

#### **Notice 2021-6, page 822.**

Notice 2021-6 waives the requirement to file and furnish certain 1099 series forms relating to specified grants, payments, subsidies and loan forgiveness excludible from income under various COVID-19 relief acts. The notice does not waive information reporting requirements to file and furnish Forms 1098 and 1098-T with respect to those amounts.

### ADMINISTRATIVE; EMPLOYMENT TAX

#### **Notice 2021-11, page 827.**

Notice 2021-11 modifies Notice 2020-65 by providing additional tax relief to taxpayers affected by the Coronavirus Disease (COVID-19) emergency, pursuant to the Consolidated Appropriations Act, 2021. Notice 2020-65, issued on August 28, 2020, gave employers the option to defer the employee portion of Social Security taxes (for employees whose wages are below a certain amount) from September 1, 2020, to December 31, 2020. Any taxes deferred under Notice 2020-65 were to be withheld and paid ratably from employee wages between January 1, 2021, until April 30, 2021. However, the Consolidated Appropriations Act, 2021, signed into law December 27, 2020, extended the period that the deferred taxes are to be withheld and paid ratably. The period is now for the entire year – from January 1, 2021, through December 31, 2021. Penalties, interest and additions to tax will now start to apply on January 1, 2022, for any unpaid balances. Notice 2021-11 makes changes to Notice 2020-65 to reflect this extended period.

### INCOME TAX

#### **Notice 2021-12, page 828.**

This notice extends the temporary relief from certain requirements under § 42 for qualified low-income housing projects and under §§ 142(d) and 147(d) for qualified residential rent-

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al projects that was provided in Notice 2020-53, 2020-30 I.R.B. 151 in response to the continuing Coronavirus Disease 2019 (COVID-19) pandemic. This notice also provides relief for additional § 42 requirements not previously addressed in Notice 2020-53.

#### **Rev. Proc. 2021-11, page 833.**

This Revenue Procedure provides methods for calculating W-2 wages for purposes of section 199A(g)(1)(B)(i), which, for certain specified agricultural or horticultural cooperatives provides a limitation based on W-2 wages to the amount of a deduction under section 199A(g)(1)(A) of 9 percent of the lesser of qualified production activities income or taxable income of a Specified Cooperative. This Revenue Procedure also modifies Revenue Procedure 2019-11, 2019-09 I.R.B. 742, to amend the method for determining W-2 wages for taxpayers with short taxable years.

#### **Rev. Rul. 2021-4, page 724.**

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term tax exempt rate. For purposes of sections 382, 1274, 1288, 7872 and other sections of the Code, tables set forth the rates for February 2021.

#### **T.D. 9946, page 726.**

The final regulations provide guidance on section 162(f) of the Internal Revenue Code (Code), as amended in 2017, concerning the deduction of certain fines, penalties, and other amounts. The final regulations also provide guidance relating to the information reporting requirements under new section 6050X of the Code with respect to those fines, penalties, and other amounts.

#### **T.D. 9947, page 748.**

These final regulations 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

Finding Lists begin on page ii.

Cooperatives) and their patrons regarding the deduction provided by section 199A(g) of the Code for eligible domestic production activities undertaken by Specified Cooperatives. These 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, these 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, these final regulations remove 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.

**T.D. 9948, page 801.**

This document contains final regulations relating to the excise taxes imposed on certain amounts paid for transportation of persons and property by air. Specifically, the final regulations relate to the exemption for amounts paid for certain aircraft management services. The final regulations also amend, revise, redesignate, and remove provisions of existing regulations that are out-of-date or obsolete and generally update the existing regulations to incorporate statutory changes, case law, and other published guidance. The final regulations affect persons that provide air transportation of persons and property, and persons that pay for those services.

## **INCOME TAX; ADMINISTRATIVE**

**Notice 2021-8, page 823.**

Notice 2021-8 provides a waiver of an amount of the addition to tax under § 6654 for underpayment of estimated income tax by individual taxpayers, where the underpayment is attributable to the amendment to § 461(l)(1)(B) made by the CARES Act. The relief, which is not automatic, applies only for the purpose of calculating installments of estimated income tax of an affected individual taxpayer that were due on or before July 15, 2020, with respect to the taxable year that began during 2019.

**Notice 2021-13, page 832.**

This notice provides partnerships with relief from certain penalties due to the inclusion of incorrect information in reporting their partners' beginning capital account balances on the 2020 Schedules K-1 (Form 1065) and the 2020 Schedules K-1 (Form 8865) as outlined in the 2020 Instructions for Form 1065, U.S. Return of Partnership Income. This notice also provides relief from accuracy-related penalties for any taxable year for the portion of an imputed underpayment attributable to the inclusion of incorrect information in a partner's beginning capital account balance reported by a partnership for the 2020 taxable year.

# The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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# Part I

## Section 1274.— Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 467, 468, 482, 483,  
1288, 7520, 7872.)

### Rev. Rul. 2021-4

This revenue ruling provides various prescribed rates for federal income tax

purposes for February 2021 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropri-

ate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

**REV. RUL. 2021-4 TABLE 1**  
Applicable Federal Rates (AFR) for February 2021  
*Period for Compounding*

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
		<i>Short-term</i>		
AFR	0.12%	0.12%	0.12%	0.12%
110% AFR	0.13%	0.13%	0.13%	0.13%
120% AFR	0.14%	0.14%	0.14%	0.14%
130% AFR	0.16%	0.16%	0.16%	0.16%
		<i>Mid-term</i>		
AFR	0.56%	0.56%	0.56%	0.56%
110% AFR	0.62%	0.62%	0.62%	0.62%
120% AFR	0.67%	0.67%	0.67%	0.67%
130% AFR	0.73%	0.73%	0.73%	0.73%
150% AFR	0.84%	0.84%	0.84%	0.84%
175% AFR	0.98%	0.98%	0.98%	0.98%
		<i>Long-term</i>		
AFR	1.46%	1.45%	1.45%	1.45%
110% AFR	1.61%	1.60%	1.60%	1.59%
120% AFR	1.75%	1.74%	1.74%	1.73%
130% AFR	1.90%	1.89%	1.89%	1.88%

**REV. RUL. 2021-4 TABLE 2**  
Adjusted AFR for February 2021  
*Period for Compounding*

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
Short-term adjusted AFR	0.09%	0.09%	0.09%	0.09%
Mid-term adjusted AFR	0.43%	0.43%	0.43%	0.43%
Long-term adjusted AFR	1.10%	1.10%	1.10%	1.10%

**REV. RUL. 2021-4 TABLE 3**

Rates Under Section 382 for February 2021

Adjusted federal long-term rate for the current month	1.10%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	1.10%

**REV. RUL. 2021-4 TABLE 4**

Appropriate Percentages Under Section 42(b)(1) for February 2021

Note: Under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%.

Appropriate percentage for the 70% present value low-income housing credit	7.23%
Appropriate percentage for the 30% present value low-income housing credit	3.10%

**REV. RUL. 2021-4 TABLE 5**

Rate Under Section 7520 for February 2021

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	.6%
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**Section 42.—Low-Income Housing Credit**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 467.—Certain Payments for the Use of Property or Services**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 483.—Interest on Certain Deferred Payments**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 280G.—Golden Parachute Payments**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs**

The applicable federal short-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change**

The adjusted applicable federal long-term rate is set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 482.—Allocation of Income and Deductions Among Taxpayers**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 7520.—Valuation Tables**

The applicable federal mid-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

**Section 7872.—Treatment of Loans With Below-Market Interest Rates**

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2021. See Rev. Rul. 2021-4, page 724.

## T.D. 9946

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Related Information Reporting Requirements

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance on section 162(f) of the Internal Revenue Code (Code), as amended in 2017, concerning the deduction of certain fines, penalties, and other amounts. This document also contains final regulations providing guidance relating to the information reporting requirements under new section 6050X of the Code with respect to those fines, penalties, and other amounts. The final regulations affect taxpayers that pay or incur amounts to, or at the direction of, governments, governmental entities or certain nongovernmental entities treated as governmental entities relating to the violation of any law or investigations or inquiries by such governments, governmental entities, or nongovernmental entities into the potential violation of any law. The final regulations also affect governments, governmental entities, and nongovernmental entities subject to the related reporting requirements.

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

*Applicability dates:* For dates of applicability, see §§1.162-21(g) and 1.6050X-1(g).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations on amended section 162(f), Sharon Y. Horn

(202) 317-4426; concerning the information reporting requirement, Nancy L. Rose (202) 317-5147. The phone numbers above may also be reached by individuals who are deaf or hard of hearing, or who have speech disabilities, through the Federal Relay Service toll-free at (800) 877-8339.

#### SUPPLEMENTARY INFORMATION:

##### Background

Prior to its amendment in 2017, section 162(f) disallowed an ordinary and necessary business expense deduction under section 162(a) for any fine or similar penalty paid to a government for the violation of any law. On February 20, 1975, the Treasury Department and the IRS issued final regulations under the prior version of section 162(f) (TD 7345, 40 FR 7437), which were amended on July 11, 1975 (TD. 7366, 40 FR 29290) (together the 1975 regulations).

Section 162(f) was amended by section 13306(a) of Public Law No. 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 6050X was added to the Code by section 13306(b) of the TCJA.

As amended by the TCJA, the general rule of section 162(f)(1) provides that no deduction otherwise allowable under chapter 1 of the Code (chapter 1) shall be allowed for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or governmental entity into the potential violation of any law. Section 162(f)(5) describes certain self-regulating nongovernmental entities that are treated as governmental entities for purposes of section 162(f). As used in this preamble, the term “governmental entities” includes nongovernmental entities treated as governmental entities under section 162(f)(5).

Section 162(f)(2) provides an exception to the general disallowance rule in section 162(f)(1) for certain amounts paid or incurred for restitution, remediation, or to come into compliance with a law. Under section 162(f)(2)(A)(i) and (ii), section 162(f)(1) does not apply to

amounts that (i) the taxpayer establishes were paid or incurred as restitution (including remediation of property) or to come into compliance with a law (establishment requirement), and (ii) are identified in a court order (order) or settlement agreement (agreement) as restitution, remediation, or amounts paid or incurred to come into compliance with a law (identification requirement). Section 162(f)(2)(B) provides that amounts paid for restitution, remediation, and to come into compliance with a law do not include any amount paid or incurred as reimbursement to a government or governmental entity for the costs of any investigation or litigation.

Section 162(f)(3) provides an exception to the general rule for amounts paid or incurred related to private party suits and section 162(f)(4) provides an exception for certain taxes due.

Section 6050X(a)(1) and 6050X(a)(2)(A) requires the appropriate official of any government or governmental entity involved in a suit or agreement described in section 6050X(a)(2)(A)(i) to file an information return if the aggregate amount involved in all orders or agreements with respect to the violation, investigation, or inquiry is \$600 or more. Section 6050X(a)(2)(B) authorizes the Secretary of the Treasury or his delegate (Secretary) to adjust the threshold amount for filing the information return as necessary to ensure the efficient administration of the internal revenue laws. Pursuant to section 6050X(a)(1), the information return must set forth (1) the amount required to be paid as a result of the order or agreement to which section 162(f)(1) applies; (2) any amount required to be paid as a result of the order or agreement that constitutes restitution or remediation of property; and (3) any amount required to be paid as a result of the order or agreement for the purpose of coming into compliance with a law that was violated or involved in the investigation or inquiry.

Section 6050X(a)(3) provides that the government or governmental entity shall file the information return at the time the agreement is entered into, as determined by the Secretary. Section 6050X(b) requires the government or governmental entity to furnish to each person who is a

party to the suit or agreement a written statement, at the time the information return is filed with the IRS, that includes (1) the name of the government or entity and (2) the information submitted to the IRS.

Under section 13306(a)(2) and (b) (3) of the TCJA, the amendments to section 162(f) and new section 6050X apply to amounts paid or incurred on or after December 22, 2017, the date of enactment of the TCJA. However, they do not apply to amounts paid or incurred under any binding order issued or agreement entered into, before December 22, 2017, and, if such order or agreement requires court approval, the required approval is obtained before December 22, 2017.

On May 13, 2020, the Internal Revenue Service published a notice of proposed rulemaking (REG-104591-18) in the **Federal Register** (85 FR 28524) providing guidance on the deduction disallowance rules in section 162(f) and the associated reporting requirements in section 6050X. No public hearing on the proposed regulations was requested and accordingly no public hearing was held.

The Treasury Department and the IRS received written comments in response to the proposed regulations. All comments were considered and are available at [www.regulations.gov](http://www.regulations.gov) or upon request. 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**

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 that are outside the scope of the final regulations are not discussed.

Part I of this Summary of Comments and Explanation of Revisions addresses §1.162-21 and Part II addresses §1.6050X-1.

## *I. Denial of Deduction for Certain Fines, Penalties, and Other Amounts*

### *A. General rule*

The proposed regulations revise §1.162-21 and provide operational and definitional guidance concerning the application of section 162(f), as amended by the TCJA. The proposed regulations provide generally that a taxpayer may not take a deduction under any provision of chapter 1 for amounts (1) paid or incurred by suit, agreement, or otherwise; (2) to, or at the direction of, a government or governmental entity; (3) in relation to the violation, or investigation or inquiry into the potential violation, of any civil or criminal law. The proposed regulations also describe an exception to the general rule, under section 162(f)(2), which allows a deduction for certain amounts identified in the order or agreement as restitution, remediation, or paid or incurred to come into compliance with a law and the taxpayer establishes that the amount was paid or incurred for the purpose identified.

The final regulations provide generally that a taxpayer may not take a deduction under any provision of chapter 1 for amounts (1) paid or incurred by suit, agreement, or otherwise; (2) to, or at the direction of, a government or governmental entity; (3) in relation to the violation, or investigation or inquiry by such government or governmental entity into the potential violation, of any civil or criminal law. This general rule applies whether or not the taxpayer admits guilt or liability or pays the amount imposed for any other reason, including to avoid the expense or uncertain outcome of an investigation or litigation. An admission of guilt or liability is not necessary because section 162(f) (1) contemplates a broader disallowance, as demonstrated by the disallowance of any amount paid or incurred, to, or at the direction of, a government or governmental entity in relation to the “investigation or inquiry” into the “potential violation of any law.”

#### *1. Suit, agreement, or otherwise*

Under the proposed regulations, suit, agreement, or otherwise includes, but is not limited to, settlement agreements;

non-prosecution agreements; deferred prosecution agreements; judicial proceedings; administrative adjudications; decisions issued by officials, committees, commissions, or boards of a government or governmental entity; and any legal actions or hearings in which a liability for the taxpayer is determined or pursuant to which the taxpayer assumes liability.

Commenters asked that the final regulations exclude administrative and certain other categories of proceedings from the definition of suit, agreement, or otherwise. The final regulations do not adopt this recommendation because the statute’s use of the phrase “suit, agreement, or otherwise” indicates that Congress intended for section 162(f)(1) to apply broadly to both formal legal proceedings as well as other less formal proceedings.

The preamble to the proposed regulations under section 6050X explains that an order or agreement is treated as binding under applicable law even if all appeals have not been exhausted with respect to the suit, agreement, or otherwise. A commenter recommended that the final regulations provide that the same meaning applies for the term “binding” order or agreement under section 162(f). The final regulations generally adopt this recommendation.

#### *2. To, or at the direction of, a government or governmental entity*

One commenter asked for clarification that, if a deduction is otherwise allowable under chapter 1, section 162(f)(1) does not disallow a deduction for amounts paid for the taxpayer’s own legal fees and related expenses incurred in defending a prosecution or other action or proceeding, including an investigation or inquiry into a potential violation of any law. Legal fees and other expenses, such as stenographic and printing charges, paid or incurred in the defense of a prosecution or civil action arising from a violation of any law, or an investigation or inquiry into a potential violation of any law, are not amounts paid or incurred to, or at the direction of, a government or governmental entity. Thus it is clear that section 162(f)(1) does not disallow a deduction for such amounts, and there is no need to clarify this rule in final regulations.

The proposed regulations provide a definition of “government or governmental entity.” The definition in the final regulations has been reorganized to provide a definition of a government in §1.162-21(e)(1) and to provide a definition of a “governmental entity” in §1.162-21(e)(2). The definitions are based on the definition in the proposed regulations but clarify that a political subdivision of a government includes a local government unit. No comments were received on the definition of “government or governmental entity” in the proposed regulations.

The proposed regulations define a nongovernmental entity treated as a governmental entity as an entity that exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange, as defined in section 1256(g)(7), or exercises self-regulatory powers, including adopting, administering, or enforcing laws and imposing sanctions, as part of performing an essential governmental function. The final regulations revise the definition to clarify that self-regulatory powers include enforcing rules, not laws. A commenter recommended that the definition of “essential governmental function” under section 115 should apply to section 162(f)(5). The final regulations do not adopt this recommendation because section 115 does not define the term “essential governmental function.” The final regulations clarify that a governmental entity includes a nongovernmental entity treated as a governmental entity.

### 3. Violation of any law

Commenters asked that the final regulations provide a definition of a “violation of any law.” The final regulations do not adopt this recommendation because they are intended to provide broad rules of general application based on the underlying principles of section 162(f) rather than narrow rules with limited application. The final regulations provide several examples to illustrate the application of section 162(f) to violations of any law.

Commenters also requested clarification that “technical violations” of any law, such as vendor overcharge errors remedied in the ordinary course of business, are not violations of any law. The commenters did not further define what

constitutes a “technical violation.” Without a more comprehensive definition, the commenters’ requests may be inconsistent with the general rule in the final regulations. Therefore, the final regulations do not adopt this comment.

Commenters recommended that the final regulations clarify that the phrase “in relation to the violation of any law or the investigation or inquiry by such government or [governmental] entity into the potential violation of any law” do not apply to a government or governmental entity enforcing its legal rights, including defending against claims, as a private party. The Treasury Department and the IRS agree that, in general, unless a government contracting or similar statute provides otherwise, a government’s recovery of vendor overcharge errors are in the nature of private party recoveries and not payments made to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry into the potential violation of any law. Similarly, as discussed with respect to private party suits in Part I.B.6 of this Summary of Comments and Explanation of Revisions, a violation of any law does not include any order or agreement in a suit in which a government or governmental entity enforces rights as a private party.

Commenters asked the Treasury Department and the IRS how section 162(f) applies to amounts paid or incurred pursuant to certain statutes that contain provisions that may apply without any finding of a violation of law, such as the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). CERCLA contains cleanup requirements and reimbursement provisions that generally apply even though there has been no violation of law. CERCLA also contains penalty provisions for specific violations of law. Although section 162(f) and the final regulations generally will not apply to CERCLA cleanup requirements and reimbursements required to be paid or incurred by provisions that apply without any violation of law, section 162(f) and the final regulations will apply to penalties required to be paid or incurred for violations of law, including penalties required to be paid or incurred by reason of a violation of specific CERCLA provisions.

### 4. Investigation or inquiry into the potential violation of any law

The Treasury Department and the IRS received several requests for additional guidance concerning “the investigation or inquiry by [a] government or [governmental] entity into the potential violation of any law.” Commenters requested that the final regulations: (1) provide that an investigation or inquiry by such government into the potential violation of any law does not include a routine investigation, inquiry, audit, review, or inspection; (2) clarify when a routine investigation, inquiry, audit, review, or inspection ends and a non-routine investigation or inquiry begins; (3) clarify whether payments related to an investigation or inquiry are deductible if the investigation or inquiry ends without a finding of a violation of any law; and (4) provide examples of routine investigations, inquiries, audits, reviews, or inspections that are not non-routine investigations or inquiries. In addition, some of the commenters requested guidance that is unique to an industry or a statute.

The Treasury Department and the IRS agree that, in general, section 162(f)(1) does not disallow a deduction for amounts paid or incurred in connection with investigations or inquiries of regulated businesses or industries conducted in the ordinary course of business if the payment is otherwise deductible as an ordinary and necessary business expense. Accordingly, the final regulations provide, in general, that amounts paid or incurred for routine investigations or inquiries, such as audits or inspections, required to ensure compliance with rules and regulations applicable to the business or industry, which are not related to any evidence of wrongdoing or suspected wrongdoing, are not amounts paid or incurred relating to the potential violation of any law. Therefore, section 162(f)(1) will not apply to disallow an otherwise deductible ordinary and necessary business expense for amounts paid or incurred for these routine investigations or inquiries. Examples to illustrate the application of this rule are provided in the final regulations.

In contrast, section 162(f)(1) explicitly disallows a deduction for amounts paid or incurred for an investigation or inquiry by the government or governmental entity



relating to the potential violation of any law. Therefore, the final regulations do not adopt the commenters' recommendation that section 162(f)(1) does not apply to amounts paid or incurred where, at the conclusion of the investigation or inquiry, there is no finding of wrongdoing, because the recommendation is inconsistent with section 162(f)(1).

The final regulations clarify that the investigation or inquiry must be one that is conducted by the government or governmental entity. Examples to illustrate the application of this rule are provided in the final regulations.

### 5. *Fine or penalty*

The proposed regulations disallow a deduction for payments made, at the taxpayer's election, in lieu of a fine or penalty. No comments were received regarding this provision and it is retained in the final regulations. One commenter asked that the final regulations adopt a definition for "fine or penalty," and expressly state that both are not deductible. Although the final regulations do not provide a definition of "fine or penalty," they provide that an amount that is paid or incurred in relation to the violation of any civil or criminal law includes a fine or penalty.

### B. *Exception to general rule*

Section 162(f)(2) provides an exception to the general disallowance rule for certain amounts identified in the order or agreement as, and established by the taxpayer to be, paid or incurred for restitution or remediation, or to come into compliance with a law. The final regulations provide definitions and other guidance on the operation of this exception.

#### 1. *Restitution and remediation*

##### a. *General*

The proposed regulations provide that an amount is paid or incurred for restitution or remediation if it restores, in whole or in part, the person, as defined in section 7701(a)(1); the government; the governmental entity; or property harmed by the violation or potential violation of any law. Commenters requested clarifi-

cation as to what comprises restitution or remediation and requested modifications to the proposed definitions. A commenter recommended that the final regulations distinguish between civil and criminal restitution and disallow the deduction for amounts paid as criminal restitution. The final regulations do not adopt this rule because section 162(f)(2) does not distinguish between civil and criminal restitution and applies to "restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law." Emphasis added. Nonetheless, it may be harder for a taxpayer to establish that an amount paid is restitution in the criminal context because of the punitive purpose underlying most criminal liability.

##### b. *Restitution or remediation of the environment*

One commenter asked whether the definition of "property" for which restitution or remediation may be provided includes the environment. Another commenter noted that restitution or remediation cannot redress irreparable harms to the environment or natural resources, such as, killing wildlife or destroying a species or an ecosystem caused by the violation of any law. The commenter recommended that the final regulations provide a special restitution and remediation rule to address amounts paid or incurred for irreparable harm to the environment, natural resources, or wildlife. The Treasury Department and the IRS agree, provided the identification and establishment requirements are met and the restitution or remediation has a strong nexus or connection to the harm to the environment, natural resources, or wildlife that the taxpayer has caused or is alleged to have caused. The final regulations revise the definition of "*restitution, remediation of property, and amounts paid to come into compliance with a law*" to clarify that, if otherwise deductible under chapter 1, an amount is paid or incurred for restitution or remediation of the environment, wildlife, or natural resources if it is paid or incurred for the purpose of conserving soil, air, or water resources, protecting or restoring the environment or an ecosystem, improving forests, or

providing a habitat for fish, wildlife, or plants, and has the requisite nexus with the harm that the taxpayer has caused or is alleged to have caused. Such amounts may include payments described in §1.162-21(e)(4)(A), to be used exclusively for the restitution or remediation of a harm to the environment, wildlife, or natural resources that the taxpayer has caused or is alleged to have caused or paid to a segregated fund or account established by, or at the direction of, the government or governmental entity for the restitution or remediation of harm to the environment, wildlife, or natural resources that the taxpayer has caused or is alleged to have caused, provided, pursuant to the order or agreement, the amounts are not disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

##### c. *Disgorgement or forfeiture*

Under the proposed regulations, the section 162(f)(2) exception to the general deduction disallowance rule does not apply to forfeiture or disgorgement. Therefore, the proposed regulations treat any amount paid or incurred as forfeiture or disgorgement as, per se, disallowed under section 162(f)(1). To support excluding disgorgement from the definition of restitution, remediation, or amounts paid to come into compliance with a law, the preamble to the proposed regulations quotes *Kokesh v. Securities and Exchange Commission*, 137 S. Ct. 1635, 1643 (2017) ("[t]he primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains"). In *Kokesh*, the Supreme Court determined that disgorgement, when imposed as a sanction for violating a Federal securities law, constitutes a penalty under the related five-year statute of limitations because disgorgement is imposed to deter violations of securities laws by depriving violators of their ill-gotten gains and because the funds are dispersed to the United States Treasury to redress a wrong to the public at large caused by the violation. *Kokesh*, 137 S. Ct. at 1642-44. However, in *Kokesh*, the Supreme Court recognized that disgorgement may serve a compensatory purpose as well ("wrong

sought to be redressed is . . . a wrong to the individual;” “[s]ome disgorged funds are paid to victims”). *Id.*

To support excluding forfeiture from the definition of restitution, remediation, or amounts paid to come into compliance with a law, the preamble to the proposed regulations quotes *Nacchio v. United States*, 824 F.3d 1370, 1379 (Fed. Cir. 2016) (“[w]hile restitution seeks to make victims whole by reimbursing them for their losses, forfeiture is meant to punish the defendant by transferring his ill-gotten gains to the United States Department of Justice.”) In *Nacchio*, the United States Court of Appeals for the Federal Circuit disallowed the taxpayer’s deduction pursuant to a criminal conviction for insider trading, even though the government, in its discretion, subsequently used the forfeited funds to compensate victims.

Several commenters asked the Treasury Department and the IRS to reconsider the rule in the proposed regulations, which excludes disgorgement and forfeiture from the definition of “restitution, remediation, and coming into compliance.” One commenter explained the exclusion is contrary to the expressed intent of Congress because the statute provides an exception to the disallowance rule of section 162(f)(1) for restitution and that, in *Kokesh*, the Supreme Court stated, “[g]enerally, disgorgement is a form of [r]estitution measured by the defendant’s wrongful gain.” *Kokesh*, 137 S. Ct. at 1640. Commenters noted that, in *Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936 (2020), which was decided after the publication of the proposed regulations, the Supreme Court recognized that, amounts paid through disgorgement that do not exceed the wrongdoer’s net profits and that are awarded to individual victims may constitute an equitable remedy. Commenters also noted that, in *Liu*, the Supreme Court expressly declined to answer whether under *Kokesh* disgorgement necessarily constitutes a penalty. *Liu*, 140 S. Ct. at 1946.

In consideration of the comments submitted with respect to disgorgement and the Supreme Court’s decision in *Liu*, the final regulations will not treat disgorgement of net profits as, per se, nondeductible under section 162(f)(1). Instead, tax-

payer’s claim for a deduction for amounts paid or incurred through disgorgement will not be disallowed if the amount is otherwise deductible under chapter 1; the order or agreement identifies the payment, not in excess of net profits, as restitution, remediation, or an amount paid to come into compliance with a law; the taxpayer establishes that the amount was paid as restitution, remediation, or an amount paid to come into compliance with a law; and the origin of the taxpayer’s liability is restitution, remediation, or an amount paid to come into compliance with a law. However, amounts paid or incurred through disgorgement will be disallowed if, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes. The final regulations provide an example to illustrate the application of section 162(f) to disgorgement.

Commenters also requested that the Treasury Department and the IRS reconsider the rule in the proposed regulations that excludes forfeiture from the definition of “restitution, remediation, and coming into compliance,” but did not address forfeiture independently from their discussion of disgorgement. Virtually all states have some form of asset recovery legislation and the United States Code contains many forfeiture provisions. Because the final regulations cannot provide specific rules about the application of section 162(f) to every asset recovery statute, the final regulations will not treat forfeiture of net profits as, per se, nondeductible under section 162(f)(1). Instead, taxpayer’s claim for a deduction for an amount paid or incurred through forfeiture will not be disallowed if the amount is otherwise deductible under chapter 1; the order or agreement identifies the payment, not in excess of net profits, as restitution, remediation, or an amount paid to come into compliance with a law; the taxpayer establishes that the amount was paid as restitution, remediation, or an amount paid to come into compliance with a law; and the origin of the taxpayer’s liability is restitution, remediation, or an amount paid to come into compliance with a law. However, amounts paid or incurred through forfeiture will be disallowed if, pursuant to the order or agreement, the amounts

are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes. The final regulations provide an example to illustrate the application of section 162(f) to forfeiture.

#### d. *Payment to a fund*

Under the proposed regulations, restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred to an entity; to a fund, including a restitution, remediation, or other fund; to a group; or to a government or governmental entity, to the extent it was not harmed by the taxpayer’s violation or potential violation of a law. Commenters asked that the Treasury Department and the IRS reconsider this rule. In consideration of the comments, the final regulations remove the per se exclusion. However, the final regulations provide that restitution and remediation do not include amounts paid or incurred pursuant to an order or agreement to the general account or treasury of the government or governmental entity for general enforcement efforts or other discretionary purposes or amounts paid or incurred that do not meet the requirements of § 1.162-21(e)(4)(i). In addition, the final regulations provide that if amounts paid or incurred pursuant to an order or agreement to an entity, fund, group, or government or governmental entity are subsequently returned to the taxpayer, the taxpayer will be required to include those amounts in income under the tax benefit rule.

Several commenters noted that restitution funds may not be exhausted if, for example, there are unclaimed amounts or when less than the entire fund is required to be used to make harmed parties whole. One commenter recommended that the final regulations provide an example to illustrate that when unclaimed amounts revert to a government or governmental entity’s general account the nature of those amounts does not change as long as it was reasonably expected, at the time the taxpayer made the payment to the fund, that the amount would be used for restitution payments to harmed parties. Although the final regulations do not provide this example, the Treasury Department and the IRS generally agree that, if the order or agree-

ment identifies the payment to a fund, described in §1.162-21(e)(4)(A) or (e)(4)(B), as restitution or remediation, and the taxpayer establishes that it made the payment to a fund for the purpose identified, for example, by providing the canceled check making the payment to the fund, a deduction will not be disallowed if, after the taxpayer makes the payment, the amount paid to the fund is not used for the purpose identified as long as the amount does not revert to the taxpayer or for the benefit of the taxpayer.

## 2. *Coming into compliance with a law*

The proposed regulations provide that an amount is paid or incurred to come into compliance with a law by performing specific services, taking a specific corrective action, providing specific property, or a combination thereof. The final regulations also list amounts that will not be treated as paid or incurred to come into compliance with a law. The final regulations clarify that the services performed, actions taken, and the provision of property must be done to come into compliance with the law that has been violated, or potentially violated.

One commenter requested that the final regulations treat amounts paid or incurred pursuant to an order or agreement to upgrade equipment or property to a higher standard than required by law as coming into compliance with a law. The final regulations modify an example in the proposed regulations to clarify that if an order or agreement requires a taxpayer to come into compliance with a law and the taxpayer elects to upgrade equipment or property to a higher than required standard, any amount paid or incurred in excess of the amount paid or incurred to come into compliance with a law will not be disallowed by section 162(f)(1) or the related final regulations because it is not an amount paid or incurred to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry into the potential violation of any law.

Another commenter requested that the final regulations define the class of services and actions that qualify as having been made to come into compliance with a law under section 162(f)(2)(A)(i)(II). The

final regulations do not adopt this recommendation because they are intended to provide broad rules of general application based on the underlying principles of section 162(f) rather than narrow rules with limited application that risk excluding certain services or actions. The commenter also suggested that the government or governmental entity not be required to verify the accuracy of the amount expended by a taxpayer to perform the activities to come into compliance. The regulations do not require the government or governmental entity to verify the accuracy of the amount expended by a taxpayer to perform the activities to come into compliance.

## 3. *Identification requirement*

Section 162(f)(2)(A)(ii) requires an order or agreement to identify an amount paid or incurred as restitution, remediation, or to come into compliance with a law. Under the proposed regulations, an order or agreement identifies a payment by stating the nature of, or purpose for, each payment each taxpayer is obligated to pay and the amount of each payment identified.

To satisfy the identification requirement, the proposed regulations require the order or agreement to specifically state the amount of the payment and that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. The proposed rule provides that the identification requirement may be met if the order or agreement uses a different form of the requisite words, such as “remediate” or “comply with a law.”

The Treasury Department and the IRS received several recommendations and requests for clarification regarding how orders or agreements may meet the identification requirement when the payment amount is not identified. One commenter suggested that, if the total amount to be paid is known at the time the agreement is entered into or the order is issued, the order or agreement must identify separately the amount to be paid as restitution, remediation, or to come into compliance with a law in order to meet the identification requirement. In contrast, several other commenters asked whether the identification requirement may be met if

the order or agreement identifies the total payment as restitution, remediation, or paid to come into compliance with a law without allocating the payment amount among “restitution,” “remediation,” and “coming into compliance.” Some commenters expressed the concern that it may not be possible to satisfy the identification requirement in an order or agreement that imposes lump-sum judgments or settlements, involves multiple taxpayers, or multiple damage awards, because the order or agreement may not segregate the amounts to be paid as restitution, remediation, or to come into compliance with a law from the disallowed amounts, or allocate the payments among the multiple taxpayers.

The final regulations do not adopt a rule that a total payment amount will be allocated in an order or agreement among “restitution,” “remediation,” and/or “coming into compliance” in order to meet the identification requirement under section 162(f)(2)(A)(ii) because it could be burdensome on governments and governmental entities and taxpayers and would be difficult for the IRS to administer. Instead, the final regulations modify the proposed rule for payment amounts not identified so that it applies to orders or agreements that impose lump-sum payment judgments for “restitution, remediation, and coming into compliance,” or that involve multiple taxpayers or multiple damage awards. The payment amount not identified rule provides that the identification requirement may be met even if the order or agreement does not allocate the total lump-sum payment amount or multiple damage award among restitution, remediation, or to come into compliance, or allocate the total payment among multiple taxpayers. The final regulations also clarify that the identification requirement may be met even if the order or agreement does not provide an estimated payment amount.

Several commenters asked for clarification about how a taxpayer may meet the identification requirement. Consistent with section 162(f)(2)(A)(ii), the final regulations provide that the order or agreement, not the taxpayer, must meet the identification requirement with language specifically stating, or describing, that the amount will be paid or incurred

as restitution, remediation, or to come into compliance with a law.

Under the proposed regulations, the identification requirement is presumed to be met if an order or agreement specifically states that the payment, and the amount of the payment, constitutes restitution, remediation, or an amount paid to come into compliance with a law. Commenters requested that the final regulations adopt a more permissive rule pursuant to which the identification requirement is presumed to be met if the order or agreement uses words other than “restitution,” “remediation” or “remediate,” and “come into compliance,” or “comply.” In addition, a commenter also asked for a more permissive rule if an order or agreement is in a foreign language. The final regulations provide that the identification requirement is met, not presumed to be met, if the order or agreement specifically states that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. In response to the comments, the final regulations also provide a similar result if the order or agreement uses a different form of the required words, such as, “remediate” or “comply with a law.” An order or agreement in a foreign language may meet the identification requirement if the taxpayer provides a complete and accurate certified English translation of the order or agreement that describes the nature and purpose of the payment using the foreign language equivalent of restitution, remediation, or coming into compliance with the law.

An order or agreement will also meet the identification requirement, despite not using the words “restitution,” “remediation,” “remediate,” “come into compliance,” or “comply,” if the nature and purpose of the payment, as described in the order or agreement, are clearly and unambiguously to restore the injured party or property or to correct the non-compliance. The final regulations provide that an order or agreement will also meet the identification requirement if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer to (1) restore, in whole or in part, the party, property, environment, wildlife, or natural resources harmed, injured, or

damaged by the violation or potential violation of that law or (2) to perform services, take action, provide property, or do any combination thereof to come into compliance with that law.

The proposed regulations provide that the IRS may challenge an order or agreement’s identification of the payment amount as restitution, remediation, or made to come into compliance with a law for the purposes of meeting the identification requirement. One commenter recommended that a substantive challenge to the characterization of a payment would more appropriately fit under the establishment requirement, rather than under the identification requirement. To address this comment, the identification requirement in the final regulations does not include a rebuttable presumption.

#### 4. *Establishment requirement*

Section 162(f)(2)(A)(i) requires that a taxpayer establish that an amount was paid as restitution or remediation, or that the amount was paid to come into compliance with a law. The proposed regulations provide that the taxpayer may satisfy the establishment requirement by providing documentary evidence (1) that the taxpayer was legally obligated to pay the amount the order or agreement identified as restitution, remediation, or to come into compliance with a law; (2) of the amount paid or incurred; and (3) of the date on which the amount was paid or incurred. A commenter recommended that the final regulations clarify what the taxpayer must prove to meet the establishment requirement. The commenter also advised that it would be more appropriate for the IRS to challenge the characterization of the payment amount as restitution, remediation, or made to come into compliance with a law under the establishment requirement rather than under the identification requirement. The final regulations clarify that the establishment requirement is met if the documentary evidence submitted by the taxpayer proves that the taxpayer was legally obligated to pay the amount identified in the order or agreement as restitution, remediation, or to come into compliance with a law and that it was paid or incurred for the nature and purpose identified.

If the order or agreement identifies a lump-sum payment or a multiple damage award that includes some combination of restitution, remediation, and coming into compliance with a law, the taxpayer must establish the exact amount paid or incurred for each purpose. Likewise, if an order or agreement involves multiple taxpayers, each taxpayer must establish the amount that taxpayer paid or incurred as restitution, remediation, or to come into compliance.

The proposed regulations provided a non-exhaustive list of documents that taxpayers may use to satisfy the establishment requirement. Commenters requested that the final regulations include additional examples of such documents. The final regulations expand the list of documentary evidence that may be used to meet the establishment requirement. The taxpayer may be able to use documentary evidence in a foreign language to satisfy the establishment requirement if the taxpayer provides a complete and accurate certified English translation of the documentary evidence.

#### 5. *Information return may not satisfy the identification requirement or the establishment requirement*

The proposed regulations provide that reporting of the amount by a government or governmental entity under section 6050X does not satisfy the identification requirement or the establishment requirement. A commenter requested that the final regulations provide that a government or governmental entity’s submission of an information return under section 6050X can satisfy the identification requirement under section 162(f)(2)(A)(ii) and/or the establishment requirement under section 162(f)(2)(A)(i). The final regulations do not adopt this recommendation. The reporting requirement imposed by section 6050X is for tax administration purposes and does not serve as documentation that the taxpayer has met the identification requirement or the establishment requirement. Therefore, the taxpayer may not use the information reported on the Form 1098-F to satisfy the identification requirement or the establishment requirement.

## 6. *Private party suit*

Under section 162(f)(3), the general rule that disallows a deduction does not apply to any amount paid or incurred pursuant to an order in a suit in which no government or governmental entity is a party. Like the proposed regulations, the final regulations clarify that section 162(f)(1) does not apply to any amount paid or incurred by reason of any order or agreement in a suit in which no government or governmental entity is a party. A commenter asked for clarification in the final regulations that section 162(f)(1) does not apply to any amount paid or incurred by reason of any order or agreement in a suit in which a government or governmental entity enforces rights as a private party. For example, payments pursuant to contract disputes that are not due to fraud or other potentially illegal activity wherein the government or governmental entity enforces its rights as a private party contracting for goods and/or services, and not in its enforcement, regulatory, or administrative capacity, generally are not payments made at the direction of a government or governmental entity. The final regulations generally adopt this recommendation. An example has been provided in the final regulations to illustrate the application of this rule.

A commenter asked for clarification about the application of section 162(f) to *qui tam* cases brought by private citizens on behalf of a government or governmental entity. The final regulations do not adopt a single rule concerning *qui tam* cases, but certain principles apply to determine whether a deduction for the amounts paid or incurred will be allowed. In general, a government or governmental entity is the real party in interest in the suit and receives any funds paid pursuant to the order or agreement, including any share ultimately paid by the government or governmental entity to the relator, whether or not the government or governmental entity intervenes in the suit. Accordingly, any amount paid or incurred to a government or governmental entity as a result of the suit will likely be disallowed unless an exception to section 162(f)(1) applies.

## 7. *Pre and postjudgment interest*

A commenter asked whether section 162(f)(1) disallows a deduction for

prejudgment and postjudgment interest. Section 162(f)(1) applies to prejudgment interest paid or incurred to, or at the direction of, a government or governmental entity for the violation of any law or for the investigation or inquiry into a violation or potential violation of any law. However, a deduction for prejudgment interest will not be disallowed if the prejudgment interest is identified as a component of the total amount identified in the order or agreement as restitution and the taxpayer establishes that it was paid for this purpose. In general, section 162(f)(1) applies to postjudgment interest on amounts to be paid or incurred to, or at the direction of, a government or governmental entity for the violation of any law or investigation or inquiry into a potential violation of any law. However, if postjudgment interest is paid on an amount to which an exception under section 162(f)(2) applies, the exception also applies to that postjudgment interest.

## 8. *Failure to pay tax and related interest and penalties*

The proposed regulations provide that section 162(f)(1) does not apply to amounts paid or incurred as otherwise deductible taxes or related interest. In accordance with section 162(f)(2)(A)(iii), the final regulations provide that, in the case of any amount paid or incurred as restitution for failure to pay any tax imposed under Title 26, section 162(f)(1) does not disallow a deduction for an amount equal to or less than the amount otherwise allowed under chapter 1 if the tax had been timely paid. For example, section 162(f)(1) does not disallow a deduction of an amount paid or incurred as restitution for failure to pay a tax imposed under Title 26 of the Code, such as certain excise or employment taxes otherwise deductible under chapter 1. However, a deduction for amounts paid or incurred as restitution for failure to pay a Federal income tax is disallowed because Federal income taxes are not otherwise deductible under chapter 1. *See* section 275(a)(1).

The Treasury Department and the IRS received several comments about the application of section 162(f) to federal, state, and local taxes, and any related interest

and penalties. Under the proposed regulations, if penalties are imposed with respect to otherwise deductible taxes, a taxpayer may not deduct the interest paid with respect to such penalties. A commenter requested clarification that the taxpayer also may not deduct the penalties. The Treasury Department and the IRS agree and the final regulations are revised accordingly to provide that if penalties are imposed with respect to otherwise deductible taxes, a taxpayer may not deduct the penalties or the interest paid with respect to such penalties.

## 9. *Material change*

The proposed regulations contained a material change rule under which some orders issued, or agreements entered, before December 22, 2017, were subject to section 162(f)(1) as amended by the TCJA. Several commenters considered the definition of “material change” in the proposed regulations as “overly broad,” and suggested it could cause unnecessary administrative disputes and discourage taxpayers from negotiating with governments or governmental entities to clarify the terms of an order or agreement, resulting in increased litigation and burdening taxpayers, governments and governmental entities, and courts. One commenter argued that section 13306(a)(2) of the TCJA (the transition rule for section 162(f)) precludes adopting a material change rule for any binding orders issued or agreements entered into before December 22, 2017. The commenter recommended that the final regulations provide that the amendment to section 162(f) applies only to orders issued or agreements entered into after December 22, 2017.

In response to this comment, the Treasury Department and the IRS have determined that section 162(f), as amended by TCJA, does not apply to any pre-December 22, 2017 binding order or agreement even if modified on or after December 22, 2017. In addition, material changes to an order or agreement will generally result in a new order or agreement subject to section 162(f). For these reasons, the final regulations do not include the material change rule included in the proposed regulations.

## II. Reporting Information for Certain Fines, Penalties, and Other Amounts

### A. General rule

The purpose of the regulations under section 6050X is to provide appropriate officials of governments or governmental entities the operational, administrative, and definitional rules for complying with the statutory information reporting requirements for suits or agreements to which section 6050X(a)(1) applies.

In general, under the final regulations, if the aggregate amount a payor is required to pay pursuant to an order or agreement for a violation, investigation, or inquiry to which section 6050X(a)(1) and (a)(2) applies equals or exceeds the threshold amount, the appropriate official of a government or governmental entity that is a party to the order or agreement must file an information return with the IRS regarding certain amounts paid or incurred pursuant to the order or agreement, the payor's taxpayer identification number (TIN), and other information required by the information return and the related instructions. The appropriate official of a government or governmental entity that is a party to the order or agreement must also furnish a written statement with the same information to the payor.

#### 1. Government, governmental entity, or nongovernmental entity treated as a governmental entity

The proposed regulations provided a definition of "government or governmental entity." No comments were received on the definition of "government or governmental entity" in the proposed regulations. The definition in the final regulations has been reorganized to provide a definition of a government in §1.6050X-(f)(2) and to provide a definition of a "governmental entity" in §1.162-21(f)(3). The definitions are based on the definition in the proposed regulations but clarify that a political subdivision of a government includes a local government unit. The final regulations also clarify that a governmental entity includes a nongovernmental entity treated as a governmental entity.

The proposed regulations under section 6050X incorporate the definition of a

"nongovernmental entity" in the proposed regulations under section 162(f). The final regulations clarify that, for purposes of the information reporting requirements in section 6050X, a nongovernmental entity treated as a governmental entity does not include a nongovernmental entity of a territory of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands, a foreign country, or an Indian tribe.

#### 2. Suit or agreement

The proposed regulations provided that the information reporting is required for a "suit, agreement, or otherwise" pursuant to section 162(f)(1). A commenter noted that this rule is inconsistent with the statutory language of section 6050X, which only concerns a "suit or agreement." The final regulations clarify that a government or governmental entity involved in a suit or agreement to which section 6050X(a)(2) applies must file an information return for payment amounts described in section 6050X(a)(1).

Another commenter recommended that the final regulations clarify that a suit or agreement is treated as binding under applicable law even if all appeals have not been exhausted. The final regulations generally adopt this recommendation.

#### 3. Payor

The final regulations define "payor" as the person, as defined in section 7701(a)(1), which, pursuant to an order or agreement, has paid or incurred, or is liable to pay or incur, an amount to, or at the direction of, the government or governmental entity in relation to the violation or potential violation of any law. In general, the payor will be the person to which section 162(f) and §1.162-21 apply.

One commenter recommended that the final regulations provide that governments and governmental entities do not have a reporting requirement, and do not need to furnish a written statement, pursuant to section 6050X for the amounts described in section 6050X(a)(1) that tax-exempt, non-profit payors are required to pay. Another commenter recommended that the final regulations provide that the informa-

tion reporting requirement should apply only for civil, not criminal, cases. A third commenter recommended that the final regulations provide that the information reporting requirement applies only to payors involved in a trade or business and not to individual payors.

The final regulations do not adopt these recommendations because they are inconsistent with section 6050X. Section 6050X does not carve out an exception for criminal cases; individuals, including those not in a trade or business; and tax-exempt organizations.

The final regulations require the appropriate official to include the TIN of the payor on the information return filed regarding the payor. Commenters asked how the appropriate official of a government or governmental entity may secure a payor's TIN. If the appropriate official does not already have the payor's TIN, the appropriate official must request the TIN. The TIN may be requested in any manner. The appropriate official must notify the payor that the law requires the payor to furnish a TIN for inclusion on the information return and that failure to furnish the TIN may subject the payor to a penalty under section 6723. The payor may provide the TIN in any manner including orally, in writing, or electronically. If the payor furnishes the TIN in writing, no particular form is required.

#### 4. Threshold amount

Section 6050X(a)(2)(B) provides the Secretary with the authority to adjust the statutory reporting threshold of \$600 as necessary to ensure the efficient administration of the internal revenue laws. Based on comments received prior to the publication of the proposed regulations from governments and governmental entities concerned about the burden of information reporting and to ensure the efficient administration of the internal revenue laws, the Treasury Department and the IRS determined that a threshold higher than \$600 was appropriate to address these concerns. The proposed regulations provided that reporting is required if the aggregate amount of all orders and agreements for the violation, investigation, or inquiry equals or exceeds \$50,000 (threshold amount). Anticipating possible

compliance burdens on filers, the Treasury Department and the IRS requested comments about the proposed \$50,000 threshold. In particular, the Treasury Department and the IRS requested data on the annual number of relevant orders issued, or agreements entered, by governments or governmental entities and the financial, time, and administrative burdens associated with different threshold amounts. After publication of the proposed regulations, the Treasury Department and the IRS received several requests from governments and governmental entities to raise the proposed \$50,000 threshold amount, but none of the comments provided data to support those requests. As a result, the final regulations maintain the proposed threshold amount and provide that reporting is required for payment amounts equal to or in excess of \$50,000.

Commenters described several situations in which the government or governmental entity may be uncertain about its reporting obligation because it is not clear that the suit or agreement requires the payor to make payments described in section 6050X(a)(1) that equal or exceed the threshold amount. In one situation, the order or agreement described in section 6050X(a)(1) requires the payor to make several payments for a violation, investigation, or inquiry, each described in section 6050X(a)(2) and each for less than the threshold amount, but the aggregate amount of all payments pursuant to the order or agreement equals or exceeds the threshold amount. In another situation, an order or agreement involving more than one violation, investigation, or inquiry, each described in section 6050X(a)(2), requires the payor to make several payments, each described in section 6050X(a)(1), and each for less than the threshold amount, but the aggregate amount of all payments pursuant to the order or agreement equals or exceeds the threshold amount.

The commenter recommended that, in these two situations, the final regulations should treat each payment amount separately to determine if the aggregate amount involved in the order or agreement equals or exceeds the threshold amount. The final regulations do not provide rules for every circumstance to which section 6050X(a)(2)(A)(ii) could

apply. Form 1098-F and its instructions will contain additional guidance regarding the threshold amount.

Another commenter described a situation in which, pursuant to separate orders or agreements, the payor is required to pay separate amounts, all less than the threshold amount, for multiple acts or omissions in violation of the same law but the aggregate amount of the payments to be made pursuant to all orders and agreements equals or exceeds the threshold amount. The commenter requested that, in this situation, the final regulations treat each order and agreement separately. This situation is addressed by section 6050X(a)(2)(A)(ii), which provides that the government or governmental entity must file an information return for a suit or agreement if “the aggregate amount involved in all court orders and agreements with respect to the violation, investigation, or inquiry” equals or exceeds the threshold amount. Therefore, the final regulations do not adopt the rule proposed by the commenter. The final regulations also provide that in this situation, the appropriate official must file only one information return for all amounts the payor is required to pay pursuant to these orders or agreements.

#### 5. Requirement to file return

The appropriate official of a government or governmental entity must comply with the information reporting requirements of section 6050X and the related regulations by filing Form 1098-F, *Fines, Penalties, and Other Amounts*, or any successor form, as provided by the instructions, with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, on or before the annual due date as provided in the final regulations. Under the final regulations, the information return filed by the government or governmental entity with the IRS must provide the amount a payor is required to pay, pursuant to section 6050X(a)(1)(A) and §1.6050X-1(b)(1)(i), as a result of the order or agreement, the separate amounts required to be paid as restitution, remediation, or to come into compliance with a law, pursuant to section 6050X(a)(1)(B) and (a)(1)(C) and §1.6050X-1(b)(1)(ii), as a result of the order or agreement, the payor’s TIN, and any additional information

required by the information return and the related instructions.

The Treasury Department and the IRS received comments requesting that the final rules require information reporting only for amounts paid directly to a government or governmental entity. A commenter also requested final rules pursuant to which the government or governmental entity could provide the reporting information to the payor and require the payor to file the information return. None of these suggestions were adopted in the final regulations because they are inconsistent with the explicit language of section 6050X.

A commenter inquired whether the government or governmental entity reports the payment amount identified in the order or agreement, or only the amount the payor ultimately pays. Another commenter recommended that the reporting requirement apply only to payment amounts described in sections 162(f)(1) and 6050X(a)(1)(A) that are actually collected by governments and governmental entities. Section 6050X(a)(1) mandates reporting for “the amount required to be paid as a result of the suit or agreement” for a violation of any law, or an investigation or inquiry into the potential violation of any law, as well as for restitution, remediation, and to come into compliance with a law. Therefore, the final regulations do not adopt the commenter’s recommendation. Instead, the final regulations clarify that governments and governmental entities have a reporting obligation for the amounts, described in section 6050X(a)(1) and §1.6050X-1(b)(1)(i) and (ii), required to be paid pursuant to the order or agreement.

A commenter inquired whether the IRS would consider using website reporting instead of requiring reporting on a form. Section 6050X prescribes reporting that is more suitable on a form. Furthermore, section 6050X(b) also requires governments and governmental entities to furnish written statements to payors. Thus, even if the final regulations permitted governments and governmental entities to report information to the IRS via a website, they would still need to provide a written statement to payors, which could not be accomplished by a website. To minimize the burden on governments

or governmental entities, the final regulations permit the appropriate official to comply with the requirements to furnish written statements to payors via the Form 1098-F or another document that contains the required information if the document conforms to applicable guidance relating to substitute statements.

A commenter expressed concerns about the information reporting requirements resulting from an order or agreement, pursuant to which payments are made over the course of several years. To minimize the burden on governments and governmental entities and to ensure the efficient administration of the internal revenue laws, the final regulations do not require an appropriate official to file information returns for each taxable year in which a payor makes a payment pursuant to a single order or agreement. Instead, the appropriate official must file only one information return to report the amounts required by section 6050X(a)(1).

Some commenters inquired about the application of the reporting obligation to governments and governmental entities for specific types of administrative and certain other categories of proceedings. The final regulations do not address the application of the reporting obligation to specific statutes or types of proceedings because the final regulations are intended to provide broad rules of general application based on the underlying principles of sections 162(f) and 6050X rather than narrow rules with limited application that risk excluding a certain “violation of any law or the investigation or inquiry . . . into the potential violation of any law.”

One commenter observed that the payors and the governments and governmental entities may have incentives to enter into an agreement concerning the filing of information returns such that payors may improperly attempt to claim deductions to which they are not entitled and governments and governmental entities do not have to incur the burden of filing information returns and furnishing written statements. The commenter recommended that the final regulations treat any agreements between payors and governments or governmental entities not to file information returns as invalid and unenforceable. The final regulations do not adopt this recommendation because section 162(f) applies

to the taxpayer regardless of whether the appropriate official files an information return with the IRS.

#### 6. *Due dates*

Section 6050X(a)(3) provides that the information return shall be filed at the time the agreement is entered into, as determined by the Secretary, not at the time of payment, as recommended by a commenter. Further, section 6050X(b) requires the written statement to be furnished to the payor at the same time the information return is filed with the IRS. Under the proposed regulations, the information return was required to be filed on or before January 31 of the year following the calendar year in which the order or agreement becomes binding under applicable law.

A commenter requested that appropriate officials of governments and governmental entities be given more time to comply with the requirement. As requested, the final regulations provide, pursuant to section 6071(a), that information returns filed with the IRS on paper are due on or before February 28 of the year following the calendar year in which the order or agreement becomes binding under applicable law. In accordance with section 6071(b), information returns filed electronically are due on or before March 31 of such year. However, to increase the likelihood that payors have the information necessary to timely prepare their income tax returns and to avoid burdening governments and governmental entities with having to determine the tax year of each payor, the final regulations require the appropriate official to furnish the written statement on or before January 31 of such year.

#### 7. *Rules for multiple payors*

The final regulations describe the application of the information reporting requirements if, pursuant to the order or agreement, the aggregate amount multiple payors are required to pay, or the costs to provide the property or the service, equals or exceeds the threshold amount. If, pursuant to the order or agreement, more than one payor is individually liable for some or all of the payment amount,

the final regulations require the appropriate official to file an information return for the separate amount that each individually liable payor is required to pay, even if a payor’s payment liability is less than the threshold amount, and to furnish a written statement containing this information to each payor. If more than one person, as defined in section 7701(a)(1), is a party to an order or agreement, there is no information reporting requirement, or requirement to furnish a written statement, with respect to any person who does not have a payment obligation or obligation for costs to provide services or to provide property.

The final regulations provide that, if an order or agreement identifies multiple jointly and severally liable payors, the appropriate official must file an information return for each payor to report the information required by §1.6050X-1(b)(1)(i) and (ii) on the amount to be paid by all jointly and severally liable payors. The appropriate official must furnish a written statement containing this information to each of those payors, regardless of which payor makes the payment.

A commenter wrote that the rules requiring reporting would be challenging to implement when multiple payors are required to make payments. However, under section 6050X(a)(1)(3), the appropriate official has an obligation to file an information return when an order or agreement becomes binding, not when the payments are made, so there is no need for governments or governmental entities to track the receipt of payments in order to comply with section 6050X or the related final regulations.

Another commenter recommended that the payment obligation of each payor be examined separately to determine whether the amount each payor is required to pay, or the costs to provide the property or the service, equals or exceeds the threshold amount. However, in the case of joint and several liability, each payor is responsible for the entire amount, which requires reporting of, and furnishing a statement to, each payor. In the case where a payor is individually liable for an amount below the threshold amount, the payor may still attempt to deduct some or all of the payment amount all of the payors are required to pay, so filing an information return for



each of the payor's liabilities is useful for tax administration.

One commenter asked for clarification that the government or governmental entity is not obligated to file an information return with the IRS if, after an order or agreement has become binding under applicable law, the payor pursues another party for contribution. Because any payment the payor receives from another party in a subsequent proceeding will not be subject to section 162(f), the government or governmental entity will not have an obligation to file an information return for any payment made by the other party.

#### 8. *Payment amount not identified*

Commenters expressed concern that it is difficult for governments and governmental entities to estimate the payment amount pursuant to the order or agreement, and whether the aggregate amount equals or exceeds the information reporting threshold, when the order or agreement does not specify an amount. The Treasury Department and the IRS agree, which is why the regulations do not require governments or governmental entities to estimate payment amounts. Accordingly, if some or all of the payment amount is not identified in the order or agreement, the regulations direct governments and governmental entities to the instructions to Form 1098-F, or any successor form.

Some orders or agreements may identify a payment described in section 6050X(a)(1)(A) and identify a payment or an obligation to provide property or to provide services, as restitution, remediation, or an amount paid to come into compliance with a law, as described in section 6050X(a)(1)(B), but not identify some or all of the payment amounts the payor must pay, or some or all of the cost to provide property or services. The final regulations provide that, if the government or governmental entity reasonably expects that the aggregate amount the payor must pay, and the costs the payor will pay or incur to provide services or to provide property, pursuant to the order or agreement, will equal or exceed the threshold amount, the appropriate official of such government or governmental entity must file an information return on Form 1098-F, or any successor form, as provided in

the instructions to the Form 1098-F, and furnish a written statement to the payor with the information supplied to the IRS on Form 1098-F.

Similarly, a commenter noted that some orders or agreements may require a payor to make payments described in section 6050X(a)(1) for which reporting is required and other payments for which reporting is not required under section 6050X. The commenter recommended that if it is not clear for which payment amount the government or governmental entity has a reporting requirement, the rule under the proposed regulations for a payment amount not identified should apply. The Treasury Department and the IRS generally agree with this recommendation. Therefore, if, under the circumstances described by the commenter, the government or governmental entity reasonably expects that the aggregate amount the payor must pay, and the costs the payor must pay to provide services or to provide property, will equal or exceed the threshold amount, the appropriate official of such government or governmental entity must file an information return.

#### 9. *Material change*

Under the proposed regulations, if there was a material change to the terms of an order or agreement for which an appropriate official of a government or governmental entity filed an information return, the appropriate official had to file a corrected information return with the IRS and furnish an amended written statement to the payor. The Treasury Department and the IRS have concluded that material changes to an order or agreement will generally result in a new order or agreement subject to the rules under section 6050X and §1.6050X-1. For this reason, and because the final regulations under §1.162-21 do not include a material change rule, the final regulations have removed the material change rule from §1.6050X-1.

#### **Applicability Dates**

The rules of §1.162-21 apply to taxable years beginning on or after the date of publication of this Treasury decision in the **Federal Register**, except that such rules do not apply to amounts paid or in-

curred under any order or agreement, pursuant to a suit, agreement, or otherwise, that became binding under applicable law before such date, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired. The rules of §1.6050X-1 apply only to orders and agreements, pursuant to suits and agreements, that become binding under applicable law on or after January 1, 2022, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

#### **Special Analyses**

##### *I. Regulatory Planning and Review – Economic Analysis*

Executive Orders 12866 and 13563 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.

The regulations have been designated by the 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 by the Office of Management and Budget (OMB) regarding review of tax regulations.

##### A. Background

Prior to the Tax Cuts and Jobs Act (TCJA), section 162(f) of the Code disallowed a deduction for any fine or similar penalty paid to a government for the violation of any law. This provision, enacted in 1969, codified existing case law that denied business deductions for fines or similar penalties. The general rule of section 162(f)(1), as amended by section 13306(a) of the TCJA, disallows any deduction for amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity or

certain nongovernmental entities treated as governmental entities, in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. Section 13306(a) also provides certain exceptions to this disallowance. Section 162(f)(2)(A)(i) and (ii) does not disallow a deduction for amounts that (1) the taxpayer establishes were paid or incurred as restitution (including remediation of property) or to come into compliance with a law, and (2) are identified in the court order or settlement agreement as restitution, remediation, or to come into compliance with a law.

In addition, under prior law, the Treasury Department and the IRS did not receive information returns from governments or governmental entities that received fines or penalties. Section 6050X of the Code, enacted by section 13306(b) of the TCJA, requires appropriate officials to file an information return if the aggregate amount involved in all orders or agreements relating to the violation, investigation, or inquiry is \$600 or more. The information return must include (1) the amount required to be paid as a result of the order or agreement; (2) any amount that constitutes restitution or remediation of property; and (3) any amount required to be paid for the purpose of coming into compliance with a law that was violated or involved in the investigation or inquiry. Section 6050X provides the Secretary with the authority to adjust the \$600 reporting threshold in order to ensure efficient tax administration.

Proposed regulations regarding these provisions were previously issued on May 13, 2020 (REG-104591-18) (proposed regulations).

## B. Need for the Regulations

Following the passage of the TCJA, the Treasury Department and the IRS received several questions and comments from Federal, state, local, and tribal governments, as well as the public, regarding the meaning of various provisions in each section and issues not explicitly addressed in the statute. The Treasury Department and the IRS have determined that such comments warrant the issuance of further guidance.

In addition, the Treasury Department and the IRS have determined that increasing the reporting threshold to reduce the reporting burden and to enhance the efficiency of tax administration is appropriate.

## C. Overview of the Regulations

The regulations provide guidance regarding sections 162(f) and 6050X. The following analysis provides further detail regarding the anticipated impacts of the regulations. Part I.D specifies the baseline for the economic analysis. Part I.E.1. summarizes the economic effects of the rulemaking, relative to this baseline. Part I.E.2. describes the economic effects of specific provisions covering (1) the reporting threshold, (2) the timing of information reporting, and (3) information reporting requirements when payment amounts are not identified.

## D. Baseline

In this analysis, the Treasury Department and the IRS assess 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.

## E. Economic Analysis of the Regulation

### I. Summary of Economic Effects

The regulations under section 162(f) provide definitions for restitution, remediation, and amounts paid to come into compliance with the law. These definitions clarify for taxpayers which amounts paid or incurred may be deductible under the statute. The regulations also clarify (1) how the taxpayer meets the establishment requirement; and (2) how the order or agreement meets the identification requirement.

The Treasury Department and the IRS have determined that the burden reduction associated with the regulations for section 162(f) is modest. In addition, while the regulations reduce uncertainty for taxpayers, they are unlikely to affect economic decision-making because most of the amounts to be paid or incurred which are subject to section 162(f) are non-discretionary.

The regulations under section 6050X provide certainty and consistency for affected governments and governmental entities by defining and clarifying the statute's terms and rules. Further, the regulations use the authority provided by the statute to the Secretary to set information reporting requirements to minimize the burden on governments and governmental entities and to ensure the efficient administration of the internal revenue laws. Most importantly, the regulations increase the reporting threshold from \$600 to \$50,000, thereby eliminating information reporting requirements for approximately 1 to 5 million orders or agreements. Using the midpoint of this range (3 million), the estimated burden reduction from this exercise of regulatory discretion is \$74 million (2018 dollars) per year relative to the no-action baseline.

This reduction in compliance burden is the only meaningful economic effect of the regulations. The regulations do not have meaningful effects on the tax liability of taxpayers, the deductibility of amounts paid to, or at the directions of, governments and governmental entities, or the incentive for individuals or businesses to engage in violations of the law.

## II. Economic Analysis of Specific Provisions

### A. Reporting Threshold

Section 6050X requires governments and governmental entities which enter orders or agreements to which section 162(f) applies to file an information return if the aggregate amount paid or incurred in all orders or agreements relating to the violation, investigation, or inquiry is equal to or exceeds a threshold of \$600. Section 6050X also provides the Secretary with the authority to adjust the statutory reporting threshold as necessary to ensure efficient tax administration. In response to multiple comments received prior to the issuance of the proposed regulations from governments and governmental entities concerned about the burden of information reporting for smaller payments amounts pursuant to orders or agreements, the regulations raise the reporting threshold to \$50,000. In the proposed regulations, the Treasury Department and the IRS solic-

ited data on the annual number of orders or agreements by governments or governmental entities that could inform the determination of the appropriate threshold amount. The Treasury Department and the IRS did not receive any such data.

The Treasury Department and the IRS considered a range of alternative thresholds including the statutory threshold of \$600, along with much higher thresholds suggested by some commenters. Upon consideration of both the enforcement needs of the IRS and the reporting burden on governments and governmental entities, the Treasury Department and the IRS exercised the authority provided to the Secretary by the statute to set the reporting threshold amount at \$50,000.

The Treasury Department and the IRS do not know of any data on the number of orders or agreements requiring taxpayers to pay amounts to, or at the direction of, governments or governmental entities, or the distribution of these amounts, such as the number that are above or below \$600. Based on communications with stakeholders, the Treasury Department and the IRS estimate that the increase in reporting threshold from \$600 to \$50,000 will reduce the number of required information returns by approximately 1 to 5 million. The Treasury Department and the IRS further estimate that the average time to complete the information return is between 0.387 and 0.687 hours. Using the midpoint of each of these ranges (3 million information returns and .537 hours) and a labor cost of \$46 per hour,<sup>1</sup> the Treasury Department and the IRS estimate that increasing the reporting threshold will reduce annual compliance burdens by \$74 million dollars (2018 dollars) per year. It should be noted that many of the lower level fines and penalties are likely to be assessed on non-businesses that are not able to deduct business expenses so they would be unaffected by the extent to which governments or governmental entities are subject to reporting requirements.

Increasing the reporting threshold from \$600 to \$50,000 is unlikely to have a significant effect on revenues because fines over \$50,000 likely account for the vast majority of fines and penalties in terms of dollar values. Based on financial reporting

values disclosed on tax returns of C corporations, S corporations and partnerships, firms with over \$50,000 in total fines and penalties account for 99 percent of all fines and penalties. However, these data should be interpreted with caution. Financial reporting of fines and penalties includes both international and domestic fines, and all fines and penalties are aggregated into yearly totals. Furthermore, firms with less than \$10 million in assets are not required to provide financial reporting values with their tax returns.

#### B. Time of Reporting

Section 6050X provides that the government or governmental entity shall file the information return at the time the order is issued or the agreement is entered into, as determined by the Secretary. The Treasury Department and the IRS received comments from governments and governmental entities prior to the issuance of the proposed regulations observing that it would be burdensome and inefficient for them to file information returns each time an order or agreement becomes binding under applicable law. Several commenters suggested that annual filing of information returns would meaningfully reduce this reporting burden. The Treasury Department and the IRS agree with this comment and have adopted it in the regulations. The Treasury Department and the IRS have not estimated the difference in compliance burden between these two alternatives because they do not have suitable data or models to do so.

Several commenters also expressed uncertainty and concern about the information reporting requirements for an order or agreement pursuant to which payments are made over the course of several years. To reduce uncertainty, and to minimize the burden on governments and governmental entities, the regulations clarify that information reporting is required only for the year in which the order or agreement becomes binding under applicable law, and not required for each taxable year in which a payor makes a payment.

The Treasury Department and the IRS considered requiring information reporting at the time the order is issued or the

agreement is entered. The Treasury Department and the IRS also considered requiring information reporting in each year in which an amount is paid or incurred pursuant to the order or agreement. However, both alternative approaches were determined to impose unnecessary burden for governments and governmental entities without creating accompanying benefits for tax administration or for taxpayers.

Under the proposed regulations, the information return was required to be filed with the IRS, and a written statement furnished to the payor, on or before January 31 of the year following the calendar year in which the order or agreement becomes binding under applicable law, even if all appeals have not been exhausted for the suit or agreement. In response to the proposed regulations, a commenter requested that governments and governmental entities be given more time to comply with the requirements. As requested, the final regulations are revised to provide that information returns filed with the IRS on paper are due on or before February 28 of the year following the calendar year in which the order or agreement becomes binding under applicable law and information returns filed electronically are due on or before March 31 of such year. However, to increase the likelihood that payors have the information necessary to timely prepare their income tax returns, the final regulations still require governments and governmental entities to furnish the written statements to payors on or before January 31 of such year.

#### C. Payment Amount Not Identified

When the expected amount paid or incurred pursuant to an order or agreement equals or exceeds the threshold amount, section 6050X requires governments or governmental entities to file an information return including: (1) the amount required to be paid as a result of the order or agreement; (2) any amount that constitutes restitution or remediation of property; and (3) any amount required to be paid for the purpose of coming into compliance with a law that was violated or involved in the investigation or inquiry. However, some orders or agreements

<sup>1</sup>This data point is derived by the IRS as part of the burden analysis described in the Paperwork Reduction Act section below.

may involve uncertain payments or costs to provide property or services without identifying some or all of the aggregate amount the payor must pay, or some or all of the aggregate cost to provide property or services. The Treasury Department and the IRS received comments expressing concern that amounts paid or incurred are often difficult to assess, and strict valuation requirements would impose undue burden on governments and governmental entities. For situations in which the amount is not identified, the regulations direct governments and governmental entities to the instructions to Form 1098-F. To address commenters' concerns, these instructions will permit governments and governmental entities to report the threshold amount of \$50,000 when the amount is unknown but expected to equal or exceed \$50,000. This rule

is necessary to improve taxpayer compliance.

The Treasury Department and the IRS considered requiring governments and governmental entities to provide an estimate of each amount to be paid or incurred; however this approach was rejected because it would impose significant burden on governments and governmental entities. The Treasury Department and the IRS did not estimate the difference in compliance burden between the final regulation and this alternative approach because they do not have suitable data or models to do so.

### Paperwork Reduction Act

#### *Collection of Information – Form 1098-F*

In general, the collection of information in the regulations is required under

section 6050X of the Code. The collection of information in these regulations is set forth in §1.6050X-1. The IRS intends that the collection of information pursuant to section 6050X will be conducted by way of Form 1098-F, *Fines, Penalties, and Other Amounts*. Form 1098-F will be used by all governments, governmental entities, and nongovernmental entities treated as governmental entities with a reporting requirement. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the regulations. In addition, when available, drafts of IRS forms are posted for comment at [www.irs.gov/draftforms](http://www.irs.gov/draftforms).

The current status of the PRA submissions related to section 6050X are provided in the following table.

Form	Type of Filer	OMB Number	Status
1098-F	Governments, Governmental Entities, And Certain Nongovernmental Entities	1545-2284	Form 1098-F is approved through 1/31/2023.

#### Related New or Revised Tax Forms

	New	Revision of Existing Form	Number of Respondents (2018, estimated)
Form 1098-F	Yes		90,100 (85,500 small governmental jurisdictions, 4,500 large governmental jurisdictions and 100 nongovernmental entities).

A reasonable burden estimate for the average time to complete Form 1098-F is between 0.387 and 0.687 hours (approximately 23 to 41 minutes). This estimate is based on survey data collected from similar information return filers. In addition, the increase in the reporting threshold under section 6050X will lead to a decrease in the number of information returns filed by approximately 1 million to 5 million returns. Using the midpoint of these ranges, or 3 million and 0.537 hours, the estimated burden reduction is \$74 million per year.

*Estimated average time per form:* .537 hours.

*Estimated number of respondents:* 90,100.

*Estimated total annual burden hours:* 48,383.70.

*Estimated change in number of information returns resulting from increased reporting threshold:* (3,000,000).

*Estimated change in burden (hours):* (1,611,150).

*Estimated change in burden (Dollars):* (\$74,161,235).

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 26 U.S.C. 6103.

### Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6) requires agencies to “prepare and make available for public

comment an initial regulatory flexibility analysis,” which will “describe the impact of the rule on small entities.” 5 U.S.C. 603(a). Section 605(b) of the RFA allows an agency to certify a rule if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

Pursuant to the RFA, the Secretary of the Treasury hereby certifies that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the RFA.

The RFA generally applies to regulations that affect small businesses, small organizations, and small governmental jurisdictions. For purposes of the RFA, small governmental jurisdictions are governments of cities, counties, towns, townships, villages, school districts, or special districts with a population of less than

50,000. This rule would affect States, as well as local governments, some of which may meet the definition of small governmental jurisdiction. Approximately 90,100 governments, governmental entities, and nongovernmental entities treated as governmental entities may be subject to the reporting requirements of section 6050X. Of those governments and governmental entities, approximately 85,500 (or 95%) are small governmental jurisdictions.

Although the regulations may affect a substantial number of small governmental jurisdictions, the economic impact of the regulations is not expected to be significant. The regulations set a reporting threshold that is higher than the minimum required by statute and also provide for governments and governmental entities to file annual returns. Both of these provisions reduce the potential burden on small governmental jurisdictions. In particular, the increase in the reporting threshold will lead to a decrease in the number of information returns filed by approximately 1 million to 5 million returns. Using the midpoint of this range, or 3 million, the estimated burden reduction is \$74 million per year (2018 dollars). It is estimated that after reading and learning about the requirements of the regulations, the burden associated with filing the annual form is approximately 23 to 41 minutes and the average cost per information return is approximately \$24.72, which would not result in a significant economic impact on small entities.

Pursuant to section 7805(f) of the Code, the proposed rule preceding this rulemaking was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small entities and no comments were received.

#### ***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. 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.

#### ***Executive Order 13132: Federalism***

Executive Order 13132 (entitled *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. The compliance costs, if any, are imposed on state and local governments by section 6050X, as enacted by the TCJA. Notwithstanding, the Treasury Department and the IRS consulted with the National League of Cities and the National Governors Association prior to the issuance of the proposed regulations. Pursuant to the requirements set forth in section 8(a) of Executive Order 13132, the Treasury Department and the IRS certify that they have complied with the requirements of Executive Order 13132.

#### ***Congressional Review Act***

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.) (CRA)). Under 5 U.S.C. 801(3), a major rule takes effect 60 days after the rule is published in the **Federal Register**.

Notwithstanding this requirement, 5 U.S.C. 808(2) allows agencies to dispense with the requirements of 5 U.S.C. 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public in-

terest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to 5 U.S.C. 808(2), the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is unnecessary and contrary to the public interest.

Following the amendments to section 162(f) and enactment of section 6050X by the TCJA, the Treasury Department and the IRS published IRS published Notice 2018–23, 2018–15 I.R.B. 474, to provide transitional guidance on the identification requirement of section 162(f) and the information reporting requirement under section 6050X and to solicit comments from the public and affected governments and governmental entities on issues related to the implementation of section 162(f) and section 6050X. Subsequently, on May 13, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-104591-18) in the **Federal Register** (85 FR 28524) providing additional guidance for taxpayers and governments and governmental entities on the deduction disallowance rules in section 162(f) and the associated reporting requirements in section 6050X. However, as demonstrated by the wide variety of public comments in response to the proposed regulations received, taxpayers and governments and governmental entities continue to express uncertainty regarding the proper application of the relevant statutory rules under section 162(f) and section 6050X. These final regulations provide crucial guidance for taxpayers and governments and governmental entities on how to apply the relevant statutory rules. In certain cases, failure to comprehend the proper application of the requirements of section 162(f) can prevent taxpayers from claiming appropriate deductions, resulting in them paying potentially higher taxes than required during a time of economic difficulty.<sup>2</sup> In addition, governments and governmental entities will require several months to update or develop data collection and reporting systems to comply with the rules under section 6050X. However, governments and governmental entities will need to know that the final regulations are effective before incurring neces-

<sup>2</sup>See Executive Order 13924 (May 19, 2020) 85 FR 31,353-54.

sary costs to timely comply with the final regulations. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date of filing for public inspection in the **Federal Register**.

### **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 Sharon Y. Horn of Associate Chief Counsel (Income Tax and Accounting), IRS. However, 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 record-keeping requirements

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

## **PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.6050X-1 also issued under 26 U.S.C. 6050X(a), (b).

\* \* \* \* \*

Par. 2. Section 1.162-21 is revised to read as follows:

### **§1.162-21 Denial of deduction for certain fines, penalties, and other amounts.**

(a) *Deduction Disallowed.* Except as otherwise provided in this section, no de-

duction is allowed under chapter 1 of the Internal Revenue Code (Code) for any amount that is paid or incurred—

(1) By suit, settlement agreement (agreement), or otherwise, as defined in paragraph (e)(5) of this section;

(2) To, or at the direction of, a government, as defined in paragraph (e)(1) of this section, or a governmental entity, as defined in paragraph (e)(2) of this section; and

(3) In relation to the violation, or investigation or inquiry by such government or governmental entity into the potential violation, of any civil or criminal law.

(i) An amount that is paid or incurred in relation to the violation of any civil or criminal law includes a fine or penalty.

(ii) An investigation or inquiry into the potential violation of any law does not include routine investigations or inquiries, such as audits or inspections, of regulated businesses that are not related to any evidence of wrongdoing or suspected wrongdoing, but are conducted to ensure compliance with the rules and regulations applicable to those businesses.

(b) *Exception for restitution, remediation, and amounts paid to come into compliance with a law—*(1) *In general.* Paragraph (a) of this section does not apply to amounts paid or incurred for restitution (including remediation) or to come into compliance with a law, as defined in paragraphs (e)(4) of this section, provided that both the identification and the establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met.

(2) *Identification requirement—*(i) *In general.* A court order (order) or an agreement, as defined in paragraph (e)(5) of this section, identifies a payment by stating the nature of, or purpose for, each payment each taxpayer is obligated to pay and the amount of each payment identified.

(ii) *Meeting the identification requirement.* The identification requirement is met if an order or agreement specifically states the amount of the payment described in paragraph (b)(2)(i) of this section and that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. If the order or agreement uses a different form of the required words (such as “remediate” or “comply with a law”) and describes the purpose for which restitution

or remediation will be paid or the law with which the taxpayer must comply, the order or agreement will be treated as stating that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. Similarly, if an order or agreement specifically describes the damage done, harm suffered, or manner of noncompliance with a law and describes the action required of the taxpayer to provide restitution, remediation, or to come into compliance with any law, as defined in paragraph (e)(4) of this section, the order or agreement will be treated as stating that the payment constitutes restitution, remediation, or an amount paid to come into compliance with any law. Meeting the establishment requirement of paragraph (b)(3) of this section alone is not sufficient to meet the identification requirement of paragraph (b)(2) of this section.

(iii) *Payment amount not identified.* (A) If the order or agreement identifies a payment as restitution, remediation, or to come into compliance with a law but does not identify some or all of the amount the taxpayer must pay or incur, the identification requirement may be met for any payment amount not identified if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer, such as paying or incurring costs to provide services or to provide property.

(B) If the order or agreement identifies a lump-sum payment or multiple damages award as restitution, remediation, or to come into compliance with a law but does not allocate some or all of the amount the taxpayer must pay or incur among restitution, remediation, or to come into compliance with a law, or does not allocate the total payment amount among multiple taxpayers, the identification requirement may be met for any payment amount not specifically allocated if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer, such as paying or incurring costs to provide services or to provide property.

(3) *Establishment requirement—*(i) *Meeting the establishment requirement.* The establishment requirement is met if the taxpayer, using documentary evidence,

proves the taxpayer's legal obligation, pursuant to the order or agreement, to pay the amount identified as restitution, remediation, or to come into compliance with a law; the amount paid or incurred; the date the amount was paid or incurred; and that, based on the origin of the liability and the nature and purpose of the amount paid or incurred, the amount the taxpayer paid or incurred was for restitution or remediation, as defined in paragraph (e)(4)(i) of this section or to come into compliance with any law, as defined in paragraph (e)(4)(ii) of this section. If the amount is paid or incurred to a segregated fund or account, as described in paragraphs (e)(4)(i)(A)(2) and (3), (e)(4)(i)(B), or (e)(4)(i)(C) of this section, the taxpayer may meet the establishment requirement even if each ultimate recipient, or each ultimate use, of the payment is not designated or is unknown. A taxpayer will not meet the establishment requirement if the taxpayer fails to prove that the taxpayer paid or incurred the amount identified as restitution, remediation, or to come into compliance with a law; the amount paid; the date the amount was paid or incurred; or that the amount the taxpayer paid or incurred was for the nature and purpose identified in the order or agreement as required by paragraph (b)(2)(i) of this section, or was made for the damage done, harm suffered, noncompliance, or to provide property or services as described in (b)(2)(iii) of this section. Meeting the identification requirement of paragraph (b)(2) of this section is not sufficient to meet the establishment requirement of paragraph (b)(3) of this section.

(ii) *Substantiating the establishment requirement.* The documentary evidence described in paragraph (b)(3)(i) of this section includes, but is not limited to, receipts; the legal or regulatory provision related to the violation or potential violation of any law; documents issued by the government or governmental entity relating to the investigation or inquiry, including court pleadings filed by the government or governmental entity requesting restitution, remediation, or demanding that defendant take action to come into compliance with the law; judgment; decree; documents describing how the amount to be paid was determined; and correspondence exchanged between the taxpayer and the government or governmental en-

tity before the order or agreement became binding under applicable law, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

(c) *Other exceptions*—(1) *Suits between private parties.* Paragraph (a) of this section does not apply to any amount paid or incurred by reason of any order or agreement in a suit in which no government or governmental entity is a party or any order or agreement in a suit pursuant to which a government or governmental entity enforces its rights as a private party.

(2) *Taxes and related interest.* Paragraph (a) of this section does not apply to amounts paid or incurred as otherwise deductible taxes or related interest. However, if penalties are imposed relating to such taxes, paragraph (a) of this section applies to disallow a deduction for such penalties and interest payments related to such penalties.

(3) *Failure to pay title 26 tax.* In the case of any amount paid or incurred as restitution for failure to pay tax imposed under title 26 of the United States Code, paragraph (a) of this section does not disallow a deduction for title 26 taxes, such as excise and employment taxes, which are equal to or less than the deduction otherwise allowed under chapter 1 of the Code if the tax had been timely paid.

(d) *Application of general principles of Federal income tax law*—(1) *Taxable year of deduction.* If, under paragraph (b) or (c) of this section, the taxpayer is allowed a deduction for the amount paid or incurred pursuant to an order or agreement, the deduction is taken into account under the rules of section 461 and the related regulations, or under a provision specifically applicable to the allowed deduction, such as §1.468B-3(c).

(2) *Tax benefit rule applies.* If the deduction allowed under paragraphs (b) or (c) of this section results in a tax benefit to the taxpayer, the taxpayer must include in income, under sections 61 and 111, the recovery of any amount deducted in a prior taxable year to the extent the prior year's deduction reduced the taxpayer's tax liability.

(i) A tax benefit to the taxpayer includes a reduction in the taxpayer's tax liability for a prior taxable year or the creation of a net operating loss carryback or carryover.

(ii) A taxpayer's recovery of any amount deducted in a prior taxable year includes, but is not limited to—

(A) Receiving a refund, recoupment, rebate, reimbursement, or otherwise recovering some or all of the amount the taxpayer paid or incurred, or

(B) Being relieved of some or all of the payment liability under the order or agreement.

(e) *Definitions.* For section 162(f) and §1.162-21, the following definitions apply:

(1) *Government.* A government means—

(i) The government of the United States, a State, or the District of Columbia;

(ii) The government of a territory of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands;

(iii) The government of a foreign country;

(iv) An Indian tribal government, as defined in section 7701(a)(40), or a subdivision of an Indian tribal government, as determined in accordance with section 7871(d); or

(v) A political subdivision (such as a local government unit) of a government described in paragraph (e)(1)(i), (ii), or (iii) of this section.

(2) *Governmental entity.* A governmental entity means—

(i) A corporation or other entity serving as an agency or instrumentality of a government (as defined in paragraph (e)(1) of this section), or

(ii) A nongovernmental entity treated as a governmental entity as described in paragraph (e)(3) of this section.

(3) *Nongovernmental entity treated as a governmental entity.* A nongovernmental entity treated as a governmental entity is an entity that—

(i) Exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange, as defined in section 1256(g)(7); or

(ii) Exercises self-regulatory powers, including adopting, administering, or enforcing rules and imposing sanctions, as part of performing an essential governmental function.

(4) *Restitution, remediation of property, and amounts paid to come into compliance with a law*—(i) *Amounts for restitution or remediation.* An amount is paid or incurred for restitution or remediation pursuant to paragraph (b)(1) of this section if it is paid or incurred to restore, in whole or in part, the person, as defined in section 7701(a)(1); government; governmental entity; property; environment; wildlife; or natural resources harmed, injured, or damaged by the violation or potential violation of any law described in paragraph (a)(3) of this section to the same or substantially similar position or condition as existed prior to such harm, injury, or damage.

(A) *Environment, wildlife, or natural resources.* Restitution or remediation of the environment, wildlife, or natural resources includes amounts paid or incurred for the purpose of conserving soil, air, or water resources, protecting or restoring the environment or an ecosystem, improving forests, or providing a habitat for fish, wildlife, or plants. The amounts must be paid or incurred—

(1) To, or at the direction of, a government or governmental entity to be used exclusively for the restitution or remediation of a harm to the environment, wildlife, or natural resources;

(2) To a segregated fund or account established by a government or governmental entity and, pursuant to the order or agreement, the amounts are not disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes; or

(3) To a segregated fund or account established at the direction of a government or governmental entity.

(4) Paragraph (e)(4)(i)(A) of this section applies only if there is a strong nexus or connection between the purpose of the payment and the harm to the environment, natural resources, or wildlife that the taxpayer has caused or is alleged to have caused.

(B) *Disgorgement or forfeiture.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met, restitution may include amounts paid or incurred as disgorgement or forfeiture, if paid or incurred at the direction of a government or governmental entity directly to the person, as defined in section 7701(a)(1), harmed by

the violation or potential violation of any law or to, or at the direction of, the government or governmental entity, to establish a segregated fund or account for the benefit of such harmed person. This paragraph (e)(4)(i)(B) does not apply if the order or agreement identifies the payment amount as in excess of the taxpayer's net profits or, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

(C) *Segregated funds or accounts.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met, restitution or remediation may include amounts paid or incurred, pursuant to an order or agreement, to a segregated fund or account to restore, in whole or in part, the person, as defined in section 7701(a)(1); government; governmental entity; property; environment; wildlife; or natural resources harmed, injured, or damaged by the violation or potential violation of any law described in paragraph (a)(3) of this section. This paragraph (e)(4)(i)(C) does not apply if, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

(ii) *Amounts to come into compliance with a law.* An amount is paid or incurred to come into compliance with a law that the taxpayer has violated, or is alleged to have violated, by performing services; taking action, such as modifying equipment; providing property; or doing any combination thereof to come into compliance with that law.

(iii) *Amounts not included.* Regardless of whether the order or agreement identifies them as such, restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred—

(A) As reimbursement to a government or governmental entity for investigation costs or litigation costs incurred in such government or governmental entity's investigation into, or litigation concerning, the violation or potential violation of any law; or

(B) At the taxpayer's election, in lieu of a fine or penalty.

(5) *Suit, agreement, or otherwise.* A suit, agreement, or otherwise includes, but is not limited to, suits; settlement agreements; orders; non-prosecution agreements; deferred prosecution agreements; judicial proceedings; administrative adjudications; decisions issued by officials, committees, commissions, or boards of a government or governmental entity; and any legal actions or hearings which impose a liability on the taxpayer or pursuant to which the taxpayer assumes liability.

(f) *Examples.* The application of this section is illustrated by the following examples.

(1) *Example 1.* (i) *Facts.* Corp. A enters into an agreement with State Y's environmental enforcement agency (Agency) for violating state environmental laws. Pursuant to the agreement, Corp. A pays \$40X to the Agency in civil penalties, \$80X in restitution for the environmental harm that the taxpayer has caused, \$50X for remediation of contaminated sites, and \$60X to conduct comprehensive upgrades to Corp. A's operations to come into compliance with the state environmental laws.

(ii) *Analysis.* The identification requirement is satisfied for those amounts the agreement identifies as restitution, remediation, or to come into compliance with a law. If Corp. A meets the establishment requirement, as provided in paragraph (b)(3), paragraph (a) of this section will not disallow Corp. A's deduction for \$80X in restitution and \$50X for remediation. Under paragraph (a) of this section, Corp. A may not deduct the \$40X in civil penalties. Paragraph (a) of this section will not disallow Corp. A's deduction for the \$60X paid to come into compliance with the state environmental laws. See section 161, concerning items allowed as deductions, and section 261, concerning items for which no deduction is allowed, and the regulations related to sections 161 and 261.

(2) *Example 2.* (i) *Facts.* Corp. A enters into an agreement with State T's securities agency (Agency) for violating a securities law by inducing B to make a \$100X investment in Corp. C stock, which B lost when the Corp. C stock became worthless. As part of the agreement, Corp. A agrees to pay \$100X to B as restitution for B's investment loss, incurred as a result of Corp. A's actions. The agreement specifically states that the \$100X payment by Corp. A to B is restitution. The agreement also requires Corp. A to pay a \$40X penalty for violating Agency law. Corp. A pays the \$140X.

(ii) *Analysis.* Corp. A's \$100X payment to B is identified in the agreement as restitution. If Corp. A establishes, as provided in paragraph (b)(3) of this section, that the amount paid was for that purpose, paragraph (a) of this section will not disallow Corp. A's deduction for the \$100X payment. Under paragraph (a) of this section, Corp. A may not deduct its \$40X payment to the Agency because it was paid for Corp. A's violation of Agency law.

(3) *Example 3.* (i) *Facts.* Corp. B is under investigation by State X's environmental enforcement agency for a potential violation of State X's law governing emissions standards. Corp. B enters into



an agreement with State X under which it agrees to upgrade the engines in a fleet of vehicles that Corp. B operates to come into compliance with State X's law. Although the agreement does not provide the specific amount Corp. B will incur to upgrade the engines to come into compliance with State X's law, it identifies that Corp. B must upgrade existing engines to lower certain emissions. Under the agreement, Corp. B also agrees to construct a nature center in a local park for the benefit of the community. Instead of paying \$12X, to come into compliance with State X's law, Corp. B pays \$15X to upgrade the engines to a standard higher than that which the law requires. Corp. B presents evidence to establish that it would cost \$12X to upgrade the engines to come into compliance with State X's law.

(ii) *Analysis.* Because the agreement describes the specific action Corp. B must take to come into compliance with State X's law, and Corp. B provides evidence, as described in paragraph (b)(3)(ii) of this section, to establish that the agreement obligates it to incur costs to come into compliance with a law, paragraph (a) of this section will not disallow Corp. B's deduction for the \$12X Corp. B incurs to come into compliance. Corp. B may also deduct the \$3X if it is otherwise deductible under chapter 1 of the Code. However, Corp. B may not deduct the amounts paid to construct the nature center because no facts exist to establish that the amount was paid either to come into compliance with a law or as restitution or remediation.

(4) *Example 4.* (i) *Facts.* Corp. D enters into an agreement with governmental entity, Trade Agency, for engaging in unfair trade practices in violation of Trade Agency laws. The agreement requires Corp. D to pay \$80X to a Trade Agency fund, through disgorgement of net profits, to be used exclusively to pay restitution to the consumers harmed by Corp. D's violation of Trade Agency law. Corp. D pays \$80X to Trade Agency fund and Trade Agency disburses all amounts in the restitution fund to the harmed consumers.

(ii) *Analysis.* The agreement identifies the \$80X payment to the fund as restitution. Trade Agency uses the funds exclusively to provide restitution to the harmed consumers and does not use it for discretionary or general enforcement purposes. If Corp. D establishes, as provided in paragraph (b)(3) of this section, that the \$80X constitutes restitution under paragraph (e)(4)(i)(B) of this section, paragraph (a) of this section does not apply.

(5) *Example 5.* (i) *Facts.* B, a regulated banking institution, is subject to the supervision of, and annual examinations by, governmental entity, R. In the ordinary course of its business, B is required to pay annual assessment fees to R, which fees are used to support R in supervising and examining banking institutions to ensure a safe and sound banking system. Following an annual examination conducted in the ordinary course of B's business, R issues a letter to B identifying concerns with B's internal compliance functions. B takes corrective action to address R's concerns by investing in its internal compliance functions. R does not conduct an investigation or inquiry into B's potential violation of any law.

(ii) *Analysis.* The payment of annual assessment fees by B to R in the ordinary course of business is not related to the violation of any law or the investigation or inquiry into the potential violation of any law. In

addition, B's costs of taking the corrective action are not related to the violation of any law or the investigation or inquiry into the potential violation of any law as described in section 162(f)(1). Paragraph (a) of this section will not disallow the deduction of the annual assessment fees and the cost of the corrective actions.

(6) *Example 6.* (i) *Facts.* B, a regulated banking institution, is subject to the supervision of, and annual examinations by, governmental entity, R. Following an annual examination conducted in the ordinary course of B's business, R pursues an enforcement action against B for violation of banking laws. B and R enter a settlement agreement, pursuant to which B agrees to undertake certain improvements to come into compliance with banking laws and to pay R \$20X for violation of banking laws. B pays the \$20X.

(ii) *Analysis.* If the agreement meets the identification requirement of paragraph (b)(2) of this section and B meets the establishment requirement of paragraph (b)(3) of this section, paragraph (a) of this section will not disallow the deduction of the costs of the corrective actions to come into compliance with banking laws. However, B may not deduct the \$20X paid to R because the amount was not paid to come into compliance with a law or as restitution or remediation.

(7) *Example 7.* (i) *Facts.* Corp. C contracts with governmental entity, Q, to design and build a rail project within five years. Corp. C does not complete the project. Q sues Corp. C for breach of contract and damages of \$10X. A jury finds Corp. C breached the contract and Corp. C pays \$10X to Q.

(ii) *Analysis.* The suit arose out of a proprietary contract, wherein Q enforced its rights as a private party. Paragraph (a) of this section will not disallow Corp. C's deduction of the payment of \$10X pursuant to this suit.

(8) *Example 8.* (i) *Facts.* Corp. C contracts with governmental entity, Q, to design and build a rail project within five years. Site conditions cause construction delays and Corp. C asks Q to pay \$50X in excess of the contracted amount to complete the project. After Q pays for the work, it learns that, at the time it entered the contract with Corp. C, Corp. C knew that certain conditions at the project site would make it challenging to complete the project within five years. Q sues Corp. C for withholding critical information during contract negotiations in violation of the False Claims Act (FCA). The court enters a judgment in favor of Q pursuant to which Corp. C will pay Q \$50X in restitution and \$150X in treble damages. Corp. C pays the \$200X.

(ii) *Analysis.* The suit pertains to Corp. C's violation of the FCA. The order identifies the \$50X Corp. C is required to pay as restitution, as described in paragraph (b)(2) of this section. If Corp. C establishes, as provided in paragraph (b)(3) of this section, that the amount paid was for restitution, paragraph (a) of this section will not disallow Corp. C's deduction for the \$50X payment. Under paragraph (a) of this section, Corp. C may not deduct the \$150X paid for the treble damages imposed for violation of the FCA because the order did not identify all or part of the payment as restitution.

(9) *Example 9.* (i) *Facts.* Corp. T operates a truck fleet company incorporated in State A. State A requires that all vehicles registered in State A have a vehicle emissions test every two years. Corp. T's 40

trucks take the emissions test on March 1 for which it pays the \$15 per vehicle. Under State A law, if a vehicle fails the emissions test, the vehicle owner has 30 days to certify to State A that the vehicle has been repaired and has passed the emissions test. State A imposes a \$1X penalty per vehicle for failure to comply with this 30-day rule. Twenty trucks pass; twenty trucks fail. Corp. T does not submit the required certification to State A for the twenty trucks that failed the emissions test. State A imposes a \$40X penalty against Corp. T. Corp. T pays the \$40X.

(ii) *Analysis.* Emissions tests are conducted in the ordinary course of operating a truck fleet company and, therefore, paragraph (a) of this section does not apply to the \$600 Corp. T pays for the emissions tests. However, Corp. T may not deduct the \$40X penalty for failure to comply with State A requirements because the amount is required to be paid to a government in relation to the violation of a law.

(10) *Example 10.* (i) *Facts.* Corp. G operates a chain of 20 grocery stores in County X. Under County X's health and food safety code and regulations, Corp. G is subject to annual inspections for which Corp. G is required to pay an inspection fee of \$40 per store. Pursuant to the annual inspection, the County X health inspector finds violations of County X's health and food safety code and regulations in three of Corp. G's 20 stores. County X bills Corp. G \$800 for the annual inspection fees for the 20 stores and a \$1,000 fine for each of the three stores, for a total fine of \$3,000, for violations of the health and food safety code. Corp. G pays the fees and fines.

(ii) *Analysis.* Paragraph (a) of this section will not disallow Corp. G's deduction for the \$800 inspection fees paid in the ordinary course of a regulated business. Under paragraph (a) of this section, Corp. G may not deduct the \$3,000 fine for violation of the County X's health code and food safety ordinances because it was paid to a government in relation to the violation of a law.

(11) *Example 11.* (i) *Facts.* Corp. G operates a chain of grocery stores in County X. Under County X's health and food safety code and regulations, Corp. G is subject to annual inspections. Pursuant to an annual inspection, the County X health inspector finds that the refrigeration system in one of Corp. G's stores does not keep food at the temperature required by the health and food safety code and regulations. The County X health inspector issues a warning letter instructing Corp. G to correct the violation and bring the refrigeration system into compliance with the law before a reinspection in 60 days or face the imposition of fines if it fails to comply. Corp. G pays \$10,000 to bring its refrigeration system into compliance with the law.

(ii) *Analysis.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3), respectively, of this section are met, paragraph (a) of this section will not disallow Corp. G's deduction for the \$10,000 it pays to bring its refrigeration system into compliance with the law.

(12) *Example 12.* (i) *Facts.* Corp. G operates a chain of grocery stores in County X. Under County X's health and food safety code and regulations, Corp. G is subject to annual inspections. Pursuant to an annual inspection, the County X health inspector finds that the refrigeration system in one of Corp. G's stores does not keep food at the temperature required

by the health and food safety code and regulations. The County X health inspector issues a warning letter instructing Corp. G to correct the violation and bring the refrigeration system into compliance with the law before a reinspection in 60 days or face the imposition of fines if it fails to comply. The County X health inspector later reinspects the refrigeration system. Corp. G pays a reinspection fee of \$80. During the reinspection, the health inspector finds that Corp. G did not bring its refrigeration system into compliance with the law. The health inspector issues a citation imposing a \$250 fine on Corp. G. Corp. G pays the \$250 fine.

(ii) *Analysis.* Paragraph (a) of this section will disallow Corp. G's deduction for the \$80 inspection fee because it is paid in relation to the investigation or inquiry by County X into the potential violation of the law. Paragraph (a) of this section will also disallow Corp. G's deduction for the \$250 fine paid for violation of the law.

(13) *Example 13.* (i) *Facts.* Accounting Firm was convicted of embezzling \$500X from Bank in violation of State X law. The court issued an order requiring Accounting Firm to pay \$100X in restitution to Bank. The court also issued an order of forfeiture and restitution for \$400X, which was seized by the State X officials. Accounting Firm paid \$100X to Bank. The \$400X seized was deposited with Fund within the State X treasury and, at the discretion of the State X Attorney General, was used to support law enforcement programs.

(ii) *Analysis.* Although the order identified the amount forfeited as restitution, paragraph (a) of this section will disallow Accounting Firm's deduction for the \$400X forfeited because, under paragraph (e)(4)(i)(B) of this section, it does not constitute restitution. If Accounting Firm establishes, as provided in paragraph (b)(3) of this section, that the \$100X constitutes restitution under paragraph (e)(4)(i), paragraph (a) of this section will not disallow Accounting Firm's deduction for the \$100X paid, provided the \$100X is otherwise deductible under chapter 1.

(g) *Applicability date.* The rules of this section apply to taxable years beginning on or after January 19, 2021, except that such rules do not apply to amounts paid or incurred under any order or agreement pursuant to a suit, agreement, or otherwise which became binding under applicable law before such date, determined without regard to whether all appeals have been exhausted or the time for filing appeals has expired.

Par. 3. Add §1.6050X-1 to read as follows:

**§1.6050X-1 Information reporting for fines, penalties, and other amounts by governments, governmental entities, and nongovernmental entities treated as governmental entities.**

(a) *Information reporting requirement.* The appropriate official, as defined in

paragraph (f)(1) of this section, of a government, as defined in paragraph (f)(2) of this section, a governmental entity, as defined in paragraph (f)(3) of this section, or nongovernmental entity treated as a governmental entity, as defined in paragraph (f)(4) of this section, that is a party to a suit or agreement to which section 6050X(a)(1) and (a)(2) applies, must—

(1) File an information return, as described in paragraph (b) of this section, if the aggregate amount the payor, as defined in paragraph (f)(5) of this section, is required to pay pursuant to all court orders (orders) and settlement agreements (agreements), relating to the violation of any law, or the investigation or inquiry into the potential violation of any law, equals or exceeds the threshold amount provided in paragraph (f)(6) of this section;

(2) Furnish a written statement as described in paragraph (c) of this section to each payor; and

(3) Request the payor's taxpayer identification number (TIN) if it is not already known, and notify the payor that the law requires the payor to furnish a TIN for inclusion on the information return and that the payor may be subject to a penalty for failure to furnish the TIN. See sections 6723, 6724(d)(3), and §301.6723-1 of this chapter. The TIN may be requested in any manner, and the payor may provide the TIN in any manner, including orally, in writing, or electronically. If the TIN is furnished in writing, no particular form is required. Form W-9, Request for Taxpayer Identification Number and Certification, may be used, or the request may be incorporated into documents related to the order or agreement.

(b) *Requirement to file return—*(1) *Content of information return.* The information return must provide the following:

(i) The amount required to be paid to, or at the direction of, a government or governmental entity, pursuant to section 6050X(a)(1)(A), as a result of the orders and/or agreements;

(ii) The separate amounts required to be paid as restitution, remediation, or to come into compliance with a law, as described in section 6050X(a)(1)(B) and (C), as a result of the orders and/or agreements;

(iii) The payor's TIN; and

(iv) Any additional information required by the information return and the related instructions.

(2) *Form and manner of reporting.* The appropriate official required to file an information return, under paragraph (a)(1) of this section, must file Form 1098-F, Fines, Penalties, and Other Amounts, or any successor form, as provided by the instructions, with Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

(3) *Multiple orders and/or agreements.* The appropriate official must file only one Form 1098-F for amounts required to be paid as a result of multiple orders and/or agreements with respect to the violation of a law, investigation or inquiry into the potential violation of a law.

(4) *Time of reporting.* Returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service (IRS) on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the orders and/or agreements become binding under applicable law, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

(c) *Requirement to furnish written statement—*(1) *In general.* The appropriate official must furnish a written statement to each payor for which it is required to file an information return under paragraphs (a)(1) and (b) of this section. The written statement must include:

(i) The information that was reported to the IRS relating to such payor; and

(ii) A legend that identifies the statement as important tax information that is being furnished to the IRS.

(2) *Copy of the Form 1098-F.* The appropriate official may satisfy the requirement of this paragraph (c) by furnishing a copy of the Form 1098-F, or any successor form, filed regarding the payor, or another document that contains the information required by paragraph (c)(1) of this section if the document conforms to applicable revenue procedures or other guidance relating to substitute statements. See §601.601 of this chapter.

(3) *Time for furnishing written statement.* The appropriate official must furnish a written statement to the payor on or before January 31 of the year following the calendar year in which the order or

agreement becomes binding under applicable law, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

(d) *Rules for multiple payors*—(1) *Multiple payors — individual liability.* If, pursuant to an order or agreement the aggregate amount multiple individually liable payors are liable to pay, for the violation of any law, or the investigation or inquiry into the potential violation of any law, equals, or exceeds, the threshold amount under paragraph (f)(6) of this section, the appropriate official must file an information return under paragraphs (a)(1) and (b) of this section to report the amount required to be paid by each payor, even if a payor's payment liability is less than the threshold amount. The appropriate official must furnish a written statement, under paragraph (c) of this section, to each payor. If more than one person, as defined in section 7701(a)(1), is a party to an order or agreement, there is no information reporting requirement, or requirement to furnish a written statement, with respect to any person who does not have a payment obligation or obligation for costs to provide services or to provide property.

(2) *Multiple payors — joint and severally liability.* If, pursuant to an order or agreement, multiple payors are jointly and severally liable to pay for the violation of any law, or the investigation or inquiry into the potential violation of any law, an amount that, in the aggregate, equals or exceeds the threshold amount under paragraph (f)(6) of this section, the appropriate official must file an information return, under paragraphs (a)(1) and (b) of this section for each of the jointly and severally liable payors. Each information return must report all amounts required to be paid by all of the payors pursuant to the order or agreement. The appropriate official must furnish a written statement, under paragraph (c) of this section, to each of the jointly and severally liable payors.

(e) *Payment amount not identified.* If some or all of the payment amount is not identified, as described in §1.162-21(b)(2)(iii), for paragraphs (a), (b), and (c) of this section, the appropriate official must file an information return, and furnish the

written statement to the payor, as provided by the instructions to Form 1098-F, or any successor form, including instructions as to the amounts (if any) to include on Form 1098-F, only if the government or governmental entity reasonably expects that the aggregate amount required to be paid or incurred pursuant to the order or agreement, relating to the violation of any law, or the investigation or inquiry into the potential violation of any law, will equal or exceed the threshold amount under paragraph (f)(6) of this section.

(f) *Definitions.* The following definitions apply under this section:

(1) *Appropriate official*—(i) *One government or governmental entity.* If the government or governmental entity has not assigned one of its officers or employees to comply with the reporting requirements of paragraph (a), (b), and (c) of this section, the term *appropriate official* means the officer or employee of a government or governmental entity having control of the suit, investigation, or inquiry. If the government or governmental entity has assigned one of its officers or employees to comply with the reporting requirements of paragraph (a), (b), and (c) of this section, such officer or employee is the appropriate official.

(ii) *More than one government or governmental entity*—(A) *In general.* If more than one government or governmental entity is a party to an order or agreement, only the appropriate official of the government or governmental entity listed first on the most recently executed order or agreement is responsible for complying with all reporting requirements under paragraphs (a), (b), and (c) of this section, unless another appropriate official is appointed by agreement under paragraph (f)(1)(ii)(B) of this section.

(B) *By agreement.* The governments or governmental entities that are parties to an order or agreement may agree to appoint one or more other appropriate officials to be responsible for complying with the information reporting requirements of paragraphs (a), (b), and (c) of this section.

(2) *Government.* For purposes of this section, *government* means the government of the United States, a State, the District of Columbia, or a political subdivision (such as a local government unit) of any of the foregoing.

(3) *Governmental entity.* For purposes of this section, *governmental entity* means—

(i) A corporation or other entity serving as an agency or instrumentality of a government (as defined in paragraph (f)(2) of this section), or

(ii) A nongovernmental entity treated as a governmental entity as described in paragraph (f)(4) of this section.

(4) *Nongovernmental entity treated as governmental entity.* For purposes of this section, the definition of nongovernmental entity treated as a governmental entity as set forth in §1.162-21(e)(3) applies but does not include a nongovernmental entity of a territory of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands, a foreign country, or an Indian tribe.

(5) *Payor.* The payor is the person, as defined in section 7701(a)(1), which, pursuant to an order or agreement, has paid or incurred, or is liable to pay or incur, an amount to, or at the direction of, a government or governmental entity in relation to the violation or potential violation of any law. In general, the payor will be the person to which section 162(f) and §1.162-21 of the regulations apply.

(6) *Threshold amount.* The *threshold amount* is \$50,000.

(g) *Applicability date.* The rules of this section apply only to orders and agreements, pursuant to suits and agreements, which become binding under applicable law on or after January 1, 2022, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

Approved: January 7, 2021

David J. Kautter,  
*Assistant Secretary of the Treasury  
(Tax Policy).*

(Filed by the Office of the Federal Register on January 14, 2021; 4:15pm and published in the issue of the Federal Register for January 19, 2021 86 F.R. 4970)

## T.D. 9947

# DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

## 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).

FOR FURTHER INFORMATION CONTACT: Jason Deirmenjian at (202) 317-4470 (not a toll-free number).

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](http://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 regula-

tions 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). Pro-

posed §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 includable in the patron's QBI under §1.199A-7(c)(2) and whether the qualified item from the SSTB is includable 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 UBIG 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 per-

sonal 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 re-

spect 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. Comments on interaction of section 199A(b)(7) reduction and §1.199A-4

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 taxpay-

er must engage in more complex calculations, specifically the W-2 wage and UBI/A 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. Comments on examples in proposed §1.199A-7(g)*

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. Comments related to definition of "agricultural or horticultural products"*

##### *i. General comments on definition*

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 *agricultural or horticultural products* 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] cooperative 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, re-packaging, 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, re-packaging, 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 in-

come 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. *Farm Service* 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 re-

sponse, 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. *Pass Through of Section 199A(g) Deduction*

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 a 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) de-

duction 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 a 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 deduc-

tion 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 199A(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 applies, 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. *Comments on rules for Specific Cooperative partners in proposed §1.199A-8(f)*

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), in-

cluding 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. Interaction of MPGE rules in proposed §1.199A-9(f)(1) with (f)(2) and (3)*

MPGE is defined under proposed §1.199A-9(f)(1) as manufacturing, producing, growing, extracting, installing, developing, growing, 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. §1.199A-12, Expanded Affiliated Group (EAG) Rules**

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 *Farm-land* 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 January 19, 2021. 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 January 19, 2021, 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 January 19, 2021 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 January 19, 2021, 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 co-

operatives 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 need-



ed 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 perform-

ing 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 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 in-

come 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. Collections of information conducted through Form 1099-PATR

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 pro-

posed §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](http://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.

Form	Type of Filer	OMB Number(s)	Status
Form 1099-PATR	[Business (Legacy Model)]	1545-0118	Approved by OIRA through 6/30/2023. Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201602-1545-024">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201602-1545-024</a>
Form 1065, Schedule K-1	Business (NEW Model)	1545-0123	Approved by OIRA through 1/31/2021. Link: <a href="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">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</a>

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) UBI 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 des-

igned 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 record-keeping 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

\* \* \* \* \*

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).

\* \* \* \* \*

## §§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. See special rule in paragraph (d)(3) of this section relating to SSTBs that may affect QBI.

(2) *QBI determinations made by patron.* 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) *Qualified items of income, gain, deduction, and loss determinations made and reported by Cooperatives.* 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 suc-

cessor 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 UBI 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) *Example 4. Patron of Specified Cooperative – Reasonable Method under paragraph (f)(2)(i) of this section.* 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 indepen-

dent 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 January 19, 2021. 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 ap-

plicable 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 DPGR.

(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) deduc-

tion 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 15<sup>th</sup> 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 \$200 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) *Example 8. Nonexempt Specified Cooperative passing through the section 199A(g) deduction to patrons paid a patronage dividend and advances on expected patronage net earnings.* (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 January 19, 2021. 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 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. *See* §1.199A-12(d).

(ii) *Non-DPGR.* 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) *Use of historical data for multiple-year transactions.* If a Specified Co-

operative 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 as-

sembling 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 Coopera-

tive (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 Co-

operative'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 tax-

able 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-insignificant-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 non-identification.* 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, li-

cense, 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 para-

graph (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 January 19, 2021. 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 Cooper-

ative 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) *Gross receipts recognized in an earlier taxable year.* 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) *COGS associated with activities undertaken in an earlier taxable year*—

(A) *In general.* 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) *Example.* 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 inven-

tory 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 Coopera-



tive'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 January 19, 2021. 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 com-

ensation 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 January 19, 2021. Taxpay-

ers, 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 non-exempt 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 Co-

operative 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 ( $\$720 \times \$2,000/\$10,000$ ), \$216 to Y ( $\$720 \times \$3,000/\$10,000$ ), and \$360 to Z ( $\$720 \times \$5,000/\$10,000$ ). 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 ( $\$1,350 \times (\$16,000/\$20,000)$ ) and S is allocated \$270 ( $\$1,350 \times \$4,000/\$20,000$ ).

(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 ( $\$144 \times (\$600 / (\$600 + \$0 + \$1,200))$ ), Y is allocated \$0 of the EAG's section 199A(g) deduction ( $\$144 \times (\$0 / (\$600 + \$0 + \$1,200))$ ), and Z is allocated \$96 of the EAG's section 199A(g) deduction ( $\$144 \times (\$1,200 / (\$600 + \$0 + \$1,200))$ ). 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 ( $\$180 \times (\$8,000 / (\$8,000 + \$0))$ ). Y's section 199A(g) deduction for its taxable year ending December 31, 2020, is \$0 ( $\$180 \times \$0 / (\$8,000 + \$0)$ ).

(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 ( $\$360 \times (\$2,000 / (\$8,000 + \$0 + \$2,000))$ ).

(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 part-



nership (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 January 19, 2021. 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) *Definition.* The term *income derived from sources other than patronage* used in this paragraph (c) means income from nonpatronage sources within the meaning of §1.1388-1(f)(3).

\* \* \* \* \*

(e) *Applicability date.* Paragraph (c) (2) of this section applies to taxable years beginning after January 19, 2021. For taxable years beginning on or before January 19, 2021, 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) *Patronage and nonpatronage sourced items*—(1) *Directly related use test.* Whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test.

(2) *Patronage sourced income or deductions.* 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 January 19, 2021. 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,

*Assistant Secretary of the Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on January 14, 2021, 8:45 a.m., and published in the issue of the Federal Register for January 19, 2020, 85 F.R. 5544)

**T.D. 9948**

**DEPARTMENT OF THE  
TREASURY  
Internal Revenue Service  
26 CFR Parts 40 and 49**

**Excise Taxes;  
Transportation of Persons  
by Air; Transportation of  
Property by Air; Aircraft  
Management Services**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the excise taxes imposed on certain amounts paid for transportation of persons and property by air. Specifically, the final regulations relate to the exemption for amounts paid for certain aircraft management services. The final regulations also amend, revise, redesignate, and remove provisions of existing regulations that are out-of-date or obsolete and generally update the existing regulations to incorporate statutory changes, case law, and other published guidance. The final regulations affect persons that provide air transportation of persons and property, and persons that pay for those services.

DATES: *Effective Date:* These regulations are effective January 14, 2021.

*Applicability Dates:* For dates of applicability, see §§40.0-1(e), 49.4261-1(g), 49.4261-2(d), 49.4261-3(e), 49.4261-7(k), 49.4261-9(c), 49.4261-10(i), 49.4262-1(f), 49.4262-2(e), 49.4262-3(e), 49.4281-1(e), 49.4263-1(b), 49.4263-3(b), 49.4271-1(g), and 49.4721-2.

FOR FURTHER INFORMATION CONTACT: Michael H. Beker at (202) 317-6855 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### Background

This document amends the Facilities and Services Excise Tax Regulations (26 CFR part 49) under sections 4261, 4262, 4263, 4264, 4271, 4281, and 4282 of the Internal Revenue Code (Code). This document also amends the Excise Tax Procedural Regulations (26 CFR part 40).

Sections 4261 and 4271 impose excise taxes on certain amounts paid for transportation of persons or property, respectively, by air, collectively referred to herein as “air transportation excise tax.” Section 13822 of Public Law 115-97, 131 Stat. 2054, 2182 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), added an exception to the air transportation excise tax in new section 4261(e)(5). Specifically, section 4261(e)(5)(A) provides that “[n]o tax shall be imposed by [section 4261] or section 4271 on any amounts paid by an aircraft owner for aircraft management services related to – (i) maintenance and support of the aircraft owner’s aircraft, or (ii) flights on the aircraft owner’s aircraft.”

Section 4261(e)(5)(B) defines the term “aircraft management services” to include: (a) assisting an aircraft owner with administrative and support services, such as scheduling, flight planning, and weather forecasting; (b) obtaining insurance; (c) maintenance, storage, and fueling of aircraft; (d) hiring, training, and provision of pilots and crew; (e) establishing and complying with safety standards; and (f) such other services as are necessary to support flights operated by an aircraft owner.

Section 4261(e)(5)(C)(i) provides that the term “aircraft owner” includes a person who leases an aircraft other than under a “disqualified lease.” Section 4261(e)(5)(C)(ii) defines the term “disqualified lease” for purposes of section 4261(e)(5)(C)(i) as “a lease from a person providing aircraft management services with respect to the aircraft (or a related person (within the meaning of section 465(b)(3)(C)) to the person providing such services), if the lease is for a term of 31 days or less.”

Finally, section 4261(e)(5)(D) provides that in the case of amounts paid to any person which (but for section 4261(e)(5)) are subject to air transportation excise tax, a

portion of which consists of amounts described in section 4261(e)(5)(A), section 4261(e)(5) “shall apply on a pro rata basis only to the portion which consists of amounts described in” section 4261(e)(5)(A). The Conference Report accompanying the TCJA, H.R. Rep. No. 115-466, at 536 (2017) (Conference Report), provides that in the event that a monthly payment made to an aircraft management company is allocated in part to exempt services and flights on the aircraft owner’s aircraft, and in part to flights on aircraft other than that of the aircraft owner, air transportation excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

On July 31, 2020, a notice of proposed rulemaking (REG-112042-19) was published in the **Federal Register** (85 FR 46032) under sections 4261, 4262, 4263, 4264, 4271, 4281, and 4282 of the Code, and part 40 of the Excise Tax Procedural Regulations (proposed regulations). No public hearing was requested or held. The Department of the Treasury (Treasury Department) and the IRS received three comments in response to the proposed regulations. The comments addressing the proposed regulations are summarized in the Summary of Comments and Explanation of Revisions section of this preamble. All comments were considered and are available at [www.regulations.gov](http://www.regulations.gov) or upon request. After full consideration of the comments received, this Treasury decision adopts as final regulations the proposed regulations with the modifications described in the Summary of Comments and Explanation of Revisions section of this preamble.

### Summary of Comments and Explanation of Revisions

#### I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions and modifications. This Summary of Comments and Explanation of Revisions discusses these revisions and modifications as well as the comments received in response to the proposed regulations. The final regulations provide guidance under sections 4261, 4262, 4263, 4264, 4271,

4281, and 4282 of the Code related to air transportation excise tax. The final regulations also provide guidance under part 40 of the Excise Tax Procedural Regulations.

Part II of this Summary of Comments and Explanation of Revisions discusses rules related to the exemption from air transportation excise tax for amounts paid for certain aircraft management services provided in section 4261(e)(5) of the Code (aircraft management services exemption). Part III of this Summary of Comments and Explanation of Revisions discusses §49.4261-1 and other rules of general applicability related to the excise tax on amounts paid for the transportation of persons by air imposed by section 4261, as well as rules in §49.4261-7(h)(2) related to aircraft charters. See the Explanation of Provisions section of the proposed regulations for a discussion of the rules under 26 CFR part 40 and 26 CFR part 49 that were included in the proposed regulations, for which no comments were received. Those proposed rules are adopted by this Treasury decision – except as discussed in parts II and III of this Summary of Comments and Explanation of Revisions – without change.

#### II. Aircraft Management Services Exemption Rules

##### a. Definition of Aircraft Management Services

Proposed §49.4261-10(b)(1) defined the term “aircraft management services” to mean the services listed in section 4261(e)(5)(B), as well as “other services.” Proposed §49.4261-10(b)(1)(ii) defined “other services” as any service (including, but not limited to, purchasing fuel, purchasing aircraft parts, and arranging for the fueling of an aircraft owner’s aircraft) provided directly or indirectly by an aircraft management services provider to an aircraft owner, that is necessary to keep the aircraft owner’s aircraft in an airworthy state or to provide air transportation to the aircraft owner on the aircraft owner’s aircraft at a level and quality of service required under the agreement between the aircraft owner and the aircraft management services provider.

A commenter stated that the term “airworthy” generally indicates that an aircraft

– or one or more of its component parts – meets its type design and is in a condition of safe operations. The commenter noted that some services provided by an aircraft management services provider in maintaining an aircraft do not directly pertain to the airworthiness of an aircraft. These services include, but are not limited to, upgrades in equipment, installation of optional equipment, optional modifications, refurbishment of an aircraft interior, and painting of an aircraft’s exterior. The commenter suggested that the final regulations remove the phrase “that is necessary to keep the aircraft owner’s aircraft in an airworthy state” from the definition of “other services.”

The Treasury Department and the IRS agree with the commenter that the final regulations should clarify that the definition of aircraft management services is not limited to those services necessary to keep an owner’s aircraft in an airworthy state. As a result, the final regulations adopt the change suggested by the commenter and remove the phrase “that is necessary to keep the aircraft owner’s aircraft in an airworthy state” from final §49.4261-10(b)(1)(ii).

## b. Definition of Aircraft Owner

### i. Leases

Proposed §49.4261-10(b)(3)(i) provided that the term “aircraft owner” means an individual or entity that leases or owns (that is, holds title to or substantial incidents of ownership in) an aircraft managed by an aircraft management services provider, commonly referred to as a “managed aircraft.” Proposed §49.4261-10(b)(3)(i) further provided that the term “aircraft owner” does not include a lessee of an aircraft under a disqualified lease, as defined in proposed §49.4261-10(b)(4).

Regarding leases that qualify a person as an aircraft owner under proposed §49.4261-10(b)(3)(i), a commenter noted that while many aircraft leases are in writing and contain provisions that make it clear that the arrangement constitutes a lease, that is not the case for all aircraft leasing arrangements. The commenter further noted that courts have found that the basic attributes of a lease are “the right to possess, use, and control the air-

craft” (citing *Petit Jean Air Service, Inc v. U.S.*, 74-1 U.S.T.C. 16, 135 (E.D. Ark. 1974)). To this end, the commenter suggested that the final regulations add to the end of §49.4261-10(b)(3)(i) the sentence “An arrangement (whether written, oral, or implied) that transfers the right to possess, use, and control an aircraft to an individual or entity qualifies as a lease for the purposes of determining whether that individual or entity meets the definition of aircraft owner.”

The Treasury Department and the IRS note that the suggested “right to possess, use, and control an aircraft” language from the commenter is nearly identical to the possession, command, and control test created through existing published guidance. As described in the preamble to the proposed regulations, possession, command, and control is a facts-and-circumstances analytical framework that is used to determine whether a person is providing taxable transportation to another person in cases where each of the parties contribute some, but not all, of the elements necessary for complete air transportation services. The possession, command, and control test has caused confusion and uncertainty in the air transportation excise tax area for decades; in fact, it is partly for that reason – and disagreements between the IRS and taxpayers over the application of the possession, command, and control test to aircraft management services arrangements – that section 4261(e)(5) was added to the Code. *See, e.g.*, Conference Report at 535. As explained in the preamble to the proposed regulations, section 4261(e)(5) directly addresses a situation that, but for section 4261(e)(5), would be analyzed using the possession, command, and control test. The preamble to the proposed regulations further explained that in situations to which the aircraft management services exemption applies, the possession, command, and control test is not relevant.

As a result, the Treasury Department and the IRS decline to introduce into the final regulations a test that is similar to a test that has been the source of confusion, uncertainty, disagreement, and difficulties in administration. Therefore, the final regulations do not adopt the language the commenter proposed to be added to the end of §49.4261-10(b)(3)(i) and do not

provide a special definition of the term “lease” solely for purposes of the aircraft management services exemption.

### ii. Owner trusts

A commenter requested clarification regarding whether trustees and beneficiaries of “owner trusts” qualify as aircraft owners for purposes of the aircraft management services exemption. The commenter described an owner trust as an ownership structure used for the limited purpose of registering an aircraft in the U.S. with the Federal Aviation Administration (FAA). The structure, which is sanctioned by the FAA, is commonly used by non-U.S. persons to satisfy the U.S. citizenship requirements applicable to registering an aircraft with the FAA. Most owner trusts are established using one of a small number of U.S.-based aviation trust companies – which are not related to the trust beneficiary – as trustee. The trustee holds legal title to the aircraft and satisfies the U.S. citizenship requirement for purposes of registering the aircraft with the FAA, thereby permitting registration in the U.S. of an aircraft that would otherwise be ineligible for such registration.

The commenter stated that an owner trust agreement works in conjunction with an operating agreement that, generally, is separate from, but closely related to, the trust agreement. The operating agreement may contain explicit lease language or may instead use the term “license to use” and provides that the beneficiary holds the exclusive right to lease or license and to possess, use, and operate the aircraft (typically requiring a nominal rent or license payment to the trustee, or in some cases, no payment at all). Regardless of how the transfer of control is described in the operating agreement, the result is that the beneficiary holds the exclusive right to lease or license the aircraft, and to possess, use, and operate the aircraft. An operating agreement will usually require that the beneficiary retain the crew and maintain the aircraft per FAA guidance and manufacturer’s recommendations. The commenter stated that the relationship created through the operating agreement is consistent with the trustee’s status as a holder of only bare legal title, sometimes referred to as “nominal title,” to the aircraft.

In addition, the commenter explained that the beneficiary of an owner trust holds many of the attributes of aircraft ownership, other than legal title. The attributes of aircraft ownership that the beneficiary possesses include: the right to any income generated by – and obligation to pay all expenses associated with – the aircraft; the upside benefit or downside risk as to the aircraft’s value; bearing the risk of loss; being considered the owner of the aircraft for Federal income tax purposes; and discretion as to when to sell the aircraft. The commenter noted that since both the trustee and the beneficiary of an owner trust are owners of interests in the aircraft, payments for aircraft management services from either party should be eligible for the aircraft management services exemption. The commenter further noted that regardless of whether the operating agreement is written in terms of a lease or a license, the arrangement is not a disqualified lease (as that term was defined in proposed §49.4261-10(b)(4)).

For purposes of section 4261(e)(5), such an operating agreement between the trustee and the beneficiary of an owner trust is treated as a lease, regardless of whether the document expressly refers to the arrangement as a lease. Therefore, under the terms of the operating agreement, the beneficiary of an owner trust is the lessee of the aircraft held in trust. Both section 4261(e)(5)(C) and proposed §49.4261-10(b)(3) recognize lessees, other than lessees under a disqualified lease, as an aircraft owner.

Based on the foregoing, the final regulations include a definition of “owner trust.” The final regulations also clarify that the beneficiary of an owner trust is an “aircraft owner” so long as the lease is not a disqualified lease.

### iii. Affiliated groups, disregarded entities, and other close relationships

As discussed in the preamble to the proposed regulations, the proposed regulations applied the principle of statutory interpretation that, as matters of legislative grace, exemptions to tax should be narrowly construed. Therefore, the proposed regulations defined “aircraft owner” as an individual or entity that leases (other than under a disqualified lease) or owns

(that is, holds title to or substantial incidents of ownership in) an aircraft managed by an aircraft management services provider. The proposed regulations did not include in the definition of “aircraft owner” persons that are related to the aircraft owner (for example, another member of the same affiliated group (as defined in section 4282 of the Code)), but are not the aircraft owner itself. As a result, under the proposed regulations, the aircraft management services exemption applied only to payments for aircraft management services that are made by the actual aircraft owner or lessee.

A commenter disagreed with the assertion in the preamble to the proposed regulations that treating payments from parties who are directly related to an aircraft owner as though they were from the aircraft owner, and thus exempt from air transportation excise tax, “would effectively expand the exemption [provided in section 4261(e)(5)] in a manner not authorized by Congress.” The commenter claimed that this assertion is at odds with other Code provisions and implies an unduly narrow and formalistic interpretation of the statute that is inconsistent with the flexible approach otherwise evinced in the proposed regulations. The commenter further claimed that the assertion has no basis in the legislative history, but rather the legislative history implies that at least some related-party payments of aircraft management fees should be excluded from air transportation excise tax under section 4261(e)(5).

The commenter noted that while the statute and legislative history are relatively silent about who or what the term “aircraft owner” includes, the legislative history enumerates several examples of what the term *does not* include. Specifically, the legislative history states that the term “aircraft owner” does not include ownership of stock in a commercial airline or participation in a fractional aircraft ownership program. The commenter stated that the legislative history expresses Congress’s concern about the use of the aircraft management services exemption to circumvent the ordinary application of air transportation excise tax as contemplated in other Code provisions. By negative inference, the commenter reasoned, Congress did not express any similar concerns if the

aircraft management services exemption applied to payments made by a party related to the aircraft owner. The commenter asserted that the narrow interpretation of “aircraft owner” in the proposed regulations does nothing to further Congress’s goal of preventing arrangements designed to circumvent the ordinary application of air transportation excise tax.

The commenter asserted that when an affiliated corporation in a corporate group pays for aircraft management services on behalf of an aircraft owning corporate entity within the group, there is no avoidance of air transportation excise tax. Further, the commenter asserted that there is statutory precedent for ignoring the distinction among corporate entities in the air transportation excise tax area; specifically, the commenter pointed to the affiliated group exemption provided in section 4282 of the Code. Under section 4282(a), if one member of an affiliated group is the owner or lessee of an aircraft, and such aircraft is not available for hire by persons who are not members of such group, air transportation excise tax does not apply to any payment received by one member of the affiliated group from another member of such group for services furnished to such other member in connection with the use of such aircraft. Citing the legislative history to section 4282 (*see* S. Rep. No. 91-706 at 17-18, 1970-1 C.B. 386), the commenter asserted that section 4282 captures Congress’s general approach to related-party payments in the area of air transportation excise tax; that is, Congress decided to ignore nominal ownership of an aircraft by one member of an affiliated group and instead looked to the true economic ownership of the aircraft by the group. The commenter asserted that the final regulations should do the same and ignore the formalities of nominal ownership of an aircraft and apply the aircraft management services exemption to payments by any party that is the true economic owner of the aircraft.

The commenter requested that the Treasury Department and the IRS consider expanding the definition of “aircraft owner” to include disregarded entities, members of an affiliated group, and family members. The commenter also noted that it is not uncommon for an individual to operate an aircraft but place title to

the aircraft in a single member limited liability company (SMLLC) and that such arrangement is, in effect, a constructive lease, but that state law concepts of constructive leases will result in needless and complex controversy.

Another commenter similarly requested that the Treasury Department and the IRS consider expanding the definition of “aircraft owner” to include the single member of a SMLLC that holds title to an aircraft. The commenter reasoned that if the member pays an aircraft management services provider for aircraft management services on behalf of the SMLLC, it is economically indistinguishable from a case in which the individual first transfers funds into the SMLLC and then the SMLLC pays the aircraft management services provider. In either situation, the commenter asserted, there is no circumvention of air transportation excise tax; the only difference is who writes the check paying the aircraft management services provider.

The Treasury Department and the IRS continue to have the concerns described in the preamble to the proposed regulations. Specifically, the Treasury Department and the IRS are concerned that extending the aircraft management services exemption to payments made by certain related parties – as suggested by the commenters – would effectively ignore the requirement that payments be made by the “aircraft owner.” Such an interpretation would be inconsistent with a plain reading of the statute and would violate a fundamental principle of statutory construction – that effect must be given, if possible, to every word Congress uses in the statute. *See U.S. v. Menasche*, 348 U.S. 528, 538–539 (1955).

Further, as described in the preamble to the proposed regulations, a fundamental aspect of administering the Federal excise tax laws is respecting each entity as an entity separate from its owner. *See* §1.1361-4(a)(8) of the Income Tax Regulations and §301.7701-2(c)(2)(v) of the Procedure and Administration Regulations. This longstanding treatment of a wholly-owned entity as an entity separate from its owner for Federal excise tax purposes applies even though the entity may not be viewed as separate from its owner for Federal income tax purposes. Consistent with this longstanding treatment, final §40.0-1(d)

of the Excise Tax Procedural Regulations makes it clear that each business unit that is required to have a separate Employer Identification Number is treated as a separate person. The Treasury Department and the IRS decline to create what would effectively be an exception to the way certain entities are treated for Federal excise tax purposes because this would create unnecessary confusion among taxpayers and IRS examiners. For example, it would not be appropriate to respect an entity for fuel excise tax liability and reporting purposes but then disregard the same entity for purposes of the aircraft management services exemption even though a transaction may involve the same aircraft.

Based on the foregoing, the final regulations do not generally incorporate the commenters’ request to expand the definition of “aircraft owner” to include disregarded entities, members of an affiliated group, or family members of the owner. Instead, the final regulations clarify that amounts paid for aircraft management services by a party related to the aircraft owner (including members of an affiliated group, members of a limited liability company, disregarded entities, and family members) are not amounts paid by the aircraft owner solely by virtue of the relationship between the aircraft owner and the related party. The final regulations further clarify that if one related party leases an aircraft to another related party, amounts paid by the lessee to an aircraft management services provider for aircraft management services related to the leased aircraft qualify for the aircraft management services exemption, provided the lease is not a disqualified lease and all other requirements of section 4261(e)(5) are satisfied.

#### v. Principal-agent

Proposed §49.4261-10(a)(1) provided, in relevant part, that the aircraft management services exemption does not apply to amounts paid to an aircraft management services provider on behalf of an aircraft owner (other than in a principal-agent scenario in which the aircraft owner is the principal).

A commenter requested that the final regulations clarify what relationships qualify as a “principal-agent scenario” for

purposes of qualifying payments for the aircraft management services exemption. The commenter noted that all entities, depending on the type of entity formation, have one or more officers, directors, managers, members or partners that may be in a principal-agent relationship with an aircraft owner. Therefore, the commenter suggested that the final regulations clarify that for purposes of §49.4261-10(a)(1), officers and directors of corporations, managers and members of limited liability companies (LLCs), and partners of a partnership are deemed agents when such corporations, LLCs, or partnerships are the aircraft owner. Alternatively, the commenter suggested that the final regulations clarify that the agency laws of the individual fifty states should be recognized for purposes of determining whether a principal-agent relationship exists between an aircraft owner and another person.

As a general matter, for Federal tax purposes, state agency law applies in determining whether a principal-agent relationship exists. Likewise, in the context of the aircraft management services exemption, state law applies in determining whether the relationship between the aircraft owner and another person is a principal-agent relationship. Therefore, the final regulations adopt the principal-agent language from the proposed regulations as written. The Treasury Department and the IRS will consider providing additional guidance on this issue and invite comments regarding whether a principal-agent rule that relates specifically to the aircraft management services exemption is necessary. Any comments that favor additional guidance should include suggestions for how a more detailed principal-agent rule should be structured. Unless and until the Treasury Department and the IRS provide additional guidance, state agency law applies in determining whether a principal-agent relationship exists between the aircraft owner and another person.

#### vi. Evidence that payments are made by the aircraft owner

Regarding proposed §49.4261-10(a)(3), a commenter requested that the final regulations clarify what facts or evidence are sufficient to show that the aircraft owner is the party making the payments to

the aircraft management services provider so that those payments qualify for the aircraft management services exemption. The commenter suggested that the final regulations provide that “reasonable documentation” from the aircraft owner stating that payments for aircraft management services originate from a source covered by the aircraft management services exemption will satisfy the aircraft management services provider’s obligation to determine whether a payment comes from a permissible source and constitutes adequate documentation thereof. The commenter believes that including this rule in the final regulations will improve administrability for both aircraft management services providers and the IRS.

The task of verifying the source of every payment received by an aircraft management services provider for services related to an aircraft owner’s aircraft is a burdensome one for aircraft management services providers. Verification is important because if a payment is received from someone other than the aircraft owner (as that term is defined in the final regulations), the aircraft management services exemption does not apply and the aircraft management services provider must collect any applicable air transportation tax on the amount paid. If the aircraft management services provider fails to do so, section 4263(c) applies. *See also* §49.4261-1(b)(2).

The Treasury Department and the IRS recognize that in the context of the aircraft management services exemption, it is important for aircraft management services providers to understand their obligations with regard to verifying that payments are made by aircraft owners and that failure to verify may trigger the application of section 4263(c). However, because section 4263(c) has broad implications for all members of the air transportation industry, issues related to section 4263(c) require additional study and input from a broader cross-section of stakeholders in the air transportation industry. Accordingly, these issues should be addressed in a separate published guidance project.

#### vii. Substantial incidents of ownership

Proposed §49.4261-10(b)(3)(i) provided, in relevant part, that the term “air-

craft owner” means an individual or entity that leases or owns (that is, holds title to or substantial incidents of ownership in) an aircraft managed by an aircraft management services provider, commonly referred to as a “managed aircraft.” The Treasury Department and IRS did not receive comments specifically relating to the “substantial incidents of ownership” language. However, the “substantial incidents of ownership” language is problematic because, among other things, it creates an opportunity for abuse by providing a mechanism by which parties can circumvent the disqualified lease rule in section 4261(e)(5)(C). For example, parties that wish to enter into an aircraft lease for 31 days or less could structure the transaction as a transfer of substantial incidents of ownership in the aircraft for a period of 31 days or less. By doing so, the parties could avoid creating a disqualified lease while still availing themselves of the exemption in section 4261(e)(5). Congress clearly did not intend for the aircraft management services exemption to apply in such situations as evidenced by the disqualified lease language in section 4261(e)(5)(C). Because of these concerns, the final regulations clarify that the phrase “substantial incidents of ownership” in §49.4261-10(b)(3)(i) does not apply to an interest with a duration of 31 days or less.

#### viii. Other Changes Related to the Definition of Aircraft Owner

As stated earlier, proposed §49.4261-10(b)(3)(i) defined “aircraft owner”, in relevant part, in terms of “an individual or entity.” Final §49.4261-10(b)(3)(i) replaces the phrase “individual or entity” with the word “person.” This change improves the precision of the aircraft owner definition because the Code provides a generally applicable definition of “person” in section 7701(a)(1). This change also makes §49.4261-10(b)(3)(i) easier to read.

#### b. Fractional Ownership Aircraft and Other Arrangements

Proposed §49.4261-10(b)(3)(ii) provided that a participant in a fractional aircraft ownership program, as defined in section 4043(c)(2) of the Code, does not qualify as an aircraft owner of the program’s managed

aircraft if the amount paid for such person’s participation is exempt from air transportation excise tax by reason of section 4261(j). Proposed §49.4261-10(b)(3)(ii), referred to herein as the “other arrangements anti-abuse rule,” further provided that a participant in a business arrangement that seeks to circumvent the surtax imposed by section 4043 by operating outside of subpart K of 14 CFR part 91, and that allows an aircraft owner the right to use any of a fleet of aircraft (through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other similar arrangement), is not an aircraft owner with respect to any of the aircraft owned or leased as part of that business arrangement.

A commenter observed that the other arrangements anti-abuse rule appears to be aimed at persons who create a structure providing access to a fleet of aircraft that fails to meet the definition of “fractional ownership aircraft program” in section 4043 in an effort to avoid the fuel surtax imposed by section 4043, while retaining the right to claim the aircraft management services exemption to also avoid paying air transportation excise tax. The commenter further observed that the phrase “seeking to circumvent the surtax imposed by section 4043” in the other arrangements anti-abuse rule indicates that for the rule to apply, the primary intent in creating the arrangement must be to avoid the section 4043 surtax. Thus, the commenter noted, if there is a legitimate non-tax business purpose for creating the structure, the other arrangements anti-abuse rule should not apply, and the aircraft management services exemption should apply to amounts paid for aircraft management services relating to the aircraft in the structure. The commenter also observed that the phrase “right to use any of a fleet of aircraft (through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other similar arrangement)” in the proposed rule appears to apply to structures that are akin to fractional programs, but do not meet the definition of a fractional program in section 4043(c)(2).

Based on the foregoing observations, the commenter disagreed with several aspects of the other arrangements anti-abuse rule. First, the commenter disagreed with

the proposed rule as unclear regarding how it would apply to structures that provide access to a fleet of aircraft that exist for reasons unrelated to the applicability of the fuel surtax imposed by section 4043. The commenter further disagreed with the proposed rule for failing to define the point at which a structure becomes enough like a fractional ownership aircraft program for the rule to apply. Finally, the commenter disagreed with the proposed rule because the commenter believes that it can be misinterpreted to include various legitimate structures in which aircraft management services are provided, including (a) instances where a substitute aircraft is provided from the aircraft management services provider's charter fleet (which is addressed in proposed §49.4261-10(c)); (b) leasing structures where a lessor is providing an insured and maintained aircraft but no pilots (which would not have previously been subject to the tax under the possession, command and control test); and (c) the routine use of interchange agreements between aircraft owners.

The Treasury Department and the IRS share the concerns of the commenter that the proposed other arrangements anti-abuse rule may capture aircraft ownership structures and leasing arrangements that are legitimate and not created for purposes of circumventing the fuel surtax imposed by section 4043. The Treasury Department and the IRS are further concerned that the other arrangements anti-abuse rule would create too much taxpayer uncertainty and confusion, which would be compounded by the similarly worded rule in proposed §49.4261-10(i) (see later discussion of this rule). As a result, the final regulations in §49.4261-10(b)(3)(ii) do not include the other arrangements anti-abuse rule. Therefore, the final regulations in §49.4261-10(b)(3)(ii) merely clarify and confirm that a participant in a fractional ownership aircraft program is not an aircraft owner for purposes of the exemption in section 4261(e)(5) if the amount paid for such person's participation is exempt from the tax imposed by section 4261 by reason of section 4261(j).

#### c. Definition of Disqualified Lease

Proposed §49.4261-10(b)(4) provided that the term "disqualified lease" has the

meaning given to it by section 4261(e)(5)(C)(ii). Proposed §49.4261-10(b)(4), referred to herein as the "disqualified lease anti-abuse rule," further provided that a disqualified lease also includes any arrangement that seeks to circumvent the rule in section 4261(e)(5)(C)(ii) by providing a lease term that is greater than 31 days but does not provide the lessee with exclusive and uninterrupted access and use of the leased aircraft, as identified by the aircraft's airframe serial number and tail number. In addition, proposed §49.4261-10(b)(4) provided that the fact that a lease permits the lessee to use the aircraft for for-hire flights, as defined in §49.4261-10(b)(5), when the lessee is otherwise not using the aircraft does not, because of this fact alone, cause a lease with a term that is greater than 31 days to be a disqualified lease.

A commenter disagreed with the disqualified lease anti-abuse rule as a general matter, because, in the commenter's opinion, it significantly expands the definition of "disqualified lease" beyond the definition provided in the statute, ensnaring common non-abusive situations that should not be subject to the rule, and frustrating the intended purpose of the statute. The commenter also disagreed with several specific aspects of the disqualified lease anti-abuse rule. First, the commenter disagreed with the disqualified lease anti-abuse rule for not including language limiting its application to only a lease of an aircraft from a person providing aircraft management services for such aircraft.

Second, the commenter disagreed with the requirement in the disqualified lease anti-abuse rule that the lease should provide the lessee with exclusive and uninterrupted access and use of the leased aircraft as overly broad. The commenter stated that the problem with this aspect of the disqualified lease anti-abuse rule is that many aircraft are leased on a non-exclusive basis for valid business purposes, such as liability protection, state sales and use tax compliance, and FAA regulatory requirements.

Third, the commenter disagreed with the disqualified lease anti-abuse rule as improperly subjecting entity-based co-ownership structures to air transportation excise tax. To illustrate this concern, the commenter offered as an example a sit-

uation in which two pilots form a limited liability company to purchase an aircraft. For FAA regulatory compliance reasons, the LLC enters into non-exclusive aircraft dry leases with each of the pilots who will operate the aircraft. Since neither lessee in such an arrangement would have exclusive and uninterrupted use of the aircraft, the proposed disqualified lease anti-abuse rule would cause those otherwise qualified leases to be disqualified leases.

Fourth, the commenter observed that the "for hire" language in the disqualified lease anti-abuse rule allows a lessee to use the leased aircraft to provide "for hire" flights. The commenter disagreed with this aspect of the rule, stating that an aircraft must typically be leased to an on-demand air taxi operator to conduct such for-hire flights. Therefore, the commenter continued, an aircraft owner may lease its aircraft without a crew on a non-exclusive basis directly to an on-demand air taxi operator in addition to leasing its aircraft without a crew pursuant to a separate non-exclusive lease to a related party for reasons unrelated to air transportation excise tax; in such a case, the aircraft will be leased to each lessee on a non-exclusive basis. The commenter concluded that, based on the language of the disqualified lease anti-abuse rule, these facts could cause the non-exclusive leases to be disqualified leases.

Finally, the commenter disagreed with the disqualified lease anti-abuse rule because the commenter believes that it is possible that an aircraft owner that provides limited services relating to the aircraft could be deemed an aircraft management services provider based on the broad definitions of the terms "aircraft management services" and "aircraft management services provider." The commenter explained that most business aircraft owners provide at least some services, such as insurance, hangarage, or maintenance, when they lease their aircraft for valid business reasons such as liability protection planning, maintenance consistency, insurance requirements, and state sales and use tax compliance.

To illustrate the commenter's concern, the commenter offered the example of an entity that purchases an aircraft and enters into two non-exclusive leases to its parent company and to a sister company with

a term greater than 31 days. The lessor may obtain the hangar and the insurance for the aircraft since there is typically one hangar and one insurance policy covering the aircraft even if there is more than one non-exclusive aircraft lessee. Applying the proposed disqualified lease anti-abuse rule to this situation, the commenter concluded that the lessor could be viewed as an aircraft management services provider and the arrangement would be subject to the disqualified lease anti-abuse rule. The commenter further concluded that this scenario would inappropriately broaden the scope of the disqualified lease anti-abuse rule since the statutory language was not meant to apply the disqualified lease provision to lessors that provide only partial or limited services.

The commenter suggested that final §49.4261-10(b)(4) remove the disqualified lease anti-abuse rule in its entirety so that the regulatory definition of “disqualified lease” merely restates the statutory definition of the term.

The Treasury Department and the IRS share the concerns of the commenter, particularly that the disqualified lease anti-abuse rule may capture common, legitimate leasing arrangements. Therefore, the final regulations remove the disqualified lease anti-abuse language from the definition of “disqualified lease” in §49.4261-10(b)(4). As a result, the final version of §49.4261-10(b)(4) simply defines “disqualified lease” by reference to its statutory definition in section 4261(e)(5)(C)(ii).

#### d. Definition of Private Aviation

Proposed §49.4261-10(a)(2) limited the aircraft management services exemption to aircraft management services related to aircraft used in private aviation. Proposed §49.4261-10(b)(6) defined the term “private aviation” as the use of an aircraft for civilian flights except scheduled passenger service. A commenter observed that the apparent intent of proposed §49.4261-10(a)(2), when read in combination with the definition of “private aviation” in proposed §49.4261-10(b)(6), is to prevent the aircraft management services exemption from applying to amounts paid for aircraft management services related to scheduled commercial airline aircraft and flights. The commenter also observed

that proposed §49.4261-10(d) makes clear that the aircraft management services exemption is available for aircraft and flights operated under the charter services rules of part 135 of the FAA regulations (14 CFR part 135). The commenter suggested that the final regulations clarify that “scheduled passenger service” refers to flights conducted by airlines that sell tickets on an individual seat basis to the general public. The commenter also suggested that the final regulations further clarify that the term “private aviation” includes charter flights operated under part 135 of the FAA regulations.

The Treasury Department and the IRS agree with the commenter that the final regulations should clarify the types of flight operations permitted under the private aviation rule in §49.4261-10(a)(2). Therefore, the final regulations incorporate the commenter’s suggested changes to the definition of private aviation provided in §49.4261-10(b)(8). Specifically, the final regulations clarify that “scheduled passenger service” refers to flights for which tickets are sold on an individual seat basis to the general public. In addition, the definition of private aviation is modified to explicitly include operations conducted under part 135 of the FAA regulations.

#### e. Section 4261(e)(5)(D)

Section 4261(e)(5)(D) provides that in the case of amounts paid to any person which (but for section 4261(e)(5)) are subject to air transportation excise tax, a portion of which consists of amounts described in section 4261(e)(5)(A), section 4261(e)(5) “shall apply on a pro rata basis only to the portion which consists of amounts described in” section 4261(e)(5)(A). The Conference Report provides that in the event that a monthly payment made to an aircraft management company is allocated in part to exempt services and flights on the aircraft owner’s aircraft, and in part to flights on aircraft other than that of the aircraft owner, air transportation excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

Proposed §49.4261-10(c)(1), which generally tracked the pro rata allocation language in the Conference Report, pro-

vided that if an aircraft management services provider provides flight services to an aircraft owner on a substitute aircraft during a calendar quarter, air transportation excise tax applies to that portion of the amounts paid by the aircraft owner to the aircraft management services provider, determined on a pro rata basis, that are related to the flight services provided on the substitute aircraft. Stated differently, the proposed regulations provided that when an aircraft owner is provided flights on a substitute aircraft by an aircraft management services provider (for example, when the aircraft owner’s aircraft is unavailable due to maintenance), a portion of the amounts paid by the aircraft owner to the aircraft management services provider is subject to air transportation excise tax.

Proposed §49.4261-10(c)(2) proposed a method, based on the ratio of flight hours provided on a substitute aircraft compared to the total flight hours provided to the aircraft owner on the aircraft owner’s aircraft and on substitute aircraft during a calendar quarter, for calculating the taxable portion of the amount paid to the aircraft management services provider.

A commenter objected to proposed §49.4261-10(c) as unnecessary; the commenter reasoned that – assuming flights provided on a substitute aircraft are treated as charter flights provided by the aircraft management services provider to the aircraft owner and subject to air transportation excise tax – there is no need for a special calculation to determine the amount paid for such flights. Similarly, again assuming flights provided on a substitute aircraft are treated as charter flights provided by the aircraft management services provider to the aircraft owner and subject to air transportation excise tax, multiple commenters objected to proposed §49.4261-10(c) because it could result in air transportation excise tax being applied to the same air transportation twice - once on the amount paid for the charter on the substitute aircraft and then again on a portion of the amount paid for aircraft management services to the aircraft management services provider providing the substitute aircraft.

One commenter offered several comments regarding the allocation methodology in proposed §49.4261-10(c)(2).



First, the commenter disagreed with the proposed allocation methodology because it may result in air transportation excise tax being imposed on amounts paid for non-transportation items. Second, the commenter disagreed with the proposed allocation methodology because it may result in the application of air transportation excise tax to an amount disproportionate to the fair market value of the transportation services actually provided on the substitute aircraft. Third, the commenter disagreed with the proposed allocation methodology because it promotes a loss of revenue to aircraft management services providers. The commenter explained that to avoid having to pay air transportation excise tax on an allocated portion of the amount paid for aircraft management services, the aircraft owner need only hire the replacement aircraft from an operator different than the one that provides aircraft management services to the aircraft owner. Thus, the commenter asserted that the proposed rule incentivizes aircraft owner behavior that will result in lost revenue to the aircraft management services provider. Fourth, the commenter disagreed with the proposed allocation methodology as increasing taxpayer uncertainty because the amount of air transportation excise tax that results from the method will not be known at the time an aircraft management services provider would invoice an aircraft owner for services provided on a substitute aircraft.

A third commenter disagreed with the allocation methodology in proposed §49.4261-10(c) because the calculation, in the commenter's view, will ordinarily produce nonsensical results since the cost profile of a substitute aircraft will likely be different from the cost profile for the aircraft owner's aircraft. The commenter asserted that averaging the costs of two aircraft with different cost profiles will produce an arbitrary result with no rational relationship to a reasonable, fair market charter rate for flights on the substitute aircraft. The commenter further asserted that the allocation methodology calculation will be further skewed if the aircraft owner-taxpayer owns multiple aircraft with varying flight hours from one quarter to the next, buys or sells aircraft during the quarter, or pays multiple aircraft management services providers rather than a

single aircraft management services provider.

All three commenters suggested that the final regulations either completely remove §49.4261-10(c), as drafted in the proposed regulations, or that the final regulations adopt a different approach than the proposed allocation methodology. All three commenters also suggested that in situations where a substitute aircraft is provided to an aircraft owner, air transportation excise tax should be calculated based on the amount paid by the aircraft owner for the substitute aircraft (that is, in a manner similar to how air transportation excise tax is calculated on amounts paid for charter flights). A commenter also suggested that if an aircraft owner pays less than fair market value for the use of the substitute aircraft, then air transportation excise tax should be calculated on the fair market value rather than the actual amount paid for the substitute aircraft.

In the alternative, if the proposed allocation methodology is incorporated into the final regulations, a commenter suggested that the final regulations provide that when an aircraft owner pays for a substitute aircraft, then the aircraft owner will receive a credit for any air transportation excise tax that it paid in relation to hiring a substitute aircraft against the amount of tax calculated under the allocation methodology. Another commenter suggested that if the proposed allocation methodology is incorporated into the final regulations, then the final regulations provide that an aircraft owner may elect to pay air transportation excise tax on the fair market value of the flight provided on the substitute aircraft rather than pay the air transportation excise tax calculated using the proposed methodology.

The comments prompted the Treasury Department and the IRS to reevaluate the approach taken in the proposed regulations with regard to section 4261(e)(5)(D). Based on this reevaluation, the Treasury Department and the IRS reached two conclusions.

First, section 4261(e)(5)(D) has broader applicability than just the provision of substitute aircraft as evidenced by the plain language of that provision.

Second, the allocation methodology in the proposed regulation is problematic. Specifically, the Treasury Department and

the IRS share the concerns expressed by the commenters, particularly with regard to the potential for double taxation and uncertainty under the proposed rule.

For these reasons, the final regulations adopt the general approach suggested by the commenters. Specifically, final §49.4261-10(c)(1) restates section 4261(e)(5)(D) as a generally applicable rule. Final §49.4261-10(c)(1) further provides that the tax base for the portion that is subject to the tax imposed by section 4261(a) is the amount paid for such flights or services, provided the amount paid is separable and shown in exact amounts in the records pertaining to the charge. This rule is consistent with commenter suggestions and also reflects the general approach in the air transportation excise tax area that the section 4261(a) tax is imposed on the actual amount paid for taxable transportation. The separability element of the rule is consistent with the rule in §49.4261-2(c) regarding situations in which a payment covers charges for transportation and nontransportation services. If the portion of the amount paid that is subject to the tax imposed by section 4261(a) is not separable and is not shown in exact amounts in the records pertaining to the charge, the tax base is the fair market value of the flights or services; however, the tax base does not exceed the total amount paid (that is, the sum of the portion that is subject to the tax imposed by section 4261(a) and the portion that consists of amounts described in section 4261(e)(5)(A)). For clarity, the final regulations also include a definition of "fair market value" that applies to allocations. The definition of "fair market value" is consistent with commenter suggestions.

In addition, final §49.4261-10(c)(2) treats the provision of a flight on a substitute aircraft to the aircraft owner by an aircraft management services provider as an aircraft charter, with the aircraft owner as the charterer. The final regulations further provide that the allocation rule in final §49.4261-10(c)(1) applies in determining the tax base.

The final regulations also provide guidance for situations in which a substitute aircraft is used to provide a for-hire flight. In that instance, the final regulations instruct taxpayers and collectors to follow

the aircraft charter rules in §49.4261-7(h) (2).

The final regulations update the first example and add a second example in §49.4261-10(h) to illustrate these rules.

#### f. Aircraft Available for Hire

Proposed §49.4261-10(e)(1) provided that whether an aircraft owner permits an aircraft management services provider or other person to use its aircraft to provide for-hire flights (for example, when the aircraft is not being used by the aircraft owner or when the aircraft is being moved in deadhead service) does not affect the application of the aircraft management services exemption. Proposed §49.4261-10(e)(1) further provided that an amount paid for for-hire flights on the aircraft owner's aircraft does not qualify for the aircraft management services exemption. Therefore, under proposed §49.4261-10(e)(1), an amount paid for a for-hire flight on an aircraft owner's aircraft is subject to air transportation excise tax unless the amount paid is otherwise exempt from air transportation excise tax other than by reason of the aircraft management services exemption.

A commenter expressed concern that the wording of proposed §49.4261-10(e)(1) may cause confusion and result in the misapplication of air transportation excise tax to amounts paid that should qualify for the aircraft management services exemption. Specifically, the commenter's concern relates to the second and third sentences of proposed §49.4261-10(e)(1), which explain that amounts paid for for-hire flights are subject to air transportation excise tax. The commenter observed that under section 4261(e)(5), amounts paid by an aircraft owner for flights on the aircraft owner's aircraft are exempt from air transportation excise tax. The commenter further observed that under proposed §49.4261-10(d), operating an aircraft owner's aircraft under part 135 of the FAA regulations does not affect the application of the aircraft management services exemption. The commenter's concern is that aircraft operations conducted under part 135 of the FAA regulations could arguably be considered for-hire flights; however, proposed §49.4261-10(e)(1) does not provide a carve-out for part 135 flights

paid for by the aircraft owner. Therefore, in order to clarify that amounts paid by an aircraft owner for flights operated under part 135 are not subject to air transportation excise tax, the commenter suggested that the final regulations incorporate a carve-out by modifying the second sentence of proposed §49.4261-10(e)(1) to read: "However, an amount paid for for-hire flights on the aircraft owner's aircraft, *except payments made by such aircraft owner*, does not qualify for the section 4261(e)(5) exemption." (emphasis added to denote new wording).

The Treasury Department and the IRS agree with the commenter. As a result, final §49.4261-10(e) incorporates the commenter's suggested change.

#### g. Coordination with Fuel Tax Provisions

Proposed §49.4261-10(g) provided that taxable fuel (as defined in section 4083(a)) or any liquid taxable under section 4041(c) that is used as fuel on a flight for which amounts paid are exempt from air transportation excise tax by reason of the aircraft management services exemption is not fuel used in commercial aviation, as that term is defined in section 4083(b). Thus, under the proposed rule, if the aircraft management services exemption applies to amounts paid in relation to a flight, then the higher noncommercial fuel tax rate (as compared to the commercial fuel tax rate) automatically applies to fuel used during such flight.

A commenter stated that proposed §49.4261-10(g) is inconsistent with the air transportation excise tax-fuel tax statutory scheme and contrary to Congressional intent with regard to that scheme. The commenter asserted that if Congress had intended that all flights qualifying for the aircraft management services exemption be treated as non-commercial flights for fuel tax purposes, Congress could have adopted a corresponding code section to that effect as it did with other exemptions to air transportation excise tax. Specifically, the commenter pointed to the exemptions to air transportation excise tax provided in sections 4261(h) (skydiving), 4261(i) (seaplanes), 4281 (small aircraft on nonestablished lines), and 4282 (affiliated group members), each of which section 4083(b) explicitly excludes from

the definition of "commercial aviation" for purposes of determining applicable fuel tax rates. By not providing a similar, explicit definitional exclusion in section 4083(b) (or other Code section) for the aircraft management services exemption, the commenter asserted, Congress left the determination of which fuel tax rate – commercial or non-commercial – applies to a particular flight to the application of the general definition of "commercial aviation" in section 4083(b). Therefore, the commenter suggested that the final regulations provide that if the aircraft management services exemption applies to amounts paid for a flight, the determination of whether fuel used during the flight is subject to commercial or non-commercial fuel tax rates is made simply through an application of the definition of commercial aviation provided in section 4083(b).

The Treasury Department and the IRS agree with the commenter that proposed §49.4261-10(g) is inconsistent with the air transportation excise tax-fuel excise tax statutory scheme. As a result, the final regulations do not adopt the rule in proposed §49.4261-10(g). The rule in proposed §49.4261-10(e)(2) relating to fuel used in for-hire flights is similarly inconsistent with the air transportation excise tax-fuel excise tax statutory scheme. Therefore, the final regulations also do not adopt the rule proposed in §49.4261-10(e)(2). Because final §49.4261-10 does not provide fuel excise tax guidance related to the exemption in section 4261(e)(5), persons affected by the aircraft management services exemption should continue to follow current statutory, regulatory, and administrative guidance related to the rates of tax for aviation fuel.

#### h. Coordination with Fractional Ownership Aircraft Exemption; Anti-Abuse Rule

Proposed §49.4261-10(i) provided, in relevant part, that the aircraft management services exemption does not apply to any amount paid for aircraft management services by a participant in any transaction or arrangement, or through other means, that seeks to circumvent the surtax imposed by section 4043. A commenter expressed concern that confusion could result from

the phrasing of the first sentence of proposed §49.4261-10(i) because it is essentially identical to the phrasing of the second sentence of proposed §49.4261-10(b)(3)(ii) (excluding fractional aircraft ownership programs and similar arrangements from the definition of “aircraft owner”). The commenter suggested that the first sentence in the final version of §49.4261-10(i) simply cross-reference §49.4261-10(b)(3)(ii), rather than repeating the similar language. Specifically, the commenter suggested the following language for the first sentence of final §49.4261-10(i): “The aircraft management services exemption does not apply to any amount paid for aircraft management services by a participant in the type of business arrangement described in [§49.4261-10(b)(3)(ii)] that does not qualify the participant as an aircraft owner.”

The Treasury Department and the IRS believe that the rule in proposed §49.4261-10(i) is problematic for the same reasons as the other arrangements anti-abuse rule in proposed §49.4261-10(b)(3)(ii) (discussed earlier); specifically, it may capture aircraft ownership structures that are legitimate and not created for purposes of circumventing the fuel surtax imposed by section 4043. The Treasury Department and the IRS further believe that, like the other arrangements anti-abuse rule in proposed §49.4261-10(b)(3)(ii), the rule in proposed §49.4261-10(i) would have created taxpayer uncertainty and confusion. Because the final regulations in §49.4261-10(b)(3)(ii) clarify that a participant in a fractional ownership aircraft program is not an aircraft owner for purposes of the exemption in section 4261(e)(5), an additional coordination rule is redundant. As a result, the final regulations do not adopt proposed §49.4261-10(i).

#### i. Adequate records

Proposed §49.4261-10(a)(3) stated that in order to qualify for the aircraft management services exemption, an aircraft owner and aircraft management services provider must maintain adequate records to show that the amounts paid by the aircraft owner to the aircraft management services provider relate to aircraft management services for the aircraft owner’s aircraft or for flights on the aircraft owner’s aircraft.

A commenter requested that the final regulations provide guidance on the types of records required to satisfy this requirement. The Treasury Department and the IRS agree. Accordingly, the final regulations add language to §49.4261-10(a)(3) stating that such records may include the agreement, if any, between the aircraft owner and the aircraft management services provider, evidence of aircraft ownership, evidence that amounts paid for aircraft management services came from the aircraft owner, the aircraft management services provider’s fee schedule, and documents to support any allocations required under the pro rata allocation rule.

#### j. Examples

Proposed §49.4261-10(j) included two examples illustrating certain aspects of the rules in proposed §49.4261-10. Proposed §49.4261-10(j)(1) (Example 1) illustrated the substitute aircraft allocation methodology in proposed §49.4261-10(c)(1) and (2).

A commenter stated that it interpreted proposed §49.4261-10(j)(1)(i) (presenting the facts of Example 1) as saying that if a company hires an aircraft management company to provide only pilot services to the aircraft owner, then – but for the aircraft management services exemption – air transportation excise tax would apply to the amounts paid by the aircraft owner to the aircraft management services provider. Based on its interpretation, the commenter expressed its opinion that the example presents an extreme position with regard to the application of air transportation excise tax to an aircraft owner-aircraft management services provider relationship. The commenter further stated that the second sentence in proposed §49.4261-10(j)(1)(i) may cause confusion regarding the application of the possession, command, and control test in cases that are not governed by section 4261(e)(5). In addition, the commenter stated that the second sentence in proposed §49.4261-10(j)(1)(i) is irrelevant to the rest of the example, thereby compounding the other problems that the commenter mentioned. The commenter suggested that the final regulations remove the second sentence from §49.4261-10(j)(1)(i).

As noted earlier, the final regulations include a revised pro rata allocation rule. The final regulations also revise the first example (including deletion of the second sentence) and add a second example to illustrate the revised pro rata allocation rule. In addition, the final regulations revise the third example (proposed §49.4261-10(j)(2)) to remove the fuel references in light of the decision not to adopt proposed §49.4261-10(e)(2) and (g) in the final regulations.

### III. Generally Applicable Air Transportation Excise Tax Rules and Aircraft Charter Rules

#### a. Payment and Collection Obligations

Proposed §49.4261-1(b)(1) restated, in general terms, statutory provisions and existing regulations related to the duties and obligations of a person that makes a payment subject to the taxes imposed by section 4261 (that is, the taxpayer) and a person that receives such payments (that is, the collector). The duties and obligations include those imposed on the collector to collect the applicable tax from the taxpayer, to report the tax on Form 720, *Quarterly Federal Excise Tax Return*, and to remit the tax to the IRS. The duties and obligations enumerated in the proposed regulations also include the requirement that the collector make semimonthly deposits of the taxes imposed by section 4261.

Proposed §49.4261-1(b)(2) restated the rule in section 4263(c), which provides that if any tax imposed by section 4261 is not paid at the time payment for transportation is made, then, to the extent the tax is not collected under any other provision of subchapter C of chapter 33 of the Code, the tax must be paid by the carrier providing the initial segment of transportation that begins or ends in the United States.

Regarding proposed §49.4261-1(b)(1), a commenter expressed concern that current published guidance (primarily in the form of revenue rulings) does not adequately address the duties and obligations of charter brokers with regard to collecting and reporting air transportation excise tax. The commenter described a charter broker as an intermediary that charters aircraft from a certificated air carrier (who

actually provides the flight services), and that may act as an agent of the air carrier, an agent of the passengers, or as a principal in the chartering transaction. The commenter stated that the lack of guidance related to charter brokers has created considerable confusion in the charter broker industry. Further, the commenter stated that the need for clear and precise guidance is compounded by the aircraft charter rules provided in proposed §49.4261-7(h) (discussed later) and section 4263(c), which imposes liability on the air carrier providing the initial segment of transportation that begins or ends in the U.S. in cases where any tax imposed by section 4261 is not paid at the time the payment for transportation is made. Therefore, the commenter requested that the final regulations provide guidance regarding the circumstances in which a charter broker (rather than an air carrier) is obligated to collect air transportation excise tax and file Forms 720. The commenter suggested that such guidance should be consistent with the approaches taken in Rev. Rul. 68-256, 1968-1 C.B. 489; Rev. Rul. 75-296, 1975-2 C.B. 440; and Rev. Rul. 2006-52, 2006-2 C.B. 761.

Regarding proposed §49.4261-1(b)(2), a commenter stated that the obligation placed on the air carrier to pay the tax imposed by section 4261 if the party responsible for collecting it fails to do so creates confusion and unfair liability exposure for the air carrier. Further, the commenter stated, as an example, that an IRS examiner could assert tax liability on the air carrier for uncollected tax when the air carrier has no means to determine whether another responsible party, such as a charter broker, had collected and paid over the tax. To alleviate these concerns, the commenter suggested that the final regulations provide that if an air carrier documents that it informed the charter broker of its obligation to collect the taxes imposed by section 4261 and file Forms 720 (see the discussion of proposed §49.4261-7(h) later), then the air carrier will not be liable for uncollected tax under section 4263(c). The commenter also suggested that the final regulations provide that if the IRS asserts liability on an air carrier under section 4263(c) (irrespective of whether the air carrier can show that it informed the

charter broker of its obligations to collect and report) during an examination, then the air carrier should be entitled to obtain information from the IRS on whether the tax was paid by the charter broker or any other party.

The Treasury Department and the IRS understand and share the commenters' concerns related to uncertainty and the possibility of surprise that may result from another party's IRS examination because of the rules in section 4263(c) and proposed §49.4261-1(b)(2). Because the interactions between section 4263(c) and other air transportation excise tax rules are complex and have broad implications for other members of the air transportation industry, the Treasury Department and the IRS believe that these issues require additional study and input from a broader cross-section of the air transportation industry. Further, the Treasury Department and the IRS believe that section 4263(c) issues should be addressed in a separate published guidance project that could also potentially consider the interplay between section 4263(c) and the existing regulatory rules in §49.4261-7(h) and §49.4291-1.

However, because, as mentioned earlier, proposed §49.4261-1(b)(1) merely restated currently applicable statutory and regulatory rules, the final regulations adopt proposed §49.4261-1(b)(1) without change. In addition, the final regulations do not adopt the second sentence of proposed §49.4261-1(b)(2) so that the final regulations simply track the language of section 4263(c), as currently written, without further comment. The Treasury Department and the IRS believe it is necessary to finalize these rules because the existing regulations related to section 4263(c) reflect prior law, which has created widespread confusion among taxpayers and collectors in the air transportation area.

#### b. Aircraft Charters

Proposed §49.4261-7(h), which generally restated existing rules in §49.4261-7(h), provided rules related to the application of the taxes imposed by section 4261 to situations in which a person provides air transportation services on an aircraft that was chartered from – and operated by – another party, commonly referred to as

a “wet lease.” Proposed §49.4261-7(h)(2) provided that the charterer of an aircraft who sells transportation to other persons must collect and account for the tax with respect to all amounts paid to the charterer by such other persons. The proposed rule further provided that, in such a case, no tax will be due on the amount paid by the charterer for the charter of the aircraft but that it is the duty of the owner of the aircraft to advise the charterer of the charterer's obligation for collecting, accounting for, and paying over the tax to the IRS. This requirement is intended to ensure the parties communicate with each other regarding air transportation excise tax and prevent misunderstandings about which party is responsible for collecting tax under the arrangement.

Two commenters requested clarification regarding the duty of the “owner of the aircraft to advise the charterer of the charterer's obligations for collecting, accounting for, and paying over the tax” to the IRS imposed under the proposed rule. A commenter stated that in the air charter industry, the air carrier does not typically own the aircraft used to provide charter flights. Because the proposed rule imposes on the aircraft owner the duty to advise the charterer of its obligations, the commenter stated that confusion about which party must advise the charterer may result from the phrasing of the proposed rule. The commenter suggested the proposed rule use the phrase “air carrier” rather than “owner of the aircraft.”

A commenter also requested clarification about how and when the duty to advise the charterer of its obligations with regard to air transportation excise tax must be satisfied. Specifically, the commenter asked whether the duty to advise applies separately to each specific charter flight, or whether the duty may be satisfied as part of a long-term underlying agreement between the aircraft owner and the charterer such as a lease agreement for the aircraft owner's aircraft entered into by the aircraft owner and the charterer. The commenter also requested clarification regarding whether the duty to advise the charterer of its obligations with regard to air transportation excise tax creates an obligation on the part of the aircraft owner to collect the tax if the charterer fails to do so.

The Treasury Department and the IRS understand and share the commenters' concern that, because the owner of a chartered aircraft may not be the party that operates the aircraft, the phrasing of the proposed rule may cause confusion. In addition, the Treasury Department and the IRS understand the need for clarification regarding the duty of the aircraft owner to advise the charterer of its collection obligations. However, because these rules are complex and have broad applicability to the air transportation industry, additional study and stakeholder input is required. Accordingly, a separate published guidance project is necessary to address: (a) the possible shifting of the duty to advise the charterer about its obligations for collecting, accounting for, and paying over the tax to the IRS to the air carrier operating the chartered aircraft instead of the owner of the chartered aircraft; (b) whether the duty to advise applies separately to each specific charter flight, or whether the duty may be satisfied as part of a long-term agreement between the aircraft owner and the charterer; and (c) whether the duty to advise the charterer of its obligations with regard to air transportation excise tax creates an obligation on the part of the aircraft owner to collect the tax if the charterer fails to do so.

Because proposed §49.4261-7(h) merely restated currently applicable rules, the final regulations adopt proposed §49.4261-7(h) without change. Until additional guidance is issued, §49.4261-7(h), as finalized, and other existing published guidance apply.

#### **Effect on Other Documents**

Revenue Ruling 67-414 (1967-2 C.B. 382), Revenue Ruling 72-309 (1972-1 C.B. 348), and Revenue Ruling 2002-34 (2002-1 C.B. 1150) are obsoleted on January 19, 2021.

#### **Applicability Dates**

For dates of applicability, see §§40.0-1(e), 49.4261-1(g), 49.4261-2(d), 49.4261-3(e), 49.4261-7(k), 49.4261-9(c), 49.4261-10(i), 49.4262-1(f), 49.4262-2(e), 49.4262-3(e), 49.4281-1(e), 49.4263-1(b), 49.4263-3(b), 49.4271-1(g), and 49.4721-2.

#### **Special Analyses**

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this final rule will not have a significant economic impact on a substantial number of small entities. Although the rule may affect a substantial number of small entities, the economic impact of the regulations is not likely to be significant. Data are not readily available about the number of taxpayers affected, but the number is likely to be substantial for both large and small entities because the rule may affect entities that serve as holding companies for aircraft that do not have many revenues or employees. The economic impact of these regulations is not likely to be significant, however, because these final regulations primarily clarify the application of the aircraft management services exception added to the Code by the TCJA. These final regulations will assist taxpayers in understanding the rules to qualify for the exemption under section 4261(e)(5) and make it easier for taxpayers to comply and IRS examiners to administer the exemption. Accordingly, the Secretary of the Treasury's delegate certifies that the rule will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS welcome comments on the impact of these regulations on small entities.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

#### **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 Michael H. Beker, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

#### **List of Subjects**

##### *26 CFR Part 40*

Excise taxes, Reporting and record-keeping requirements.

##### *26 CFR Part 49*

Excise taxes, Reporting and record-keeping requirements, Telephone, Transportation.

#### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 40 and 49 are amended as follows:

##### **PART 40—EXCISE TAX PROCEDURAL REGULATIONS**

Paragraph 1. The authority citation for part 40 is amended by removing the entry for §40.6071(a)-3 to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 40.0-1 is amended by redesignating paragraph (d) as paragraph (e), adding a new paragraph (d), and revising newly redesignated paragraph (e) to read as follows:

##### *§40.0-1 Introduction.*

\* \* \* \* \*

(d) *Person.* For purposes of this part, each business unit that has, or is required to have, a separate employer identification number is treated as a separate person.

Thus, business units (for example, a parent corporation and a subsidiary corporation, a partner and the partner's partnership, or the various members of a consolidated group), each of which has, or is required to have, a different employer identification number, are separate persons.

(e) *Applicability date*—(1) *Paragraphs (a), (b), and (c) of this section.* Paragraphs (a), (b), and (c) of this section apply to returns for periods beginning after March 31, 2013. For rules that apply before that date, see 26 CFR part 40, revised as of April 1, 2012.

(2) *Paragraph (d) of this section.* Paragraph (d) of this section applies to returns for periods beginning on or after January 19, 2021. For rules that apply before that date, see 26 CFR part 40, revised as of April 1, 2020.

#### **§40.6071(a)-3 [Removed]**

Par. 3. Section 40.6071(a)-3 is removed.

### **PART 49—FACILITIES AND SERVICES EXCISE TAX REGULATIONS**

Par. 4. The authority citation for part 49 continues to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Par. 5. Section 49.4261-1 is revised to read as follows:

#### **§49.4261-1 Imposition of tax; in general.**

(a) *In general.* Section 4261 of the Internal Revenue Code (Code) imposes three separate taxes on amounts paid for certain transportation of persons by air. Tax attaches at the time of payment for any transportation taxable under section 4261. The applicability of each section 4261 tax is generally determined on a flight-by-flight basis.

(1) *Percentage tax.* Section 4261(a) imposes a 7.5 percent tax on the amount paid for the taxable transportation of any person. See section 4262(a) of the Code and §49.4262-1(a) for the definition of the term *taxable transportation*.

(2) *Domestic segment tax.* Section 4261(b)(1) imposes a \$3 tax (indexed annually for inflation pursuant to section

4261(e)(4)) on the amount paid for each domestic segment of taxable transportation. See section 4261(b)(2) for the definition of the term *domestic segment*. The domestic segment tax does not apply to a domestic segment beginning or ending at an airport that is a rural airport for the calendar year in which the segment begins or ends (as the case may be). See section 4261(e)(1)(B) for the definition of the term *rural airport*.

(3) *International travel facilities tax.* Section 4261(c) imposes a \$12 tax (indexed annually for inflation pursuant to section 4261(e)(4)) on any amount paid (whether within or without the United States) for any transportation by air that begins or ends in the United States. The international travel facilities tax does not apply to any transportation that is entirely taxable under section 4261(a) (determined without regard to sections 4281 and 4282). See section 4261(c)(2). A special rule applies to Alaska and Hawaii flights. See section 4261(c)(3).

(b) *Payment and collection obligations*—(1) *In general.* The taxes imposed by section 4261 are collected taxes. In general, the person making the payment subject to tax is the *taxpayer*. See section 4261(d). The person receiving the payment is the *collector* (also commonly referred to as the collecting agent). See section 4291 of the Code. The collector must collect the applicable tax from the taxpayer, report the tax on Form 720, *Quarterly Federal Excise Tax Return*, and remit the tax to the Internal Revenue Service. See sections 4291, 6011, and 7501 of the Code. See §40.6011(a)-1 of this chapter and §49.4291-1. The collector must also make semimonthly deposits of the taxes imposed by section 4261. See section 6302(e) of the Code. See §§40.0-1(c), 40.6302(c)-1, and 40.6302(c)-3 of this chapter. See section 4263(a) and (c) of the Code for special rules relating to the payment and collection of tax.

(2) *Failure to collect tax.* If any tax imposed by section 4261 is not paid at the time payment for transportation is made, then, to the extent the tax is not collected under any other provision of subchapter C of chapter 33 of the Code, the tax must be paid by the carrier providing the initial segment of transportation that begins

or ends in the United States. See section 4263(c). See section 6672 of the Code for rules relating to the application of the trust fund recovery penalty.

(c) *Type of aircraft.* The taxes imposed by section 4261 generally apply regardless of the type of aircraft on which the transportation is provided, provided all of the other conditions for liability are present and no specific statutory exemption applies. See paragraph (f) of this section for a list of statutory exemptions from tax. Amounts paid for the transportation of persons by air cushion vehicles, also known as hovercraft, are not subject to the taxes imposed by section 4261.

(d) *Purpose of transportation.* The purpose of the transportation (for example, business or pleasure) is not a factor in determining taxability under section 4261.

(e) *Routes.* Amounts paid for transportation may be taxable even if the transportation is not between two definite points. Unless otherwise exempt, a payment for continuous transportation that begins and ends at the same point is subject to tax. See section 4281 of the Code and §49.4281-1 for the exemption for small aircraft on nonestablished lines.

(f) *Exemptions from tax; cross-references*—(1) *Aircraft management services.* For the exemption for certain aircraft management services, see section 4261(e)(5) of the Code and §49.4261-10.

(2) *Hard minerals, oil, and gas.* For the exemption for certain uses related to the exploration, development, or removal of hard minerals, oil, or gas, see section 4261(f)(1).

(3) *Trees and logging operations.* For the exemption for certain uses related to trees and logging operations, see section 4261(f)(2).

(4) *Air ambulances.* For the exemption for air ambulances providing certain emergency medical transportation, see section 4261(g).

(5) *Skydiving.* For the exemption for certain skydiving uses, see section 4261(h).

(6) *Seaplanes.* For the exemption for certain seaplane segments, see section 4261(i).

(7) *Fractionally-owned aircraft.* For the exemption for certain aircraft in fractional ownership aircraft programs, see section 4261(j).

(8) *Small aircraft on nonestablished lines.* For the exemption for certain small aircraft on nonestablished lines, see section 4281 of the Code and §49.4281-1.

(9) *Affiliated groups.* For the exemption for certain transportation of members of an affiliated group, see section 4282.

(10) *United States and territories.* For exemptions authorized by the Secretary of the Treasury or his delegate for the exclusive use of the United States, see section 4293.

(g) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

Par. 6. Section 49.4261-2 is amended by:

1. Revising paragraphs (a) and (b).
2. Adding paragraph (d).

The revisions and addition read as follows:

#### §49.4261-2 Application of tax.

(a) *Tax on total amount paid.* The tax imposed by section 4261(a) of the Internal Revenue Code (Code) is measured by the total amount paid for taxable transportation, whether paid in cash or in kind.

(b) *Tax on transportation of each person.* The taxes imposed by section 4261(b) and (c) of the Code are head taxes and, therefore, apply on a per-passenger basis. The taxes apply to each passenger for whom an amount is paid, regardless of whether the payment is made as a single lump sum or is made individually for each passenger. In the case of charter flights for which a fixed amount is paid, the section 4261(b) and (c) taxes are computed by multiplying the applicable rate of tax by the number of passengers transported on the aircraft.

\* \* \* \* \*

(d) *Applicability date.* Paragraphs (a) and (b) of this section apply to amounts paid on and after January 19, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

Par. 7. Section 49.4261-3 is amended by:

1. Removing “§49.4262(c)-1” wherever it appears and adding “§49.4262-3” in its place.
2. In the first sentence of paragraph (a), removing “The tax imposed by section

4261(a)” and adding “The taxes imposed by section 4261(a) and (b) of the Internal Revenue Code (Code)” in its place.

3. In the second sentence of paragraph (a), adding “under section 4261(a) and (b)” at the end of the sentence.

4. Revising paragraphs (b) and (c).

5. In paragraph (d), removing “section 4262(b) and §49.4262(b)-1” and adding “section 4262(b) of the Code and §49.4262-2” in its place.

6. Adding paragraph (e).

The revisions and additions read as follows:

#### §49.4261-3 Payments made within the United States.

\* \* \* \* \*

(b) *Other transportation.* In the case of transportation, other than that described in paragraph (a) of this section, for which payment is made in the United States, the taxes imposed by section 4261(a) and (b) apply with respect to the amount paid for that portion of such transportation by air which is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such portion is not a part of uninterrupted international air transportation within the meaning of section 4262(c)(3) of the Code and §49.4262-3(c). Transportation that:

- (1) Begins in the United States or the 225-mile zone and ends outside such area,
- (2) Begins outside the United States or the 225-mile zone and ends inside such area, or
- (3) Begins outside the United States and ends outside such area, is taxable only with respect to the portion of the transportation by air which is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such portion is not a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c).

Thus, on a trip by air from Chicago to London, England, with a stopover at New York, for which payment is made in the United States, if the portion from Chicago to New York is not a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c), the taxes would apply to

the part of the payment which is applicable to the transportation from Chicago to New York. However, if the portion from Chicago to New York is a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c), the taxes would not apply.

(c) *Method of computing tax on taxable portion.* Where a payment is made for transportation which is partially taxable under paragraph (b) of this section, the tax imposed by section 4261(a) may be computed on that proportion of the total amount paid which the mileage of the taxable portion of the transportation bears to the mileage of the entire trip.

\* \* \* \* \*

(e) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

#### §49.4261-4 [Amended]

Par. 8. Section 49.4261-4 is amended by:

1. In paragraph (a), removing the first “4261(a)” and adding “4261 of the Internal Revenue Code (Code)” in its place.
2. In paragraph (a), removing “section 4261(a) (see section 4264(d))” and adding “section 4261 (see section 4263(d) of the Code)” in its place.
3. In paragraph (b), removing “§49.4262(c)-1” and adding “§49.4262-3” in its place.
4. In the first sentence of paragraph (d), removing “§49.4262(c)-1” and adding “§49.4262-3” in its place.
5. In the first sentence of paragraph (d), removing “six-hour” and adding “12-hour” in its place.

#### §49.4261-5 [Amended]

Par. 9. Section 49.4261-5 is amended as follows:

1. In paragraph (a), removing “4261(b)” wherever it appears and adding “4261(a) and (b)” in its place.
2. In paragraph (c), removing “§49.4262(b)-1” and adding “§49.4262-2” in its place.

Par. 10. Section 49.4261-7 is amended by:

1. In the introductory paragraph, removing “4263, 4292, 4293, or 4294” and adding “4261, 4281, 4282, or 4293 of the Internal Revenue Code,” in its place.

2. Removing and reserving paragraphs (b), (d), (e), and (g).

3. Revising paragraph (h).

4. In paragraph (i), removing “paragraph (c) of §49.4261-2 and paragraph (f)(4) of §49.4261-8” and adding “§§49.4261-2(c) and 49.4261-8(f)(4)” in its place.

5. Adding paragraph (k).

The revision and addition read as follows:

*§49.4261-7 Examples of payments subject to tax.*

\*\*\*\*\*

(h) *Aircraft charters*—(1) When no charge is made by the charterer of an aircraft to the persons transported, the amount paid by the charterer for the charter of the aircraft is subject to tax.

(2) The charterer of an aircraft who sells transportation to other persons must collect and account for the tax with respect to all amounts paid to the charterer by such other persons. In such case, no tax will be due on the amount paid by the charterer for the charter of the aircraft but it shall be the duty of the owner of the aircraft to advise the charterer of the charterer’s obligation for collecting, accounting for, and paying over the tax to the Internal Revenue Service.

\*\*\*\*\*

(k) *Applicability date.* Paragraph (h) of this section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### **§49.4261-8 [Amended]**

Par. 11. Section 49.4261-8 is amended as follows:

1. In the introductory paragraph, removing “4263, 4292, 4293, or 4294” and adding “4261, 4281, 4282, or 4293 of the Internal Revenue Code” in its place.

2. Paragraphs (f)(2), (3), and (5) are removed and reserved.

Par. 12. Section 49.4261-9 is revised to read as follows:

#### **§49.4261-9 Mileage awards.**

(a) *Tax imposed.* Any amount paid (and the value of any other benefit provided) to an air carrier (or any related person) for the right to provide mileage awards for or other reductions in the cost of any transportation of persons by air is an amount paid for taxable transportation and is therefore subject to the tax imposed by section 4261(a) of the Internal Revenue Code. *See* section 4261(e)(3)(A).

(b) *[Reserved]*

(c) *Applicability date.* This section applies to amounts paid on and after January 19, 2021.

Par. 13. Section 49.4261-10 is revised to read as follows:

#### **§49.4261-10 Aircraft management services.**

(a) *In general*—(1) *Overview.* This section prescribes rules relating to the exemption under section 4261(e)(5) of the Internal Revenue Code (Code) for amounts paid (in cash or in kind) by an aircraft owner to an aircraft management services provider for certain aircraft management services (aircraft management services exemption). Pursuant to section 4261(e)(5), the tax imposed by section 4261 of the Code does not apply to amounts paid by an aircraft owner to an aircraft management services provider for aircraft management services related to maintenance and support of the aircraft owner’s aircraft; or related to flights on the aircraft owner’s aircraft (flight services). The aircraft management services exemption applies to amounts paid by an aircraft owner to an aircraft management services provider for flight services on the aircraft owner’s aircraft, even if the aircraft owner is not on the flight. The aircraft management services exemption does not apply to amounts paid to an aircraft management services provider by another person on behalf of an aircraft owner (other than in a principal-agent scenario in which the aircraft owner is the principal). In addition, amounts paid for aircraft management services by a party related to the aircraft owner are not amounts paid by the aircraft owner solely by virtue of the relationship between the aircraft owner and the related party. However, if an aircraft owner leases

an aircraft to another person, including a related party, amounts paid by the lessee to an aircraft management services provider for aircraft management services related to the leased aircraft qualify for the aircraft management services exemption, provided the lease is not a disqualified lease and all other requirements of section 4261(e)(5) are satisfied. For example, amounts paid for aircraft management services by one member of an affiliated group (as that term is defined in section 4282 of the Code) for flights on an aircraft owned by another member of the affiliated group are not amounts paid by the aircraft owner unless the member owning the aircraft leases the aircraft to the member of the affiliated group that pays for the aircraft management services. *See* paragraph (b) of this section for definitions of terms used in this section.

(2) *Private aviation.* The aircraft management services exemption is limited to aircraft management services related to aircraft used in private aviation.

(3) *Adequate records required.* In order to qualify for the aircraft management services exemption, an aircraft owner and aircraft management services provider must maintain adequate records to show that the amounts paid by the aircraft owner to the aircraft management services provider relate to aircraft management services specifically for the aircraft owner’s aircraft or for flights on the aircraft owner’s aircraft and to support any allocations required under paragraph (c) under of this section. Such records may include the agreement, if any, between the aircraft owner and the aircraft management services provider, evidence of aircraft ownership, evidence that amounts paid for aircraft management services came from the aircraft owner, and the aircraft management services provider’s fee schedule.

(b) *Definitions.* This paragraph provides definitions applicable to this section.

(1) *Aircraft management services.* The term *aircraft management services* means—

(i) *Statutory services.* The services listed in section 4261(e)(5)(B)(i)-(v); and

(ii) *Other services.* Any service (including, but not limited to, purchasing fuel, purchasing aircraft parts, and arranging for the fueling of an aircraft owner’s aircraft) provided directly or in-



directly to an aircraft owner in order to provide air transportation to the aircraft owner on the aircraft owner's aircraft at a level and quality of service required under the agreement between the aircraft owner and the aircraft management services provider.

(2) *Aircraft management services provider.* The term *aircraft management services provider* means a person that provides aircraft management services to an aircraft owner.

(3) *Aircraft owner*—(i) *In general.* Except as otherwise provided in this section, the term *aircraft owner* means a person that owns an aircraft managed by an aircraft management services provider (commonly referred to as a managed aircraft), or a person that leases a managed aircraft (lessee) pursuant to a lease that is not a disqualified lease. A person owns a managed aircraft if the person holds legal title to the aircraft, or if the person holds substantial incidents of ownership in the aircraft for a period of more than 31 days. A lessee includes the beneficiary of an owner trust that holds legal title to the managed aircraft.

(ii) *Persons not included in the definition of aircraft owner.* A lessee of an aircraft under a disqualified lease cannot be an aircraft owner with respect to the aircraft leased pursuant to the disqualified lease. A person that owns stock in a commercial airline does not qualify as an aircraft owner of that commercial airline's aircraft. A participant in a fractional aircraft ownership program, as defined in section 4043(c)(2) of the Code, does not qualify as an aircraft owner of the program's managed aircraft if the amount paid for such person's participation is exempt from the tax imposed by section 4261 reason of section 4261(j).

(4) *Disqualified lease.* The term *disqualified lease* has the meaning given to it by section 4261(e)(5)(C)(ii).

(5) *Fair market value.* The term *fair market value* means the value of comparable flights or services provided with respect to a comparable aircraft as of the date such flights or services are provided. The aircraft management services provider's published fee schedule in effect on the date(s) the flights or services are provided may be used as evidence of fair market value.

(6) *For-hire flight.* The term *for-hire flight* means the use of an aircraft to transport passengers for compensation that is paid in cash or in kind. The term includes, but is not limited to, charter flights, air taxi flights, and sightseeing flights (commonly referred to as flightseeing flights).

(7) *Owner trust.* The term *owner trust* means an arrangement in which legal title of an aircraft is held in the name of the trustee of the trust for the limited purpose of registering the aircraft in the United States with the Federal Aviation Administration pursuant to the registration requirements in 49 U.S.C. sections 40102(a) and 44102(a), and 14 CFR part 47.

(8) *Private aviation.* The term *private aviation* means the use of an aircraft for civilian flights, except scheduled passenger service for which tickets (or substitutes equivalent to tickets) are sold on a seat-by-seat basis to the general public. The term includes, but is not limited to, civilian flights operated under Part 135 (14 CFR Part 135) of the Federal Aviation Regulations prescribed by the Federal Aviation Administration (FARs).

(9) *Substitute aircraft.* The term *substitute aircraft* means an aircraft, other than the aircraft owner's aircraft, that is provided by an aircraft management services provider to the aircraft owner when the aircraft owner's aircraft is not available, regardless of the reason for the unavailability.

(c) *Pro rata allocation*—(1) *In general.* Except as provided in paragraph (c)(2)(iii) of this section, when an amount paid to an aircraft management services provider includes a portion that is subject to the tax imposed by section 4261 and a portion that consists of amounts described in section 4261(e)(5)(A), the exception in section 4261(e)(5) applies on a pro rata basis only to the portion that consists of amounts described in section 4261(e)(5)(A). See section 4261(e)(5)(D). In such case, the tax base for the portion that is subject to the tax imposed by section 4261(a) is the amount paid for the flights or services, provided the amount paid is separable and shown in exact amounts in the records pertaining to the charge. If the portion of the amount paid that is subject to the tax imposed by section 4261(a) is not separable, the tax base is the fair market value of the flights or services. However, the tax

base determined in the previous sentence may not exceed the total amount paid (that is, the sum of the portion that is subject to the tax imposed by section 4261(a) and the portion that consists of amounts described in section 4261(e)(5)(A)).

(2) *Substitute aircraft*—(i) *Flight treated as a charter.* If an aircraft management services provider provides a flight to an aircraft owner on a substitute aircraft, the flight is treated as a charter flight provided by the aircraft management services provider to the aircraft owner, regardless of whether the aircraft owner is on the flight, and the aircraft owner is treated as the charterer of such flight. If the flight constitutes taxable transportation, as defined in section 4262 of the Code, the tax imposed by section 4261(a) applies, unless the flight is exempt from such tax by reason of an exemption other than the aircraft management services exemption. See section 4261(b) and (c) for other taxes that may apply to flights provided by an aircraft management services provider to an aircraft owner on substitute aircraft.

(ii) *General rule for flights provided on substitute aircraft.* In cases where an aircraft management services provider provides a flight to an aircraft owner on a substitute aircraft and an allocation is required, the rule in paragraph (c)(1) of this section applies in determining the tax base. In all other cases, the tax base and the tax imposed by section 4261(a) thereon must be determined in accordance with the rules of §49.4261-7(h)(1), unless the flight is otherwise exempt from such tax by reason of an exemption other than the aircraft management services exemption.

(iii) *Special rule for for-hire flights provided on substitute aircraft.* In cases where a substitute aircraft is used to provide a for-hire flight and an amount is paid for the flight by someone other than the aircraft owner, the tax base and the tax imposed by section 4261(a) thereon must be determined in accordance with the rules in §49.4261-7(h)(2), unless the flight is otherwise exempt from such tax by reason of an exemption other than the aircraft management services exemption.

(d) *Choice of flight rules.* Whether a flight on an aircraft owner's aircraft operates pursuant to the rules under FARs Part 91 (14 CFR part 91) or pursuant to the

rules under FARs Part 135 does not affect the application of section 4261(e)(5).

(e) *Aircraft available for hire.* Whether an aircraft owner permits an aircraft management services provider or other person to use its aircraft to provide for-hire flights (for example, when the aircraft is not being used by the aircraft owner or when the aircraft is being moved in deadhead service) does not affect the application of section 4261(e)(5). However, an amount paid for for-hire flights on the aircraft owner's aircraft, except payments made by the aircraft owner, does not qualify for the aircraft management services exemption under section 4261(e)(5). Therefore, an amount paid by someone other than the aircraft owner for a for-hire flight on the aircraft owner's aircraft is subject to the tax imposed by section 4261 unless the flight is otherwise exempt from such tax by reason of an exemption other than the aircraft management services exemption. See §49.4261-7(h) for rules relating to the application of the tax imposed by section 4261 on amounts paid for certain charter flights.

(f) *Billing methods.* Except as otherwise provided in this section, the method an aircraft management services provider bills, invoices, or otherwise charges an aircraft owner for aircraft management services, whether by specific itemization of costs, flat monthly or hourly fee, or otherwise, does not affect the application of section 4261(e)(5).

(g) *Multiple aircraft management services providers not disqualifying.* Whether an aircraft owner pays amounts to more than one aircraft management services provider for aircraft management services does not affect the application of section 4261(e)(5).

(h) *Examples.* The following examples illustrate the provisions of this section.

(1) *Example 1—(i) Facts.* During the first quarter of 2021, an aircraft owner pays a \$3,000 monthly management fee to an aircraft management services provider for services related to operating the aircraft owner's aircraft. The aircraft owner used its own aircraft for all but one of the flights the owner took during the period. On the one occasion that the aircraft owner's aircraft was unavailable when the aircraft owner wanted to fly, the aircraft management services provider used a substitute aircraft to transport the aircraft owner. The flight was within the continental United States and the aircraft owner received no compensation for the transportation of other passengers on the flight. The aircraft owner paid \$1,000

for the flight on the substitute aircraft. The aircraft management services provider included the \$1,000 charge for the substitute aircraft as a separate line item on the monthly management fee invoice.

(ii) *Analysis.* The tax imposed by section 4261(a) applies to services that do not qualify for the section 4261(e)(5) exemption; in this case, the flight provided on the substitute aircraft. The flight provided on the substitute aircraft is treated as a charter flight for purposes of the tax imposed by section 4261(a), and the owner is treated as the charterer of the flight. The amount paid by the aircraft owner for the flight on the substitute aircraft is the section 4261(a) tax base. The monthly invoice from the aircraft management services provider to the aircraft owner included a line item in the amount of \$1,000 for the charter flight. Because \$1,000 is the actual amount paid for the flight, this amount is the section 4261(a) tax base. The tax imposed by section 4261(b) also applies to the flight on a per-passenger basis. See §49.4261-2(b) for rules regarding the application of the tax imposed by section 4261(b).

(2) *Example 2—(i) Facts.* Same facts as in paragraph (h)(1) of this section (Example 1), except the invoice does not show the amount paid for the flight on the substitute aircraft and that amount is not otherwise separable from the monthly management fee. The fair market value of the flight on the substitute aircraft is \$1,000.

(ii) *Analysis.* The tax imposed by section 4261(a) applies to the flight provided on the substitute aircraft. The amount paid for the flight on the substitute aircraft is not otherwise separable from the monthly management fee. Because \$1,000 is the fair market value of the flight, and such amount does not exceed the \$3,000 monthly management fee paid by the aircraft owner, this amount is the section 4261(a) tax base. The tax imposed by section 4261(b) also applies to the flight on a per-passenger basis. See §49.4261-2(b) for rules regarding the application of the tax imposed by section 4261(b).

(3) *Example 3—(i) Facts.* An aircraft owner pays a monthly management fee to an aircraft management services provider for aircraft management services related to the aircraft owner's aircraft. When the aircraft is not being used by the owner, the owner sometimes permits a charter company to use the aircraft to provide charter flights. At other times when the aircraft is not being used by the owner, the owner permits a tour operator to use the aircraft for flightseeing tours. All charter and flightseeing flights on the aircraft constitute taxable transportation, as that term is defined in section 4262, and no exemptions (other than section 4261(e)(5)) apply. No charter or flightseeing flights are provided on a substitute aircraft. The aircraft's maximum certificated takeoff weight is 7,000 pounds.

(ii) *Analysis.* Amounts paid by the aircraft owner to the aircraft management services provider for aircraft management services related to the aircraft owner's aircraft are exempt under section 4261(e)(5). Amounts paid by the charterer or passengers for the charter flights are subject to tax under section 4261(a) and (b). See §49.4261-7(h) for rules relating to the application of the tax imposed by section 4261 on amounts paid for charter flights. See §49.4261-2(b) for rules regarding the application of the tax imposed by section 4261(b). Amounts paid by flightsee-

ing customers for flightseeing tours are also subject to tax under section 4261(a) and (b). If a payment for a flightseeing tour includes charges for nontransportation services, the charges for the nontransportation services may be excluded in computing the tax payable provided the payments are separable and provided in exact amounts. See §49.4261-2(c).

(i) *Applicability date.* This section applies to amounts paid on and after January 19, 2021.

#### §49.4262(a)-1 [Redesignated]

Par. 14. Section 49.4262(a)-1 is redesignated as §49.4262-1.

Par. 15. Newly redesignated §49.4262-1 is amended by:

1. In paragraph (a) introductory text, removing "section 4262(b) (see §49.4262(b)-1)" and adding "section 4262(b) of the Internal Revenue Code (Code) (see §49.4262-2)" in its place.

2. In the first sentence of paragraph (a)(1), removing "Transportation" and adding "Transportation by air" in its place.

3. In the first sentence of paragraph (a)(1), removing "(the "225-mile zone")" and adding "(225-mile zone)" in its place.

4. Revising paragraph (a)(2).

5. In paragraph (b), removing "subparagraphs (1) and (5) of this paragraph" and adding "paragraph (b)(1) and (5) of this section" in its place.

6. In paragraph (b), removing "subject to the tax" and adding "subject to the taxes imposed by section 4261(a) and (b)" in its place.

7. Revising paragraph (b)(2).

8. Removing and reserving paragraph (c).

9. Revising introductory paragraph (d); designating *Example (1)* as paragraph (d)(1) and revising newly designated paragraph (d)(1).

10. In paragraph (d):

a., Designating *Example (2)* as paragraph (d)(2) and removing and reserving newly designated paragraph (d)(2).

b. Designating *Example (3)* as paragraph (d)(3) and removing "6 hours" wherever it appears and adding "12 hours" in its place and also removing "subject to tax" wherever it appears and adding "subject to the taxes imposed by section 4261(a) and (b)" in its place.

c. Designating *Example (4)* as paragraph (d)(4), and removing "six hours" wherever it appears and adding "12 hours"

in its place and also removing “subject to tax” wherever it appears and adding “subject to the taxes imposed by section 4261(a) and (b)” in its place.

11. Revising paragraph (e).
12. Adding paragraph (f).

The revisions and addition read as follows:

*§49.4262-1 Taxable transportation.*

(a) \* \* \*

(2) In the case of any other transportation by air, that portion of such transportation that is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such transportation is not part of *uninterrupted international air transportation* within the meaning of section 4262(c)(3) of the Code and §49.4262-3(c). Transportation from one port or station in the United States occurs whenever a carrier, after leaving any port or station in the United States, makes a regularly scheduled stop at another port or station in the United States irrespective of whether stopovers are permitted or whether passengers disembark.

\* \* \* \* \*

(b) \* \* \*

(2) New York to Vancouver, Canada, with a stop at Toronto, Canada;

\* \* \* \* \*

(d) *Examples.* The following examples illustrate the application of section 4262(a)(2) and the taxes imposed by section 4261(a) and (b) of the Code:

(1) *Example (1).* A purchases in New York a ticket for air transportation from New York to Nassau, Bahamas, with a scheduled stopover of 14 hours in Miami. The part of the transportation from New York to Miami is taxable transportation as defined in section 4262(a) because such transportation is from one station in the United States to another station in

the United States and the trip is not uninterrupted international air transportation (because the scheduled stopover interval in Miami is greater than 12 hours). Therefore, the amount paid for the transportation from New York to Miami is subject to the taxes imposed by section 4261(a) and (b).

\* \* \* \* \*

(e) *Examples of transportation that is not taxable transportation.* The following examples illustrate transportation that is not taxable transportation:

(1) New York to Trinidad with no intervening stops;

(2) Minneapolis to Edmonton, Canada, with a stop at Winnipeg, Canada;

(3) Los Angeles to Mexico City, Mexico, with stops at Tijuana and Guadalajara, Mexico;

(4) New York to Whitehorse, Yukon Territory, Canada, by air with a scheduled stopover in Chicago of five hours. Amounts paid for the transportation referred to in examples set forth in paragraphs (e)(1), (2), and (3) of this section are not subject to the tax regardless of where payment is made, since none of the trips:

(i) Begin in the United States or in the 225-mile zone and end in the United States or in the 225-mile zone, nor

(ii) Contain a portion of transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States. The amount paid within the United States for the transportation referred to in the example set forth in paragraph (4) of this section is not subject to tax since the entire trip (including the domestic portion thereof) is *uninterrupted international air transportation* within the meaning of section 4262(c)(3) and §49.4262-3(c). In the event the transportation is paid for outside the United States, no tax is due since the

transportation does not begin and end in the United States.

\* \* \* \* \*

(f) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

**§49.4262(b)-1 [Redesignated]**

Par. 16. Section 49.4262(b)-1 is redesignated as §49.4262-2.

Par. 17. Newly redesignated §49.4262-2 is amended as follows:

1. In paragraph (a), “section 4262(b)” is removed and “section 4262(b) of the Internal Revenue Code” is added in its place.

2. In paragraph (b)(2), *Example (2)* is removed and reserved.

3. Revise paragraph (d).

4. Add paragraph (e).

The revisions and additions read as follows:

**§49.4262-2 Exclusion of certain travel.**

\* \* \* \* \*

(d) *Example.* The application of paragraph (c) of this section may be illustrated by the following example: A purchases in San Francisco a ticket for transportation by air to Honolulu, Hawaii. The portion of the transportation which is outside the continental United States and is outside Hawaii is excluded from taxable transportation. The tax applies to that part of the payment made by A which is applicable to the portion of the transportation between the airport in San Francisco and the three-mile limit off the coast of California (a distance of 15 miles) and between the three-mile limit off the coast of Hawaii and the airport in Honolulu (a distance of 5 miles). The part of the payment made by A which is applicable to the taxable portion of his transportation and the tax due thereon are computed in accordance with paragraph (c)(1) as follows:

Table 1 to paragraph (d)

Mileage of entire trip (San Francisco airport to Honolulu airport) (miles).....	2,400
Mileage in continental United States (miles).....	15
Mileage in Hawaii (miles).....	5
	20
Fare from San Francisco to Honolulu.....	\$168.00
Payment for taxable portion (20/2400 x \$168).....	\$1.40
Tax due (7.5% (rate in effect on date of payment) x \$1.40).....	\$0.11

(All distances and fares assumed for purposes of this example. This example addresses only the computation of the tax imposed by section 4261(a). It does not address the computation of any other tax imposed by section 4261 that may apply to these facts.)

(e) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### §49.4262(c)-1 [Redesignated]

Par. 18. Section 49.4262(c)-1 is redesignated as §49.4262-3.

Par. 19. Newly redesignated §49.4262-3 is amended as follows:

1. In the first sentence of paragraph (a), removing “includes only the 48 States existing on July 25, 1956 (the date of the enactment of the Act of July 25, 1956 (Pub. L. 796, 84th Cong., 70 Stat. 644)) and the District of Columbia” and adding “means the District of Columbia and the States other than Alaska and Hawaii” in its place.

2. In paragraph (a), the last sentence is removed.

3. In paragraph (c), removing “six hours” wherever it appears and adding “12 hours” in its place.

4. In paragraph (c), removing “6 hours” wherever it appears and add “12 hours” in its place.

5. In paragraph (c), removing “six-hour” wherever it appears and adding “12-hour” in its place.

6. In paragraph (c)(2), removing “paragraph (a)(2) of §49.4264(c)-1” and adding “§49.4263-3(a)(2)” in its place.

7. Adding paragraphs (d) and (e).

The additions read as follows:

#### §49.4262-3 Definitions.

\* \* \* \* \*

(d) *Transportation.* For purposes of the regulations in this subpart, the term *transportation* includes layover or waiting time and movement of the aircraft in deadhead service.

(e) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### §49.4263-5 [Redesignated]

Par. 20. Section 49.4263-5 is redesignated as §49.4281-1.

Par. 21. Newly redesignated §49.4281-1 is amended by:

1. Revising paragraphs (a) and (b).

2. In paragraph (c), adding a sentence at the end of the paragraph.

3. Adding paragraphs (d) and (e).

The revisions and additions read as follows:

#### §49.4281-1 Small aircraft on nonestablished lines.

(a) *In general.* Amounts paid for the transportation of persons on a small aircraft of the type sometimes referred to as air taxis shall be exempt from the tax imposed under section 4261 of the Internal Revenue Code provided the aircraft has a maximum certificated takeoff weight of 6,000 pounds or less determined as provided in paragraph (b) of this section. The exemption does not apply, however, when the aircraft is operated on an established line or when the aircraft is a jet aircraft.

(b) *Maximum certificated takeoff weight.* The term *maximum certificated takeoff weight* means the maximum certificated takeoff weight shown in the type certificate or airworthiness certificate issued by the Federal Aviation Administration.

(c) \* \* \* An aircraft is not considered as operated on an established line at any time during which the aircraft is being operated on a flight the sole purpose of which is sightseeing.

(d) *Jet aircraft.* For purposes of this section, the term *jet aircraft* does not include any aircraft which is a rotorcraft (such as a helicopter) or propeller aircraft.

(e) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### §49.4264(a)-1 [Redesignated]

Par. 22. Section 49.4264(a)-1 is redesignated as §49.4263-1.

Par. 23. Newly redesignated §49.4263-1 is revised to read as follows:

#### §49.4263-1 Duty to collect the tax; payments made outside the United States.

(a) *Duty to collect tax.* Where payment upon which tax is imposed by section 4261 of the Internal Revenue Code is made outside the United States for a prepaid order, exchange order, or similar order, the person furnishing the initial transportation pursuant to such order must collect the applicable tax. *See* section 4291 and the regulations under section 4291 for cases where persons receiving payment must collect the tax. *See* section 6672 for rules relating to the application of the trust fund recovery penalty.

(b) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### §49.4264(b)-1 [Redesignated]

Par. 24. Section 49.4264(b)-1 is redesignated as §49.4263-2.

#### §49.4263-2 [Amended]

Par. 25. Newly redesignated §49.4263-2 is amended as follows:

1. In the first sentence of paragraph (a), removing “4264(b)” and adding “4263(b) of the Internal Revenue Code (Code)” in its place.

2. In the last sentence of paragraph (a), removing “office of the district director for the district in which the person making the report is located,” and adding “Commissioner” in its place.

3. In paragraph (b), adding “of the Code” at the end of the paragraph.

4. In paragraph (c), removing “*Illustration.*” and adding “*Example.*” in its place.

5. In the last sentence of paragraph (c), removing “office of the district director of internal revenue for the district in which the carrier is located,” and adding in its place “Commissioner”.

#### §49.4264(c)-1 [Redesignated]

Par. 26. Section 49.4264(c)-1 is redesignated as §49.4263-3.

Par. 27. Newly redesignated §49.4263-3 is amended by:

1. Revising paragraph (a).
2. In paragraph (b), removing the second sentence.
3. In paragraph (b), removing “4264” wherever it appears and adding “4263” in its place.
4. In paragraph (b), adding “of the Code” after “4291” in the first sentence.
5. Removing and reserving paragraph (c).
6. Adding paragraph (d).

The revisions and additions read as follows:

**§49.4263-3 Special rule for the payment of tax.**

(a) *In general.* For the rules applicable under section 4263(c) of the Internal Revenue Code, see §49.4261-1(b)(2).

\*\*\*\*\*

(d) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

**§49.4264(d)-1 [Redesignated]**

Par. 28. Section 49.4264(d)-1 is redesignated as §49.4263-4.

**§49.4263-4 [Amended]**

Par. 29. Newly redesignated §49.4263-4 is amended by removing “4264(d)” and adding “4263(d)” in its place.

**§49.4264(e)-1 [Redesignated]**

Par. 30. Section 49.4264(e)-1 is redesignated as §49.4263-5.

**§49.4264(f)-1 [Redesignated]**

Par. 31. Section 49.4264(f)-1 is redesignated as §49.4263-6.

**§49.4263-6 [Amended]**

Par. 32. Newly redesignated §49.4263-6 is amended by removing and reserving paragraph (b).

Par. 33. Section 49.4271-1 is amended by revising paragraphs (a) and (b) and adding paragraph (g) to read as follows:

**§49.4271-1 Tax on transportation of property by air.**

(a) *Purpose of this section.* Section 4271 of the Internal Revenue Code (Code) imposes a 6.25 percent tax on amounts paid within or without the United States for the taxable transportation of property (as defined in section 4272 of the Code). This section sets forth rules as to the general applicability of the tax. This section also sets forth rules authorized by section 4272(b)(2) which exempt from tax payments for the transportation of property by air in the course of exportation (including shipment to a possession of the United States) by continuous movement, and in due course so exported.

(b) *Imposition of tax*—(1) The tax imposed by section 4271 applies only to amounts paid to persons engaged in the business of transporting property by air for hire.

(2) The tax imposed by section 4271 does not apply to amounts paid for the transportation of property by air if such transportation is furnished on an aircraft having a maximum certificated takeoff weight (as defined in section 4281(b) of the Code) of 6,000 pounds or less, unless such aircraft is operated on an established line or when such aircraft is a jet aircraft. The tax imposed by section 4271 also does not apply to any payment made by one member of an affiliated group (as defined in section 4282(b) of the Code) to another member of such

group for services furnished in connection with the use of an aircraft if such aircraft is owned or leased by a member of the affiliated group and is not available for hire by persons who are not members of such group.

\*\*\*\*\*

(g) *Applicability date.* This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

Par. 34. Section 49.4271-2 is added to read as follows:

*§49.4271-2 Aircraft management services.*

For rules regarding the exemption for certain amounts paid by aircraft owners for aircraft management services, *see* §49.4261-10. This section applies to amounts paid on and after January 19, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

**§49.4282-1 [Reserved]**

Par. 35. Add and reserve §49.4282-1.

Sunita Lough,  
Deputy Commissioner for Services  
and Enforcement.

Approved: January 10, 2021

David J. Kautter,  
Assistant Secretary of the Treasury  
(Tax Policy)

(Filed by the Office of the Federal Register on January 14, 2021, 4:15 pm., and published in the issue of the Federal Register for January 19, 2021, 86 F.R. 4990)

# Part III

## Waiver of Information Reporting Requirements with Respect to Certain Amounts Excluded from Gross Income

### Notice 2021-6

#### I. PURPOSE

This notice waives the requirement to file certain information returns or furnish certain payee statements otherwise required by the Internal Revenue Code (Code) pursuant to section 279 of the COVID-related Tax Relief Act of 2020 (COVID Relief Act), enacted as Subtitle B of Title II of Division N of the Consolidated Appropriations Act, 2021, Pub. L. 116-260, 134 Stat. 1182 (December 27, 2020) (CAA 2021). Specifically, this notice waives the requirement to file certain information returns or furnish certain payee statements otherwise required by chapter 61 of the Code with respect to amounts excluded from gross income by reason of section 7A(i) of the Small Business Act (15 U.S.C. § 631 et seq.) or sections 276(b), 277, or 278 of the COVID Relief Act. This notice also obsoletes Announcement 2020-12, 2020-41 I.R.B. 893.

#### II. BACKGROUND

Section 1102 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (March 27, 2020), as amended by the Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142, 134 Stat. 641 (June 5, 2020) (collectively, CARES Act), established the Paycheck Protection Program (PPP), allowing qualifying businesses (eligible recipients) to obtain loans guaranteed by the Administrator of the Small Business Administration (Administrator) under section 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)) (PPP covered loans). Section 1106 of the CARES Act (originally codified at 15 U.S.C. § 9005) provides that an eligible recipient of a PPP covered loan is eligible

for forgiveness of indebtedness for all or a portion of the stated principal amount of the PPP covered loan if certain conditions are satisfied. Section 304 of the Economic Aid to Hard-Hit Small Businesses, Non-profits, and Venues Act (Economic Aid Act), enacted as Title III of Division N of the CAA 2021, redesignated, transferred, and amended section 1106 of the CARES Act (15 U.S.C. § 9005) as section 7A of the Small Business Act, to be inserted after section 7 of the Small Business Act (15 U.S.C. § 636). Section 276(a)(1) of the COVID Relief Act amended section 7A(i) of the Small Business Act, as redesignated, transferred, and amended by the Economic Aid Act, to provide that, for taxable years ending after March 27, 2020 (the date of the enactment of the CARES Act), no amount is included in the gross income of an eligible recipient by reason of forgiveness of a PPP covered loan.

Section 311 of the Economic Aid Act authorizes Paycheck Protection Program Second Draw (PPP II) covered loans for qualifying businesses (eligible entities) guaranteed by the Administrator under section 7(a)(37) of the Small Business Act (15 U.S.C. § 636(a)(37)), and provides that an eligible entity is eligible for forgiveness of a PPP II covered loan in the same manner as an eligible recipient with respect to a PPP covered loan made under section 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)). Section 276(b)(1) of the COVID Relief Act provides that no amount of a forgiven PPP II loan is included in the gross income of an eligible entity.

Sections 3504, 18004, and 18008 of the CARES Act authorize institutions of higher learning to award emergency financial aid grants to assist students with unexpected expenses and unmet financial needs that result from a qualifying emergency and with expenses related to the disruption of campus operations due to the COVID-19 pandemic. Section 277(a) of the COVID Relief Act provides that these grants, as well as other emergency financial aid grants made to students in response to a qualifying emergency (as defined in section 3502(a)(4) of the CARES Act), are not included in the gross income of a student receiving such a grant.

Section 1109 of the CARES Act authorizes the Department of the Treasury (Treasury Department), in consultation with the Administrator, and the Chairman of the Farm Credit Administration to establish criteria for various lenders that do not already participate in lending under Small Business Administration programs, to participate in the PPP to provide loans. Section 1109(d)(2)(D) requires that lenders use terms and conditions that, to the maximum extent practicable, are consistent with the terms and conditions for PPP covered loan forgiveness under section 1106 of the CARES Act. Section 278(a)(1) of the COVID Relief Act provides that no amount of such a forgiven loan is included in the gross income of a borrower.

Section 1110 of the CARES Act (15 U.S.C. § 9009) and section 331 of the Economic Aid Act provide for Economic Injury Disaster Loan grants (EIDL grants) to certain eligible entities under section 7(b)(2) of the Small Business Act (15 U.S.C. § 636(b)(2)). Section 278(b)(1) of the COVID Relief Act provides that an advance under section 1110(e) of the CARES Act or any funding under section 331 of the Economic Aid Act is not included in the gross income of the person that receives such advance or funding.

Section 1112(c) of the CARES Act (15 U.S.C. § 9011(c)) authorizes the Administrator to subsidize certain loan payments by paying principal, interest, and any associated fees owed on certain loans. Section 278(c)(1) of the COVID Relief Act provides that such a payment is not included in the gross income of the person on whose behalf the payment is being made. Section 278(c)(2) provides that no deduction shall be denied by reason of the exclusion of the loan payments from gross income.

Section 324(b) of the Economic Aid Act authorizes the Administrator to provide grants to shuttered venue operators. Section 278(d)(1) of the COVID Relief Act provides that such a grant is not included in the gross income of the person that receives the grant.

Section 279 of the COVID Relief Act authorizes the Secretary of the Treasury or the Secretary's delegate to provide an

exception from any requirement to file an information return otherwise required under chapter 61 of the Code with respect to any amount excluded from gross income by reason of section 7A(i) of the Small Business Act or sections 276(b), 277, or 278 of the COVID Relief Act.

Announcement 2020-12, published prior to the enactment of the COVID Relief Act, stated that when all or a portion of the stated principal amount of a covered loan is forgiven because the eligible recipient satisfies the forgiveness requirements under section 1106 of the CARES Act, an applicable entity is not required to, for federal income tax purposes only, and should not, file a Form 1099-C, *Cancellation of Debt*, information return with the Internal Revenue Service (IRS) or provide a payee statement to the eligible recipient under section 6050P of the Code as a result of the qualifying forgiveness.

### III. GRANT OF RELIEF

Under the authority provided by section 279 of the COVID Relief Act, the Treasury Department and the IRS waive the requirement to file information returns or furnish payee statements as described in the following list:

1. *Original PPP covered loan forgiveness.* A lender is not required to file with the IRS, or furnish to a borrower, a Form 1099-C reporting forgiveness of PPP covered loans under section 7A(i) of the Small Business Act as redesignated, transferred, and amended by the Economic Aid Act.
2. *PPP II covered loan forgiveness.* A lender is not required to file with the IRS, or furnish to a borrower, a Form 1099-C reporting forgiveness of PPP II covered loans under section 311 of the Economic Aid Act.
3. *Student emergency financial aid grants.* A grantor is not required to file with the IRS, or furnish to a student, a Form 1099-MISC, *Miscellaneous Information*, reporting the payment of an emergency grant to the student under section 3504, 18004, or 18008 of the CARES Act or another emergency financial aid grant described in section 277(b)(3) of the COVID Relief Act made to students in response to qualifying emergencies.

4. *Treasury Program loan forgiveness.* A lender is not required to file with the IRS, or furnish to a borrower, a Form 1099-C reporting forgiveness of loans under section 1109 of the CARES Act.
5. *EIDL grants.* The Administrator is not required to file with the IRS, or furnish to a recipient, a Form 1099-MISC reporting the payment of an advance under section 1110(e) of the CARES Act or a grant under section 331 of the Economic Aid Act.
6. *Loan subsidies.* Neither the Administrator nor a lender is required to file with the IRS, or furnish to a borrower, a Form 1099-MISC reporting the payment of principal, interest, and any associated fees through a loan subsidy authorized under section 1112(c) of the CARES Act.
7. *Shuttered venue operator grants.* The Administrator is not required to file with the IRS, or furnish to a recipient, a Form 1099-MISC reporting the payment of a grant to a shuttered venue operator under section 324(b) of the Economic Aid Act.

### IV. OTHER INFORMATION REPORTING

The waivers of information reporting requirements described in section III of this notice apply only to requirements to file and furnish Form 1099 series information returns and payee statements for the described grants, payments, subsidies, or loan forgiveness, which are excluded from gross income. The waivers do not affect any requirements to file and furnish other forms, such as forms in the 1098 series. For example, the waiver does not apply to the requirement to file and furnish Form 1098-T, *Tuition Statement*, with respect to any payments received for qualified tuition and related expenses, including qualified tuition and related expenses paid with grants described in this notice.

Because borrowers may deduct mortgage interest that the Small Business Administration (SBA) paid to lenders under section 1112 of the CARES Act, lenders may include those mortgage interest payments in Box 1 of Form 1098, *Mortgage Interest Statement*, notwithstanding § 1.6050H-1(e)(3)(ii) of the Income Tax

Regulations. The payments should be included on both the Form 1098 that is filed with the IRS and the copy that is furnished to borrowers. Including this interest on Form 1098 will inform borrowers of the total amount of mortgage interest they may deduct. In addition, this reporting will avoid discrepancies between interest reported to the IRS and interest claimed as a deduction by borrowers on their income tax returns. The filing of information returns with the IRS omitting mortgage interest that the SBA paid to lenders under section 1112 of the CARES Act could result in the issuance of underreporter notices (IRS Letter CP2000) to eligible recipients who correctly deduct that interest. Lenders who are unable to furnish by February 1, 2021, a Form 1098 to a borrower that includes mortgage interest that the SBA paid to lenders under section 1112 of the CARES Act may furnish a corrected Form 1098 including this interest in box 1. Lenders are encouraged to do so as promptly as possible.

### V. EFFECT ON OTHER DOCUMENTS

Announcement 2020-12 is obsolete.

### VI. DRAFTING INFORMATION

The principal author of this notice is Isaac Brooks Fishman of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Isaac Brooks Fishman at (202) 317-5436 (not a toll-free number).

## Relief from Addition to Tax for Underpayment of Estimated Income Tax by Individuals Affected by Amendment to Section 461(l)(1)(B)

### Notice 2021-8

#### SECTION 1. PURPOSE

This notice provides a waiver of the addition to tax under § 6654 of the Internal

Revenue Code (Code) for underpayment of estimated income tax by individual taxpayers, where the underpayment is attributable to the amendment to § 461(l)(1)(B) of the Code made by section 2304(a) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (March 27, 2020). To qualify for the relief provided in section 4.01 of this notice, the individual taxpayer must fulfill the requirements stated in section 4.02 of this notice.

## SECTION 2. SCOPE

.01 *Limited relief for addition to tax attributable to amendment to § 461(l)(1)(B)*. The relief provided in section 4.01 of this notice is limited to waiving an amount of the addition to tax under § 6654 that is attributable solely to the CARES Act amendment to § 461(l)(1)(B). The relief provided does not waive the addition to tax under § 6654 that is attributable to other CARES Act provisions, including the CARES Act amendment to § 172(b) of the Code. The relief is limited to individual taxpayers whose circumstance is described in section 3.02(3)(a) of this notice and is subject to other limitations provided in this notice.

.02 *Relief available only for certain installments due on or before July 15, 2020*. The relief provided in section 4.01 of this notice applies only for the purpose of calculating installments of estimated income tax of an individual taxpayer that were due on or before July 15, 2020, with respect to the taxable year that began during 2019. Regarding calculating the amounts of installments of estimated income tax of an individual taxpayer due after July 15, 2020, § 6654 applies in the normal course, and section 4.01 of this notice does not apply. Thus, in the case of a fiscal-year individual taxpayer, for the purpose of calculating any required installment amount for the taxable year that began in 2019 that is due after July 15, 2020, the individual taxpayer must calculate the required annual payment by using the income tax figures on the original income tax return of the taxable year that began in 2019, as if no relief under section 4.01 of this notice were provided.

.03 *Relief available to certain trusts and estates*. The relief described in sec-

tion 4.01 of this notice is available to any qualifying estate or trust that is treated as an individual for purposes of § 6654 and that is subject to the § 6654 estimated tax payment requirements with respect to its income. For purposes of this notice, any reference to an individual includes a reference to a trust or estate that is treated as an individual for purposes of § 6654.

## SECTION 3. BACKGROUND

.01 *Underpayment of estimated income tax by individual*.

(1) *Estimated income tax and liability for addition to tax*. Generally, the Code requires taxpayers to pay Federal income taxes as they earn income. To the extent these taxes are not withheld from wages or other income, a taxpayer normally must pay estimated income tax on a quarterly basis. Individual taxpayers who fail to make a sufficient or timely payment of estimated income tax are liable for an addition to tax under § 6654(a).

(2) *Quarterly payments of estimated income tax*. Section 6654 provides that, in the case of an individual, estimated income tax is generally required to be paid in four installments, each in the amount of 25 percent of the required annual payment. Generally, under § 6654(d)(1)(B), the required annual payment is the lesser of (i) 90 percent of the tax shown on the return for the taxable year; or (ii) 100 percent of the tax shown on the return of the individual for the preceding taxable year (110 percent if the individual's adjusted gross income on the previous year's return exceeded \$150,000), provided that the preceding taxable year was 12 months in duration and the individual filed a return for that preceding taxable year. An individual taxpayer whose income varies during the taxable year may be able to use the annualized income installment method described in § 6654(d)(2) to reduce the installment amount for installments for the taxable year that are due earlier, consequently increasing the installment amount for installments for the taxable year that are due later.

(3) *Required annual payment based on original return*. The required annual payment is based on the tax shown on the original income tax return (original return) for the taxable year, rather than the tax

shown on any amended income tax return (amended return). In § 6654(d)(1)(B), the term "return for the taxable year" refers to the original return for the taxable year and does not refer to an amended return filed after the filing due date of the return for the taxable year. *See, e.g., Mendes v. Commissioner*, 121 T.C. 308, 324 (2003) ("We have repeatedly held that a taxpayer's estimated tax liability is based upon the taxpayer's tax liability as stated on the original tax return as filed . . ."). Thus, for example, for the 2019 taxable year, the return for the taxable year of a calendar-year taxpayer is the return filed by July 15, 2020, or by October 15, 2020, if the taxpayer received an extension of time to file under § 6081 of the Code. Similarly, § 1.6654-2(b)(3) of the Income Tax Regulations provides that, with respect to an individual, the term "return for the preceding taxable year" means the individual's income tax return for that preceding taxable year required by § 6012(a)(1) of the Code and the individual's self-employment tax return for that preceding year which is required by § 6017 of the Code (that is, the original return of the individual for that preceding taxable year) and does not refer to an amended return filed after the filing due date of that return. For purposes of § 6654, an amended return filed before the filing due date is considered the original return, but an amended return filed after the filing due date is not considered the original return. However, a joint return filed after the filing due date that replaces previously filed separate returns is considered the original return. *See* § 6013(b)(1); Rev. Rul. 80-355, 1980-2 C.B. 374 (Dec. 22, 1980).

(4) *Due dates for installments of estimated income tax*. Estimated income tax installments of an individual having a calendar-year taxable year generally are due on April 15, June 15, and September 15 of the taxable year, and on January 15 of the following year. *See* § 6654(c)(2). For an individual with a fiscal-year taxable year, the due dates of installments of estimated income tax are determined by substituting corresponding months. *See* § 6654(k)(1). Certain taxpayers are subject to specialized installment amounts and due dates. *See* §§ 6654(h), (i), and (j).

(5) *Exceptions to the addition to tax*. An individual taxpayer will not be subject



to the addition to tax under § 6654(a) if an exception applies. Under § 6654(e)(1), no addition to tax will be imposed on an individual taxpayer if the taxpayer owes less than \$1,000 in tax, after subtracting tax withheld on wages. Under § 6654(e)(2), an individual will not be subject to an addition to tax if (i) the individual did not have any tax liability for the previous taxable year, (ii) the preceding taxable year was 12 months, and (iii) the individual was a citizen or resident of the United States throughout the preceding taxable year. Under § 6654(e)(3)(A), the addition to tax will not be imposed with respect to any underpayment to the extent the Secretary of the Treasury or his delegate (Secretary) “determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.”

*.02 Limitation on excess business losses of noncorporate taxpayers.* Section 461(l)(1)(B) disallows the deduction of an excess business loss (as defined in section 3.02(1) of this notice) in the taxable year in which the loss is incurred.

(1) *Excess business loss.* The term “excess business loss” is defined generally as the excess (if any) of (a) the aggregate deductions for the taxable year attributable to trades or businesses of a non-corporate taxpayer, over (b) the sum of (i) the aggregate gross income or gain for the taxable year attributable to such trades or businesses of such taxpayer, and (ii) \$250,000 (\$500,000 in the case of a joint return) subject to adjustment for inflation for taxable years beginning after 2018. *See* § 461(l)(3)(A) and (C). An excess business loss is determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee. *See* § 461(l)(3)(A). Capital loss deductions are not taken into account in computing an excess business loss. *See* § 461(l)(3)(B)(i). The amount of capital gain taken into account in calculating the excess business loss cannot exceed the lesser of capital gain net income attributable to a trade or business or capital gain net income. *See* § 461(l)(3)(B)(ii). Any disallowed excess business loss is treated as a net operating loss (NOL) for the taxable year for purposes of determining any NOL carryover under § 172(b) for subsequent taxable years. *See* § 461(l)(2).

(2) *CARES Act amendment to § 461(l)(1)(B).* Prior to enactment of the CARES Act, the disallowance under § 461(l)(1)(B) applied to any taxable year beginning after December 31, 2017, and before January 1, 2026. Section 2304(a) of the CARES Act amended § 461(l)(1)(B) to make the disallowance applicable only for any taxable year beginning after December 31, 2020, and before January 1, 2026.

(3) *Potential underpayments of estimated income tax resulting from CARES Act amendment to § 461(l)(1)(B).*

(a) *Addition to tax.* An individual taxpayer may have underpaid one or more installments of estimated income tax for the taxable year that began in 2019, if the individual taxpayer anticipated having a lower required annual payment after utilizing an NOL carryover attributable to a prior-year excess business loss that, before the enactment of the CARES Act, would have been available as an NOL carryover to reduce taxable income in the taxable year that began in 2019 but now is no longer available due to the CARES Act amendment to § 461(l)(1)(B). Such an individual taxpayer may be liable for an addition to tax for underpayment of estimated income tax for the taxable year that began in 2019, if the individual taxpayer does not have zero tax liability for the previous taxable year or does not otherwise qualify for the exception provided in § 6654(e)(2).

(b) *Exception to addition to tax based on equity and good conscience considerations.* The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have determined that it would be against equity and good conscience to impose an addition to tax under § 6654 for certain underpayments of estimated income tax resulting from changes made by the CARES Act to § 461(l)(1)(B). The relief provided in section 4.01 of this notice is intended for individual taxpayers whose circumstance is described in section 3.02(3)(a) of this notice.

(4) *Potential underpayments of estimated income tax resulting from CARES Act amendment to § 172(b).*

(a) *Five-year NOL carryback and waiver.* Section 2303(b) of the CARES Act amended § 172(b) to provide a five-year carryback for NOLs arising in taxable years beginning after December 31,

2017, and before January 1, 2021. *See* § 172(b)(1)(D)(i). Under § 172(b)(3), taxpayers, including corporate and individual taxpayers, may elect to forgo the new five-year carryback of such NOLs. The Treasury Department and the IRS understand that, in the absence of an election under § 172(b)(3), corporate and individual taxpayers may have underpaid one or more installments of estimated income tax for the taxable year that began in 2019 due to consequences similar to those described in section 3.02(3)(a) of this notice.

(b) *No exception to addition to tax based on equity and good conscience considerations.* The Treasury Department and the IRS have determined that the effect on estimated income tax requirements of the CARES Act amendment to § 461(l)(1)(B) is distinguishable from the effect of the CARES Act amendment to § 172(b). Specifically, the Treasury Department and the IRS note that an individual taxpayer cannot make an election to opt out of the effect of the CARES Act amendment to § 461(l)(1)(B). In contrast, taxpayers may elect under § 172(b)(3) to forgo the new five-year carryback for NOLs. As a result, the Treasury Department and the IRS have determined that it would not be against equity and good conscience to impose an addition to tax under § 6654 for underpayments of estimated income tax resulting from changes made by the CARES Act to § 172(b), and thus have decided not to provide relief with respect to the new NOL carryback that taxpayers may elect to forgo.

#### **SECTION 4. LIMITED WAIVER OF ADDITION TO TAX FOR UNDERPAYMENT OF ESTIMATED INCOME TAX**

*.01 Waiver.* If an individual taxpayer’s circumstance is described in section 3.02(3)(a) of this notice and the individual taxpayer satisfies all of the qualification requirements described in section 4.02 of this notice, a portion of the addition to tax under § 6654 that is attributable to the CARES Act amendment to § 461(l)(1)(B) will be waived for the individual taxpayer’s installments of estimated income tax that were due on or before July 15, 2020, with respect to any taxable year that began during 2019. The amount of the waiver is

determined under section 4.02(3)(b) of this notice. This waiver is provided under the authority granted to the Secretary under § 6654(e)(3)(A).

**.02 Qualification requirements.** To qualify for the waiver provided in section 4.01 of this notice, an individual taxpayer must satisfy all of the requirements described in this section 4.02.

(1) **2019 taxable year.** The individual taxpayer must have a 12-month taxable year for the taxable year that began in 2019.

(2) **Timely filed 2018 Federal income tax return.** The individual taxpayer must have timely filed an original income tax return for the taxable year that began during 2018 that reported an excess business loss on Form 461, *Limitation on Business Losses*.

(3) **Qualifying waiver request.** The individual taxpayer must make a request for the waiver provided in section 4.01 of this notice in accordance with all of the requirements described in this section 4.02(3).

(a) **Timely filed 2019 Federal income tax return.** The individual taxpayer must timely file an original income tax return for the affected taxable year that began during 2019 and correctly account for the CARES Act amendment to § 461(l)(1)(B) on the original income tax return for that taxable year.

(b) **Complete 2019 Form 2210 or Form 2210-F.** The individual taxpayer must complete the 2019 version of Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts*, or the 2019 version of Form 2210-F, *Underpayment of Estimated Tax by Farmers and Fishermen*, as applicable, for the affected taxable year that began during 2019.

(i) **Required calculation of applicable taxes.** A taxpayer requesting relief under this notice must determine lines 1 through 3 of Form 2210, or lines 1 through 5 of Form 2210-F, by calculating the figures and amount of applicable taxes resulting from a revised amount of taxable income. For this purpose, the term “revised amount of taxable income” means the taxable income of the individual taxpayer, as reported on the original income tax return (as described in section 3.01(3) of this notice) for the taxable year that began in 2019, reduced (but

not below zero) by the Taxable Income Reduction Amount (as defined in section 4.03(1) of this notice).

(ii) **Calculation of required annual payment and installment payments.** The individual taxpayer must use the resulting current year tax (line 4 of Form 2210, or line 6 of Form 2210-F) to calculate the required annual payment and the required installment payments for installments due on or before July 15, 2020.

(iii) **Calculation involving annualized income installment method.** An individual taxpayer using the annualized income installment method under § 6654(d)(2) must also reduce (but not below zero) the amount in each column of line 13 of Schedule AI of Form 2210 by the Taxable Income Reduction Amount (as defined in section 4.03(1) of this notice) if the column relates to an installment due on or before July 15, 2020.

(c) **Attachments to Form 2210 or Form 2210-F.** The individual taxpayer must attach to the Form 2210 or the Form 2210-F:

(i) The Form 461 filed as part of the timely filed original income tax return for the taxable year that began in 2018;

(ii) The Form 461 filed as part of the most recent amended income tax return filed before March 27, 2020, for the taxable year that began in 2018, if an amended income tax return for that taxable year was filed before March 27, 2020; and

(iii) A statement detailing how the taxpayer determined its Taxable Income Reduction Amount (as defined in section 4.03(1) of this notice).

(d) **Designation.** The individual taxpayer must include “Notice 2021-8” on the top of the Form 2210 or Form 2210-F.

(e) **Submission of forms.** The individual taxpayer must submit the Form 2210 or Form 2210-F either with an original or amended income tax return for the affected taxable year that began in 2019, or, if an original income tax return for that taxable year has already been filed and the § 6654 addition to tax that is to be the subject of the relief has already been paid, then with a Form 843, *Claim for Refund and Request for Abatement*. The Form 2210 or Form 2210-F may be submitted electronically with an electronically filed Form 1040-X, *Amended U.S. Individual Income Tax Return*.

**.03 Taxable Income Reduction Amount.**

(1) **General definition.** The term “Taxable Income Reduction Amount” means, regarding an individual taxpayer, the lesser of:

(a) The amount by which the 2018 EBL (as defined in section 4.03(2)(a) of this notice) would have reduced (but not below zero) the Pre-CARES Act 2018 Taxable Income (as defined in section 4.03(2)(b) of this notice) if the 2018 EBL were not disallowed; and

(b) The amount equal to 80 percent of the taxable income that would have been determined for the taxable year that began in 2019 if the CARES Act had not been enacted, computed without regard to the deduction allowable under § 172.

(2) **Additional definitions.** For purposes of this section 4.03, regarding an individual taxpayer:

(a) **2018 EBL.** The term “2018 EBL” means the following:

(i) If the individual taxpayer did not file an amended income tax return before March 27, 2020, for the taxable year that began in 2018, the term “2018 EBL” means the excess business loss reported on the individual taxpayer’s timely filed original income tax return for the taxable year that began in 2018.

(ii) If the individual taxpayer filed an amended income tax return before March 27, 2020, for the taxable year that began in 2018, the term “2018 EBL” means the lesser of:

(A) The excess business loss reported on the individual taxpayer’s timely filed original income tax return for the taxable year that began in 2018; and

(B) The excess business loss reported on the most recent amended income tax return filed before March 27, 2020, for the taxable year that began in 2018.

However, if the amounts described in sections 4.03(2)(a)(ii)(A) and (B) of this notice are equal, the term “2018 EBL” means the amount stated in section 4.03(2)(a)(ii)(B) of this notice.

(b) **Pre-CARES Act 2018 Taxable Income.** The term “Pre-CARES Act 2018 Taxable Income” means the following:

(i) If the 2018 EBL is based on the taxpayer’s timely filed original income tax return, as described in section 4.03(2)(a)(i) or section 4.03(2)(a)(ii)(A) of this notice, the term “Pre-CARES Act 2018

Taxable Income” means the amount of taxable income reported on the timely filed original income tax return of the individual taxpayer for the taxable year that began in 2018 (that is, the amount on line 10 of the 2018 Form 1040, U.S. Individual Income Tax Return, or the comparable line of any other applicable 2018 income tax return).

(ii) If the 2018 EBL is based on the taxpayer’s most recent amended income tax return filed before March 27, 2020, as described in section 4.03(2)(a)(ii)(B) of this notice, the term “Pre-CARES Act 2018 Taxable Income” means the amount of taxable income of the individual taxpayer reported on the most recent amended income tax return filed before March 27, 2020, for the taxable year that began in 2018.

(3) *Examples.* The examples in sections 4.03(3)(b) and (c) of this notice illustrate the determination of the Taxable Income Reduction Amount as defined in section 4.03(1) of this notice.

(a) *Assumptions applicable to both examples.* For the purpose of these examples, assume all of the following:

(i) The taxpayer is an individual calendar-year taxpayer.

(ii) The taxpayer satisfies all conditions for the waiver described in section 4.02 of this notice.

(iii) No loss limitation rule applies to the taxpayer.

(iv) The taxpayer, before the enactment of the CARES Act, would have had taxable income (determined without regard to the deduction allowable under § 172) in the 2019 taxable year of \$1,000,000, so that the amount stated in section 4.03(1)(b) (80 percent of the taxable income that would have been determined for the taxable year that began in 2019 if the CARES Act had not been enacted and computed without regard to the deduction allowable under § 172) is \$800,000.

(b) *Example 1.* Assume that the taxpayer has a 2018 EBL of \$1,000,000 and Pre-CARES Act 2018 Taxable Income of \$1,500,000. As a result, the amount stated in section 4.03(1)(a) (the amount by which the 2018 EBL would reduce the Pre-CARES Act 2018 Taxable Income if the 2018 EBL were not disallowed) is \$1,000,000. The Taxable Income Reduction Amount is \$800,000, the lesser of \$1,000,000 and \$800,000.

(c) *Example 2.* Assume that the taxpayer has a 2018 EBL of \$1,000,000 and Pre-CARES Act 2018 Taxable Income of \$700,000. As a result, the amount stated in section 4.03(1)(a) (the amount by which the 2018 EBL would reduce the Pre-CARES Act 2018 Taxable Income if the 2018 EBL were not disallowed) is \$700,000. The Taxable Income Reduction Amount is \$700,000, the lesser of \$700,000 and \$800,000.

## SECTION 5. ADDITIONAL INFORMATION

Visit [IRS.gov/Form2210](https://www.irs.gov/Form2210), [IRS.gov/Form2210F](https://www.irs.gov/Form2210F), or [IRS.gov](https://www.irs.gov) more generally for forms, instructions, and additional information.

The principal author of this notice is Alexander Wu of the Office of the Associate Chief Counsel (Procedure and Administration). For further information, please contact Mr. Wu at (202) 317-6845 (not a toll-free number).

## Additional Relief with Respect to Employment Tax Deadlines Applicable to Employers Affected by the Ongoing Coronavirus (COVID-19) Disease 2019 Pandemic

### Notice 2021-11

#### I. PURPOSE

Pursuant to section 274 of the COVID-related Tax Relief Act of 2020, which was enacted as Subtitle B of Title II of Division N of the Consolidated Appropriations Act, 2021, Pub. L. 116-260, 134 Stat.1182 (Dec. 27, 2020), this notice modifies Notice 2020-65, 2020-38 I.R.B. 567 (September 14, 2020), by extending the time period during which employers must withhold and pay Applicable Taxes (as defined in Notice 2020-65 and described herein). Specifically, this notice provides that the end date of the period during which employers must withhold and pay Applicable Taxes is postponed from April 30, 2021, to December 31, 2021, and associated interest, penalties, and additions to tax for late payment with respect to any unpaid Applicable Taxes will begin to accrue on January 1, 2022, rather than on May 1, 2021.

#### II. BACKGROUND

On August 8, 2020, the President of the United States issued a Presidential

Memorandum directing the Secretary of the Treasury to use his authority pursuant to section 7508A of the Internal Revenue Code (Code) to defer the withholding, deposit, and payment of certain payroll tax obligations. Section 7508A provides the Secretary of the Treasury or his delegate (Secretary) with authority to postpone the time for performing certain acts under the internal revenue laws for a taxpayer determined by the Secretary to be affected by a Federally declared disaster as defined in section 165(i)(5)(A). Pursuant to section 7508A(a), a period of up to one year may be disregarded in determining whether the performance of certain acts is timely under the internal revenue laws.

In Notice 2020-65, the Secretary determined that employers that are required to withhold and pay the employee share of social security tax under section 3102(a) or the railroad retirement tax equivalent under section 3202(a) are affected by the COVID-19 emergency for purposes of the relief described in the Presidential Memorandum (Affected Taxpayers). For Affected Taxpayers, Notice 2020-65 postponed the due date for the withholding and payment of the tax imposed by section 3101(a), and so much of the tax imposed by section 3201 as is attributable to the rate in effect under section 3101(a), on Applicable Wages (collectively Applicable Taxes) until the period beginning on January 1, 2021, and ending on April 30, 2021. Notice 2020-65 also provided that for purposes of the notice, Applicable Wages means wages as defined in section 3121(a) or compensation as defined in section 3231(e) paid to an employee on a pay date during the period beginning on September 1, 2020, and ending on December 31, 2020, but only if the amount of such wages or compensation paid for a bi-weekly pay period is less than the threshold amount of \$4,000, or the equivalent threshold amount with respect to other pay periods, determined on a pay period-by-pay period basis.

Section 274 of the COVID-related Tax Relief Act of 2020 requires the Secretary to ensure that Notice 2020-65, and any successor or related regulation, notice, or guidance, is applied by substituting “December 31, 2021” for “April 30, 2021”

and by substituting “January 1, 2022” for “May 1, 2021” in each place it appears.

### III. MODIFICATION TO NOTICE 2020-65

In response to section 274 of the COVID-related Tax Relief Act of 2020, the relief provided by Notice 2020-65 is modified as follows: for Affected Taxpayers, the due date for the withholding and payment of Applicable Taxes is postponed until the period beginning on January 1, 2021, and ending on December 31, 2021.<sup>1</sup>

An Affected Taxpayer must withhold and pay the total Applicable Taxes deferred under Notice 2020-65 ratably from wages and compensation paid between January 1, 2021 and December 31, 2021, or interest, penalties, and additions to tax will begin to accrue on January 1, 2022, with respect to any unpaid Applicable Taxes. If necessary, an Affected Taxpayer may make arrangements to otherwise collect the total Applicable Taxes from an employee.

### IV. EFFECT ON OTHER DOCUMENTS

Notice 2020-65 is modified.

### V. DRAFTING INFORMATION

The principal authors of this notice are attorneys of the Office of Associate Chief Counsel, Employee Benefits, Exempt Organizations, and Employment Taxes, with the participation of staff from other offices. For further information regarding the guidance under this notice, please call (202) 317-4774 (not a toll-free number).

## Notice 2021-12

### I. PURPOSE

Because of the Coronavirus Disease 2019 (COVID-19) pandemic, the De-

partment of the Treasury and the Internal Revenue Service issued Notice 2020-53, 2020-30 I.R.B. 151, to provide temporary relief from certain requirements under § 42 of the Internal Revenue Code (Code) for qualified low-income housing projects and under §§ 142(d) and 147(d) of the Code for qualified residential rental projects. In response to the continuing presence of the pandemic, this notice extends that temporary relief and also provides temporary relief from additional § 42 requirements not previously addressed in Notice 2020-53. Section III of this notice describes the persons eligible for the relief granted in sections IV through VI of this notice.

### II. BACKGROUND

#### A. Qualified low-income housing projects

In this notice, the terms “Agency,” and “Owner” have the same meanings as described in section 5 of Rev. Proc. 2014-49, 2014-37 I.R.B. 535.

Section 42(a) provides that the amount of the low-income housing credit for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under § 42(d)(5)). Section 42(c)(1)(B) defines applicable fraction and § 42(d)(1) and (2) define the eligible basis of a new building and an existing building, respectively.

Section 42(c)(2) defines a qualified low-income building as any building which is part of a qualified low-income housing project at all times during the “compliance period” (that is, the period of 15 taxable years beginning with the first taxable year of the credit period) and to which § 168(e)(2)(A) applies. To be a

qualified low-income housing project, one of the § 42(g) minimum set-aside tests, as elected by the taxpayer, must be satisfied.

Under § 42(d)(4)(A) and (B), the adjusted basis for a qualified low-income building includes the adjusted basis of the property (of a character subject to the allowance of depreciation) used in common areas or provided as comparable amenities to all residential rental units in the building.

Section 42(e) provides general rules under which rehabilitation expenditures incurred by taxpayers related to a low-income building may be treated as a separate new building. Under § 42(e)(3)(A)(ii), to qualify as a separate new building, the rehabilitation expenditures with respect to a low-income building during a 24-month period (§ 42(e) 24-month minimum rehabilitation expenditure period) must be at least the greater of two statutory criteria.

Section 42(f) sets forth the definition and special rules relating to the credit period. Under § 42(f)(3)(A), in the case of any building which was a qualified low-income building as of the close of the first year of the credit period, if as of the close of any taxable year in the compliance period (after the first year of the credit period) the qualified basis of the building exceeds the qualified basis of the building at the close of the first year of the credit period, then the applicable percentage that applies under § 42(a) for the taxable year to such excess will be the percentage equal to 2/3 of the applicable percentage that would otherwise apply. For example, if the credit period begins in the year a building is placed in service, but full occupancy of the building by low-income tenants does not occur until the following (or any subsequent) year, there is an increase in qualified basis and the applicable percentage used to determine credits for this increase is equal to 2/3 of the applicable percentage that would otherwise apply.

Section 42(g) sets forth three alternative minimum set-aside tests for low-income housing projects. The Owner of a project must elect one and satisfy that cho-

<sup>1</sup> Section 7503 of the Code provides that “when the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday.” The term “legal holiday” includes a legal holiday in the District of Columbia. Because December 31, 2021 is a legal holiday, payments made on January 3, 2022, the next day that is not a Saturday, Sunday, or legal holiday, will be considered timely by operation of section 7503 of the Code. Because section 7503 of the Code does not operate to extend the due date for payment, interest and penalties still begin to accrue on January 1, 2022 if payments are not made by January 3, 2022.

sen test each taxable year. Once a taxpayer elects to use a particular set-aside test, the election is irrevocable.

Section 42(h)(1)(E) provides general rules for carryover allocations of the low-income housing credit. A carryover allocation is defined in § 1.42-6(a)(1) of the Income Tax Regulations as an allocation that meets the requirements of § 42(h)(1)(E) (relating to carryover allocations for single buildings) or § 42(h)(1)(F) (relating to carryover allocations for multiple building projects).

Under § 42(h)(1)(E)(i), if a qualified building is placed in service not later than a statutorily specified date, the building is relieved of a requirement concerning the timing of the allocation. Section 42(h)(1)(E)(ii) provides in part, for purposes of § 42(h)(1)(E)(i), that the term “qualified building” means any building which is part of a project if the taxpayer’s basis in the project (as of the date that is 1 year after the date that the allocation was made) is more than 10 percent of the taxpayer’s reasonably expected basis in the project (as of the close of the second calendar year following the calendar year in which an allocation is made) (10-percent test).

In general, under § 42(j)(1), if (1) a building is beyond the first year of the credit period, and (2) at the end of the taxable year, the building’s qualified basis with respect to the taxpayer is less than the qualified basis with respect to the taxpayer at the end of the preceding taxable year, then the credits, if any, for the year of the reduction are determined using the reduced qualified basis, and the taxpayer’s Federal income tax liability for the year of the reduction is increased by the credit recapture amount prescribed in § 42(j)(2).

Section 42(j)(4)(E) provides generally that a building is not subject to recapture by reason of a casualty loss to the extent the loss is restored by reconstruction or replacement within a reasonable period established by the Secretary of the Treasury or his delegate (Secretary).

Section 42(m)(1) requires an Agency to allocate housing credit dollar amounts among candidate proposed housing projects. The allocation must be pursuant to a qualified allocation plan (QAP) that has been approved by the governmental unit of which the Agency is a part. A QAP not only sets forth selection criteria by which

an Agency makes these allocations but also provides a procedure that the Agency must follow in monitoring for noncompliance with the provisions of § 42, including monitoring for noncompliance with habitability standards through regular site visits.

Section 1.42-5 of the Income Tax Regulations provides the general requirements of Agencies’ compliance-monitoring responsibilities under their monitoring procedures that must be part of all QAPs. Among the requirements, an Agency must perform physical inspections and low-income certification review.

Section 1.42-5(c)(1)(iii) requires, generally, that the Owner of a low-income housing project certify at least annually to the Agency that, for the preceding 12-month period, the Owner has received an annual income certification from each low-income tenant, and the documentation to support that certification.

Section 1.42-5(e)(4) defines the correction period for noncompliance as the period specified in an Agency’s compliance-monitoring procedure during which an Owner must supply any missing certifications and bring the project into compliance with the provisions in § 42. The correction period is not to exceed 90 days from the date of the notice to the Owner. An Agency may extend the correction period for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

Under § 1.42-13(a) of the Income Tax Regulations, the Secretary may provide guidance to carry out the purposes of § 42 through various publications in the Internal Revenue Bulletin.

#### B. Qualified residential rental projects financed by bonds

In this notice, the terms “Issuer” and “Operator” have the same meanings as described in section 4 of Rev. Proc. 2014-50, 2014-37 I.R.B. 540.

Generally, under § 103 of the Code, if private activity bonds are not qualified bonds within the meaning of § 141 of the Code, then those private activity bonds are not tax-exempt. Section 141(e) provides in part that the term “qualified bond” means any private activity bond if such bond is an exempt facility bond, and § 142(a) pro-

vides in part that the term “exempt facility bond” means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified residential rental projects. To be a qualified residential rental project, a residential rental housing project must meet the requirements in § 142(d).

Section 142(d)(1) provides that the term “qualified residential rental project” means any project for residential rental property if, at all times during the qualified project period, such project meets the requirements under § 142(d)(1)(A) or (B) (§ 142(d) set-aside requirements), whichever is elected by the Issuer at the time of the issuance of the issue with respect to such project.

Section 142(d)(2)(A) provides that the term “qualified project period” means the period beginning on the first day on which 10 percent of the residential units in the project are occupied and ending on the latest of (i) the date that is 15 years after the date on which 50 percent of the residential units in the project are occupied, (ii) the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding, or (iii) the date on which any assistance provided with respect to the project under section 8 of the United States Housing Act of 1937 terminates.

Rev. Proc. 2004-39, 2004-2 C.B. 49, sets forth procedures for determining whether a residential rental project complies with the applicable § 142(d) set-aside requirements. Under section 5.02 of that revenue procedure, if bonds are issued to acquire an existing residential rental project, then for a period of up to 12 months beginning on the issue date of the bonds (12-month transition period), a failure to satisfy the § 142(d) set-aside requirements does not cause the acquired project to fail to be a qualified residential rental project.

Section 147(d)(1) provides, with certain exceptions, that a private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the net proceeds of such issue is to be used for the acquisition of any property (or an interest therein) unless the first use of such property is pursuant to such acquisition. The private activity bonds to which § 147(d) applies include bonds to finance qualified residential rental projects.

Section 147(d)(2) provides that § 147(d)(1) shall not apply with respect to any building (and the equipment therefor) if the rehabilitation expenditures with respect to such building, equal or exceed 15 percent of the portion of the cost of acquiring such building (and equipment) financed with the net proceeds of the issue.

Section 147(d)(3)(C) provides that the term “rehabilitation expenditures” shall not include any amount which is incurred after the date 2 years after the later of (i) the date on which the building was acquired, or (ii) the date on which the bond was issued (§ 147(d) 2-year rehabilitation expenditure period).

### C. Postponement of certain deadlines by reason of Presidentially declared disasters

On March 13, 2020, the President of the United States issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act), 42 U.S.C. 5121 et seq., in response to the ongoing COVID-19 pandemic (Emergency Declaration).<sup>2</sup> The Emergency Declaration instructed the Secretary “to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate, pursuant to 26 U.S.C. 7508A(a).” Subsequent to the Emergency Declaration, the President issued major disaster declarations under the authority of the Stafford Act with respect to all 50 States, the District of Columbia, and 5 territories (Major Disaster Declarations).<sup>3</sup> In addition, under § 1.42-13(a), the Secretary has the general authority to issue guidance and provide relief to carry out the purposes of § 42.

In the context of a Presidentially-declared Major Disaster, Rev. Proc. 2014-49 provides temporary relief from certain requirements of § 42 for Agencies and Owners of low-income housing projects. Under section 8 of Rev. Proc. 2014-49, in the case of a casualty loss suffered due to a Major Disaster that has reduced a low-income building’s qualified basis, the Agency that has jurisdiction over the building must determine what constitutes

a reasonable restoration period. The reasonable restoration period established by the Agency must not extend beyond the end of the 25th month following the close of the month of the Major Disaster declaration (25-month reasonable restoration period). Subject to completing the restoration, to determine the credit amount allowable during the reasonable restoration period for a building described in section 8 of Rev. Proc. 2014-49, an Owner must use the building’s qualified basis at the end of the taxable year immediately preceding the first day of the incident period for the Major Disaster.

Rev. Proc. 2014-49 also provides emergency housing relief for individuals who are displaced by a Major Disaster from their principal residences in certain Major Disaster Areas. See Rev. Proc. 2014-49, sections 12–14. In the context of a Presidentially-declared Major Disaster, Rev. Proc. 2014-50 provides temporary relief from certain requirements under § 142(d) for qualified residential rental projects financed with exempt facility bonds issued by State and local governments under § 142. Rev. Proc. 2014-50 also provides emergency housing relief for individuals who are displaced by a Major Disaster from their principal residences in certain Major Disaster Areas. See Rev. Proc. 2014-50, sections 5–7.

Notice 2020-23, 2020-18 I.R.B. 742, issued April 9, 2020, provided certain relief to affected taxpayers and postponed due dates until July 15, 2020, with respect to certain tax filings and payments, certain time-sensitive government actions, and all time-sensitive actions listed in Rev. Proc. 2018-58, 2018-50 I.R.B. 990 (Dec. 10, 2018), that were due to be performed on or after April 1, 2020, and before July 15, 2020, including certain actions under § 42 for qualified low-income housing projects.

Notice 2020-53, issued on July 1, 2020, extended until December 31, 2020, the relief provided in Notice 2020-23 for § 42 qualified low-income housing projects, as well as providing until December 31, 2020, additional relief under § 42 and under §§ 142(d) and 147(d) for qualified residential rental projects.

## III. SCOPE OF THE RELIEF GRANTED IN THIS NOTICE

Sections IV.A through F of this notice apply to certain deadlines related to low-income housing projects under § 42. Sections V.A through D apply to relief involving operational waivers for low-income housing projects, and Section V.E applies to relief involving operational waivers both for those projects and for qualified rental projects under § 142(d). Sections VI.A and B apply to private activity bonds that are issued for the acquisition of buildings intended to be qualified residential rental projects and that would be qualified bonds (as defined in § 141(e)) if the applicable requirements of §§ 142(d) and 147(d)(2) are satisfied. All of the provisions in Sections IV through VI also apply to Agencies, Owners, Issuers, and Operators that have responsibilities with respect to those projects and bonds.

## IV. GRANT OF RELIEF FOR DEADLINES RELATED TO THE LOW-INCOME HOUSING CREDIT

### A. THE 10-PERCENT TEST FOR CARRYOVER ALLOCATIONS

For purposes of § 42(h)(1)(E)(ii), if the last day for an Owner of a building with a carryover allocation to meet the 10-percent test is on or after April 1, 2020, and before September 30, 2021, the last day for the Owner to meet the 10-percent test is postponed to the earlier of one year from the original due date or September 30, 2021.

### B. THE § 42(e) 24-MONTH MINIMUM REHABILITATION EXPENDITURE PERIOD

For purposes of § 42(e)(3)(A)(ii), if the 24-month minimum rehabilitation expenditure period for a building originally ends on or after April 1, 2020, and before September 30, 2021, the last day for the Owner to incur the minimum rehabilitation expenditures with respect to the building is postponed to the earlier of one

<sup>2</sup> See <https://www.whitehouse.gov/wp-content/uploads/2020/03/LetterFromThePresident.pdf>.

<sup>3</sup> See <https://www.fema.gov/coronavirus/disaster-declarations>.

year from the original end date or September 30, 2021.

#### C. PLACED IN SERVICE DEADLINE

For purposes of § 42(h)(1)(E)(i), if the deadline for a low-income building to be placed in service is the close of calendar year 2020, the last day for the Owner of the building to place the building in service is postponed to December 31, 2021.

#### D. REASONABLE PERIOD FOR RESTORATION OR REPLACEMENT IN THE EVENT OF CASUALTY LOSS

For purposes of § 42(j)(4)(E) in the case of a casualty loss not due to a pre-COVID-19-pandemic Major Disaster, and of section 8.02 of Rev. Proc. 2014-49 in the case of a casualty loss due to a pre-COVID-19-pandemic Major Disaster, if a low-income building's qualified basis is reduced by reason of the casualty loss and the reasonable period to restore the loss by reconstruction or replacement (Reasonable Restoration Period) ends on or after April 1, 2020, then the last day of the Reasonable Restoration Period is postponed by a period of one year from the original end date but not beyond December 31, 2021. Notwithstanding the preceding sentence, the Agency may require a shorter extension, or no extension at all.

For purposes of determining the credit amount allowable under § 42(a) in the case of a credit year that ends on or after April 1, 2020, and not later than the end of the Reasonable Restoration Period (taking into account any extension under the preceding paragraph), if the Owner restores the building by the end of that extended Reasonable Restoration Period, then the Owner must use the building's qualified basis at the end of the taxable year immediately preceding the first day of the casualty as the building's qualified basis for that credit year.

#### E. EXTENSION TO SATISFY OCCUPANCY OBLIGATIONS

For purposes of § 42(f), if the close of the first year of the credit period with respect to a building is on or after April 1, 2020, and on or before June 30, 2021, then the qualified basis for the building for the

first year of the credit period is calculated by taking into account any increase in the number of low-income units by the close of the 6-month period following the close of that first year.

#### F. CORRECTION PERIOD

For purposes of § 1.42-5, if a correction period that was set by the Agency ends on or after April 1, 2020, and before September 30, 2021, then the correction period is extended by a year, but not beyond December 31, 2021. Notwithstanding the preceding sentence, the Agency may require a shorter extension, or no extension at all.

### V. GRANT OF RELIEF FOR OPERATIONAL PROVISIONS

#### A. INCOME RECERTIFICATIONS

An Owner of a low-income building is not required to perform income recertifications under § 1.42-5(c)(1)(iii) in the period beginning on April 1, 2020, and ending on September 30, 2021. The Owner must resume the income recertifications as due under § 1.42-5(c)(1)(iii) not later than October 1, 2021.

#### B. COMPLIANCE-MONITORING

For purposes of § 1.42-5, an Agency is not required to conduct compliance-monitoring inspections or reviews in the period beginning on April 1, 2020, and ending on September 30, 2021. The Agency must resume compliance-monitoring inspections or reviews as due under § 1.42-5 not later than October 1, 2021.

#### C. COMMON AREAS AND AMENITIES

If an amenity or common area in a low-income building or project is temporarily unavailable or closed during some or all of the period from April 1, 2020, to September 30, 2021, and if the unavailability or closure is in response to the COVID-19 pandemic and not because of other noncompliance for § 42 purposes, then this temporary unavailability or closure does not result in a reduction of the eligible basis of the building.

### D. GUIDANCE PERMITTING AGENCIES TO CONDUCT TELEPHONIC HEARINGS

For the purposes of an Agency's QAP meeting the requirements of § 42(m)(1)(A), if a hearing on or after April 1, 2020, and before September 30, 2021, is held by teleconference that is accessible to the residents of the locality where the Agency has jurisdiction by calling a toll-free telephone number, then the hearing does not fail to satisfy § 42(m)(1)(A) solely on the grounds that it was not held in-person.

### E. EMERGENCY HOUSING FOR MEDICAL PERSONNEL AND OTHER ESSENTIAL WORKERS

If individuals are medical personnel or other essential workers (as defined by State or local governments) that provide services during the COVID-19 pandemic, then, for purposes of providing emergency housing from April 1, 2020, to September 30, 2021, under Rev. Proc. 2014-49 or under Rev. Proc. 2014-50, Agencies, Issuers, Owners, and Operators of low-income housing projects may treat these individuals as if they were Displaced Individuals (defined under section 5.02 of Rev. Proc. 2014-49 or Section 4.04 of Rev. Proc. 2014-50, as applicable). That is, Agencies, Issuers, Owners, and Operators may provide emergency housing for these individuals pursuant to the provisions of the applicable revenue procedure. See sections 12, 13, and 14 of Rev. Proc. 2014-49 and sections 5, 6, and 7 of Rev. Proc. 2014-50.

### VI. GRANT OF RELIEF FOR DEADLINES ASSOCIATED WITH QUALIFIED RESIDENTIAL RENTAL PROJECTS

#### A. THE 12-MONTH TRANSITION PERIOD TO MEET SET-ASIDES FOR QUALIFIED RESIDENTIAL RENTAL PROJECTS

For purposes of section 5.02 of Rev. Proc. 2004-39, the last day of a 12-month transition period for a qualified residential rental project that ends on or after April 1, 2020, and before September 30, 2021, is postponed to September 30, 2021.

## B. THE § 147(d) 2-YEAR REHABILITATION EXPENDITURE PERIOD FOR BONDS USED TO PROVIDE QUALIFIED RESIDENTIAL RENTAL PROJECTS

If a bond is used to provide a qualified residential rental project and if the § 147(d) 2-year rehabilitation expenditure period for the bond ends on or after April 1, 2020, and before September 30, 2021, then the last day of that period is postponed to the earlier of one year from the original due date or September 30, 2021.

## VII. EFFECT ON OTHER DOCUMENTS

Notice 2020-23, Notice 2020-53, Rev. Proc. 2004-39, Rev. Proc. 2014-49, and Rev. Proc. 2014-50 are amplified.

## VIII. DRAFTING INFORMATION

The principal authors of this notice are Dillon Taylor and Michael Torruella Costa, Office of Associate Chief Counsel (Passthroughs & Special Industries) and David White, Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice relating to the low-income housing credit, please contact Dillon Taylor or Michael Torruella Costa on (202) 317-4137 (not a toll-free call); for further information regarding this notice relating to qualified residential rental projects, please contact David White on (202) 317-4562 (not a toll-free number).

# Relief for Partnerships from Certain Penalties Related to the Reporting of Partners' Beginning Capital Account Balances

## Notice 2021-13

### SECTION 1. PURPOSE

The purpose of this notice is to provide partnerships with relief from certain

penalties due to the inclusion of incorrect information in reporting their partners' beginning capital account balances on the 2020 Schedules K-1 (Form 1065) and the 2020 Schedules K-1 (Form 8865) as outlined in the 2020 Instructions for Form 1065, U.S. Return of Partnership Income (2020 Form 1065 Instructions). This notice also provides relief from accuracy-related penalties for any taxable year for the portion of an imputed underpayment attributable to the inclusion of incorrect information in a partner's beginning capital account balance reported by a partnership for the 2020 taxable year.

## SECTION 2. BACKGROUND

Section 6031 of the Internal Revenue Code (Code) and §§ 1.6031(a)-1 and 1.6031(b)-1T of the Income Tax Regulations generally require a partnership:

- to make a return for each taxable year stating the items of its gross income and deductions allowable by subtitle A of the Code and any other information as prescribed by forms and instructions for the purpose of carrying out the provisions of subtitle A of the Code, and
- to furnish to its partners statements containing each partner's distributive share of the partnership's items of income, gain, loss, deduction, or credit required to be shown on the partnership return and any additional information required to apply particular provisions of subtitle A of the Code to the partner with respect to items related to the partnership as prescribed by form or accompanying instructions.

Pursuant to section 6031 and the accompanying Income Tax Regulations, the Internal Revenue Service (IRS) has, in forms and instructions, long required the reporting of partner capital account balances.

Prior to the 2020 taxable year, partnerships could report their partners' capital accounts for the taxable year on Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., using one of a variety of methods that are based on different principles (for example, tax basis, generally accepted accounting principles (GAAP), section 704(b) book, or any other method). Starting in the 2018 taxable

year, however, the instructions for Form 1065 required partnerships that did not report tax basis capital accounts to their partners to report separately the beginning and ending tax basis capital account balance of any partner that would have a negative beginning or ending tax basis capital account balance.

Beginning in the 2020 taxable year, the 2020 Form 1065 Instructions require partnerships to calculate and report their partners' capital accounts using the transactional approach for the tax basis method, irrespective of whether the beginning or ending balance is negative for a partner. The instructions for Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, refer to the Form 1065 Instructions for reporting partners' capital accounts. Under the transactional approach outlined in the 2020 Form 1065 Instructions, partnerships report partner contributions, each partner's share of partnership net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles, instead of methods based on other principles such as GAAP. The 2020 Form 1065 Instructions explain that if a partnership did not report its partners' capital accounts using the tax basis method in the 2019 taxable year and did not maintain its partners' capital accounts under the tax basis method in its books and records, the partnership may determine its partners' beginning capital accounts for the 2020 taxable year using any one of the following methods: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method (each as described in the 2020 Form 1065 Instructions).

Section 6698 imposes a penalty for failing to file a return or report at the time prescribed therefor, or for filing a return or a report that fails to show the information required under section 6031. A return required under section 6031 includes Form 1065 and each Schedule K-1. A failure to file a partnership return that shows information required under section 6031 would generally subject a partnership to the section 6698 penalty. A section 6698 penalty will not be imposed if it is shown that the failure is due to reasonable cause.

Section 6721 imposes a penalty for any failure to file an information return



on or before the required filing date, and for any failure to include all of the information required to be shown on the return or the inclusion of incorrect information. When regulations under section 6011 require a partnership to file a partnership return electronically, each Schedule K-1 required to be included with the return with respect to each partner is treated as a separate information return subject to the section 6721 penalty. *See* section 6724(e) of the Code. Failure to electronically file a correct Schedule K-1 when required would generally subject a partnership to a section 6721 penalty.

Section 6722 imposes a penalty for any failure to furnish a payee statement on or before the date prescribed therefor to the person to whom such statement is required to be furnished, and for any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information. Section 6724(d)(2) provides a definition for “payee statement” that applies to section 6722. Under section 6724(d)(2)(A), a Schedule K-1 furnished to each partner is considered a payee statement. A failure to furnish a correct Schedule K-1 as required under section 6031 would generally subject a partnership to the section 6722 penalty.

Section 6724 provides an exception to a penalty for any failure under sections 6721 and 6722 if it is shown that the failure is due to reasonable cause and not to willful neglect. Under § 301.6724-1 of the Procedure and Administration Regulations, a penalty is waived for reasonable cause only if the filer establishes that either there are significant mitigating factors with respect to the failure or the failure arose from events beyond the filer’s control. In addition, the filer must establish that the filer acted in a responsible manner both before and after the failure occurred.

Section 6662 imposes an accuracy-related penalty on portions of an underpayment attributable to one or more types of misconduct, such as negligence or substantial understatement of income tax. Under section 6221, the applicability of any penalties, additions to tax, or additional amounts that relate to an adjustment to a partnership-related item must be determined at the partnership level for partnerships subject to the centralized partnership

audit regime enacted by the Bipartisan Budget Act of 2015, Pub. L. 114-74, 129 Stat. 584. Section 6233 makes partnerships subject to the centralized audit regime liable for the section 6662 penalties calculated on the imputed underpayment.

### **SECTION 3. RELIEF FROM PENALTIES UNDER SECTIONS 6698, 6721, AND 6722**

A partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners’ beginning capital account balances on the 2020 Schedules K-1 if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners’ beginning capital account balances using any one of the following methods, as outlined in the instructions: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method. For purposes of this notice, “ordinary and prudent business care” means the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in handling account information. In demonstrating ordinary and prudent business care, taxpayers are reminded that capital account balances are part of a partnership’s books and records and must be maintained accordingly.

In addition, a partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners’ ending capital account balances on Schedules K-1 in taxable year 2020 or its partners’ beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief under this notice is available. The penalty relief provided in this notice is in addition to the reasonable cause exception to penalties for failing to properly report the partners’ beginning capital account balances, as described in section 2 of this notice.

A partnership that fails to timely file a 2020 Form 1065, Form 8865, and Sched-

ules K-1 is not eligible for the relief provided by this notice. A partnership that fails to include a partner’s beginning capital account balance on the Schedule K-1 is also not eligible for relief. This notice does not relieve a partner of its obligation to determine the adjusted basis of its interest in the partnership for purposes of determining its tax liability or that of any other person as prescribed in section 705 of the Code and § 1.705-1(a)(1) of the Income Tax Regulations.

### **SECTION 4. RELIEF FROM PENALTIES UNDER SECTION 6662**

The IRS will waive any accuracy-related penalty under section 6662 for any taxable year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner’s beginning capital account balance reported by the partnership for the 2020 taxable year to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under section 3 of this notice. This notice does not prevent the IRS from imposing an accuracy-related penalty under section 6662 for any portion of an imputed underpayment related to capital account reporting by the partnership that is not described in the previous sentence.

### **SECTION 5. CONTACT INFORMATION**

The principal author of this notice is Margaret Burow of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information, please contact Ms. Burow at (202) 317-5279 (not a toll-free number).

*26 CFR 1.199A-11: Wage limitation for the section 199A(g) deduction*

## **Rev. Proc. 2021-11**

### **SECTION 1. PURPOSE**

This revenue procedure provides methods for calculating W-2 wages as defined in section 199A(g)(1)(B)(ii) of the Internal Revenue Code (Code) and §1.199A-11 of the Income Tax Regulations for pur-

poses of the W-2 wage limitation provided in section 199A(g)(1)(B)(i). Specified agricultural or horticultural cooperatives (Specified Cooperatives) are permitted a deduction under section 199A(g)(1)(A) equal to the lesser of 9 percent of qualified production activities income (QPAI) or taxable income of a Specified Cooperative, but not to exceed the W-2 wage limitation. This revenue procedure also modifies Revenue Procedure 2019-11, 2019-09 I.R.B. 742, to amend the method for determining W-2 wages for taxpayers with short taxable years.

## SECTION 2. BACKGROUND

.01 Section 199A(g)(1)(B)(i) limits the amount of the deduction under section 199A(g)(1)(A) to 50 percent of the W-2 wages of the Specified Cooperative (as defined in §1.199A-8(a)(2)) for the taxable year. Section 199A(g)(1)(B)(ii) provides that *W-2 wages* are determined in the same manner as under section 199A(b)(4), without regard to section 199A(b)(4)(B) (which excludes from the definition amounts not properly allocable to qualified business income for purposes of section 199A(c)(1)) and after application of section 199A(b)(5) (concerning acquisitions, dispositions, and short taxable years), except that such wages do not include any amount which is not properly allocable to domestic production gross receipts (DPGR) for purposes of section 199A(g)(3)(A).

.02 Section 199A(b)(4)(A) defines the term *W-2 wages* to mean, with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) of the Code paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199A(b)(4)(C) provides that W-2 wages shall not include any amount that is not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return.

.03 Section 1.199A-11(c) provides the Internal Revenue Service with authority to issue guidance providing computational methods that may be used to calculate W-2 wages.

.04 This revenue procedure provides three methods for calculating W-2 wages (as defined in section 199A(g)(1)(B)(ii) and §1.199A-11) for purposes of section 199A(g) and the regulations thereunder. The first method (unmodified Box method) allows for a simplified calculation, while the second method (modified Box 1 method) and third method (tracking wages method) provide greater accuracy.

.05 W-2 wages calculated under this revenue procedure are not necessarily the W-2 wages that are properly allocable to DPGR and eligible for use in computing the section 199A(g) limitations. Under §1.199A-8(b)(5)(ii)(B), a Specified Cooperative that is not qualified as a farmer's cooperative organization under section 521 of the Code (nonexempt Specified Cooperative) must use only patronage W-2 wages that are properly allocable to patronage DPGR to compute its section 199A(g)(1)(B)(i) W-2 wage limitation. Under §1.199A-8(c)(2), a Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 (exempt Specified Cooperative) must calculate separate patronage and nonpatronage deductions under section 199A(g)(1)(A) and apply separate patronage and nonpatronage W-2 wage limitations (unless an exempt Specified Cooperative treats all of its nonpatronage gross receipts and related deductions as patronage as described in §1.199A-8(b)(2)(ii), in which case, only one W-2 wage limitation would apply). Under §1.199A-11(b)(2) the Specified Cooperative must determine the amount of wages that is properly allocable to DPGR for purposes of calculating QPAI (as defined in section 199A(g)(3)(A)). The Specified Cooperative may use any reasonable method that is satisfactory to the Secretary of the Treasury or his delegate based on all of 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. Then, the amount of W-2 wages that are properly allocable to DPGR is used in determining the W-2 wage limitation under section 199A(g)(1)(B)(i) as determined under §1.199A-8(b)(5)(ii)(B) or

§1.199A-8(c)(2) depending upon whether the Specified Cooperative is nonexempt or exempt, respectively.

## SECTION 3. RULES OF APPLICATION

.01 *In general.* In calculating W-2 wages for a taxable year under the methods described in this revenue procedure, include only wages properly reported on Forms W-2 that meet the applicable rules of §1.199A-11(a), §1.199A-8(b)(5)(ii)(B), and §1.199A-8(c)(2), as applicable. Specifically, §1.199A-11(a)(2) provides that, except as provided in §1.199A-11(d)(2) (concerning short taxable years that do not include December 31), the Forms 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 for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative. Section 1.199A-11(a)(1) also provides that, for purposes of §1.199A-11, employees of the Specified Cooperative are limited to employees of such Specified Cooperative as defined in section 3121(d)(1) and (2) of the Code (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). Therefore, Forms W-2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W-2 in which the "Statutory Employee" box in Box 13 is checked) should not be included in calculating W-2 wages under any of the methods described in this revenue procedure.

.02 *No application in determining whether amounts are wages for employment tax purposes.* The discussions of "wages" in this revenue procedure and in the regulations under section 199A(g) are for purposes of section 199A(g) only and have no application in determining whether amounts are wages under section 3121(a) for purposes of the Federal Insurance Contributions Act, under section 3306(b) of the Code for purposes of the Federal Unemployment Tax Act, or under section 3401(a) of the Code for purposes of the Collection of Income Tax at Source on Wages (Federal income tax

withholding), or any other wage-related determination. See §1.199A-11(a)(1) of the regulations.

#### **SECTION 4. DEFINITION OF W-2 WAGES AND CORRELATION WITH BOXES ON FORM W-2**

.01 *Definition of W-2 wages.* Section 199A(g)(1)(B)(ii) provides that *W-2 wages* are determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B)). Section 199A(b)(4)(A) provides that *W-2 wages* means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, as also provided in §1.199A-11(b)(1), *W-2 wages* include: (i) the total amount of wages (as defined in section 3401(a)); (ii) the total amount of elective deferrals (within the meaning of section 402(g)(3) of the Code); (iii) the compensation deferred under section 457 of the Code; and (iv) the amount of designated Roth contributions (as defined in section 402A of the Code).

.02 *Correlation with Form W-2.* The elective deferrals under section 402(g)(3) and the amounts deferred under section 457 directly correlate to coded items reported in Box 12 on the 2019 Form W-2. Box 12, Code D is for elective deferrals to a section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement); Box 12, Code E is for elective deferrals under a section 403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental section 457(b) deferred compensation plan; Box 12, Code S is for employee salary reduction contributions under a section 408(p) SIMPLE (simple retirement account); Box 12, Code AA is for designated Roth contributions (as defined in section 402A) under a section 401(k) plan; and Box 12, Code BB is for designated Roth contributions (as defined in

section 402A) under a section 403(b) salary reduction agreement. However, designated Roth contributions are also reported in Box 1, wages, tips, other compensation and are subject to Federal income tax withholding.

#### **SECTION 5. METHODS FOR CALCULATING W-2 WAGES**

For any taxable year, a Specified Cooperative must calculate *W-2 wages* for purposes of section 199A(g)(1)(B)(i) using one of the three methods described in section 5.01, 5.02, and 5.03 of this revenue procedure. For a Specified Cooperative with a short taxable year, see section 6 of this revenue procedure. In calculating *W-2 wages* for a taxable year under the methods described in section 5.01, 5.02, and 5.03 of this revenue procedure, the Specified Cooperative includes only those Forms W-2 that are for the calendar year ending with or within the taxable year of the Specified Cooperative and that meet the rules of application described in section 3 of this revenue procedure.

.01 *Unmodified Box method.* Under the unmodified Box method, *W-2 wages* are calculated by taking, without modification, the lesser of—

(1) The total entries in Box 1 of all Forms W-2 filed with SSA by the Specified Cooperative with respect to employees of the Specified Cooperative for employment by the Specified Cooperative; or

(2) The total entries in Box 5 of all Forms W-2 described in section 5.01(1) of this revenue procedure.

.02 *Modified Box 1 method.* Under the modified Box 1 method, the Specified Cooperative makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the Specified Cooperative. *W-2 wages* under this method are calculated as follows—

(1) Total the amounts in Box 1 of all Forms W-2 filed with SSA by the Specified Cooperative with respect to employees of the Specified Cooperative for employment by the Specified Cooperative;

(2) Subtract from the total in section 5.02(1) of this revenue procedure amounts included in Box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes

of income tax withholding under section 3402(o) of the Code (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72, 1990-2 C.B. 211); and

(3) Add to the amount obtained after section 5.02(2) of this revenue procedure the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the Specified Cooperative for employment by the Specified Cooperative and that are properly coded D, E, F, G, or S.

.03 *Tracking wages method.* Under the tracking wages method, the Specified Cooperative actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. *W-2 wages* under this method are calculated as follows—

(1) Total the amounts of wages subject to Federal income tax withholding that are paid to employees of the Specified Cooperative for employment by the Specified Cooperative and that are reported on Forms W-2 filed with SSA by the Specified Cooperative for the calendar year; and

(2) Add to the amount obtained after section 5.03(1) of this revenue procedure the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the Specified Cooperative for employment by the Specified Cooperative and that are properly coded D, E, F, G, or S.

#### **SECTION 6. APPLICATION IN CASE OF SHORT TAXABLE YEAR**

.01 *Special rule for Specified Cooperative with a short taxable year.* In the case of a Specified Cooperative with a short taxable year, subject to the rules of application described in section 3 of this revenue procedure, the *W-2 wages* of the Specified Cooperative for the short taxable year shall 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. See §1.199A-11(e) of the regulations.

.02 *Method required for a short taxable year and modifications required in application of method.* The W-2 wages of a Specified Cooperative with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the Specified Cooperative must apply the method as follows—

(1) For purposes of section 5.03(1) of this revenue procedure, the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form(s) W-2 for any calendar year(s) containing any day within that short taxable year;

(2) For purposes of section 5.03(2) of this revenue procedure, only the portion of the total amounts reported in Box 12, Codes D, E, F, G, or S on Forms W-2, that are actually deferred or contributed during the short taxable year are included in W-2 wages; and

(3) For purposes of this section 6.02, if, at the time the Specified Cooperative files its income tax return, the Specified Cooperative has paid wages during the short taxable year that are reportable but not yet reported as W-2 wages in a Form W-2 filed with the Social Security Administration (SSA), the Specified Cooperative may include these wages as W-2 wages for the short taxable year, but only if such wages are properly included in a Form W-2 filed with the SSA on or before the 60th day after the due date (including extensions) for the Form W-2.

## **SECTION 7. MODIFICATION OF REVENUE PROCEDURE 2019-11**

.01 Revenue Procedure 2019-11 provides methods for calculating W-2 wages, as defined in section 199A(b)(4) and § 1.199A-2, for purposes of determining the deduction for qualified business income under section 199A(a)(1). Section 6 of Rev. Proc. 2019-11 provides a method for determining W-2 wage in the case of a taxpayer with a short taxable year. Specifically, section 6.01 of Rev. Proc. 2019-11

provides that for purposes of determining W-2 wages in the case of a taxpayer with a short taxable year, “the W-2 wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure.”

.02 Under the tracking wages method in section 5.03 of Rev. Proc. 2019-11, W-2 wages are calculated by totaling the amounts of wages subject to Federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year and adding to this amount the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S. Section 6.02(A) of Rev. Proc. 2019-11 further provides that, in applying the tracking wages method in the case of a short taxable year, “the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year (or, for a short taxable year that does not contain a calendar year ending with or within such short taxable year, wages subject to federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year containing such short taxable year).”

.03 Under section 6.02(A) of Rev. Proc. 2019-11, taxpayers with a short taxable year containing, but not ending on, December 31 can include only W-2 wages actually or constructively paid during the portion of the short taxable year in the calendar year ending on December 31 and cannot include the W-2 wages actually or constructively paid during the portion of the short taxable year that falls within the following calendar year. Section 6 of this revenue procedure, which similarly addresses calculating W-2 wages for taxpayers with a short taxable year, addresses this issue by providing that, for

purposes of section 5.03 of this revenue procedure (which parallels section 5.03 of Rev. Proc. 2019-11), the total amount of wages subject to Federal income tax withholding and reported on Form W-2 includes wages subject to Federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form(s) W-2 for *any calendar year(s) containing any day within that short taxable year*. In addition, section 6.02 of this revenue procedure provides that a Specified Cooperative may include in W-2 wages for the short taxable year any wages paid during the short taxable year that are otherwise includable as W-2 wages except that they have not been reported on Forms W-2 because the Forms W-2 on which those wages must be reported are not yet due, but only if such wages are properly included in a Form W-2 filed with the SSA on or before the 60th day after the due date (including extensions) for such return.

.04 This revenue procedure modifies Rev. Proc. 2019-11 so that taxpayers with a short taxable year containing, but not ending on, December 31 can include *all* wages actually or constructively paid during the short taxable year, and so that the provision in section 6 of Rev. Proc. 2019-11 concerning the calculation of W-2 wages for taxpayers with short taxable years is consistent with the similar provision in section 6 of this revenue procedure.

.05 Accordingly, section 6.02 of Rev. Proc. 2019-11 is modified to read as follows:

.02 *Method required for a short taxable year and modifications required in application of method.* The W-2 wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—

(A) For purposes of section 5.03(A) of this revenue procedure, the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually or constructively paid to employ-

ees during the short taxable year and reported on Form(s) W-2 for any calendar year(s) containing any day within that short taxable year;

(B) For purposes of section 5.03(B) of this revenue procedure, only the portion of the total amounts reported in Box 12, Codes D, E, F, G, or S on Forms W-2, that are actually deferred or contributed during the short taxable year are included in W-2 wages; and

(C) For purposes of this section 6.02, if, at the time of the filing of the taxpayer's income tax return, the taxpayer has paid wages during the short taxable year that are reportable but not yet reported as W-2 wages in a Form W-2 filed with the Social Security Administration (SSA), then the taxpayer may still include those

wages as W-2 wages for the short taxable year, but only if such wages are properly included in a Form W-2 filed with the SSA on or before the 60th day after the due date (including extensions) for such return.

#### **SECTION 8. EFFECT ON OTHER REVENUE PROCEDURES**

Revenue Procedure 2019-11 is modified by section 7 of this revenue procedure.

#### **SECTION 9. EFFECTIVE DATE**

This revenue procedure applies to taxable years ending after December 31, 2017.

#### **SECTION 10. DRAFTING INFORMATION**

The principal authors of this revenue procedure are Andrew Holubeck and Mikhail Zhidkov of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) and Jason Deirmenjian of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Department of the Treasury and the Internal Revenue Service participated in its development. For further information regarding this revenue procedure contact Andrew Holubeck or Mikhail Zhidkov at (202) 317-4774, or Jason Deirmenjian at (202) 317-4470 (not a toll-free number).

# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

# Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.  
ER—Employer.

ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel’s Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.

PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020–27 through 2020–52 is in Internal Revenue Bulletin 2020–52, dated December 27, 2020.

## **Finding List of Current Actions on Previously Published Items<sup>1</sup>**

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020-27 through 2020-52 is in Internal Revenue Bulletin 2020-52, dated December 27, 2020.



# **Internal Revenue Service**

## **Washington, DC 20224**

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## **INTERNAL REVENUE BULLETIN**

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at [www.irs.gov/irb/](http://www.irs.gov/irb/).

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## **We Welcome Comments About the Internal Revenue Bulletin**

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page ([www.irs.gov](http://www.irs.gov)) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.