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Room 5203

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Sirs and Madams:

The National Council of Farmer Cooperatives is pleased to submit on behalf of its members the following comments on proposed Treasury regulations regarding farmer cooperatives and their patrons.

I. Description of NCFC and its interest in the proposed regulations.

The National Council of Farmer Cooperatives ("NCFC") is a national trade association founded in 1929 to represent America's farmer cooperatives. NCFC's nation-wide membership includes approximately 200 local and regional marketing, supply, and bargaining cooperatives, along with farm credit banks and state councils of cooperatives. NCFC members handle almost every type of agricultural commodity produced in the United States, market these commodities domestically and abroad, and furnish production supplies and credit to their individual and farmer cooperative members.

NCFC constituent members, in turn, represent nearly 2,000 farmer cooperatives across the United States, whose members include a majority of our nation's more than two million farmers, ranchers and growers. NCFC represents the interests of these farmer cooperatives and their members before Congress, administrative agencies, and in courts where cases of importance may affect farmer cooperative interests.

Section 199A(g) is critically important to NCFC and its members and NCFC was involved heavily in the legislation that amended section 199A(g) in 2018. As discussed in further detail below, section 199A(g) was modified to restore marketplace balance by replicating the operation of former section 199 as it applied to farmer cooperatives and their patrons before the enactment of the Tax Cuts and Jobs Act of 2017 ("TCJA").

NCFC appreciates the opportunity to provide comments on the proposed regulations. Replicating the operation of section 199, layered upon the intricacies of subchapter T of the Internal Revenue Code ("Code"), is a difficult task, and we appreciate the effort represented by these proposed regulations. The primary focus of this submission is to identify areas where the proposed regulations do not reflect our understanding of Congressional intent to replicate former section 199 and the underlying regulations in the context of the longstanding rules governing subchapter T in order to maintain the competitive balance in agricultural markets before the enactment of the TCJA.

There are several instances in the preamble to the proposed regulations where Treasury and the Internal Revenue Service ("IRS") solicit comments on specific issues. We appreciate the Government's openness and willingness to engage in further discussions on important topics. Many of the issues for which comments are solicited are addressed herein. We continue to study the others. In addition, because of the relatively short 60-day comment period for these proposed regulations, there may be additional issues that come to light that we have not addressed in this submission. We hope to have the opportunity to share our thoughts on additional issues as they arise.

II. Legislative background.

Section 199A, as initially enacted in the TCJA, allowed a patron of a cooperative to calculate his or her deduction under section 199A by taking into account 20 percent of the qualified cooperative dividends received during the year. For this purpose, qualified cooperative dividends meant any patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any other similar amount, provided such amount was includible in gross income and was received from either (1) a tax-exempt organization described in section 501(c)(12) or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. In addition, section 199A(g) provided a separate section 199A deduction for a specified agricultural or horticultural cooperative (a "specified cooperative").

The TCJA also repealed section 199, a provision that provided a deduction equal to 9 percent of the lesser of the qualified production activities income ("QPAI") or taxable income of a taxpayer (limited to 50 percent of the wages paid by the taxpayer that were attributable to QPAI). Section 199 provided special rules for specified cooperatives. Under these rules, the section 199 deduction was calculated at the cooperative level, and the cooperative could elect to pass through any portion of the deduction to its patrons. For purposes of determining the amount of the deduction, the QPAI and taxable income of the cooperative was calculated without taking into account certain deductions allowed with respect to certain payments to patrons.

Thus, under the original section 199A, it appeared that a patron of a specified cooperative was allowed a section 199A deduction equal to 20 percent of an amount that could approximate the farmer's gross income, while a farmer who transacted with an entity that was not a specified cooperative was allowed a section 199A deduction equal to 20 percent of his or her net income. This difference appeared to provide an incentive for farmers to transact with cooperatives rather than non-cooperative entities. To address this situation, Congress amended section 199A in the Consolidated Appropriations Act, 2018 ("2018 Act").[1]

[1] Section 101 of Division T of Pub. L. 115-141.

Under the amendments to section 199A, Congress intended to restore the competitive balance that existed between specified cooperatives and non-cooperative entities before the enactment of the TCJA by modifying section 199A(g) to replicate the specific rules applicable to cooperatives and their patrons under former section 199 and the underlying regulations. The principal features of these amendments were: (1) the calculation of a section 199A(g) deduction at the specified cooperative level based on section 199 parameters and principles, (2) the ability for a specified cooperative to retain or pass through any portion of this deduction to its patrons, and (3) the requirement that a patron adjust his or her section 199A(a) deduction to reflect the section 199(g) deduction calculated at the cooperative level.[2] The intent of Congress to replicate prior section 199 in revised section 199A(g) is evidenced by section 199A(g)(6) directing Treasury to promulgate any regulations "based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)" and the numerous references in the legislative history to former section 199 and the underlying regulations.[3]

III. Issues for comment.

A. Patronage and nonpatronage issues.

1. Ability to calculate Section 199A(g) deduction with respect to nonpatronage activity.

Prop. Treas. reg. sec. 1.199A-8(b)(2)(ii) provides that a specified nonexempt cooperative can only use patronage gross receipts and related deductions to calculate its section 199A(g) deduction. Prop. Treas. reg. sec. 1.199A-8(c)(2) provides that an exempt specified cooperative must calculate two separate section 199A(g) deductions; one with respect to patronage activity and another with respect to nonpatronage activity. There is no authority for these limitations or allocations (the "nonpatronage limitation") under section 199A(g).[4] There is no reference anywhere in section 199A(g) to "patronage" or "nonpatronage." There is no indication in the legislative history that a specified cooperative must make any of the allocations required to separate patronage from nonpatronage activity and treat each part differently.

The plain language of section 199A(g) indicates that there is no such limitation. Section 199A(g) provides that the deduction is available for a taxpayer that is a specified agricultural or

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[2] The 2018 Act also did away with the separate cooperative-level deduction that the TCJA provided in the original version of section 199A(g).

[3] See, e.g., Joint Committee on Taxation, *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), March 22, 2018, ("The proposal modifies the deduction for qualified business income of a specified agricultural or horticultural cooperative under section 199A(g) to instead provide a deduction for qualified production activities income of a specified agricultural or horticultural cooperative that is similar to the deduction for qualified production activities income under former section 199.") at page 21. See, also the reference to former section 199 and the underlying regulation in footnotes 115, 116, 117, 118, 120, 122, and 124 and the related text.

[4] Much of the following discussion equally applies to the treatment of nonpatronage activity for both exempt cooperatives and nonexempt cooperatives under the proposed regulations. Additional analysis regarding the treatment of nonpatronage income of exempt cooperatives is discussed separately below.

horticultural cooperative. It does not provide that it is available for only the patronage activities of a specified cooperative. Section 199A(g)(1) provides that the deduction is based on the QPAI "of the taxpayer" or the taxable income "of the taxpayer," but not in excess of 50 percent of the W-2 wages "of the taxpayer" properly allocable to domestic production gross receipts ("DPGR"). Elsewhere there are similar references to "the taxpayer" in sections 199A(g)(3)(A) and (D). A specified agricultural or horticultural cooperative is one "taxpayer," not two taxpayers (a patronage taxpayer and a nonpatronage taxpayer).

As discussed in Part II above, and as clearly expressed in 199A(g)(6) and the legislative history, section 199A(g), as amended, was intended to replicate former section 199. The nonpatronage activities of specified cooperatives qualified for the former section 199 deduction. Cooperatives made their section 199 computations on an aggregate (patronage and nonpatronage) basis.

If Congress intended to so significantly limit the section 199A(g) deduction, as suggested by the proposed regulations, it could and would have done so, as demonstrated elsewhere in section 199A. In section 199A(a), Congress required individuals to distinguish between qualified businesses and specified service trades and businesses. It required calculations to be made on a disaggregated, business-by-business basis. None of these distinctions or allocations are present in section 199A(g) with respect to patronage and nonpatronage activity.

Further, Congress specifically considered what limitations were appropriate for the section 199A(g) deduction, and imposed several that did not exist under prior section 199.[5] Congress limited the section 199A(g) deduction to QPAI from the gross receipts from the disposition of "agricultural or horticultural products." Previously, a specified cooperative could claim a section 199 deduction with respect to the disposition of any "qualified production property," including non-agricultural products.

Further, Congress limited persons entitled to claim a section 199A(g) deduction to specified agricultural or horticultural cooperatives. In so doing, it excluded noncooperative corporations. The exclusion of noncooperative corporations applies to C corporation patrons of specified cooperatives. Congress explicitly decided that such patrons could no longer claim deductions passed through from specified cooperatives.

So Congress clearly knew how to limit, in section 199A, benefits previously enjoyed by specified cooperatives and their patrons under section 199. But it stopped with the limitations previously described above. It did not extend any limitation to any nonpatronage activities of the cooperatives.

There is no basis for the nonpatronage limitation in the legislative history of section 199A(g). Nothing in the legislative history even remotely supports the restrictions contained in the proposed regulations. To the contrary, as discussed in Part II above, the legislative history is replete with expressions that section 199A(g) was intended to replicate section 199. Specified cooperatives had no limitations on the use of section 199 with respect to nonpatronage activity.

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[5] Congress also knew how to carry over limitations under former section 199 into section 199A(g). See, section 199A(g)(3)(D)(ii) disallowing gross receipts related to dispositions to related persons.

Treasury has several grants of regulatory authority – in general under section 7805, with respect to section 199A under section 199A(f)(4), and with respect to section 199A(g) specifically under section 199A(g)(6). None of these grants of authority support the nonpatronage limitation of the proposed regulations. To the contrary, the limitation is explicitly contrary to the authority so granted.

Treasury and the IRS indicate that prop. Treas. reg. sec. 1.199A-8 is issued under the authority granted pursuant to section 199A(g)(6).[6] That section provides that:

> The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this subsection, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this subsection with respect to any activity described in paragraph (3)(D)(i). Such regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal).

There is nothing in this language that allows Treasury and the IRS to promulgate the nonpatronage limitation (or suggests they should). As discussed in greater detail below, the limitation is not "necessary to carry out the purposes" of section 199A(g). It certainly cannot be said that the nonpatronage limitation is "based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)." Nor is the nonpatronage limitation necessary to avoid double counting.

The "purpose" of the section 199A(g) is to continue the application of section 199 for specified cooperatives as in the past with the few changes specifically contained in the statute, none of which are prohibitions with respect to nonpatronage activities. If there is a "purpose" in section 199A to deny benefits to C corporations, it is a purpose to deny section 199A(a) benefits to C corporations. That purpose is not a purpose of section 199A(g), and the regulatory authority does not extend beyond carrying out the purposes of section 199A(g). The calculation of the deduction under section 199A(a) is very different than the calculation of the deduction under section 199A(g). The rate of the deduction is different (20 percent versus 9 percent), the bases of the deductions are different (qualified business income versus QPAI), and the limitations are different (50 percent of wages or 25 percent of wages plus 2.5 percent unadjusted basis (and applicable in only prescribed instances) versus 50 percent of wages (and applicable in all

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[6] For the sake of completeness, we will note that Treasury and the IRS do not have the authority to promulgate the nonpatronage limitation under other Code sections not cited by Treasury and the IRS. Section 199A(f)(4) provides certain authority regarding the allocation of items and wages under section 199A. This does not provide authority to issue regulations to restrict the section 199A(g) computation for cooperatives, particularly where Congress has provided more explicit authority under section 199A(g)(6) (the provision cited as authority in these proposed regulations).

Section 7805 provides Treasury with general authority to provide regulations to interpret provisions in the Internal Revenue Code. However, as discussed throughout this section, the nonpatronage limitation is more in the nature of a legislative regulation than an interpretative one, is therefore beyond the scope of section 7805, and in any event is superseded by the directive in section 199A(g)(6).

instances)). In essence, section 199A(g) should be viewed and administered as a Code section separate and distinct from the rest of section 199A.

Moreover, the regulatory authority of section 199A(g)(6) directs that the "regulations shall be based on the regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)." This Congressional direction to promulgate regulations for a new Code section based on regulations applicable to a recently repealed Code section is extraordinary, and should not be so casually dismissed by the proposed regulations. It further demonstrates Congressional resolve that the amendments to section 199A(g) in 2018 were intended to replicate section 199 as it was interpreted and administered before its repeal in 2017. As more fully discussed in the paragraphs above, under prior law, a specified cooperative included nonpatronage activity in its section 199 deduction and nothing in section 199 or the underlying regulations required a separate calculation or allocation for nonpatronage activity. The nonpatronage limitation of the proposed regulations is made from whole cloth and is not supported by section 199A(g) or its legislative history. In fact, it is directly contrary to the Congressional directive to promulgate regulations under section 199A(g) that are based on regulations promulgated under section 199.

The preamble to the proposed regulations provides certain explanations for the nonpatronage limitations. First, the preamble provides that, "Separating a nonexempt Specified Cooperative's patronage items from its nonpatronage items is consistent with the structure and intent of section 199A." The preamble goes on to say that:

> Section 199A in its entirety is 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 under section 11. C corporations are expressly prohibited under section 199A(a) from claiming a section 199A(a) deduction, and under section 199A(g)(2)(D)(i) from claiming a section 199A(g) deduction. Although section 199A(g) provides a deduction for Specified Cooperatives, the statutory prohibitions preventing C corporations from benefiting under section 199A(g) (which were absent from the statutory text of former section 199) are in conflict with permitting a section 199A(g) deduction for the nonpatronage business of a nonexempt Specified Cooperative. Instead, nonpatronage source income of a nonexempt Specified Cooperative receives an alternate benefit shared by other C corporations: the TCJA's reduction of the top rate of tax under section 11 from 35 percent to 21 percent.

The preambles read too much into the "structure" of section 199A. The section 199A(a) deduction denied to C corporate entities is a 20 percent deduction on the qualified business income. There is little dispute that Congress provided the section 199A(a) deduction in response to its reduction in the corporate tax rate in TCJA. But that relationship is not at all informative regarding the availability and scope of the section 199A(g) deduction for a specified cooperative. The section 199A(g) deduction is separate and distinct from the section 199A(a) deduction; it is allowed at different rate, upon a different base, and subject to different limitations. The section 199A(a) deduction and the current section 199A(g) deduction were enacted in different public laws and in different years. The current section 199A(g) deduction was enacted for a purpose separate and distinct from that of the original enactment of section 199A (discussed further below). It is not appropriate to project a legislative rationale for a provision in the TCJA to a provision in subsequent legislation where such public laws were enacted to serve different purposes.

The preamble is too dismissive when it says "(a)lthough section 199A(g) provides a deduction for Specified Cooperatives…" That is exactly the point. Section 199A(g) allows a deduction to specified cooperatives pursuant to a set rate (9 percent), a well-defined base (QPAI), and subject to a clear limitation (50 percent of wages). There is no dispute that nonpatronage income falls within the scope of QPAI. There is no reason to look beyond the statutory construction of section 199A(g) to divine a "structure" of section 199A. The words of the statute are clear. Even if one needed to look beyond the statute, the legislative history is the best indication of Congressional intent for purposes of interpreting the statute. Nothing in the legislative history of the 2018 Act supports the nonpatronage limitation. To the contrary, as oft-repeated herein, the legislative history makes it clear that the section 199A(g) deduction was to be determined pursuant to the rules applicable to former section 199. Specified cooperatives were allowed a section 199 deduction with respect to QPAI from nonpatronage activity. If Congress wanted a different result in the 2018 Act, it would have so indicated.

The preamble states that "the statutory prohibitions preventing C corporations from benefiting under section 199A(g) … are in conflict with permitting a section 199A(g) deduction for the nonpatronage business of a nonexempt Specified Cooperative." It is unclear what conflict exists. Specified cooperatives are C corporations. Specified cooperatives are allowed section 199A(g) deductions; other than their patrons on a pass-through basis, no other taxpayer is so allowed. If there is a conflict, it is that some corporations are allowed a section 199A(g) deduction (i.e., specified cooperatives) and all others are not. But there can be no doubt that was precisely what Congress intended. Treasury and the IRS cannot then carve out a portion of a specified cooperative's income and disallow the section 199A(g) deduction for such portion.

Further, this "conflict" always existed within section 199A. As originally enacted in TCJA, section 199A(g) allowed specified cooperatives a section 199A deduction. The deduction more closely resembled the current section 199A(a) deduction in that the deduction was 20 percent of the modified income of the cooperative (gross income less certain payments to patrons), and limited to 50 percent of wages or 25 percent of wages plus 2.5 percent unadjusted basis of property of the cooperative. The deduction was not allowed to any other corporation not affiliated with a cooperative. The deduction could not be passed through to patrons. It is clear that as originally enacted in TCJA, the section 199A(g) deduction applied to nonpatronage income, and there is nothing in the modifications to section 199A(g) in the 2018 Act that suggested that the new version of section 199A(g) should exclude nonpatronage activity.

The preamble then concludes that nonpatronage income of a specified cooperative "receives an alternate benefit" of the section 11 rate reduction. There is nothing "alternative" about the corporate rate reduction. Specified cooperatives do not elect between the rate reduction and the section 199A(g) deduction. Both apply. The section 199A(g) deduction applies to all qualified activities of the cooperative (whether derived from patronage or nonpatronage sources). The reduced section 11 rate applies to all taxable income of the cooperative (whether derived from patronage or nonpatronage sources). There is no conditional relationship between the section 11 rate and the section 199A(g) deduction.[7]

Finally, the preamble attempts to divine Congressional intent regarding the treatment of nonpatronage activity by examining the events that gave rise to the modifications to sections 199(A)(a) and (g) in the 2018 Act.

> Moreover, the 2018 Act amended section 199A to address concerns that the TCJA created an unintended incentive for farmers and other producers to sell their agricultural or horticultural products to Cooperatives over independent buyers. The amendment to section 199A was intended to ensure a level playing field between Cooperatives and independent buyers. Without the split between patronage and nonpatronage businesses, Specified Cooperatives that may benefit from both a section 199A(g) deduction (from which taxpayers other than Specified Cooperatives cannot benefit) and the reduced corporate tax rate on nonpatronage business would be significantly advantaged over independent buyers who could benefit only from the reduced corporate tax rate under section 11.

It is true that following the passage of TCJA that section 199A, as originally enacted, could have provided an incentive for farmers and other producers to transact with specified cooperatives rather than non-cooperative entities, primarily because the section 199A(a) deduction allowed to cooperative patrons was 20 percent of gross farm income while the deduction allowed to other farmers was 20 percent of net farm income. The focus was on the behavioral response of farmers: to whom would they sell in order to enhance their own tax position? The focus never was on whether section 199A(g), as original enacted to include a 20 percent cooperative-level deduction for nonpatronage activity, could potentially skew the markets.

Congress responded to this perceived discontinuity by trying to recreate the pre-TCJA tax positions of specified cooperatives and their patrons relative to non-cooperative entities and their farm customers. The most prominent features of the Congressional response were (1) eliminating the special 20-percent deduction for cooperative payments to their patrons, (2) treating farmers' receipts from cooperatives the same as receipts from noncooperatives for purposes of section 199A(a), and (3) largely restoring former section 199 as it applied to specified cooperatives and their patrons.[8] In restoring section 199 for specified cooperatives and their patrons, Congress reinstated the following key features: (1) the deduction was calculated at the cooperative level using the rate, base, and limitation previously applicable to former section 199;[9] (2) the cooperative could retain the section 199A(g) deduction or pass it through to patrons who receive

[7] Under the theory of the preamble, Treasury could disallow any deduction that is allowable to some corporations but not others (e.g., percentage depletion in excess of basis) on the theory that the TCJA corporate tax rate cut was "good enough" to make up for the disallowance of the deduction.

[8] See the discussion above for specific limitations that Congress imposed on the section 199A(g) deduction.

[9] Specifically, that the section 199A(g) deduction was 9 percent of the lesser of (1) QPAI or (2) taxable income of the cooperative (each determined without regard to the deductions allowed under sections 1382(b) and (c)). The deduction could not exceed 50 percent of the wages of the cooperative attributable to QPAI.

qualified payments from the cooperative;[10] and (3) patrons were required to make certain adjustments to their section 199A(a) deduction to eliminate the potential for double counting.[11] Congress also required that any rules not specifically provided in the legislative text should follow the rules applicable to former section 199.

The modifications to section 199A in 2018 addressed the perceived concerns of all parties. Entities that were not cooperatives were concerned that farmers had an incentive to transact with cooperatives. This was addressed by eliminating the special 20 percent deduction for receipts from cooperatives and treating such receipts the same as any other receipts of the farmer. Cooperatives were concerned that whatever benefits section 199 previously provided were lost with its repeal. This was addressed by legislatively restoring the mechanisms of section 199 through sections 199A(g) and (b)(7). It was the clear understanding of all involved that specified cooperatives would continue to enjoy the benefits of section 199 (including with respect to nonpatronage activity), except to the extent expressly changed by section 199A(g). To ensure this understanding, Congress limited Treasury's regulatory authority to that "based on regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal)."

The eligibility to determine a section 199 deduction (or section a 199A(g) deduction either before or after its modification in 2018) for qualified nonpatronage activity was not addressed by Congress because it was not a matter of concern. Indeed, it is difficult to see why a farmer would have an incentive to transact with a cooperative because the cooperative is eligible for a section 199A(g) deduction with respect to nonpatronage activity. The transaction with the cooperative makes the farmer eligible for patronage benefits (primarily patronage dividends), not nonpatronage benefits. It was the treatment of patronage items under the TCJA version of section 199A that prompted the changes in 2018. The treatment of nonpatronage activities was left alone. For Treasury and the IRS to raise a concern regarding the effect of nonpatronage activity on competitive balance is misplaced and unsupported when there is no evidence of such a concern in the statute, legislative history or any other contemporaneous record with respect to the parties involved. To the contrary, the statute and legislative history support the eligibility for a specified cooperative to claim a section 199A(g) deduction with respect to qualified nonpatronage activity.

2. **Separate allocations between patronage and nonpatronage income**.

Prop. Treas. reg. sec. 1.199-8 provides a four-step process that requires exempt and nonexempt specified cooperatives to identify and allocate items of gross income and related deductions between patronage and nonpatronage activities. This requirement is burdensome and unnecessary. The preamble to the proposed regulations provides that these steps are necessary to affect the provisions of the proposed regulations that treat patronage source income differently than nonpatronage source income for purposes of section 199A(g). As discussed in detail in the previous section, disparate treatment of patronage and nonpatronage is not supported by the

[10] Other than to C corporations.

[11] See, section 199A(b)(7) and Treas. reg. sec. 1.199-6(l).

statute, legislative history or prior section 199 and the underlying regulations. Should Treasury and IRS modify the regulations to remove the nonpatronage limitation as requested, these allocation rules should also disappear.

It is possible that Treasury and IRS may still require allocations between patronage and nonpatronage income even after they clarify that nonpatronage income qualifies for the section 199A(g) deduction. After all, the proposed regulations require exempt cooperatives to make this allocation, even though the proposed regulations provide that an exempt cooperative is allowed a section 199A(g) deduction with respect to its separately calculated nonpatronage income. So perhaps the allocation serves a purpose other than to identify patronage activity that, under the proposed regulations, does not qualify for the section 199A(g) deduction.

Separate allocations between patronage and nonpatronage income were not required under former section 199 and the underlying regulations. As with the nonpatronage limitation, the separate allocations of the proposed regulation are not supported either by a change in the language or direct evidence that this significant change was intended. What was intended is that section 199A(g) be identical to section 199, with a few specific exceptions. Separate allocations are not one of these exceptions.

Former section 199 and the underlying regulations to the contrary, it appears that the IRS does not agree that separate computations were not required under section 199. The instructions to Form 8903 seem to require separate calculations and the IRS currently is litigating this position in Tax Court in the *GROWMARK* and *AGP* cases.[12]

It is beyond the scope of this submission to rehash the litigants' respective positions in the *GROWMARK* and *AGP* cases. However, it is worth noting that it is inappropriate for proposed regulations under section 199A to adopt the Government's litigating position under section 199, given the Congressional mandate that section 199A(g) guidance follow the rules applicable to former section 199. It would be more prudent, and fairer, for Treasury and the IRS to reserve on this issue until the court's disposition of the cases.

3. Exempt cooperatives and nonpatronage income.

As indicated above, prop. Treas. reg. sec. 1.199A-8 requires both exempt and nonexempt cooperatives to separately allocate and treat patronage and nonpatronage activity. In the case of a nonexempt cooperative, no deduction is allowed under section 199A(g) with respect to nonpatronage income. In the case of an exempt cooperative, the deduction is allowed, but cannot be used other than with respect to nonpatronage income.

The preamble to the proposed regulations maintains that "calculating two section 199A(g) deductions is consistent with the administration of former section 199." The preamble cites nothing in former section 199 or the proposed regulations for this assertion. Indeed, there is nothing in section 199(A)(g), the legislative history or former section 199 and the underlying

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[12] See, *GROWMARK, Inc. and Subsidiaries v. Commissioner*, Tax Court Docket No. 23797-14, and *Ag Processing Inc a cooperative v. Commissioner*, Tax Court Docket No. 23479-14.

regulations to support this position. Further, a tax system that does not mandate burdensome allocations is more administrable than one that requires such allocations.

To the contrary, although the IRS has asserted that nonexempt cooperatives cannot use certain tax attributes applicable to patronage activity to calculate nonpatronage income,[13] the IRS has never applied this position to exempt cooperatives because exempt cooperatives are entitled to a deduction for nonpatronage income distributed on a patronage basis.[14]

4. Changes to Subchapter T.

a. In general.

In addition to providing definitional and operating rules for cooperatives and their patrons under modified section 199A(g), the package of proposed regulations provides new definitions of "patronage" and "nonpatronage." Unlike many of the provisions applicable to the proposed regulations under section 199A(g), Treasury nominally appears to have the authority to interpret "patronage" and "nonpatronage." However, there is nothing in TCJA or the modifications to section 199A(g) in the 2018 Act that would compel the need to define (or, more accurately, re-define) these terms at this time.[15] To the contrary, Congress modified section 199A(g) in the 2018 Act with the then-current understanding of the operation of the subchapter T rules, and gave no direction to change those rules. Regulations under section 1388 have not been issued since 1963 (the "1963 regulations"). Nothing substantive has changed that would compel a re-examination of basic tenets of subchapter T at this time.

Prop. Treas. reg. sec. 1.1388-1(f) on its face looks simple and benign. Nevertheless, as discussed below, these mere four sentences overturn, or at least muddle, decades of case law; resurrect positions that the IRS abandoned long ago; and promulgate, in regulations, the IRS' litigating positions in cases currently before the courts.

b. Definition of patronage and nonpatronage.

The preamble to the proposed regulations provides that the definition of "patronage" and "nonpatronage" "is consistent with the current caselaw under section 1388." It is difficult to judge the accuracy of this assertion because the preamble cites no cases. We do not believe that the definition in the proposed regulation is consistent with existing caselaw. Rather, we believe the definition is inconsistent with established caselaw and contains elements of the IRS's failed litigating position. At the very least, the definition in the proposed regulation creates a degree of

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[13] See, *GROWMARK, Inc. and Subsidiaries v. Commissioner*, Tax Court Docket No. 23797-14, and *Ag Processing Inc a cooperative v. Commissioner,* Tax Court Docket No. 23479-14.

[14] See, for example, *Farm Service*, 619 F.2d 718 (8th Cir. 1980), (which applied to a nonexempt cooperative) where the court appears to largely have justified the limitations it placed on patronage losses in an effort to preserve the distinction between exempt and nonexempt cooperatives.

[15] Particularly given that section 199A(g) is a temporary provision expiring in 2025, while prop. Treas. reg. sec. 1.1388-1(f) will affect cooperatives permanently.

uncertainty that cooperatives had thought was settled by case law and the IRS acquiescence thereof long ago.

The 1963 regulations provided a definition of "income derived from sources other than patronage" in Treas. reg. sec. 1.1382-3(c)(2). As discussed in detail below, the definition in prop. Treas. reg. sec. 1.1388-1 appears inconsistent with Treas. reg. sec. 1.1382-3(c)(2), and nothing in the proposed regulations reconciles or coordinates the two definitions.

Section 1388(j)(4) defines patronage earnings as earnings "which are derived from business done with or for patrons…" It is easy to see how activity *with patrons* gives rise to patronage income. Activity *for patrons* requires additional analysis. Treas. reg. sec. 1.1382-3(c)(2) provides that nonpatronage income is:

> incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets constitutes income derived from sources other than patronage.

The regulation appears to provide two rules: (1) a somewhat subjective directly related test and (2) a seemingly objective *per se* rule for certain types of investment-like income (rents, investment income from securities, and the sale of capital assets). Cooperatives and the IRS engaged in litigation to apply these rules under various fact patterns. Most of these cases involved types of income (interest, dividends, rents, and gains from the sale of capital assets) that seemingly would be nonpatronage income under the *per se* rule of Treas. reg. sec. 1.1382-3(c)(2).[16]

We will not examine these cases in detail in this submission. We believe the standard adopted and consistently applied by courts is that where a cooperative earns income as a result of an activity that "actually facilitates" or is "directly related" to its cooperative purpose, the income is properly characterized as patronage-sourced.

We further note that the IRS acquiesced after it lost the *Farmland* case.[17] That AOD concluded that the "patronage or nonpatronage character of every item of income or loss will be determined by the relationship of the activity producing the income or loss to the cooperative's business of

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[16] See, *Linnton Plywood Association v. United States*, 410 F.Supp. 1100 (D. Oregon 1976) (dividends from a corporate glue manufacturing joint venture); *Astoria Plywood Corporation v. United States*, 79-1 U.S.T.C. ¶9197 (D. Oregon 1979) (lease termination payment); *St. Louis Bank for Cooperatives v. United States*, 624 F.2d 1041 (Ct. Cl. 1980) (interest on working capital, gain on the sale of an automobile, interest on bonds held to meet capital requirements); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988 (8th Cir. 1982), *cert. den*. (dividend on stock owned in a bank for cooperatives); *Cotter & Company v. United States*, 765 F.2d 1102 (CAFC 1985) (interest on working capital, rent, sprinkler income); *Illinois Grain Corporation v. Commissioner*, 87 T.C. 435 (1986), *acq*. and *nonacq*. (interest on working capital, barge rents); *Caldwell Sugars Co-Op., Inc. v. United States*, 692 F.Supp. 659 (E.D. La. 1988) (storage fees paid by the Commodity Credit Corporation); *Dundee Citrus Growers Association v. Commissioner*, 62 T.C.M. 879 (1991) (interest on pool proceeds earned prior to distribution); *CF Industries, Inc. v. United States*, 995 F.2d 101 (7th Cir. 1993) (interest on working capital); *Farmland Industries, Inc. v. Commissioner*, 78 T.C.M. 846, *acq*. (1999) (gains on the sale of Section 1231 assets and stock).

[17] AOD 2001-003 (March 28, 2001).

serving the patrons." It stated that "the Service will view the examples of nonpatronage income in the regulations as instructive, but not controlling. It will look at the facts and circumstances to determine if each item of income or loss is patronage or nonpatronage sourced."

The preamble indicates that the proposed regulation "is consistent with the current case law under section 1388." For a variety of reasons, we do not believe this is the case. First, Treasury and the IRS have not changed the oft-litigated language of Treas. reg. sec. 1.1382-3(c)(2) that is seemingly in conflict with the proposed regulation.

Second, the test developed by the courts is whether income is derived from activity that "actually facilitates" or is "directly related" to the cooperative's purpose. The proposed regulation defines the "directly related use test" for patronage source as providing 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 proposed regulation seems to include the "actually facilitates" part of the "actually facilitates or directly related" disjunctive test used by the courts, but (ironically) does not appear to include the "directly related" part of the test.

Finally, the proposed regulation focuses on "transactions" that give rise to certain types of income or deduction. We believe that in the relevant cases cited (and the IRS acquiescence thereto), the focus is not on whether a "transaction" actually facilitates the accomplishment of the cooperative's mission, but rather whether "the activity" that produces the income or deduction actually facilitates or is directly related to the accomplishment of the cooperative's mission. For instance, in *St. Louis Bank,* the court observed: "Defendant's analysis is too narrow. Plaintiff's loans of surplus funds [which produced the income in controversy] cannot be viewed in isolation from plaintiff's overall business function."[18] In *Cotter*, the Court of Appeals observed:

> "Allowing the Claims Court's narrow focus, which considers the transaction without regard to the totality of the circumstances, would allow the surgical removal of one of the series of transactions from the economic realities that necessitated it. Consideration of the relatedness of a transaction to a cooperative's function must be undertaken by viewing the business environment to which it is arguably related. … The activity producing the income may not be so narrowly defined as to limit it only to its income-generating characteristic *when such a characterization is not consistent with the actual activity*." (Emphasis added).[19]

The IRS previously endorsed the more appropriate rule regarding the generation of income in an activity and the cooperative's purpose. In Revenue Ruling 75-228, the IRS held that DISC dividends were patronage source because "(t)he classification of an item as either patronage or nonpatronage source is dependent on the activity generating the income to the marketing, purchasing or service activities of the cooperative."[20] The focus on individual *transactions*

[18] *St. Louis Bank*, at 1049-1050.

[19] *Cotter*, at 1106-1107.

[20] 1975-1 C.B. 278.

invokes the narrow per se rules of Treas. reg. sec. 1.1382-3(c)(2), while the focus on *activities* involves a broader and a more appropriate analysis in the context of the cooperative's purpose to service patrons.

We do not believe that Treasury and the IRS need to promulgate a definition of patronage and nonpatronage income at this time. However, should the government decide to move forward with a definition, it should (1) reconcile any definition with that of Treas. reg. sec. 1.1382-3(c)(2), taking into account caselaw and the IRS acquiescence to the *Farmland* case; and (2) clarify that the "directly related" standard applies to income and deductions from *activities* that *actually facilitate or are directly related to* the cooperative's purpose. Treasury and the IRS should also clarify the cases that they believe represent well-settled law.

c. Treatment of patronage and nonpatronage income and deductions.

The last sentence of prop. Treas. reg. sec. 1.1388-1(f) provides that, "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)."

This sentence describes an operating rule and does not relate to or belong in a definition of "patronage and nonpatronage."

We question the appropriateness of including this sentence in this package of regulations. It is not necessary with respect to the guidance proposed under section 199A(g). It applies to all cooperatives, not just specified cooperatives. Moreover, this sentence represents a significant change in cooperative tax law.

Subchapter T requires a determination of "net earnings … from business done with or for patrons" for the sole purpose of determining whether a distribution qualifies as a patronage dividend.[21] Once that determination is made, the normal rules of corporate taxation apply to a cooperative except to the extent otherwise expressly provided in the Code. Treas. reg. sec. 1.1382-2(a)(1) provides: "In determining the taxable income of any cooperative organization to which part I, subchapter T, chapter 1 of the Code, applies, there shall be allowed as deductions from gross income, *in addition to the other deductions allowable under chapter 1 of the Code*, the deductions with respect to patronage dividends provided in section 1382(b) and paragraphs (b) and (c) of this section" (emphasis added).

There is no discussion of the last sentence of prop. Treas. reg. sec. 1.1388-1(f) in the preamble to the proposed regulations. It just appears. As we discussed, the limitation on the use of patronage section 199A(g) deductions contained in prop. Treas. reg. sec. 1.199A-8(b)(6) is, in itself, unwarranted. The last sentence of prop. Treas. reg. sec. 1.1388-1(f) expands this treatment to all deductions and losses that the IRS deems to fall into different patronage and nonpatronage

[21] See, section 1388(a)(3).

buckets. It effectively and inappropriately treats each cooperative as two taxpayers – a patronage taxpayer and a nonpatronage taxpayer.

As we discussed above, there is pending litigation (*GROWMARK* and *Ag Processing*) awaiting a decision in the Tax Court involving whether there are any limitations on the use of "patronage" section 199 deductions by nonexempt cooperatives. It is inappropriate for the IRS to, in effect, promulgate its litigating position and then extend it to all deductions of all cooperatives (not just specified cooperatives). Prop. Treas. reg. sec. 1.199A-8(b)(6) (focused on section 199A(g) deductions) and prop. Treas. reg. sec. 1.1388-1(f) (applying more broadly) should be withdrawn until litigation resolves these issues.

As in the case of language used in the patronage/nonpatronage definition, this sentence in the proposed regulation threatens to create confusion and to reopen old controversies. There are no rules in Subchapter T related to the treatment of losses incurred by cooperatives other than Section 1388(j) (discussed below). For many years, the IRS sought to impose extra-statutory limitations on the ability of cooperatives to recognize and use net operating losses. As a result, there has been much controversy in this area over the years. Following is a short review of the development of this issue in caselaw.

At first, the IRS asserted that cooperatives could not have losses. The IRS argued that implicit in the idea of operating on a cooperative basis was the notion that cooperatives should recoup any losses they incur from their patrons. While some cooperatives do that, most do not. The IRS's belief that cooperatives could not have losses was rejected by the Tax Court in *Associated Milk Producers v. Commissioner*,[22] and that position was subsequently abandoned by the IRS.

The IRS then argued that losses "may be carried over to offset income in other years of the same members whose business produced the losses" and that any losses of members who terminate their membership before the losses are used may not be carried over. This view was rejected by the Tax Court in *Ford-Iroquois FS, Inc. v. Commissioner*,[23] and also subsequently abandoned by the IRS.

Cooperatives often account for their activities for patronage dividend purposes on the basis of allocation units. Many follow the practice of netting the losses of unprofitable allocation units against the net earnings of profitable allocation units before paying patronage dividends to patrons of the profitable units. For a time, the IRS took the position that patronage loss netting was not permitted. In fact, the IRS went so far as to suggest that a cooperative that engaged in such a practice was not operating on a cooperative basis and therefore ineligible for the benefits of Subchapter T. This issue was resolved when Congress added section 1388(j) as part of the Tax Reform Act of 1986. In section 1388(j), Congress rejected the IRS position (retroactive to the enactment of Subchapter T in 1962) and allowed cooperatives to net between allocation units.

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[22] 68 T.C. 789 (1977).

[23] 74 T.C. 1213 (1980).

The IRS then shifted its strategy and looked outside of Subchapter T for a basis of restricting the use of losses by cooperatives. The IRS argued that cooperatives were "membership organizations" which were precluded by Section 277 from carrying membership losses back. This position was rejected by the Claims Court in *Landmark Inc. v. United States*,[24] and by the Tax Court in *Buckeye Countrymark v. Commissioner.*[25] Eventually, the IRS abandoned its effort to apply Section 277 to Subchapter T cooperatives.

Two cases have placed limitations on patronage deductions claimed by nonexempt cooperatives under certain circumstances.[26] Both cases dealt with unusual situations where nonexempt cooperatives incurred patronage losses as a result of making deductible per-unit retain and patronage dividend distributions to their members. In both, the courts recognized that cooperatives could incur losses which could be carried back and over, but they concluded that the cooperatives could not carry patronage losses resulting from the payment of patronage distributions back and over against nonpatronage income. Both decisions dealt with nonexempt cooperatives. They strongly suggested that their conclusions would have been different if the cooperatives involved had been exempt since such cooperatives are permitted to distribute nonpatronage income on a deductible basis to their patrons. The last sentence in the proposed regulation deals with both exempt and nonexempt cooperatives.

The cases did not establish a general rule that nonexempt cooperatives can never offset patronage losses against nonpatronage income. For instance, they did not address whether netting would be inappropriate if the cooperative made no patronage distributions, but still incurred a loss. Nor did they deal with deductions, like those of sections 199 and 199A(g), that are special creatures of tax laws not involving an actual outlay and not affecting economic income.

The scope of these decisions has been the subject of much discussion over the years. Subsequent Tax Court decisions have rejected IRS attempts to extend the holdings of these cases beyond their facts.[27]

Cooperatives are permitted to offset nonpatronage losses against patronage income. Initially, the IRS actually required such netting. See, Rev. Rul. 70-420, 1970-2 C.B. 64. When some cooperatives objected to required netting, the IRS revoked Rev. Rul. 70-420, and replaced it with Rev. Rul. 74-377, 1974-2 C.B. 274, which recognized that such netting is not required, but strongly implied it is permitted. Courts have recognized (at the urging of the Government) that whatever policy rationale there may be for limiting use of patronage losses resulting from patronage distributions, that rationale does not apply to nonpatronage losses.[28] In *Certified*

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[24] 25 Ct. of Claims 100 (1992).

[25] 103 T.C. 547 (1994).

[26] *Farm Service Cooperative v. Commissioner*, 619 F.2d 718 (8th Cir. 1980) and *Certified Grocers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987).

[27] See, for example, *Lamesa Cooperative Gin v. Commissioner*, 78 T.C. 894 (1982) ("The Court of Appeals was careful to define the issue before it relatively narrowly.")

[28] See, *Farm Service*, footnote 16, and *Certified Grocers*, footnote 21.

Grocers, the IRS made yet another argument in an attempt to limit the ability of cooperatives to use losses. It argued that the cooperative was not entitled to file a consolidated tax return with its noncooperative subsidiaries in an effort to deny any benefit of the consolidated return net operating loss rules. This position was rejected by the Tax Court.

The proposed regulation seeks to put in a regulation litigating positions that the courts have rejected, Congress has overruled, and the IRS itself has abandoned.

The cases where the IRS was successful are limited to losses resulting from patronage distributions. The proposed regulations would apply to any patronage losses, whether or not created by distributions to patrons. The cases were also limited to patronage losses. It has long been recognized that, whatever the *Farm Service* case may mean with respect to patronage losses, it does not place a limitation on the use of nonpatronage losses. In fact, on brief to the Eighth Circuit in *Farm Service*, the Government represented to the court: "But nothing prevents a cooperative from offsetting current nonpatron losses against current patron income…" The proposed regulation prohibits netting nonpatronage losses against patronage income.

The cases were limited to nonexempt cooperatives. The IRS has never taken the position that their limitations apply to exempt cooperatives. The proposed regulation applies to exempt and nonexempt cooperatives. It has been argued by the IRS that it is necessary to place limitations on patronage losses resulting from patronage distributions to prevent nonexempt cooperatives from indirectly distributing nonpatronage income to patrons on a deductible basis. Such a limitation is not necessary in the case of exempt cooperatives because section 1382(c) permits exempt cooperatives to distribute nonpatronage income to their members on a deductible basis.

Finally, the parenthetical language at the end of the sentence ("unless otherwise permitted by the Internal Revenue Code or regulations 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)") is at best problematic. It provides a significant degree of uncertainty as to whether and when the Government may change its position yet again. It implies that Treasury and the IRS are not quite sure whether the "one size fits all" approach of the proposed regulation is appropriate in all cases and with respect to all deductions and losses. It inhibits cooperative planning and is not within the spirit of the Administrative Procedures Act.

Final regulations should delete the last sentence of proposed regulation, at least until the pending court cases are decided. A better approach would be to undertake a more thorough and deliberative examination of the area before putting forth a broad-brushed rule in a single sentence without explanation.

B. Determination of taxable income and qualified payments.

A specified cooperative determines its deduction under section 199A(g) as 9 percent of the lesser of its (1) QPAI or (2) taxable income. Prop. Treas. reg. section. 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 paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from patronage sources. Patronage net operating losses (NOLs) reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Taxable income is determined using the same method of accounting used to determine distributions under section 1382(b) and qualified payments to eligible taxpayers.

There are several issues with this paragraph. First, section 1382 does not define the taxable income of a cooperative. A cooperative is a C corporation that determines its taxable income the same as any other corporation under section 63, taking into account the adjustments provided in subchapter T, including section 1382.

In addition, as discussed in greater detail above, the determination of taxable income (and the use of NOLs) includes both patronage and nonpatronage income (and NOLs) on an aggregated basis.

Finally, the implication in the last sentence of prop. Treas. reg. section. 1.199A-8(b)(5)(ii)(C) that a cooperative must use the same method of accounting to determine taxable income and distributions under section 1382(b) and qualified payments is in error.[29] Taxable income is determined under section 63 (taking into account the adjustments provided in subchapter T) using the methods provided in the Internal Revenue Code. Cooperatives may wish to use book income or modified book income to determine patronage dividends or other payments to patrons because the cooperative feels that such method better reflects, over time, economic income than does taxable income.

Consider a cooperative that elects to expense the cost of qualified property under section 168(k). If such deduction is substantial, a cooperative that determines patronage dividends based on taxable income concepts would have smaller payments to patrons that transact with the cooperative in the year qualified property was placed in service relative to payments to patrons that transact with the cooperative in later years (when depreciation deductions are unavailable). The use of book income smooths these differences over the life of the property.

Cooperatives have long been allowed to determine payments to patrons pursuant to methods other than a tax basis. Section 1388(a)(3) defines patronage income with reference to the "net earnings" of the organization. "Net earnings" is not defined in the statute or by Treasury or the IRS in guidance. "Net earnings" generally is thought to refer to an amount that does not necessarily correlate with taxable income, in the same way that the earnings and profits of a corporation does not correlate to taxable income. Otherwise, the statute would simply reference "taxable income" rather than "net earnings."

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[29] The last sentence of prop. Treas. reg. section. 1.199A-8(d)(2)(ii) (relating to the definition of a qualified payment) also requires consistency with methods used to determine taxable income, and also is in error. The proposed regulations have other similar consistency requirements for exempt and nonexempt cooperatives. They all should be deleted.

Treasury and the IRS have recognized that the "net earnings" of a cooperative can be computed based on a taxable or book income basis. Example 2 of Treas. reg. sec. 1.199-6(m) provides that "Cooperative X is required to reduce its patronage dividend deduction … passed through to its member*s (whether or not Cooperative X pays patronage on book or Federal income tax net earnings) ...*" (emphasis added). Similarly, page 4 of Form 1120-C (U.S. Income Tax Form for Cooperative Associations) for 2018 requires a cooperative to disclose the accounting method used to compute distributable patronage. The choices are "Book," "Tax," and "Other."

The final regulations should correct the cross-references discussed above, clarify that payments to patrons need not be determined on a tax basis, and include language like that in the parenthetical in Example 2 of Treas. reg. sec. 1.199-6(m).[30]

C. Methods of allocation.

Section 199A, like former section 199, requires several allocations of gross receipts, expenses, and other items between qualified and non-qualified activities.

The proposed regulations require a specified cooperative to allocate its gross receipts for the taxable year between domestic production gross receipts ("DPGR") and non-DPGR based on "a reasonable method." Further, the "chosen reasonable method must be consistently applied from one taxable year to another."[31] Finally, the proposed regulations provide a series of factors for determining whether the method used by the taxpayer is "a reasonable method," including (1) whether the information used is the most accurate available; (2) the relationship between the gross receipts and the method used;[32] (3) the accuracy of the method chosen as compared with other possible methods; (4) whether the method is used for internal management or other business purposes; (5) whether the method is used for other Federal or state income tax purposes; (6) the time, burden, and cost of using alternative methods; and (7) whether the method is used consistently from year to year.[33]

The requirements under the proposed regulations differ from prior law section 199. Prior law required the use of "any reasonable method" to allocate gross receipts and other items.[34] Further, under section 199, "a change in a taxpayer's method of allocating or apportioning [items] does not constitute a change in method of accounting to which the provisions of section 446 and 481 and the regulations thereof apply." Thus, it was clear that under former section 199, a taxpayer could modify its method of allocation so long as such method is reasonable. Finally,

[30] Similarly the last sentence of prop. Treas. reg. sec. 1.199A-8(d)(2)(ii), regarding the method to determine qualified payments, should be struck.

[31] Prop. Treas. reg. sec. 1.199A-9(c)(1).

[32] It is unclear what is meant by this requirement.

[33] This last factor seems odd given that the proposed regulations would require consistent use of a reasonable method from year to year.

[34] Treas. reg. sec. 1.199-8(a).

the section 199 regulations do not contain a list of factors as to what constituted a reasonable method.

As oft-repeated herein, Congress intended section 199A(g) to operate the same as former section 199 with respect to specified cooperatives. Congress provided Treasury authority to prescribe regulations under section 199A(g), but mandated that such regulations must "be based on regulations applicable to cooperatives and their patrons under section 199 (as in effect before its repeal.)"[35] Legislative history clarifies that the section 199 regulations referenced in the regulatory authority include all the section 199 regulations, including Treas. reg. sec. 1.199-8(a), not just those dealing specifically with specified cooperatives.[36]

The provisions in the proposed regulations on reasonable methods for making allocations under section 199A(g) clearly deviate from the rules provided under section 199. There is nothing in section 199A(g) or its legislative history that would indicate that Treasury and the IRS should deviate from the rules of Treas. reg. sec. 1.199-8(a). To the contrary, in enacting section 199A(g), Congress indicated that Treasury and the IRS were to promulgate rules that replicated the provisions, including regulations, of section 199 to the extent possible.

Cooperatives have followed the allocation rules of section 199 for over a decade. It is inappropriate and an administrative burden to now require a cooperative to determine whether its allocation methods are "reasonable" under the new seven-factor standard in the proposed regulation, and if not, to adopt methods that it now cannot change without permission from the IRS. Further it is unclear why the standards of Treas. reg. sec. 1.199-8(a) were appropriate to apply to a multitude of taxpayers under section 199, but a more limiting standard is required the relatively few taxpayers that are specified cooperatives.

Treasury and IRS should restore and adopt the rules of Treas. reg. sec. 1.199-8(a) with respect to the use of reasonable methods of allocation under section 199A(g).

D. Treatment as a flow-through entity.

Prop. reg. sec. 1.199A-7 treats all cooperatives, including specified cooperatives, as flow-through entities, in part, with respect to payments to their patrons. Such treatment is inappropriate and reflects a basic misunderstanding of how Subchapter T has operated since its inception. Even if this treatment was appropriate, it represents an administrative burden to specified cooperatives and their patrons that outweighs the benefits to the government.

Specifically, prop. Treas. reg. secs. 1.199A-7(c)(2) and (3) would require (1) a patron to determine whether payments received from a cooperative are related to the patron's trade or business, and (2) a cooperative to determine whether its items of income, gain, deduction and

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[35] Section199A(g)(6).

[36] See, Joint Committee on Taxation, *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), March 22, 2018, ftnte. 124 at p. 24 ("See Treas. Reg. secs. 1.199-1 through -9.")

loss are from activities that qualify for the section 199A(a) deduction. Prop. Treas. reg. secs. 1.199A-7(d)(2) and (3) require patrons and cooperatives to make the same determinations and same reporting with respect to specified service trades or businesses ("SSTBs"). A cooperative makes these determinations similar to the rules applicable to relevant passthough entities ("RPEs") described in Treas. reg. sec. 1.199A-1(a)(9).[37] A cooperative would then be required to report to its patrons what portion of the payments made to the patrons relate to qualified activities and SSTBs and apparently do this separately for each line of business carried on by the cooperative, significantly increasing reporting burdens.[38]

The requirement that a cooperative determine its qualified items is inappropriate, particularly for specified cooperatives. Cooperatives are fundamentally different from RPEs and should not be subject to the same rules. Cooperatives are not pass-through entities like partnerships, LLCs and S corporations, and their members are not required to take into account their distributive shares of income, gain, loss, deduction or credit of cooperatives. Cooperatives are separate legal corporate entities and separate taxpayers. Any residual income retained by the cooperative after distributions to patrons is subject to corporate level tax. RPEs are not subject to entity level tax. The fact that Subchapter T provides a mechanism such that the patronage income of a cooperative is subject to only one level of tax is not a sufficient reason to treat a cooperative as an RPE for purposes of section 199A. There are sufficient tax differences between RPEs and cooperatives to warrant different treatment.

Patrons include amounts received from the cooperative (including patronage "dividends") as ordinary income. The character of tax items at the cooperative level does not flow through to patrons. A cooperative's otherwise tax preferred income, such as a capital gain, loses its tax preferred status when distributed to patrons.

The reporting requirements for cooperatives are different than that for RPEs. Cooperatives report relevant tax information to their patrons on a relatively simple form—Form 1099-PATR. Passthrough entities issue complicated Forms K-1 that break out each item that may have tax significance to the owners of the entity.

There is nothing in the statute that indicates that Congress intended the result in the proposed regulations. In fact, Congress recognized that cooperatives and their patrons warranted special consideration. As discussed above, section 199A(g) responds to the particular circumstances of specified cooperatives and their patrons. In addition, section 199A(c)(3)(B)(ii) specifically provides that patronage dividends described in section 1385(a)(1) are not dividends that would otherwise be treated as disqualified income. This implies that Congress considered patronage dividends to be qualified income in their totality so long as it relates to a qualified business conducted by the patron. At the very least, sections 199A(g) and (c)(3)(B)(ii) indicate that Congress considered the implications of payments to patrons and neglected to apply the look-through rules of the proposed regulations. Further, the legislative history to the amendments to

[37] The proposed regulation present only a partial flow-through approach. Items at the cooperative level that may be beneficial to patrons under section 199A(a) (e.g., wages and unadjusted basis of property) do not flow through.

[38] See, box 13 of the draft Form 1099-PATR for 2020 released August 1, 2019.

section 199A(g) indicates that Congress intended the determination of the treatment of payments to patrons to be made only at the patron level.

> The proposal also clarifies that items of income excluded from qualified items of income, and thus excluded from qualified business income, do not include any amount described in section 1385(a)(1) (i.e., patronage dividends). Accordingly, qualified business income of a qualified trade or business includes any patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any other similar amount received from a cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss (i.e., such amount is (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included or allowed in determining taxable income for the taxable year).[39]

The issue of the proper characterization of patronage dividends at the patron level is not unique to section 199A(a). Other tax provisions require payments to patrons to be characterized at the patron level in order to be accorded the proper tax treatment. For example, Treas. reg. secs. 1.1362-2(c)(5)(ii)(C) and (iii)(C) treat patronage dividends as related to an active business and not as passive income for Subchapter S purposes. Similarly, under Treas. reg. secs. 1.469-2T(c)(3)(i)(A) and (ii)(F) patronage dividends related to an active business can be treated as active income of that business, not as portfolio income. Finally, patronage dividends related to an active business are subject to SECA tax, while regular dividends are not. None of these provisions apply a look through approach that would require a cooperative to examine activity at the entity level to characterize the treatment of a patronage dividend at the patron level. The proper approach, and one that should be adopted by the section 199A regulations, is for a patron to determine whether or not he or she is in a qualified trade or business and whether payments received from a cooperative relate to such qualified trade or business. There is no need for the cooperative to itself make such an analysis.

Patronage dividends should be characterized as qualified business income ("QBI") at the patron level, not on a "look-through" basis at the cooperative level. If the patronage dividends relate to patron activities that generate QBI from a business (such as farming), then they should be included as QBI of that business. If they do not, they should not be included in QBI. If they relate to an activity that is an SSTB in the hands of a patron, then they should be treated as income of the SSTB (with whatever consequence that might have at the patron level.) So, for instance, a patronage dividend related to a purchase of supplies by a farmer patron should be characterized at the patron level by whether the supplies were used in farming, an SSTB, or a personal activity.

The application of a flow-through approach is particularly troubling for specified cooperatives. Specified cooperatives will be subject to the determination rules of prop. Treas. reg. secs. 1.199A-7(c) and (d). Failure to make the determination and provide the necessary information to patrons in timely fashion will result in a loss of a section 199A(a) deduction for patrons. This represents a trap for the unwary, particularly for smaller cooperatives that may not be aware of

[39] Joint Committee on Taxation, *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), March 22, 2018, p. 24-5.

the requirement to distinguish between, and report with respect to, qualified business income and probably non-existent SSTB income.

Presumably, Treasury and the IRS proposed these requirements on cooperatives to ensure that a patron does not claim a section 199A(a) deduction with respect to a SSTB. If so, this concern is misplaced. It is highly unlikely that a specified cooperative engages in a SSTB. To the extent that a specified cooperatives provides services, they are services provided to the patrons themselves, not to third parties.[40] As such, any patronage dividends related to services economically are offsets to, or reductions in, expenses incurred by the patron in a qualified trade or business.

For example, assume a dairy cooperative makes veterinary services available to its patron members, and further assume that the provision of such services is an STTB.[41] A dairy farmer that avails himself or herself of such service for the farm's dairy cows pays a fee that reduces the farmer's QBI. If the cooperative later pays a patronage dividend to the farmer based on the net earnings of such services, such dividend should be treated as a rebate of the original fee, thus increasing QBI to its proper amount. It should not be treated by the patron as anything other than an amount to be taken into account in determining his or her QBI.

On the other hand, if the farmer used the veterinary services to treat a family pet, the patronage dividend relates to a personal expense and should not be taken into for QBI purposes. Both examples demonstrate that the proper treatment of payments to patrons should be made solely at the patron level. The characterization at the cooperative level is irrelevant.

The final regulations should eliminate the requirement that a cooperative determine and report the extent to which it engages in qualified trades or businesses and SSTBs pursuant to prop. Treas. reg. secs. 1.199A-7(c)(3) and (d)(3). The determination of whether a patron engages in a qualified business or an SSTB should be done at the patron level, and amounts received from a cooperative should be taken into account by the patron with respect to this determination based on the relationship between the patron's business or businesses and transactions with the cooperative. For example, a patronage dividend related to a purchase of supplies by a farmer patron should be characterized at the patron level by whether the supplies were used in farming, an SSTB or a personal activity. In addition, final Treasury regulations should provide explicitly that a cooperative is not an RPE, and all references to a cooperative as a "flow through entity" should be eliminated.

This requested treatment would eliminate unnecessary administrative burdens on cooperatives, and be consistent with the provisions of subchapter T and the patron-level determinations required by other Code provisions.

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[40] If the services are provided to third parties, the results would be nonpatronage income to the cooperative and not included in patronage dividends.

[41] This example is for illustration purposes only. We are not aware of any cooperative that provides such services, and express no opinion on the characterization of such services.

E. Treatment of patrons that are C corporations.

1. Attribution of activities of C corporate patrons.

First, the proposed regulations treat a marketing cooperative as having manufactured, produced, grown or extracted ("MPGE") any agricultural or horticultural product of its patrons, including patrons that are C corporations. The preamble to the proposed regulations solicits comments as to whether this is the appropriate rule.

We agree with this attribution rule in the proposed regulation because, as pointed out by the preamble, the statute does not distinguish between patrons in this regard. Nor should it. Not applying the attribution rule could disallow the section 199A(g) twice – once when determining the section 199A(g) deduction at the specified cooperative level and again when potentially passing it through to a C corporation (see the discussion below regarding this issue). Further, trying to determine attribution rules based on the identity of patrons may not be administrably feasible.

2. Pass through of deduction to C corporations.

The preamble provides that a specified cooperative may not "pass through to a C corporation any of the section 199A(g) deduction of the Specified Cooperative." This language does not quite track the statutory language, but reflects Congressional intent to not allow C corporate patrons a section 199A(g) flow-through deduction.[42]

Some cooperatives may know that some of their patrons are C corporations and will not pass any section 199A(g) to them. But many cooperatives may not know, and may not have the capability to determine, whether a particular patron is a C corporation or some other type of taxpayer. The final regulations should clarify that the ultimate determination of whether a patron is an eligible taxpayer as defined by section 199A(g)(2)(D) rests with the patron, and a cooperative will not be penalized if it passes through information relating to the section 199A(g) deduction to an ineligible corporate patron. Indeed, section 199A(g)(2)(A) provides an "eligible taxpayer…shall be allowed a deduction." It does not impose a requirement for the cooperative to identify eligible taxpayers.

F. Reporting requirements.

The proposed regulations impose various new reporting requirements on specified cooperatives. In addition, on August 2, 2019, the IRS released a new draft version of Form 1099-PATR. The proposed regulations and the new draft form seem to require reporting of items and allocations among activities (i.e., between SSTB activities and non-SSTB activities)[43] previously not

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[42] Technically, sections 199A(g)(2)(A) and (D)(i), read together, actually provide that a C corporation patron is not allowed a section 199A(g) deduction. Under the statute, the disallowance is determined at the patron level, not the cooperative level.

[43] See the discussion in section III.D. above regarding legal and administrative issues involved in requiring a cooperative to allocations among different trades or businesses.

required. For example, the new rules now require the reporting of qualified payments to patrons. This requirement does not apply under section 6044(b),[44] and did not apply under section 199 or former Form 109-PATR, presumably because patrons already knew the amount of qualified payments received from a cooperative.

Specified cooperatives and their advisors are still in the process of determining the need for, and cumulative burden of these new requirements. Our initial analysis is that the Economic Analysis described in the preamble to the proposed regulations likely understates the regulatory burdens since there are over two million patrons of specified cooperatives (and many more patrons of other cooperatives) that will receive Forms 1099-PATR. We hope to provide further information on this issue.

To at least partially address the burdens of these new requirements, we suggest that Treasury regulations provide that a specified cooperative should not have to report payments to its patrons if the specified cooperative foregoes a section 199A(g) deduction altogether for a taxable year. Cooperative patrons should not be subject to the unnecessary burden of complying with these special rules simply because the patrons receive qualified payments from a cooperative since receipt of a qualified payment from a cooperative does not automatically mean duplicative section 199A benefits are being taken by both the patron and cooperative. Rather, a specified cooperative's patrons should only be subject to the special rules under prop. Treas. reg. sec. 1.199A-1(e)(7) if the patrons or their cooperative claims a section 199A(g) deduction. As a practical matter, many specified cooperatives, particularly smaller cooperatives, did not calculate a former section 199 deduction because the administrative costs involved in determining the deduction and reporting the information to patrons outweighed the benefit of the deduction. Allowing a cooperative to "elect out" of section 199A(g) for a taxable year will, in essence, treat the patrons of the cooperative the same as if they had transacted with a noncooperative for that year, and ease administrative burdens for such year.

G. Definition of agricultural and horticultural products.

1. Basic definition.

The preamble to the proposed regulations specifically requests comments on the definition of agricultural and horticultural products.

It is true that the Internal Revenue Code and regulations do not contain comprehensive definitions of "farming" or "agricultural or horticultural products." No comprehensive definition existed under section 199. Yet we are unaware of any controversy under former section 199 regarding whether an item is an agricultural or horticultural product. Perhaps this is because members of the agricultural community and their advisors generally have a sense of the meaning of "farming" and "agricultural or horticultural products." Thus, promulgating a definition when it is not clear when one is needed is difficult because "farming" and "agricultural or horticultural products" may take many forms and any definition, no matter how artful, may inadvertently exclude some forms of farming and some kinds of agricultural or horticultural products.

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[44] We note that if Congress intended for Treasury and the IRS to increase the reporting requirements of a cooperative to its patrons, it would have amended section 6044.

Following are some thoughts and suggestions should Treasury and the IRS wish to continue to pursue a definition of "agricultural or horticultural products."

The preamble provides that Treasury and the IRS considered using a definition based on the Cooperative Marketing Act of 1926, the Agricultural Marketing Act of 1946, and the regulations under the Commodities Exchange Act, before settling on the 1926 Act definition in the proposed regulation. We advise against a specific reference to some other non-tax legislation or regulation. Non-tax definitions were developed for non-tax reasons and are best understood in that context. We are uncertain whether any of the suggestions in the preamble reference a sufficiently well-defined body of law that will be readily understood by tax practitioners and the IRS. A specific reference invites future controversies over what the meaning of the term may be under any particular act. Interpretations may change for non-tax reasons that will implicate the applicability of section 199A(g).

If Treasury and the IRS wish to promulgate a definition, we would suggest something along the following lines:

> Agricultural or horticultural products are agricultural, horticultural and viticultural products, including, in each case, the processed and manufactured products thereof. Agricultural and 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 sugarbeets, the edible products of trees, vines and shrubs (including fruits, nuts and berries), mushrooms, and products thereof. It includes, but is not limited to, livestock, poultry, insects, and other animals, and any products thereof including meat, milk and other dairy products, wool, fur, hides, eggs, down, honey and other products of beekeeping, silk and waste products. The term includes all other crops and products raised or produced on farms, ranches, plantations, truck farms, urban farms (through such techniques as hydroponics), feedlots, orchards, groves, bogs, greenhouses and other similar operations, and, in each case, the processed and manufactured products thereof. Agricultural and horticultural products include fish, crustaceans, shellfish, seaweed, and other aquatic products that are raised on farms. Processed and manufactured products include livestock, poultry, fish and other animals produced by cooperatives by feeding agricultural products to such animals. Agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production.[45]

Treasury and IRS also requested comments on whether the definition would limit agricultural or horticultural products "to products acquired from original producers." Although this generally will be the case, we do not see why this limitation is necessary. The limitation is not supported by section 199A(g), its legislative history, or former section 199 or its underlying regulations. The limitation could place substantial additional record keeping burden on cooperatives without providing any additional clarity to taxpayers or serve any governmental purpose.

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[45] See, further, the discussion in the next section regarding supplies.

2. Supplies and MPGE.[46]

Prop. Treas. sec. 1.199A-8(a)(4) provides that "agricultural or horticultural products include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production *that are MPGE by a Specified Cooperative*" (emphasis added). The preamble to the proposed regulations provides that this definition is consistent with the legislative history to the section 199A(g) amendments, citing the Joint Committee Report, at 23, footnote 120.[47] The Joint Committee Report contains this language, but is in error in this regard. The report provides that "consistent with former section 199," certain supplies are to be treated agricultural or horticultural products. The report goes on to cite Treas. reg. sec. 1.199-6(f). Treas. reg. sec. 1.199-6(f) does not contain the phrase "that are MPGE by a Specified Cooperative," and including this requirement is not consistent with section 199. Treas. Reg. sec. 1.199-6(f) simply says, "For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production."

For both purposes of section 199A(g) and former section 199, the activities of the patrons of a specified cooperative are attributed to the cooperative. Thus, a cooperative is deemed to MPGE agricultural or horticultural products that are MPGE by its patrons.[48] It is nonsensical for farm supplies to be agricultural or horticultural products for a cooperative if only they are MPGE by the patrons of the cooperative. The patrons are in the trade or business of using farm supplies, not producing them. Similarly, an item should be an agricultural or horticultural product if a specified cooperative supplies it to farmers, regardless of whether the cooperative produces the item itself.

As discussed further with respect to the definition of "specified cooperative," the prerequisite for being an agricultural or horticultural product (including a supply) is not whether the product is MPGE by the cooperative (or its patrons). This requirement is appropriate for determining whether the proceeds from the disposition of products are qualified production activity income. Cooperatives that provide their farmer-patrons with supplies that the patrons use in the production of agricultural or horticultural products should be specified cooperatives, and the supplies should be agricultural of horticultural products, regardless of whether the cooperative manufactured or acquired the supplies. Supply cooperatives were formed and are operated to provide their farmer-patrons with economies of scale. The per-unit price that an individual farmer will pay for fertilizer from a fertilizer manufacturer will be higher than the amount that a

[46] The determination of what constitutes MPGE applies to all agricultural and horticultural products, including crops grown and animals raised by patrons. However, we are including a discussion of MPGE in this section because of the way the proposed regulations define supplies, as discussed below.

[47] The footnote reads: "Consistent with former section 199, it is intended that agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199-6(f)."

[48] See, both section 199A(g)(4)(B) and former section 199(d)(3)(D).

cooperative will pay to purchase fertilizer in bulk for thousands of farmer-patrons. Supply cooperatives pass on these savings to their patrons, generally through patronage dividends. This is the essence of the cooperative system. To require the cooperative to manufacture, rather than purchase, fertilizer in this case simply misses the point. A cooperative that buys seed in bulk and sells portions individually to its patrons is no less a specified cooperative than a cooperative that buys grain grown from the seed individually from its patrons and sells it in bulk to grain users. Similarly, the seed and the grain are both agricultural or horticultural products.

The list of supplies that qualify as agricultural and horticultural products under Treas. reg. sec. 1.199-6(f) is relatively short ("fertilizer, diesel fuel, and other supplies"). The catch-all of "other supplies" covers many items. Final regulations may wish to clarify that other items also qualify as supplies that are treated as agricultural or horticultural products including, but not limited to, seed, feed, herbicides, pesticides, tools, fencing, replacement parts for farm machinery and similar items used in agricultural and horticultural production.

The legislative history to the amendments of section 199A(g) indicates that:

> Consistent with former section 199, it is intended that domestic production gross receipts include gross receipts of a cooperative derived from any sale, exchange, or other disposition of agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of agricultural or horticultural products (whether or not by the cooperative). See Treas. Reg. sec. 1.199-3(e)(1).[49]

Prop. Treas. reg. sec. 1.199A-9(f) seems to incorporate this rule.[50] The regulations should clarify that supplies that are used in these activities also qualify as agricultural or horticultural products. Regulations could provide that the items that qualify as supplies for this purposes would include, but would not be limited to, packing supplies, containers, associated lids, labeling, product graphics, sheet plastic, aluminum or paper wrappings, bands and cordages customarily used for packaging, storage, transportation or conveyance of agricultural products beginning with MPGE activities, through and including packing, processing, storage, handling activities and for sale and delivery of agricultural and horticultural products to customers.

Final regulations could also clarify this issue with an example. Consider a specified cooperative that purchases fertilizers in bulk from a third-party fertilizer manufacturer. The cooperative stores the fertilizer in bulk storage bins and has a processing operation that repackages the fertilizer in smaller quantities for sale to farmers who apply the fertilizer to fields where it is consumed in the production of corn by the farmer. Alternatively, or in addition, the cooperative

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[49] Joint Committee on Taxation, *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), March 22, 2018, ftnte. 118, at p. 22.

[50] See, also the related discussion in section III.J.2. regarding including the agriculture-related examples of Treas. reg. sec. 1.199-3(e)(5) (Examples 1 and 2) in prop. Treas. reg. sec. 1.199A-9(f).

conducts an activity where it uses application equipment to apply the fertilizer to the farmers' fields where it is consumed in the production of corn. These activities met the requirements of Example 1 in Treas. reg. sec. 1.199-3(e)(5), because (1) the fertilizer is acquired by the cooperative for sale or distribution within the United States, (2) it was stored, handled, or further processed within the United States, followed by (2) sales to farmers for production of an agricultural or horticultural product within the United States.

Finally, as indicated above, prop. Treas. reg. sec. 1.199A-f(1) makes it clear that the storage, handling and other processing activities related to agricultural cooperatives are activities that are treated as MPGE. However, prop. Treas. reg, sec. 1.199A-f(2) and (3) provide that packaging, repackaging, or labelling, and installing with respect to agricultural or horticultural products is not MPGE unless the cooperative is doing some other qualified activity. It may be difficult to distinguish the types of activities that qualify under paragraph (1) from those that do not under paragraphs (2) and (3) (as well as the embedded services rules of prop. Treas. reg. sec. 1.199-8(j)(3)). We look forward to discussing this issue further with you.

3. Intangible property and income.

Prop. Treas. sec. 1.199A-8(a)(4) provides that agricultural or horticultural products do not include intangible property. We do not quite understand the reason for or the scope of the exclusion. Section 199A(g)(3)(D) provides that DPGR includes gross receipts from the license of agricultural or horticultural products. The inclusion of *licensing* income implies the exploitation of intangible property.

The proposed regulations contain two examples of intangible property. The first involves the right to reproduce a seed for resale as a disqualified intangible property. This does not appear to be a realistic example because seed that is sold to farmers generally carries with it a restriction that the purchaser does not have the right to reproduce the seed for sale (or, for that matter, to use the seed to produce a second generation of seed). We also believe that the second example, involving the license of the right to reproduce an orange, is unrealistic.

We appreciate that the proposed regulations provide that the exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. Specified cooperatives with brand-name agricultural or horticultural products should not have to treat some portion of their gross receipts as attributable to intangible property simply because the products sold at a premium related to the brand name or some other similar characteristic. The operation of this rule should be made clearer in the final regulations to comport with actual, common business transactions.

To promote the sale of their patrons' agricultural or horticultural products, many agricultural marketing cooperatives have self-developed, or co-developed with third parties, finished retail consumer focused products containing their patrons' products such as fruit juices, milk, nuts or grains. Many of these cooperatives will enter into long-term agreements with third-party manufacturers who, under contract, will produce finished retail consumer focused products in packaging containing the agricultural cooperative's brand, label, tradename. The cooperative may receive a royalty or license fee stream associated with the sale of these finished products by the third-party manufacturer. This royalty or license fee stream in substance represents additional gross revenue to the cooperative for sale of the agricultural products to the third-party manufacturer that incorporated such agricultural product as an ingredient in the manufacture of the finished products from which the royalty or license fees are derived.

The final regulations should make clear, in the text and perhaps with an example, that qualified DPGR includes gross receipts received pursuant to a contract between an agricultural cooperative and a third-party manufacturer where under such contract the cooperative sells agricultural products to the third-party manufacturer and the cooperative receives royalty or license fee income on the sale of finished products containing as an ingredient the agricultural products sold by the cooperative to such third-party manufacturer.

We would be happy to discuss this matter further with Treasury and the IRS to better understand your concerns regarding intangible property and develop appropriate rules for common business transactions.

H. Definition of a specified cooperative.

Proposed Treas. reg. sec 1.199A-8(a)(2)(i) defines a specified cooperative as:

> [A] cooperative to which Part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code (Code) applies and which—
>
> > (A) (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* (emphasis added).[51]

Section 199A(g)(4)(A) defines a specified cooperative as:

> [A]n organization to which part I of subchapter applies which in engaged—
>
> > (i) in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or
> >
> > (ii) in the marketing of agricultural or horticultural products.[52]

Comparing the two sets of language, the proposed regulation adds a qualifier for marketing cooperatives that does not exist in the statute or under prior section 199 or the underlying regulations (i.e., that the agricultural or horticultural products that the cooperative markets must have been manufactured, produced, grown, or extracted by the patrons of the cooperative).

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[51] Treas. reg. sec 1.199-6(f) defined a specified cooperative properly, without the additional language highlighted in the text above.

[52] This language also was in section 199(c)(3)(F) before its repeal.

Perhaps Treasury and the IRS are reading the rule of section 199A(g)(4)(B)[53] as requiring the additional language of the proposed regulation. However the rule of section 199A(g)(4)(B) is an operating rule intended to qualify the marketing of patron-produced products as an activity for which the section 199A(g) deduction is allowed. Section 199A(g)(4)(B) does not, and should not, operate to define whether a cooperative is itself a specified cooperative.

The final regulations should modify the definition of specified cooperative to be consistent with the statutory definition.

I. Definition of qualified payments.

Prop. Treas. reg. sec. 1.199A-8(d)(2)(ii) defines "qualified payments" consistently with Treas. reg. sec. 1.199-6(e). Other than the requirement to use a tax basis method to determine qualified payments,[54] we believe this is an appropriate starting point.

Section 199A(g)(1)(E) provides that, among other things, a "qualified payment" is "an amount which … (iii) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative under paragraph (1)." Treasury regulations should clarify that qualified payments do 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 and thus do not generate QPAI.

Moreover, as also discussed in section III.F., the definition of "qualified payments" is important because the proposed regulations require a specified cooperative to report such payments to their patrons on Form 1099-PATR, and the patrons must make an adjustment under section 199A(b)(7) with respect to QBI that is attributable to qualified payments received from specified cooperatives. As a result, we would like to have a better understanding of how Treasury and IRS believe qualified payments are determined.

J. Discussion of examples.

1. Inconsistent treatment of payments as per-unit retain allocations in examples.

Examples 1 and 2 of prop. Treas. reg. sec. 1.199A-8(e) demonstrate the calculation of the deduction allowed under section 199A(g) by a nonexempt specified cooperative. The facts of both examples are almost the same. In each, the cooperative acquires grain from its patrons and remits $5,000,000 to these patrons. Both examples include an up-front payment of $4,000,000 and a subsequent patronage dividend of $1,000,000 to the patrons. In Example 1, the up-front payments are characterized as per-unit retain allocations that are deductible under section

[53] "A specified agricultural or horticultural described in subparagraph (A)(ii) shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural product marketed by the specified agricultural or horticultural which its patrons have so manufactured, produced, grown, or extracted." This language also was in section 199(c)(3)(D) before its repeal.

[54] See, section III.B. of this submission.

1382(b). In Example 2, the up-front payments are characterized as not per-unit retain allocations.

Taken together, the examples are confusing. We do not understand how under the "same facts," a payment could be characterized as a per-unit retain allocation in Example 1 and not in Example 2. Further, we are uncertain under what circumstances these payments to patrons would not be characterized as per-unit retain allocations. Example 2 should clarify why the payments are not per-unit retain allocations.

On the other hand, perhaps the examples stand for the proposition that a specified cooperative is free to characterize a payment to a patron as an amount deductible under section 1382(b) or (c) or not for purposes of section 199A. If that is the intent, this discretion should be clarified in the regulation itself, rather than as an example.

2. Storage of farm products.

The legislative history to the amendments of section 199A(g) indicates that:

> Consistent with former section 199, it is intended that domestic production gross receipts include gross receipts of a cooperative derived from any sale, exchange, or other disposition of agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of agricultural or horticultural products (whether or not by the cooperative). See Treas. Reg. sec. 1.199-3(e)(1).[55]

Prop. Treas. reg. sec. 1.199A-9(f) seems to incorporate this rule (substituting "manufacture, produced, grown, or extracted (MPGE)" for "domestic production gross receipts.)"[56] The final regulation should provide additional clarity by including Examples 1 and 2 of prior Treas. reg. sec. 1.199-3(e)(5) clarify that the storage of farm products gives rise to qualified MPGE**.**

3. Other omitted examples.

Treas. reg. sec. 1.199-6(m) contained rules applicable to specified cooperatives and their patrons. Many of these rules are contained in various portions of these proposed regulations. The examples of Treas. reg. sec. 1.199-6(m) should be restored in the section 199A(g) regulations to provide additional clarity and eliminate any unnecessary confusion regarding their omission.

4. Interplay of NOLs and patronage dividends in examples.

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[55] Joint Committee on Taxation, *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), March 22, 2018, ftnte. 118, at p. 22.

[56] Similar language is found in prior Treas. reg. sec. 1.199-3(d)(1).

Examples 6 and 7 of prop. Treas. reg. sec. 1.199A-8(e) demonstrate that the use of an NOL carryforward from a prior year reduces or eliminates taxable income for the year upon which the section 199A(g) deduction for the year is calculated. These examples seem to be based on Examples 1 and 2 of Treas. reg. sec. 1.199-1(b)(2), modified to apply to specified cooperatives. The modifications are problematic for at least two reasons.

In both examples, the facts provide that the cooperative's QPAI and taxable income is determined without regard to any deductions allowed under section 1382(b). It is correct that for purposes of calculating its section 199A(g) deduction, a specified cooperative does not reduce its QPAI and taxable income by its deductions under section 1382(b) (generally, amounts paid to patrons).[57]

However, the examples do not consider what happens in the more realistic case where the cooperative made payments to patrons that were deductible under section 1382(b).

Under the facts of Example 7, C had \$100 of taxable income after consideration of all allowable deductions. C did not make any payments to patrons, so its taxable income is \$100 both for section 63 purposes and section 199A(g) purposes (i.e., there are no section 1382 deductions to add back pursuant to section 199A(g)(1)(C)). So it is clear that C has a an NOL carryover to 2019 of \$400 (\$500 NOL carryover to 2018 – \$100 NOL used in 2018).

If, in Example 7, the cooperative had paid per-unit retain allocations or a patronage dividend of \$100 to its patrons, its taxable income for the year for section 63 purposes would have been \$0, and it would not have used any of its NOL carryover in 2018.[58] It would have had a full NOL carryover of \$500 to 2019. It should also have QPAI and taxable income of \$100 for purposes of calculating the section 199A(g) deduction for 2018.

Part (ii) of Example 7 provides that "for purposes of section 199A(g)" the amount of NOL carryover to 2019 is \$400. It is unclear what the phrase "for purposes of section 199A(g)" adds or means. What would part (ii) of Example 7 conclude if C had paid a patronage dividend of \$100? Would the NOL carryover to 2019 still be \$400 for purposes of section 199A(g), or would it be \$500 (as it is for sections 63 and 172)? Do the proposed regulations suggest that a specified cooperative has two types of NOL – one used pursuant to section 172 and another used solely for purposes of section 199A(g)?[59]

It would be inappropriate for the regulations to provide that a specified cooperative that claims deductions under section 1382(b) or (c) is deemed to have used a portion of an NOL even though it received no benefit from the NOL (because such NOL deduction substituted for a section 1382

[57] Section 199A(g)(1)(C).

[58] See, Rev. Rul. 65-106, 1965-1 C.B. 126.

[59] The last sentence of Example 5 of prop. Treas. reg. sec. 1.199A-12(b)(5)(i)(C) (dealing with EAGs) suggests that there are not separate NOLs. The NOL rules examples in prop. Treas. reg. sec. 1.199A-8 should be coordinated with the EAG NOL rules.

deduction in the section 199A(g) calculation). Similarly, it would be burdensome and inappropriate to require a specified cooperative to maintain two separate NOLs – one for purposes of section 172 and another solely for purposes of 199A(g). Nothing in the statute, legislative history, or prior section 199 and its underlying regulations suggests either of these results.

Final regulations should clarify that the amount of NOL that is taken into account for purposes of calculating the deduction under 199A(g) is the amount that the specified cooperative actually used in computing taxable income on its tax return for the year. 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) limitation.

To address these issues, we would suggest that the phrase "for purposes of section 199A(g)" be stricken from prop. Treas. reg. sec. 1.199A-8(e)(7)(ii)[60] and the inclusion of the following example:

> (8) Example 8. NOL. (i) C, a nonexempt Specified Cooperative, MPGE agricultural or horticultural products. C is not part of an EAG. In 2018, C generates QPAI and taxable income of $100, without taking into account any of its deductions under section 1382(b), the deduction under section 199A(g), or an NOL deduction. C pays a patronage dividend of $91 that it deducts on in 2018. C has an NOL carryover to 2018 of $500. C's section 199A(g) deduction for 2018 is $9 (9% × (lesser of: QPAI of $100 and taxable income of $100)). C elects to retain the section 199A(g) deduction and not pass it through to its patrons.
>
> (ii) Carryover to 2019. C's 2018 taxable income for purposes of determining its NOL carryover to 2019 is $0 ($100 - $91deduction under section 1382(b) - $9 section 199A(g) deduction). Accordingly, C's NOL carryover to 2019 is $500.

I. Treatment of partnerships.

Section 199A(g)(5)(B) provides that the rules similar to section 199A(f)(1) shall apply to specified cooperatives that are partners in partnerships. Section 199A(f)(1) essentially provides that a section 199A deduction is determined at the partner level and each partner will take into account its allocable share of the partnership items (including W-2 wages) that are necessary for the partner to determine its section 199A deduction. In this regard, section 199A(d)(1)(A) is almost identical to former section 199(f)(1).

Prop. Treas. reg. sec. 1.199A-8(f) provides that:

> 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 the cooperative's share of gross receipts and related deductions, unless

[60] Alternatively, all of prop. Treas. reg. sec. 1.199A-8(e)(7)(ii) could be struck because the paragraph adds nothing that is not otherwise obvious.

otherwise provided by the instructions to the Form. The Specified Cooperative determines what gross receipts reported by the partnership qualify as DPGR and includes these gross receipts and related deductions 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.

The proposed regulation does not replicate the regulations governing partnerships under former section 199(f)(1). For example, it does not provide for the flow through of W-2 wages from a partnership to a specified cooperative, as explicitly provided in section 199A(f)(1)(A)(iii). Final regulations should also make it clear that the specified cooperative takes into account its allocable share of W-2 wages with respect to its interest in a partnership. For this purpose, Treasury and IRS should consider promulgating rules similar to Treas. reg. secs. 1.199-5(b)(1)(i) and (3).

In some instances, a specified cooperative will conduct otherwise qualified production activities (such as marketing the agricultural or horticultural products of its patrons) through a partnership in which the cooperative is a partner. Final regulations should clarify that the gross receipts of the partnership from such activities (including MPGE, storage, handling, processing and marketing activities) are DPGR as if such activities were conducted by the specified cooperative directly.

J. Treatment of Expanded Affiliated Groups and other organizational structures.

The treatment of affiliated entities, whether or not as part of an Expanded Affiliated Group (EAG), is very important to many specified cooperatives. Historically, cooperatives have had a variety of organizational structures involving tiered entities. These include an exempt cooperative being a patron (and perhaps the sole patron) in a nonexempt cooperative, a cooperative of cooperatives (generally known as a "federated cooperative") often composed of a national cooperative and regional and sub-regional cooperatives, and a cooperative that has interests in corporations that are not cooperatives (and may join in the filing of a consolidated consolidated return).

As under former section 199, the proposed regulations should provide clear operating rules for these organizational structures. We appreciate that prop. Treas. reg. sec. 1.199A-12 is modeled after Treas. reg. sec. 1.199-7, and we encourage this development for EAGs. Applying the proposed regulations to these and other similar structures is complex, and we and our members continue to study issues applicable to tiered entities. In the meantime, we would like to bring the following matters to your attention.

1. Members of an EAG that are not cooperatives.

The proposed regulations provide that only the relevant items of specified cooperatives in an EAG are taken into account in determining the section 199A(g) deduction of the group.[61] This

[61] Prop. Treas. reg. sec. 1.199A-12(b) ("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*

limitation is contrary to former section 199, where the deduction was determined with respect to all the members of the group, whether they were noncooperative corporations or cooperative corporations. It is true that section 199A, unlike section 199, generally does not apply to corporations. However, as discussed above, the exception to the limitation to noncorporate taxpayers is section 199A(g), which applies to corporations that are specified cooperatives. In addition, Congress intended section 199A(g) to operate the same as former section 199. Nothing in section 199A(g), as modified by Congress in the 2018 Act, excludes the otherwise qualified activity of corporate subsidiaries (and partnerships wholly owned by the EAG) of a specified cooperative in an EAG. The only limitation that Congress imposed is a disallowance of the deduction for corporate patrons of a specified cooperative.[62] If Congress intended to disallow the deduction with respect to downstream C corporate subsidiaries as it did for upstream corporate patrons, it would have done so.

Moreover, Congress reiterated, in section 199A(g)(5), the rule of former section 199 that members of an EAG are to be treated as one corporation. That provision does not require that only cooperative members of an EAG are to be treated as one corporation (the rule in the proposed regulations); it applies to all members of the defined group. It is difficult to reconcile section 199A(g)(5) and the requirement that section 199A(g) is intended to replicate section 199 with the limitation of prop. Treas. reg. sec. 1.199A-12(b).

Finally, the limitation of prop. Treas. reg. sec. 1.199A-12(b) treats similarly situated specified cooperatives differently. If a specified cooperative wholly owns a C corporate subsidiary, the activity of the subsidiary is not taken into account for purposes of section 199A(g). However, if a specified cooperative owns all the interests in a limited liability company, the activity of the disregarded entity is taken into account for purposes of section 199A(g).

Consider the following common example. A specified cooperative acquires produce from its grower-patrons. The produce is processed by a C corporation that is wholly-owned by the cooperative. Another C corporation, also wholly-owned by the cooperative, sells and distributes the processed product to third parties. The specified cooperative and the corporate subsidiaries join in the filing of a consolidated tax return.

The product that it is purchased, processed, and marketed is subject to different types of regulation, and distinct entities are necessary to separate the various functions and their separate legal risks.

It is clear that section 199A(g) would apply to all the activity of the group if it was all done within the cooperative. The cooperative and its patrons should not be penalized simply because they have separated the various functions for valid business reasons. For Federal income tax purposes, the group is treated as one taxpayer because it files a consolidated tax return. The proposed regulations should not require potentially onerous allocations among members of the group simply some of the corporations are specified cooperatives and others are not.

the EAG and the section 199A(g) deduction from the nonpatronage sources *of exempt Specified Cooperatives that are members of the EAG*" (emphasis added.))

[62] Section 199A(g)(2)(D).

Final regulations should clarify that if a specified cooperative controls, in the meaning of section 199A(g)(5), a C corporation, a group of controlled C corporations or any partnerships, the activity (including W-2 wages) of such entities should be taken into account in the same manner as it was taken into account under section 199.

2. Nonpatronage activity.

Several provisions in prop. Treas. reg. sec. 1.199A-12 require members of an EAG to distinguish and treat separately income, deductions and W-2 wages from patronage and nonpatronage activity. As we have noted repeatedly, these requirements are inappropriate in that they conflict with section 199A(g), the legislative history and former section 199 and its underlying regulations. These requirements are equally inappropriate for EAGs that include specified cooperatives. Eliminating the distinctions between patronage and nonpatronage activity will reduce significantly the complexity of the EAG rules.

3. Federated cooperatives.

There is some confusion how the rules for federated cooperative operate under the proposed regulations. Prop. Treas. reg. sec. 1.199A-8(d)(1) provides that "(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 that are eligible taxpayers." Prop. Treas. reg. sec. 1.199A-8(d)(5) provides that "(a) Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction only against patronage gross income and related deductions." Taken together, these rules seem to indicate that a specified cooperative that receives a section 199A(g) deduction as a patron may retain such any portion of deduction to offset its taxable income or pass through any portion of such deduction to its patrons.

Final regulations should clarify this result. It is appropriate to treat a section 199A(g) deduction passed to a specified cooperative the same as a section 199A(g) generated by the cooperative based on its own qualified activities. To treat such deductions differently would create accounting and planning burdens and be inconsistent with the operation of former section 199.

4. Related exempt and nonexempt cooperatives.

There are situations where an exempt cooperative is the sole patron of a nonexempt cooperative. Under Treas. prop. reg. sec. 1.199A-12(a)(1), and under prior section 199, the exempt cooperative and the nonexempt cooperative are not an EAG because they are not an affiliated group under section 1504(a).[63] Under prior section 199, the nonexempt cooperative calculated its section 199 deduction and passed it through to the exempt cooperative which, in turn, passed it through to its patrons. Final regulations should clarify that a similar result occur sunder section 199A(g).

K. Effective date issues.

[63] See, section 1504(b)(1) which excludes exempt entities. See, also Treas. reg. sec. 1.1381-2(a)(1).

The preamble to the proposed regulations generally provides that the final regulations will be effective for taxable years *beginning* after final regulations are published in the Federal Register.[64] The language in the proposed regulations provides that the final regulations will be effective for taxable years *ending* after final regulations are published in the Federal Register.[65]

Treasury and the IRS should provide that the final regulations will be effective for taxable years *beginning* after final regulations are published in the Federal Register. As discussed above, cooperatives will be faced with significant new reporting and accounting requirements if the regulations are finalized as proposed. Taxpayers should be allowed sufficient time to comply with these requirements. Selecting the later date provided in the preamble will provide such time and will not harm those taxpayers who relied upon the preamble language.

Finally, the 2018 Act included a transition rule to address the effects of the repeal of section 199 and the enactment of section 199A, both effective for taxable years beginning after 2017. A transition rule was necessary because specified cooperatives generally were on a "delayed application" of section 199. The section 199 deduction determined by a specified cooperative generally was passed to its patrons pursuant to a written notice that was received, and deducted, in a year subsequent to the year in which the qualified activity that gave rise to the deduction occurred. For example, absent TCJA, a calendar-year specified cooperative would have had activity that generated a section 199 deduction in 2017 that would not be passed through and deducted by its patrons until 2018, when the written notice was received. The effective date of the repeal of section 199 would have disallowed this deduction by the patrons. Thus, without a transition rule, such deductions would be lost.

The proposed regulations provide rules regarding the transition rule. However, because these regulations likely will not be finalized until after 2019, the "transition year" likely will have passed. Requiring specified cooperatives to send amended Forms 1099-PATR, and requiring farmers to amend their Forms 1040 to conform to whatever the final regulations provide regarding the transition rule will only cause confusion and administrative burdens.

Specified cooperatives understood the transition rule as drafted by Congress and have responded or are responding accordingly. The IRS has issued new Forms 1099-PATR and instructions. No further guidance is necessary. The time has passed for Treasury and IRS to issue additional guidance. Final guidance should drop references to the transition rule and provide that any reasonable application of the transition rule will be deemed appropriate.

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[64] See, page 40 of the preamble ("Consistent with authority provided by section 7805(b)(1)(A), the proposed regulations are proposed to apply to taxable years beginning after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.")

[65] See, e.g., prop. Treas. reg. sec. 1.199A-7(h)(1).

Thank you, again, for the opportunity to comment on these proposed regulations. We appreciate the time and effort spent in the development of these rules. As indicated above, we believe adjustments are necessary, perhaps in re-proposed fashion, and would be happy to discuss these important and complicated areas with you further. In the meantime, if you have any questions or comments, please contact Marlis Carson, NCFC Senior Vice President and General Counsel at (202) 879-0825.

Sincerely,

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cc:

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