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Continuing Saga of Section 199A(g)

Justin Darisse

Throughout 2020, the National Council of Farmer Cooperatives ("NCFC") continued its concerted effort to have the U.S. Treasury and the Internal Revenue Service ("IRS") follow Congress's explicit intent for the agencies to recreate how "old" Section 199 worked for farmer co-ops when writing rules to implement the fix to the so-called grain glitch.

As you may recall, in 2019 the U.S. Treasury and IRS issued a draft proposal that would limit a co-op's deduction solely to patronage activity. Under the old Section 199, co-ops calculated the deduction on both patronage and non-patronage income, so the proposal directly contradicted Congressional intent in crafting the fix to the so-called grain glitch.

NCFC and its Section 199A Working Group – drawn from NCFC's Legal, Tax & Accounting ("LTA") and Government Affairs Committees – engaged in the early months of the year with key members of Congress to push Treasury and IRS to respect congressional intent.

These efforts seemed to pay off in early March, when both Republicans and Democrats on the House Ways and Means Committee pushed Treasury Secretary Steven Mnuchin on the issue at an oversight hearing. In response to one question, the Secretary said he was "very aware of and very focused on" the issue, and, in fact, "met for one hour on it yesterday." He noted that their job "is to implement the law and not make policy," and planned to meet with the House and Senate tax writing committees to determine what was intended.

Almost immediately after the hearing, the first wave of the pandemic hit the East Coast; the quarantine and the need to implement economic relief passed by Congress meant that across the federal government, including Treasury, work on issues unrelated to the pandemic slowed to a crawl. No follow up meeting as committed to by Secretary Mnuchin ever occurred.

Therefore, NCFC and its allies on the Hill were dismayed when notification appeared that Treasury had sent the proposed regulations – unchanged – to the Office of Information and Regulatory Affairs ("OIRA") within the Office of Management and Budget at the White House. Typically, OIRA gives regulations one final government review to ensure that economic impacts of the regulation have been considered by the drafting agency. Once a regulation returns from OIRA, the next step typically is publication in the Federal Register, after which the regulation becomes final.

NCFC and its members immediately scheduled meetings with OIRA to outline concerns with the regulation, including that Treasury failed to adequately assess the impact that the tax increase caused by the rule. In addition, the members of Congress who made comments at the March hearing reached out directly to Treasury to express their displeasure that Secretary Mnuchin did not fulfill the promise he had made at the hearing.

Though OIRA finished its review and returned the regulation to Treasury late in the summer, the work NCFC and others had done meant that it was not immediately sent to the Federal Register for publication. Working with members of the LTA Committee, NCFC was able to draft a compromise proposal on calculation of the deduction when a co-op has both patronage and non-patronage income. The draft was presented to Treasury in July and was taken into consideration.

Throughout the fall, Treasury stonewalled attempts by NCFC, our members and policy makers from the Hill to discuss the compromise further and failed to even provide updates on Treasury's thinking. Then, just before Christmas, we received notice that Treasury's proposal was back at OIRA for another review. Well-placed sources in the Administration, who had seen the new regulation, said that it was virtually unchanged from the one Treasury had submitted in the summer.

In the first week of 2021, NCFC once again met with OIRA to express cooperatives' concerns and to walk through the compromise proposal. The regulations were returned to Treasury on January 8 and submitted to the Federal Register on January 14 for publication on January 19, just hours before the Trump Administration ended. They did, in fact, get published in the January 19 Federal Register with few changes from the flawed 2018 proposed regulations.

As of mid-April 2021, NCFC continues to seek a solution by reaching out to the Biden Administration as well as to allies in Congress. A bipartisan group of Ways and Means members sent a letter to Treasury Secretary Yellen, asking her to delay of withdraw the regulations for further consideration. USDA Secretary Vilsack has also weighed in with Secretary Yellen, asking that Treasury reconsider the regulations. And NCFC has met with the new tax policy team at Treasury.

The deduction is slated to sunset on December 31, 2025 for fiscal years beginning after that date. And while the regulation controversy is ongoing, recently introduced bills would make section 199A permanent – H.R. 1381 and S. 480, the "Main Street Tax Certainty Act of 2021." It is key that the final regulations are corrected soon, so that any extension of 199A will operate as intended for farmers and their cooperatives.

Final Section 199A(g) Regulations Released

Rebecca Thoune (Smith)

Just over 19 months after the proposed Section 199A(g) regulations for cooperatives and their patrons were issued, the final regulations were published in the *Federal Register* on January 19, 2021. The final regulations specifically provide guidance regarding the application of Sections 199A(a), 199A(b)(7) and 199A(g) to cooperatives and their patrons. While many were hopeful the final regulations would not resemble the proposed regulations, for the most part they do retain the rules and structure of the proposed regulations with some modifications.

The final regulations are broken into six sections, Treas. Reg. sections 1.199A-7 to 1.199A-12. This article will summarize by section the content of the final regulations and include some areas of interest that were discussed in the preamble.

Treas. Reg. section 1.199A-7 – Section 199A(a) Rules for Cooperatives and Their Patrons

This section provides guidance and special rules regarding the deduction for qualified business income (QBI) under Section 199A(a) by patrons of cooperatives to which Part 1 of subchapter T applies. A patron determines their QBI for each trade or business however the cooperative determines the amount of qualified payments of the patron.

When a patron calculates their QBI, it Includes distributions for which the Cooperative is allowed a deduction under Sections 1382(b) and (c)(2) including patronage dividends or similar payments such as money, property, qualified written notices of allocations, and qualified per-unit retain certificates and money or property in redemption of a nonqualified written notice of allocation. The cooperative must determine at its trade or business level whether these distributions include qualified items of income, gain, deduction, and loss. Once the cooperative makes this determination the information must be reported by the cooperative to the patron based on the total net amount of these payments. Consistent with the proposed regulations, a specified cooperative must report any qualified payments and the amount of any qualified items with respect to any non-specified service trade or business (non-SSTB) and any specified service trade or business (SSTB) to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received from Cooperatives, unless otherwise provided by the instructions to the Form. If the cooperative does not report on or before the due date, the amount of distributions that may be included in QBI by the patron is presumed to be zero.

Consistent with the proposed regulations and the statute, the final regulations retain the rule that patrons of a specified cooperative that receive a qualified payment are required to reduce their Section 199A(a) deduction by the amount, if any, under Section 199A(b)(7). (Treas. Reg. section 1.199A-7(f)). This reduction applies whether the specified cooperative passes through all, some, or none of the Section 199A(g) deduction to the patron in the taxable year.

Treas. Reg. section 1.199A-8 – Deduction for Income Attributable to Domestic Production Activities of Specified Agricultural or Horticultural Cooperatives

This section contains the rules relating to the deduction for income attributable to domestic production activities of a specified agricultural or horticultural cooperative (Specified Cooperative). Consistent with the proposed regulations, a Specified Cooperative is a cooperative to which Part 1 of subchapter T applies and which manufactures, produces, grows or extracts (MPGE) in whole or significant part within the U.S. any agricultural or horticultural product, or is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the U.S. by its patrons. The regulations define two types of Specified Cooperative, an exempt which is a cooperative who qualifies as a farmer's cooperative organization under Section 521 and a nonexempt which is a cooperative not qualified under Section 521.

A key element of this section, besides the actual computation, is the definition of an agricultural or horticultural product. The final regulations retained reference to the Cooperative Marketing Act of 1926 (non-tax law definition). However, they did accept a portion of NCFC's alternative definition by providing several nonexclusive examples of items that qualify. The regulations define an agricultural or horticultural product as follows:

- Agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926)
- Aquatic products that are farmed
- Fertilizer, diesel fuel, and other supplies (for example, seed, feed, herbicides, and pesticides) used in agricultural or horticultural production that are MPGE by a Specified Cooperative

The final regulations specifically do not include intangible property other than when incorporated into a tangible agricultural or horticultural product.

The other key element of this section is the computation of the deduction for a nonexempt and exempt specified cooperative. The computation for a nonexempt cooperative is generally the most controversial item in the final regulations as a nonexempt cooperative cannot compute a deduction on nonpatronage income which is a clear reversal of Section 199. For a nonexempt cooperative the deduction is computed as follows (Treas. Reg. section 1.199A-8(b)):

Step 1: Identify patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W-2 wages, etc. and allocate them between patronage and nonpatronage

- Can only use patronage gross receipts and related deductions to calculate QPAI, oil related QPAI, the W-2 wage limitation, or taxable income
- Nonpatronage gross receipts and related deductions cannot be used to calculate a Section 199A(g) deduction
- Gross receipts = Receipts for the taxable year that are recognized under the Specified Cooperative's method of accounting used for federal income tax purposes for the taxable year
  - Total sales net of returns and allowances
  - All amounts received for services
  - Any income from investments and from incidental or outside sources
  - Interest, Dividends, Rents, royalties, and annuities

Step 2: Determine patronage gross receipts that are domestic production gross receipts (DPGR)

Step 3: Calculate qualified production activities income (QPAI)

- DPGR for the taxable year less COGS that are allocable to DPGR less other expenses, losses, or deductions that are properly allocable to DPGR
- Exclude the section 199A(g) deduction or any deduction allowed under Section 1382(b)
  - Patronage dividend, per-unit retain allocations

Step 4: Calculate deduction

- 9% of the lesser of
  - QPAI for the taxable year <u>or</u>
  - Taxable income for the taxable year
- Deduction is limited to 50% of the patronage W-2 wages attributable to DPGR for the taxable year

An exempt specified cooperative must

calculate two separate Section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced. The patronage sourced calculation is computed the same as the nonexempt specified cooperative above. The nonpatronage sourced calculation is also calculated as above however using only nonpatronage gross receipts and related nonpatronage deductions. The taxable income is limited to taxable income and related deductions from nonpatronage sources and excludes any Section 199A(g) deduction or any deduction allowable under Section 1382(c). The nonpatronage deduction cannot be allocated, it has to be used against cooperative nonpatronage net income.

In the case of an exempt or nonexempt cooperative, the deduction cannot create or increase a NOL or the amount of NOL carryover or carryback. Any deduction not used in the tax year (or passed through to patrons) is lost.

In addition, for any patronage deduction created by an exempt or nonexempt cooperative, the cooperative is permitted to pass through an amount equal to the portion of the cooperative's Section 199A(g) deduction that is allowed with respect to the portion of the cooperative's QPAI that is attributable to the qualified payments the cooperative distributed to the patron during the taxable year and identified on the notice required in Treas. Reg. section 1.199A-7(f)(3). The cooperative must identify in a written notice the amount of the Section 199A(g) deduction being passed through to the patron and the notice must be mailed to the patron no later than the 15th day of the ninth month following the close of the taxable year of the cooperative. In addition to the written notice to the patron, the cooperative must also report to the patron the amount passed through in the notice on an attachment to or on the Form 1099-PATR. Just reporting on Form 1099-PATR the amount of the pass-through does not fulfill the notice requirement.

The final regulations did provide some much-needed clarification from the proposed regulations with respect to the pass through of the deduction. Consistent with the proposed regulations a specified cooperative may pass through all, some, or none of its patronage Section 199A(g) deduction. The key difference in the final regulations is the cooperative can pass it through to all patrons. The phrase "to all patrons" is key as it puts the burden on the patron not the cooperative to determine if it is an eligible taxpayer as only eligible taxpayers may claim the deduction that is passed through. An eligible taxpayer is a Specified Cooperative or a patron other than a C Corporation. If a Specified Cooperative is able to determine a patron is not an eligible taxpayer, then the Specified Cooperative may retain, at its discretion, any of the patronage Section 199A(g) deduction that would have gone to the ineligible taxpayer.

Treas. Reg. section 1.199A-9 – Domestic Production Gross Receipts

This section provides guidance to determine what gross receipts are DPGR. It is consistent with the proposed regulations. DPGR is defined as gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is MPGE by the Specified Cooperative or its patrons in whole or significant part within the U.S. Gross receipts derived from services, guaranteed payments (for partners in a partnership), and gross receipts from the lease, rental, license, sale, exchange, or other disposition of land are not DPGR, unless a de minimis or other exception applies.

In order to determine if a gross receipt is DPGR it is important to understand two additional definitions – "MPGE" and "in whole or significant part." MPGE includes the following:

- Manufacturing, producing, growing, extracting, installing, developing,

improving, and creating agricultural or horticultural products
- Making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles
- Cultivating soil, raising livestock, and farming aquatic products
- Storage, handling, or other processing activities (other than transportation) within the U.S. related to the sale, exchange, or o ther disposition of agricultural or horticultural products but only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative

The Specified Cooperative or patron must have the benefits and burdens of ownership of the products under Federal income tax principles during the period the MPGE activity occurs. Items that do not qualify as MPGE are (a) packaging, repacking, or labeling agricultural or horticultural products and engaging in no other MPGE activity with respect to those products and (b) installation of agricultural or horticultural products and engaging in no other MPGE activity with respect to the products.

An item will be treated as MPGE in whole or significant part in the U.S. if the MPGE of the agricultural or horticultural products by the Specified Cooperative within the U.S. is substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the MPGE within the U.S., the nature of the agricultural or horticultural products, and the nature of the MPGE activity that the Specified Cooperative performs within the U.S. If the direct labor and overhead of such Specified Cooperative to MPGE the product within the U.S. accounts for 20% or more of the Specified Cooperative's COGS of the product, or, in a transaction without COGS, accounts for 20% or more of the Specified Cooperative's unadjusted depreciable basis in property, the definition is meet.

With respect to a marketing cooperative, a Specified Cooperative will be treated as having MPGE in whole or significant part any agricultural or horticultural product marketed by the Specified Cooperative which its patrons have so MPGE within the U.S.

Allocating gross receipts between DPGR and non-DPGR should be done by using a reasonable method based on all the facts and circumstances. The method must be consistently applied from one taxable year to another and books and records maintained for gross receipts must be consistent with any allocations.

The final regulations did provide some additional relief by altering the de minimis rule. Specifically, all receipts are treated as DPGR if <10% of the total gross receipts are non-DPGR. The inverse also applies for non-DPGR.

Treas. Reg. section 1.199A-10 – Allocation of COGS and other deductions to DPGR

This section describes how COGS and other deductions should be allocated to DPGR and is reflective of the proposed regulations.

COGS is determined under the methods of accounting used to compute taxable income and does not include any payment made, whether during the taxable year, or included in beginning inventory, for which a deduction is allowed under Section 1382(b) and/or (c). Consistent with gross receipts, COGS is allocated between DPGR and non-DPGR by using a reasonable method based on all the facts and circumstances and the method must be consistently applied from one taxable year to another.

The other deductions are allocated by using either the Section 861 method, the simplified production method (if eligible), or the small business simplified overall method (applies only to qualifying small Specified Cooperatives).

Treas. Reg. section 1.199A-11 – Wage Limitation for the Section 199A(g) Deduction

The wage limitation in the final regulations is most consistent with the Section 199 regulations. Some consistent items to note are as follows:

- Use Form W-2 issued for the calendar year ending during the taxable year of the cooperative
- Employee = Officers and employees of a taxpayer under the common law rules
- Wage Limitation – 50% of W-2 wages attributable to DPGR
  - Allocable to DPGR using a reasonable method based on facts and circumstances
  - Consistently applied from year to year
- Wage definition = wages, elective deferrals, compensation deferred under section 457, and designated Roth contributions
- Methods for calculating W-2 wages (provided for in Rev. Proc. 2021-11)
- Specific rules apply for acquisitions, dispositions, and short taxable years

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Treas. Reg. section 1.199A-12 – Expanded Affiliated Groups

This section discusses how members of an expanded affiliated group (EAG) compute the deduction. Unfortunately, the final regulations maintained the rule that members of an EAG that are not Specified Cooperatives are not included in computing the deduction for the group. This may be problematic for controlled groups where C corporation subsidiaries are doing manufacturing and distribution of the product.

An EAG is an affiliated group with one or more chains of includable corporations connected through stock ownership with a common parent corporation which is an includable corporation but only if (1) the common parent owns directly stock in at least one of the includable corporations, and (2) stock in each of the includable corporations (except the common parent) is owned directly by one or more of the other includable corporations. With respect to stock ownership, one must own stock which possesses more than 50% of the total voting power of the stock of such corporation and has a value equal to more than 50% of the total value of the stock of such corporation.

When computing the deduction, each nonexempt Specified Cooperative that is a member of an EAG computes its own taxable income or loss, QPAI, and W-2 wages from patronage sources. Then the income or loss, QPAI, and W-2 wages from each member of the EAG is aggregated. The deduction is computed on the aggregated amounts, and then the deduction is allocated among members of the EAG in proportion to each nonexempt Specified Cooperative's patronage QPAI regardless of whether the member has patronage taxable income or W-2 wages.

Treas. Reg. section 1.1388-1(f) – Patronage and Nonpatronage Definition

Despite multiple comments that a definition of patronage and nonpatronage is not necessary, the final regulations largely retained the definitions as in the proposed regulations, with some clarification. This regulation provides that whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying what it refers to as the "directly related use test." The final regulations state:

"If the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or services activities, the income or deduction is from patronage sources. … If the transaction producing the income or deduction does not actually facilitate the accomplishment of the cooperative's marketing, purchasing or services activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income or deduction is from nonpatronage sources."

The definition in the final regulations applies to all Subchapter T cooperatives, not just Specified Cooperatives who are eligible for a Section 199A(g) deduction. The preamble to the final regulations clarified that the directly related use test is intended to follow Rev. Rul. 69-576 and to be consistent with Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846 (1999).

Effective/Applicable Date

The final regulations were "effective" January 14, 2021, and "applicable" to taxable years beginning after January 19, 2021. Therefore, for a taxpayer that has a year-end other than January, the regulations will be applicable for their tax year ending in 2022, for a taxpayer with a January year end, the regulations will be applicable for its 2023 tax year.

CARES Act and Consolidated Appropriations Act, 2021 - Temporary Changes to Charitable Contributions Limitation

George W. Benson

Cooperatives that make significant charitable contributions often find the historic corporate "10% of taxable income limitation" on charitable deductions to be constraining. See, Section 170(b)(2)(A). After exclusions/deductions for per-unit retain allocations and patronage dividends, many cooperatives have little taxable income and thus cannot deduct all they contribute. There is a special definition of "taxable income" for this purpose contained in Section 170(b)(2)(D). That definition lists several adjustments to ordinary taxable income in determining "taxable income" for purposes of the limitation. But there is no adjustment permitting cooperatives to add back per-unit retain allocations or patronage dividends as there is in the statute for DPAD purposes. Nor is there a delegation of authority to Treasury to make other exceptions as there was in Section 163(j). As a result, while strong policy/equity arguments can be made that cooperatives should be permitted to add back patronage dividends, Section 170(b)(2)(D) probably needs to be amended to allow that to be done.

Having said that, the CARES Act temporarily increased the corporate limitation for certain "qualified contributions" from 10% to 25% of taxable income and for contributions of food inventory from 15% to 25%. For this purpose, "qualified contributions" are cash contributions to most charitable organizations made during calendar 2020 which the taxpayer elects to have covered. Also included are contributions of "food inventory" covered by Section 170(e)(3)(C).

The Consolidated Appropriations Act, 2021 ("CAA") extends the CARES Act relaxation of the corporate limitation to include contributions made during calendar 2021.

Separately, the CAA provides a special 100% limitation for "qualified disaster relief contributions." This special limitation is also elective. "Qualified disaster relief contributions" are defined as contributions "for relief efforts in one or more qualified disaster areas." They must be made during the period beginning 1/1/2020 and ending "on the date which is 60 days after the date of enactment of this Act." The CCA was signed by the President on December 27, so 60 days after the date of enactment ran on February 25, 2021.

In IR-2021-27 (January 29, 2021), the IRS provided further guidance as to the scope of this 100% limitation. The information release states:

"Under the new law, qualified disaster areas are those in which a major disaster has been declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. This does not include any disaster declaration related to COVID-19. Otherwise, it includes any major disaster declaration made by the President during the period beginning on Jan. 1, 2020, and ending on February 25, 2021, as long as it is for an occurrence specified by the Federal Emergency management Agency as beginning after Dec. 27, 2019, and no later than Dec. 27, 2020." (emphasis added).

The donor must follow the usual recordkeeping requirements that apply to charitable contributions, including obtaining a contemporaneous written acknowledgment ("CWA") from the charity prior to the due date for its return. The statute also requires affirmation from the charity that the contributions was used, or is to be used, for relief efforts in one or more qualified disaster areas (a "disaster relief statement"). Having said that, because the provision was not enacted until the end of December and guidance was not released until the end of January, IR-2021-27 states that the IRS "will not challenge a corporation's deduction of any qualified contribution made before Feb. 1, 2021, solely on the grounds that the corporation's CWA does not include the disaster relief statement."

The IRS Extends the Filing Date for Individual Returns for 2020

George W. Benson

In mid-March the Treasury Department and Internal Revenue Service ("IRS") announced an extension of the due date for individual federal income tax returns for 2020 from April 15 to May 17. See, IR-2021-59 (March 17, 2021). The extension was limited to only the due date of the returns. The IRS did not extend the April 15 due date for the first installment of estimated tax payments for individuals. The extension did not, of course, extend the due date for state income tax returns, though most states have followed the federal lead.

The authority for this action is contained in Section 7508A which generally gives the Secretary of the Treasury authority to postpone certain deadlines in the event of a federally declared disaster.[1] The Treasury has delegated this authority to the IRS. The Section 7508A authority is discretionary (though see the discussion below). The IRS can choose which federally declared disasters warrant relief, and it can then tailor the relief to the situation. The deadlines that can be extended are listed in Section 7508(a)(1).[2] Relief can include many other things that just extending return filing deadlines as was illustrated by the COVID-19 notices last year. The length of any extension is generally up to the IRS (though see the discussion below), but may not exceed one year.

A list of disaster relief declarations in recent years can be found on the IRS website at https://www.irs.gov/newsroom/tax-relief-in-disaster-situations. A typical disaster relief declaration specifies the covered disaster, the

1 – Section 7508A cross-references the definition of "federally declared disaster" in Section 165(i)(5)(A). An individual in a federally declared disaster area who suffers an uninsured or unreimbursed disaster related loss is permitted by Section 165(i) to elect to deduct the loss either on the return for the loss year or on the return for the prior year. In contrast to Section 7508A, the application of Section 165(i) does not depend upon the discretion of the IRS. There are many unanswered questions as to the extent to which Section 165(i) may apply to COVID-19 losses. See, comments submitted to the IRS by the Section on Taxation of the ABA, available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2020/091420comments.pdf. While "guidance under § 165(i) on COVID-19 losses" is included in the IRS 2020-2021 priority guidance plan, nothing has yet been released.

2 – In Rev. Proc. 2018-58, 2018-50 I.R.B. 990, the IRS lists over 250 deadlines that may be extended under Section 7508A. The revenue procedure "does not, by itself, provide any postponements under section 7508A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the Internal Revenue Service (IRS) generally will publish a notice or issue other guidance (including an IRS News Release) providing relief with respect to a federally declared disaster, or a terroristic or military action." Section 1.02. The list includes the payment period limitation for patronage dividends. If a situation should ever arise where a cooperative affected by a federally-declared disaster declaration was unable to timely pay patronage dividends because of the disaster, the cooperative should consider reaching out to try to convince the IRS to include an extension of the payment period in any relief that is granted.

covered disaster area, the affected taxpayers and the scope of the relief. See, for example, LA-2021-01 (February 17, 2021), for a declaration related to tax relief for Hurricane Zeta victims in Louisiana. The covered disaster relief area may be narrower than the area covered by the FEMA declaration for the disaster. The deadlines extended normally include only a subset of the deadlines described in Section 7508(a)(1).

Historically, most extensions have followed natural disasters (floods, fires, hurricanes or other severe weather, etc.). The extensions that have been granted for this year and last year related to the COVID-19 pandemic were issued pursuant to an emergency declaration made by the President on March 13, 2020 under section 501(b) of the Stafford Act.

Recently, there has been a renewed focus on Section 7508A and what can (and must) be done under that section.

On December 20, 2019 (just before the COVID-19 outbreak in the U.S. and unrelated to that outbreak), the Section 7508A was amended by adding what is now section (d).[3] The language of this new section is vague, and its legislative history is sketchy. The section appears to be an attempt to address taxpayer complaints arising from the time between FEMA disaster declarations and IRS announcements of relief. It seems clear that Congress intended to reduce the IRS discretion so that taxpayers know sooner that deadlines will be extended. However, extent to which IRS discretion has been reduced is not clear.

The Ways and Means Committee described the purpose of the new section as follows:

"The Committee believes that the certainty and additional time provided by an automatic extension of filing deadlines for taxpayers affected by Federally declared disasters will ease the burden of tax compliance for taxpayers dealing with the hardship of disaster recovery."[4]

The report then stated:

"The provision provides to qualified taxpayers in the case of a Federally declared disaster a mandatory 60-day period that is disregarded in determining whether the acts listed above were performed in the time prescribed…"[5]

In a floor statement, the sponsor of the provision, Representative Tom Rice, described what he thought the provision did:

"This provision provides disaster related tax relief to those who are victims of a natural disaster. Specifically, this provision allows for people to receive a 60-day extension to file their taxes if there is a federally declared disaster. I want to clarify that this extension is not limited to the current Internal Revenue Service (IRS) policy of extending a declaration for FEMA Individual Assistance or FEMA Public Assistance, but may be triggered by any federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act…"[6]

However, in proposed regulations released on January 13, 2021, the Treasury/IRS has taken the position that the scope of Section 7508A(d) is very narrow – namely, that it does not change the IRS discretion to determine which federally-declared disasters will get relief and what deadlines will be extended. In their view, the only limitation is to require that any extensions granted

3 – Section 7508A(d) was added by Section 205 of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020.

4 - H.Rep. No. 116-379 (116th Cong., 2d Sess.) (January 21, 2020), at 99.

5 - Id., at 99. The reference to the "acts listed above" was to a laundry list of activities, not just to the return filing date.

6 - *Congressional Record* (December 17, 2019), at H10599.

must be for at least 60 days beginning "on the earliest incident date specified in a disaster declaration for a Federally declared disaster and [ending] on the date that is 60 days after the latest incident date specified in the disaster declaration." Prop. Treas. Reg. § 301.7508A-1(g)(3)(i). If a declaration does not specify an incident date (as in the case of the COVID-19 declaration), "there is no mandatory postponement period under section 7508A(d). In such cases, the only postponement period will be the period determined by the Secretary under 7508A(a)." Prop. Treas. Reg. § 301.7508A-1(g)(3)(ii)(B).[7]

But not all agree. Arguably, the Treasury/IRS position effectively renders Section 7508A(d) meaningless. In the past, it is unlikely that there ever were cases where the relief granted, when the IRS decided to grant relief, was shorter than the 60-day period. The perceived problem was the uncertainty experienced by affected persons while waiting to see whether the IRS would choose to grant relief and the scope of the relief granted.

Several comment letters argue that the purpose of Section 7508A(d) was to make extensions mandatory for all federally-declared disasters.

"As we understand that 2019 legislation, Congress intended to create a new mandatory and automatic deadline extension for taxpayers who have been affected by federally-declared disasters. The U.S. Treasury Department and Internal Revenue Service (IRS) have long had the authority to postpone these same deadlines on a discretionary basis. However, the unpredictable nature of those discretionary extensions results in inefficiencies and uncertainty when there is a delay between the onset of a disaster and the IRS announcement of deadline extensions. Under this existing framework, some affected taxpayers do not know whether they will be eligible for relief until weeks after a disaster has occurred, and in some cases, well after the relevant tax deadline has passed. Thus, to eliminate those inefficiencies and uncertainties, Congress created a new mandatory and automatic deadline extension for taxpayers who have been affected by federally-declared disasters."[8]

See also the comment letter by the law firm Ivins, Phillips & Barker dated March 14, 2021, https://www.ipbtax.com/assets/htmldocuments/Comments%20on%20Section%207508A%20Proposed%20Regulations%20IPB.pdf.

It will be interesting to see how this plays out.

There are at least two cases pending in Tax Court on motions to dismiss involving taxpayers who filed their petitions late and are asking for relief based in part on Section 7508A(d).[9] The Tax Court may be required to express its view on the scope of Section 7508A(d) in dealing with those cases.

My suspicion is that the IRS will not back down from the position taken in the proposed regulations. If Section 7508A relief is to be made more certain, Congress may have to try again with language that strikes a clearer and more balanced approach between taxpayer certainty and IRS discretion.

7 – The preamble to the proposed regulations explains the reasoning behind the Treasury/IRS position. An article by two law professors analyzes why what the Treasury/IRS have proposed makes sense from a policy perspective. See, "Predicting the 'Whether' of Section 7508A(d)," by Bryan T. Camp and T. Keith Fogg, Tax Notes Federal (April 19, 2021).

8 - See, comment letter of the American Benefits Council dated March 9, 2021.

9 - See, *Lowe v. Commissioner*, Tax Court Dkt. No. 4629-20S and *Abdo v. Commissioner*, Tax Court Dkt. No. 5514-20.

New Regulations Address TCJA Changes to the All Events Test and to the Treatment of Advance Payments

George W. Benson

As part of the Tax Cuts and Jobs Act of 2017 ("TCJA"), Congress modified the accrual "all events" test and adopted new rules for advance payments received by accrual basis taxpayers. Final regulations implementing these changes were publicly released on December 21, 2020 and published in the *Federal Register* on January 6, 2021. See, T.D. 9941, 86 FR 810 (January 6, 2021).

Change to the "all events" test

The TCJA amended Section 451(b) to provide that, for accrual method taxpayers, "the all events test for an item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in (i) an applicable financial statement of the taxpayer, or (ii) such other statement as the Secretary may specify for purposes of this subsection." New Treas. Reg. § 1.451-3 provides guidance for implementing this new rule (referred to in the regulations as the "AFS income inclusion rule").

The AFS income inclusion rule applies to accrual basis taxpayers with an applicable financial statement ("AFS") as defined in Treas. Reg. § 1.451-3(b)(5). Generally, an AFS is a financial statement prepared in accordance with GAAP or IFRS. Also included are certain other financial statements (other than a tax returns) filed with the federal or a state government or agency or a self-regulatory agency. The final regulations contain rules dealing with more complex situations, such as situations where an AFS covers groups of entities and where a taxpayer's financial accounting year is different than its taxable year. See, Treas. Reg. § 1.451-3(j).

As a general matter, under the AFS income inclusion rule, "the all events test … for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as AFS revenue…" This brings the recognition of income for tax purposes more in line with the recognition of income for financial statement purposes. There are some important exceptions to this rule:

- It does not apply to taxpayers that do not have an AFS.
- It does not apply to mortgage servicing contracts.
- It does not apply "if the timing of income inclusion for that item, or portion thereof, is determined using a special method of accounting." Treas. Reg. § 1.451-3(b)(13) contains a nonexclusive list of special methods of accounting for this purpose. Examples of methods on the list include the crop method of accounting, methods of accounting provided in Sections 453 to 460, mark-to-market accounting under Section 475, etc. While not on the list, the method of accounting for patronage dividends and per-unit retain allocations provided in Section 1385 should be regarded as a special method of accounting for this purpose.

The final regulations state that the AFS income inclusion rule does not "change the treatment of a transaction or the character of an item for Federal income tax purposes. Treas. Reg. § 1.451-3(g). So, for instance, the fact that a transaction is treated as a sale or as a financing for AFS purposes does not affect the timing of the recognition of income from the transaction if it is treated as a lease, license or similar transaction for federal income tax purposes.

In addition, the final regulations state that the AFS income inclusion rule is intended to affect the time at which the all events test is treated as satisfied "and therefore does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions." See, Treas. Reg. § 1.451-3(h) and examples illustrating this limitation. So the AFS income inclusion rule would not be triggered by financial statement recognition of income upon the forgiveness of a Payroll Protection Program loan. Nor would it be triggered if income is recognized for financial statement purposes upon an exchange of real properties which qualifies for nonrecognition purposes under Section 1031.

However, the final regulations do not provide additional guidance as to the distinction between recognition and realization.

"Practitioners were hoping for better examples of income realization for tax purposes and a clear definition of something that would not be realized for tax purposes but might be recognized for financial statement purposes.

For example, practitioners are unsure what to do in the case of 'unbilled revenue' or 'unbilled receivables' for the provision of goods, in which someone may perform a service for a single deliverable that takes a while to complete… In that situation, the company may record revenue for AFS purposes but it's not earned until it completes the deliverable…

Previously, the company didn't need to realize that income for tax purposes because it wasn't fixed and determinable, but the new AFS rule could require recognition in that situation…" [10]

When an AFS income inclusion is required, the amount to be included is not always the amount of revenue reported on the AFS. See, Treas. Reg. § 1.451-3(c)(2) The revenue reported on the AFS is increased by the amount of any "(1) cost of goods sold and liabilities that are required to be accounted for under other provisions of the Code such as section 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card transactions and other reward programs, and refunds…" and "(2) amounts anticipated to be in dispute or anticipated to be uncollectable." Unless the taxpayer chooses to apply what is described as the "<u>alternative AFS revenue method</u>," the AFS revenue is reduced by any amount the taxpayer would not have a legal right to retain if the customer were to terminate the contract on the last day of the taxable year (the "<u>unenforceable rights exception</u>"). Also, the AFS revenue should be adjusted to exclude a financing component if the contract had a significant financing component. (As noted below, these exclusions also apply for taxpayers with applicable financial statements under the new advance payment rules.)

Note that the unenforceable rights exception is the default rule. The alternative AFS revenue method requires an election, which, once made, requires IRS approval to change. Commentators have pointed out difficulties of applying the unenforceable rights exception:

"The AFS income inclusion rule generally requires taxpayers to exclude from AFS revenue amounts that they do not have an enforceable right to collect at the end of the tax year. However, the application of this rule requires a detailed understanding of the facts of the transaction resulting in the revenue, as well as a comparison of the AFS standard used to report that revenue and a legal analysis of whether the taxpayer

10 – "Realization Punt in Final Biz Accounting Regs May Risk Audits," by Amy Lee Rosen, Law360 (February 17, 2021).

11 – "The Unenforceable Rights Exception to AFS Income Inclusion," by Scott H. Rabinowitz and David A Schneider, *Tax Notes Federal* (February 22, 2021).

has an unenforceable right to that revenue (taking into account potential equitable recoveries).” [11]

The alternative AFS revenue method allows taxpayers to avoid this complication, but it comes at a cost. It may require a taxpayer to include in income amounts to which it does not yet have a legal right.

The Treasury/IRS recognized that the application of the AFS income inclusion rule to sales of inventory could result in mismatches of revenue and expense. The final regulations provide for an “AFS cost offset method.” If advance payments are also involved, the taxpayer must also use the “advance payment cost offset method.” The rules applicable to these methods are contained in Treas. Reg. § 1.451-3(d) and -8(e). While some taxpayers have observed that the AFS cost offset method is better than nothing (which is what the proposed regulations provided), they are disappointed that final regulations did not go further towards full book/tax conformity by allowing an offset for estimated expenses.

Special rules are provided for contracts with multiple performance obligations (Treas. Reg. § 1.451-3(e)) and for multi-year contracts (Treas. Reg. § 1.451-3(f)).

New rules for advance payments

Accrual basis taxpayers are, as a general rule, required to include advance payments in income in the year of receipt even though accrual might not otherwise make sense under the all-events test. Realizing that the general rule can result in a significant mismatch of revenue and expense, before the TCJA the IRS permitted taxpayers to defer recognition of advance payments in certain situations. See, Rev. Proc. 2004-34, 2004-1 C.B. 991, and Treas. Reg. § 1.451-5.

The TCJA changed that. Now advance payments are governed exclusively by new Section 451(c), which, in pertinent part, provides:

“(1) In General. – A taxpayer which computes taxable income under the accrual method of accounting and receives any advance payment during the taxable year, shall –

(A) except as provided in subparagraph (B), include such advance payment in gross income for such taxable year, or

(B) if the taxpayer elects the application of this subparagraph with respect to the category of advance payments to which such advance payment belongs, the taxpayer shall –

(i) to the extent that any portion of such advance payment is required under subsection (b) [the “AFS income inclusion rule”] to be included in gross income in the taxable year in which such payment is received, so include such portion, and

(ii) include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received.”

As part of T.D. 9941, the Treasury promulgated new Treas. Reg. § 1.451-8 (advance payments for goods, services and certain other items). This new regulation is applicable to taxable years beginning on or after January 6, 2021. A taxpayer can choose to apply the rules contained in the regulations to prior taxable years provided that it does so in their entirety and in a consistent manner.

The term “advance payment” is defined in Section 451(c)(4) and Treas. Reg. § 1.451-8(a)(1). It includes any payment received by the taxpayer if “(A) the full inclusion of the payment in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting, without regard to this section; [and] (B) any portion of the payment is taken into account as AFS revenue for a subsequent taxable year, or, if the taxpayer does not have an applicable financial statement … any portion of the payment is earned by the taxpayer in a subsequent taxable year." For this purpose, the definition of "AFS" follows that used in new Treas. Reg. § 1.451-3 described above.

Advance payments are payments for services, the sale of goods, the use of intellectual property, eligible gift card sales, memberships in an organization and certain other things. Advance payments do not include rent, insurance premiums, payments with respect to financial instruments, and certain other things.

The final regulations begin by providing that, as a general rule, "an accrual method taxpayer shall include an advance payment … in gross income no later than in the taxable year in which the taxpayer receives the advance payment." Treas. Reg. § 1.451-8(b).

However, they then provide that taxpayers with an AFS may elect the "deferral method." Under that method a taxpayer "must (i) include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent taken into account as AFS revenue as of the end of such taxable year…; and (ii) include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received (next succeeding year)." Treas. Reg. § 1.451-8(c). There are special adjustments to what is reported for financial purposes for determining what is "taken into account as AFS revenue" that that are similar to those described above for the new all-events test.

Taxpayers without an AFS, are eligible to use the "non-AFS deferral method." Under that method, a taxpayer "includes the advance payment in gross income for the taxable year of receipt to the extent that it is earned in that taxable year and includes the remaining portion of the advance payment in gross income in the next succeeding year." Treas. Reg. § 1.451-8(d)(3). For this purpose, a payment is deemed earned when the all-events test is met, without regard to when the payment is received by the taxpayer.

The regulation allows taxpayers to adopt the "advance payment cost offset method" for advance payments from the sale of inventory. Under this method, a taxpayer is permitted to reduce what it otherwise would have included in income for a taxable year prior to the year the inventory is transferred "by the cost of goods in progress offset for the taxable year." This method does not permit taxpayers to include costs that will be incurred in the subsequent year in the offset. As noted above, if the taxpayer adopts the advance payment cost offset method, it must also adopt the AFS cost offset method.

There is a special carve-out from the advance payment rules for payments received for goods two years or more in advance of delivery (the "specified good exception") unless the taxpayer elects the "specified good section 451(c) method."

The final regulations contain a number of examples illustrating the application of the rules. The examples address such things as the sales of gift cards, sales of products or services where the customer earns miles or other rewards, sales of products where the customer receives a discount voucher for future purchases, etc. Special rules apply to contracts with multiple performance obligations. The regulations provide that "any payments received under the contract are allocated to the corresponding item of gross income in the same manner as such payments are allocated to the performance obligations in the taxpayer's AFS." Treas. Reg. § 1.451-8(c)(8).

Effective date

Generally, the final regulations are effective for tax years that start on or after January 1, 2021, but there are options for adopting the rules earlier.