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IRS Issues Long-Awaited Proposed §199A Regulations for Cooperatives and Their Patrons

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INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA) effected significant changes to the tax code, including a new 20% §199A deduction for “qualified business income.”¹ This provision, designed to ensure that sole proprietors and owners of pass-through businesses recognize a tax benefit somewhat on par with the rate reduction granted to C corporations,² has generated much debate, largely due to pockets of complexity and uncertainty impacting a small percentage of taxpayers seeking to claim it. Perhaps no provision in the new tax law, however, caused as much unexpected controversy as the obscure §199A(a)(2) deduction for “qualified cooperative dividends,” widely dubbed the “grain glitch.” Concern that this short-lived 20% deduction would have bestowed upon some patrons of cooperatives a deduction equal to 20% of gross sales—potentially allowing a tax-free sale and creating market distortion—prompted Congress to enact a rare fix.

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¹ Pub. L. No. 115-97. All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

² The TCJA reduced the top corporate tax rate from 35% to 21%.

CONSOLIDATED APPROPRIATIONS ACT OF 2018 FIX TO GRAIN GLITCH

The Consolidated Appropriations Act of 2018³ retroactively repealed the original §199A(a)(2) provision that allowed patrons a 20% deduction for “qualified cooperative dividends.” It also retroactively repealed the 20% deduction granted to specified agricultural and horticultural cooperatives under the original §199A(g).

Congress sought to restore market equity by replacing these provisions with a new §199A(g) deduction for agricultural and horticultural cooperatives mirroring the 9% §199 domestic production activities deduction (DPAD)⁴ repealed by the TCJA. As was the case with DPAD, §199A(g) provides these cooperatives with a choice between passing some or all of this deduction through to their patrons or keeping it all for themselves. Under §199A(g), unlike DPAD, cooperatives may not pass the deduction through to non-cooperative C corporation patrons. If passed through to patrons by the cooperative, the §199A(g) deduction supplements the standard 20% §199A(a) qualified business income (QBI) deduction patrons may take for income generated from their farming operation, including income derived from their business with cooperatives. In other words, these patrons may be entitled to two separate §199A deductions.

To partially offset the benefit of the two deductions, however, the law requires patrons who pay W-2 wages to reduce their standard 20% QBI deduction in an amount up to 9%. This reduction is required whether or not the cooperative passes through its §199A(g) deduction to the patron. Patrons who do not pay W-2 wages do not reduce their QBI deduction. They are entitled to their full 20% QBI deduction (if otherwise eligible), plus any §199A(g) deduction passed through to them by the cooperative.

This distinction among patrons preserves the special tax benefit agricultural cooperatives sometimes

³ Consolidated Appropriations Act (Pub. L. No. 115-141) Div. T, §101.

⁴ DPAD was repealed for tax years beginning in 2018 by TCJA §13305.

provided to farmers who did not pay W-2 wages under §199. Under this law, farmers who did not pay wages were eligible for the 9% DPAD only if they did patronage business with a cooperative and then only if the cooperative passed the deduction through. The cooperative's wages were used to calculate the DPAD deduction, and doing business with a cooperative that passed DPAD through to its patrons gave these farmers a deduction they otherwise would not have received. Conversely, farmers who paid W-2 wages could claim the 9% DPAD on their own, in an amount up to 50% of the W-2 wages paid, for business they did with a non-cooperative. For their cooperative business, however, a patron's eligibility for the DPAD was dependent upon a choice made by the cooperative. The cooperative calculated the DPAD, and the farmer was not allowed the deduction for its cooperative income if the cooperative chose not to pass it through.

REGULATORY BACKGROUND

Although the Treasury Department and the Internal Revenue Service (the agencies) issued proposed regulations for §199A⁵ in August 2018, and final regulations⁶ in February 2019, these regulations did not provide guidance for interpreting the cooperative provisions added by the 2018 fix to the grain glitch. Rather, the agencies stated in the preamble to the final regulations that they “intend[ed] to issue a future notice of proposed rulemaking describing proposed rules for applying section 199A to specified agricultural and horticultural cooperatives and their patrons.” The preamble to the proposed regulations had stated that the agencies “continue to study the area and intend to issue separate proposed regulations describing rules for applying section 199A to specified agricultural and horticultural cooperatives and their patrons later [in 2018].”

The agencies finally released proposed regulations for the application of §199A to cooperatives and their patrons, as modified by the grain glitch fix, on June 18, 2019. This article details two major sections of the guidance: (1) rules for how patrons of cooperatives calculate their §199A(a) QBI deduction when doing business with a cooperative,⁷ including a Specified Cooperative, and (2) rules for how Specified Cooperatives calculate and pass through the §199A(g) deduc-

tion.⁸ Both sections incorporate new reporting requirements for cooperatives.

Proposed Reg. §1.199A-7, §199A(a) Rules for Cooperatives and their Patrons

Prop. Reg. §1.199A-7 provides guidance and special rules for the application of the final §199A regulations⁹ to cooperatives¹⁰ and their patrons.¹¹ In other words, it describes how the standard §199A(a) QBI deduction applies to cooperative-related income.

QBI Deduction Not Available to C Corporations, Including Cooperatives

The proposed regulations reiterate that the QBI deduction is not available to C corporations, including cooperatives or their C corporation patrons. Only “individual” patrons are eligible for the deduction. This definition includes trusts and estates to the extent the deduction is taken at the trust or estate level.

Patronage Dividends or Similar Payments as QBI

To the extent a patron has income directly from its own trade or business (as opposed to receiving income from a cooperative), the patron will calculate the §199A(a) deduction, as specified under the final §199A regulations. To the extent the patron receives a distribution from a cooperative, including “patronage dividends or similar payments from a cooperative,” the patron follows the special rules in Prop. Reg. §1.199A-7 to calculate the §199A(a) QBI deduction.

“Patronage dividends or similar payments” include money, property, qualified written notices of allocations, and qualified per-unit retain certificates for which an exempt or nonexempt cooperative receives a deduction under §1382(b), and non-patronage distributions paid in money, property, qualified written notices of allocation as well as money or property paid in redemption of a nonqualified written notice of allocation for which an exempt cooperative receives a deduction under §1382(c)(2) (hereinafter collectively referred to as patronage dividends or similar payments).¹²

Note: This definition includes patronage dividends and per-unit retains paid in money (PURPIM).

⁵ REG-134652-18, 84 Fed. Reg. 3,015 (Feb. 8, 2019); REG-107892-18, 83 Fed. Reg. 40,884 (Aug. 16, 2018).

⁶ T.D. 9847, 84 Fed. Reg. 2,952 (Feb. 8, 2019).

⁷ REG-118425-18, 84 Fed. Reg. 28,668 (June 19, 2019). Prop. Reg. §1.199A-7.

⁸ Prop. Reg. §1.199A-8.

⁹ Reg. §1.199A-1 - §1.199A-6.

¹⁰ The proposed regulations, unless otherwise noted, apply to cooperatives to which §1381 - §1388 apply.

¹¹ Patron is defined in Reg. §1.1388-1(e).

¹² Prop. Reg. §1.199A-7(c).

“Patronage dividends or similar payments” may be included in the patron’s QBI¹³ if:

- These payments are related to the patron’s trade or business;
- These payments are qualified items of income, gain, deduction, or loss¹⁴ at the cooperative’s trade or business level;
- These payments are not income from a specified service trade or business (SSTB) at the cooperative’s trade or business level (except as permitted by the threshold rules); and
- The patron receives certain information from the cooperative about these payments.¹⁵

Patronage dividends or similar payments are generated from the trade or business the cooperative conducts with or on behalf of the patron and are tested by the cooperative at its trade or business level.¹⁶

Reporting Requirement for Qualified Items of Income, Gain, Deduction, or Loss

The cooperative must determine **and report** to the patron whether a distribution contains qualified items of income, gain, deduction, or loss.¹⁷ The patron must have that information to determine his or her §199A QBI deduction. The cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form), unless otherwise provided by the instructions to the form. The cooperative, for example, cannot include as qualified items those distributions flowing from trade or business income outside of the United States, or interest income not allocable to the cooperative’s trade or business. Items from an SSTB must be reported separately.¹⁸

If the patron does not receive this information from the cooperative on or before the due date of the Form 1099-PATR, the amount of distributions **from the cooperative that may be included in the patron’s QBI is presumed to be zero.**¹⁹ This does not apply to amounts of qualified items of income, gain deduction, and loss to the extent that they were not reported on the Form 1099-PATR or an attachment before the publication of the proposed regulations in the Federal Register. These reporting rules apply to exempt and non-exempt cooperatives and patronage and non-patronage distributions.

Note: Unlike a pass-through business, patrons of cooperatives calculate their W-2 wage and unad-

justed basis immediately after acquisition (UBIA) of qualified property limitations at the patron level, without regard to the cooperative’s W-2 wages or UBIA.²⁰ For that reason, the cooperative is not required to report this information to its patrons.

SSTB Determination

Cooperatives must also determine whether any of their “patronage dividends or similar payments” paid to patrons include items of income, gain, deduction, and loss from an SSTB directly conducted by the cooperative. If they do, the patron can treat this income as QBI only to the extent that the patron’s income is below the statutory income threshold or within the phase-in range.²¹ The cooperative can apply the gross receipts de minimis rule in Reg. §1.199A-5(c)(1) to determine if its trade or business is an SSTB.

SSTB Reporting Requirement

Cooperatives must report to the patron whether the distributions from the cooperative include items of income, gain, deduction, and loss from an SSTB directly conducted by the cooperative and whether these items are qualified items of income, gain, deduction, and loss with respect to the SSTB. The report must be made on an attachment to or on the Form 1099-PATR (or any successor form), unless otherwise instructed by the instructions to the Form. If the patron does not receive this information from the cooperative on or before the due date of the form 1099-PATR, then only the amount that a cooperative reports as qualified items of income, gain, deduction, and loss under Prop. Reg. §1.199A-7(c) may be included in the patron’s QBI. The remaining distributions from the cooperative that may be included in the patron’s QBI is presumed to be zero.²²

Special Rule for Patrons of Specified Cooperatives: §199A(b)(7) Reduction

To account for the fact that a patron of a “Specified Cooperative” may be eligible to take both an §199A(a) QBI deduction and a §199A(g) deduction, a patron of a Specified Cooperative that receives a “qualified payment” must reduce its §199A(a) QBI deduction as provided in Reg. §1.199A-1(e)(7). **This reduction applies whether the Specified Cooperative passes through some, all, or none of the Speci-**

¹³ Prop. Reg. §1.199A-7(c)(2).

¹⁴ As defined in §199A(c)(3).

¹⁵ See Prop. Reg. §1.199A-7(c)(3), §1.199A-7(d)(3)).

¹⁶ Prop. Reg. §1.199A-7(b).

¹⁷ Prop. Reg. §1.199A-7(c).

¹⁸ Prop. Reg. §1.199A-7(d).

¹⁹ Prop. Reg. §1.199A-7(c)(3).

²⁰ Prop. Reg. §1.199A-7(e).

²¹ For 2019, this statutory income threshold is \$160,700 for single filers and \$321,400 for married filing jointly (MFJ).

²² Prop. Reg. §1.199A-7(d)(3).

deduction to its patrons in that taxable year.²³

This reduction applies only to patrons of Specified Cooperatives that receive qualified payments. A Specified Cooperative is defined as a cooperative that:

(A) Manufactures, produces, grows, or extracts (MPGE) in whole or significant part within the United States any agricultural or horticultural product, or (B) Is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the United States by the patrons of the cooperative.²⁴

“Qualified payments” include patronage dividends and per-unit retains, including per-unit retains paid in money (PURPIM).²⁵

The QBI reduction equals the smaller of (1) 9% of the QBI for that trade or business that is allocable to qualified payments from the Specified Cooperative or (2) 50% of patron’s W-2 wages paid that are allocable to those qualified payments.²⁶

Note: If the patron pays no wages, there is no reduction.

Allocation

When a patron receives both qualified payments and other income that is not a qualified payment in its trade or business, the patron must allocate those items and related deductions using a “reasonable method based on all the facts and circumstances.”²⁷ Different reasonable methods may be used for the different items and related deductions. The chosen reasonable method, however, must be consistently applied from one tax year to another and must clearly reflect the income and expenses of the business. Likewise, the overall combination of methods must be reasonably based on all the facts and circumstances, and the books and records maintained for a trade or business must be consistent with any allocations.

Note: The agencies are requesting comments as to whether a permissible “reasonable method” shall be specified in regulations or permitted to include methods based upon direct tracing, allocations based on gross income, or other methods.

Safe Harbor

A patron with taxable income under the income threshold provided in §199A(e)(2) (\$160,700/

\$321,400 MFJ in 2019) is eligible to use a safe harbor allocation method.²⁸ Under this safe harbor, the patron that receives qualified payments and income other than qualified payments may apportion its deductions and W-2 wages ratably between income from qualified payments and income other than qualified payments for purposes of calculating the QBI reduction. These patrons would ratably apportion business expenses based on the proportion that the amount of qualified payments bears to the total gross receipts used to determine QBI. The same proportion applies to allocate the proper amount of W-2 wages to the portion of QBI comprising qualified payments (that portion for which a reduction must be calculated).

Note: The safe harbor is optional. If another “reasonable method” would produce an accurate, more beneficial result, the patron may use that method.

Notice Requirement for Qualified Payments

To allow patrons to make the proper reduction calculation, the Specified Cooperative must report the amount of the qualified payments made to eligible taxpayers,²⁹ on an attachment to or on Form 1099-PATR (or a successor form), unless otherwise provided by the instructions.

Note: This notice requirement imposes no presumption of zero if qualified payments are not reported.

Transition Rule

The grain glitch fix included a transition rule for patrons who received a qualified payment from a Specified Cooperative in a tax year beginning after 2017 attributable to qualified production activities income (QPAI) for which the §199 DPAD was applicable. This included qualified payments attributable to QPAI arising during a Specified Cooperative’s taxable year beginning before 2018.³⁰

This rule means that patrons can still take the §199 DPAD passed through to them by Specified Cooperatives in a taxable year beginning after 2017, as long as it is attributable to QPAI that was allowed to the Specified Cooperative for its taxable year beginning before 2018. The difficulty with this rule, however, is that no §199A(a) QBI deduction is allowed to patrons for these qualified payments.³¹ In other words, a patron who sold grain to a Specified Cooperative in 2018 and received PURPIM (a qualified payment)

²³ Prop. Reg. §1.199A-7(f)(1).

²⁴ Prop. Reg. §1.199A-8(a)(2). Specified Cooperatives are subsets of Cooperatives, as defined in Prop. Reg. §1.199A-7(a)(1).

²⁵ Prop. Reg. §1.199A-8(d)(2)(ii), applies also to Prop. Reg. §1.199A-7. See Prop. Reg. §1.199A-7(a)(3)(v).

²⁶ Reg. §1.199A-1(e)(7).

²⁷ Prop. Reg. §1.199A-7(f)(2).

²⁸ Prop. Reg. §1.199A-7(f)(2)(ii).

²⁹ Defined in §199A(g)(2)(D).

³⁰ See Consolidated Appropriations Act, §101(c)(2).

³¹ Prop. Reg. §1.199A-7(h)(2).

from that Specified Cooperative as proceeds from that sale could not include those proceeds in QBI if the grain was sold during a Specified Cooperative's taxable year beginning before 2018.

Note: The proposed regulations provide no rules for allocating expenses between qualified payments impacted by the transition rule and other QBI.

Notice Requirement

If a patron of a Specified Cooperative cannot claim a deduction under §199A for any qualified payments described in the transition rule, the Specified Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Specified Cooperative to the patron, unless otherwise provided by the form instructions.³²

Example

Sam Patron is a grain farmer and a patron of a non-exempt Specified Cooperative.³³

In 2019, Sam, who is MFJ, has taxable income of \$75,000. Sam's 2019 QBI for the grain business is \$50,000. This includes:

● Patronage dividends from 2018 business	\$20,000 +
● Gross receipts (sales to an independent grain elevator)	\$150,000 +
● Per-unit retain allocations from the Cooperative	\$80,000 -
● Expenses (\$50,000 of W-2 wages)	\$200,000
	<hr/>
	\$50,000 QBI

Sam was also allocated a \$1,000 §199A(g) deduction from the Cooperative for grain sold to the Cooperative in 2018.

Sam calculates the portion of QBI related to the qualified payments received during 2019 to be \$10,000. This is based upon Sam's PURPIM and patronage dividends, totaling \$100,000, less allocated expenses of \$90,000 (including \$25,000 of W-2 wages).

Sam's tentative QBI deduction related to the grain trade or business is \$10,000 (.20 x \$50,000). Because Sam paid W-2 wages, however, a reduction must be applied to determine the deductible QBI amount.

$$(.20 \times \$50,000) \text{ minus } \$900 = \mathbf{\$9,100}$$

(Because Sam paid W-2 wages allocated to the qualified payments, the 20% QBI deduction was **reduced by the lesser of**: 9% of the QBI allocated to the qualified payments (.09 x \$10,000)

or 50% of W-2 wages allocated to the qualified payments (.50 x \$25,000) or **\$900**)³⁴

Sam may take a QBI deduction of \$9,100 for the grain trade or business. Because this amount is less than 20% of taxable income, the full deduction may be taken. In addition, Sam may take the \$1,000 §199A(g) deduction passed through from the Cooperative. This deduction may be taken in full because it does not exceed Sam's taxable income.

Sam has a total §199A deduction of \$10,100 in 2019. If Sam had not paid wages allocable to the qualified payments, he would have had no reduction and his total QBI deduction would have been \$11,000.³⁵

Note: In this basic example, Sam used an unstated "reasonable method" to allocate his expenses (not ratable). Sam had no other income from his trade or business such as \$1245 recapture income arising from the sale of equipment. The proposed regulations do not mention whether expenses should be allocated to such income. The proposed regulations also do not clarify how the reduction would be calculated in the event of a negative QBI attributable to qualified payments.

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

Section §199A(g) provides a deduction for Specified Cooperatives and their patrons that is similar to the old DPAD (§199). Unlike the DPAD, this deduction is available only to **Specified Cooperatives** and their patrons (if the Specified Cooperative chooses to pass it through to its patrons). As noted above, Specified Cooperatives include only **agricultural or horticultural** cooperatives. Specified Cooperatives can be either exempt or non-exempt cooperatives.

Calculating the §199A(g) Deduction

Non-exempt Specified Cooperatives must follow four steps to calculate their §199A(g) deduction.³⁶ The rules for exempt Specified Cooperatives are beyond the scope of this article. The rules are similar to the old DPAD calculation, but the proposed rules specify that non-patronage income cannot be used by a non-exempt cooperative to calculate the §199A(g) deduction. Otherwise, the Specified Cooperative would receive both a lower corporate income tax rate

³² Prop. Reg. §1.199A-7(h)(3).

³³ This example is adapted from Prop. Reg. §1.199A-7(g)(1).

³⁴ Reg. §1.199A-1(e)(7).

³⁵ Prop. Reg. §1.199A-7(g)(2).

³⁶ Prop. Reg. §1.199A-8(b).

and the §199A(g) deduction for the non-patronage income.

Step One: Split patronage and non-patronage gross receipts and related deductions (only patronage gross receipts may be used to calculate the deduction).

Step Two: Identify those patronage gross receipts that qualify as domestic production gross receipts (DPGR).

Step Three: Calculate Patronage QPAI (calculating qualified production activities income from only patronage DPGR).

Step Four: Calculate Patronage §199A(g) Deduction (Equal to 9% of the lesser of QPAI or taxable income and subject to the 50% W-2 Wage limitation).

Note: On June 18, 2019, IRS also issued Notice 2019-27, which provides Methods for Calculating W-2 Wages for Purposes of §199A(g). Proposed §1.199A-11 provides detailed instructions for calculating and allocating W-2 wages for this purpose.

Passing the §199A(g) Deduction to Patrons Who Are Eligible Taxpayers

Once the Specified Cooperative calculates its §199A(g) deduction, it may, at its discretion, pass the patronage deduction to its patrons that are “eligible taxpayers.” Eligible taxpayers are (1) patrons other than C corporations and (2) patrons that are Specified Cooperatives.³⁷ A Specified Cooperative may pass through all, some, or none of its §199A(g) deduction to its patrons who are eligible taxpayers.

Note: Unlike the DPAD, Specified Cooperatives cannot pass the §199A(g) deduction to patrons who are non-cooperative C corporations.

The amount of the §199A(g) deduction that the Specified Cooperative can pass through is limited to that portion allowed with respect to the QPAI to which the qualified payments made to the eligible taxpayer are attributable.³⁸

A Specified Cooperative calculates qualified payments using the same method of accounting it uses to calculate its taxable income. These proposed rules are essentially the same as those for the DPAD calculation, with the exception of those specific provisions dealing with “eligible taxpayers.”

Notice Requirement for Passing through the §199A(g) Deduction

If the Specified Cooperative passes the §199A(g) deduction through to its patrons who are eligible tax-

payers, it must identify the amount of the deduction in a notice mailed to the patron no later than the fifteenth day of the ninth month following the close of the taxable year of the Specified Cooperative. The cooperative must also report the amount of the §199A(g) deduction passed through to the eligible taxpayer on an attachment to or on the Form 1099-PATR (or any successor form), unless otherwise stated by the instructions to the Form.³⁹

How Patrons Apply the §199A(g) Deduction if Passed Through

Patrons to whom the Specified Cooperative passes the §199A(g) deduction may deduct it up to the amount of their taxable income (in the tax year the written notice is received, which is on or before the due date of the Form 1099-PATR).⁴⁰ Taxable income for this purpose takes into account the §199A QBI deduction, but not the §199A(g) deduction. In contrast, the §199A(a) QBI deduction is limited to 20% of the taxpayer’s taxable income minus net capital gain.⁴¹ The §199A(g) deduction passed through to patrons is also not subject to the W-2 wages or UBIA of qualified property limitation.

Any §199A(g) deduction the eligible taxpayer cannot use is lost and cannot be carried forward or back to other taxable years.⁴² If the amount of the §199A(g) deduction is later determined to be excessive, recapture of the excess will occur at the Specified Cooperative level, in the taxable year the Specified Cooperative took the excess deduction.⁴³

Effective Date and Request for Comments

The proposed regulations apply to taxable years ending after the date the Treasury adopts the regulations as final, but taxpayers can rely on the proposed regulations until that date (but only if the taxpayers apply the rules in their entirety and in a consistent manner).⁴⁴ Written (including electronic) comments and requests for a public hearing must be received by August 19, 2019.

³⁹ Prop. Reg. §1.199A-8(d)(3).

⁴⁰ Prop. Reg. §1.199A-8(d)(4).

⁴¹ Treas. Reg. §1.199A-1(b)(3).

⁴² Prop. Reg. §1.199A-8(d)(4).

⁴³ Prop. Reg. §1.199A-8(g).

⁴⁴ §7805(b)(1)(A), (B).