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FINAL REGULATIONS UNDER IRC SECTION 163(J)

By Teresa H. Castanias, CPA

On July 28, 2020, the Treasury Department released final regulations with guidance on applying the limitations on the deductibility of business interest expense (BIE) under IRC Section 163(j) (the Final Regulations), which was significantly modified by the Tax Cuts and Jobs Act (TCJA) and then temporarily modified by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The Final Regulations provide guidance on what constitutes interest for purposes of the limitation, how to calculate the limitation, which taxpayers and trades or business are subject to the limitation, and how the limitation applies in certain contexts (e.g., consolidated groups). The final regulations were published in the Federal Register on September 14, 2020 and contain minor editorial changes. In response to questions from taxpayers and practitioners, the final regulations published in the Federal Register clarify that taxpayers may rely on the final regulations for any taxable year beginning after December 31, 2017, provided that certain conditions are met.

Background

IRC Section 163(j) limits the deduction for business interest expense for tax years beginning after December 31, 2017, to the sum of:

(1) the taxpayer's business interest income (BII),
(2) 30% (or 50%, as applicable) of the taxpayer's adjusted taxable income (ATI), and
(3) the taxpayer's floor plan financing interest. Business interest expense (BIE) is interest that is paid or accrued on indebtedness that is properly allocable to a trade or business.

The IRC Section 163(j) limitation does not apply to certain trades or businesses, such as an electing real property trade or business, an electing farming business and certain activities of regulated utilities. Certain activities, such as performing services as an employee, are excluded from being a trade or business. The business interest expense limitation also does not apply to certain small businesses whose gross receipts are $26 million or less. The $26 million threshold applies for the 2020 tax year and will be adjusted annually for inflation.

An electing farming business means (1) a farming business (as defined in section 263A(e)(4)) which makes the election, or (2) any trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(2)) with respect to which the cooperative makes the election. An electing farming business must use the alternative depreciation system for assets with a recovery period of ten years or more, see section 168(g)(1)(G). This covers all depreciable assets of the trade or business with a recovery period of ten years or more, not just property acquired once the election is made. See, Rev. Proc. 2019-8.

Selected Significant Changes from Proposed Regulations

The final regulations are 569 pages and cover a wide array of issues. This article is focused on only some of the significant changes from the Proposed Regulations, and particularly ones that are likely to impact cooperatives. There may be some issues that will impact your cooperative that are not covered here. Therefore, it is recommended that the reader review the Final Regulations in their entirety.

The most important for cooperatives is Treas. Reg. §1.163(j)-4(b)(6) which provides for purposes of computing its ATI, a cooperative's tentative taxable income is not reduced by the amount of any patronage dividend under Section 1382(b)(1) or by any amount paid in redemption of nonqualified written notices of allocation distributed as patronage dividends under section 1382(b)(2), any amount described in section 1382(c), or any equivalent amount deducted by an organization that operates on a cooperative basis but is not subject to taxation under sections 1381 through 1388. This is a positive addition for cooperatives that was requested by NCFC. The Final Regulations are careful to only allow an add-back for patronage dividends as defined in Section 1388(a), and not for per-unit retain amounts under Section 1382(b)(3) or (4), either paid in money or written notices of allocation. Cooperatives should note this difference and determine the impact on their situation. The rules also apply to those cooperatives that operate under pre-Subchapter T rules, such as certain rural electric and rural telephone cooperatives.

Treas. Reg. §1.163(j)-9 discusses the rules related to the election allowed for certain excepted trades or businesses, including agricultural and horticultural cooperatives and small businesses with less than $26 million in gross receipts in 2020 (indexed for inflation). These small businesses can include other types of cooperatives. The election applies to the taxable year in which the election is made and all subsequent taxable years. The election is irrevocable. The taxpayers making this election must use the alternative depreciation system for certain types of property under section 163(j)(11) and cannot claim the additional first year depreciation deduction under section 168(k) for those types of property. The Final Regulations contain information on the time and manner of making the election and the information to be included in the election statement. The election automatically terminates if a taxpayer ceases to engage in the electing trade or business.

Example 1 of the Final Regulations illustrate the importance of determining and identifying the electing trade or business. In this example, a sole proprietor farmer had two trades or businesses – a dairy and orchard. He made the election only for the dairy. There are specific rules in Treas. Reg. §1.163(j)-10 for the proper allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business. The general approach is based on the approach that money is fungible and that interest expense is attributable to all activities and property, regardless of the specific purpose for incurring the obligation to pay the interest. There are other rules in Treas. Reg. §1.163(j)-9 that may impact cooperatives that are part of a consolidated group or have investments in partnerships.

Other significant changes for cooperatives include modifications to the definitions of terms used in the 2018 Proposed Regulations. These definitions are described in Treas. Reg. §1.163(j)-1 and are used throughout the Final Regulations.

1. The Final Regulations narrow the scope of items of income or expense that are specifically defined as interest by excluding certain items, such as commitment fees, debt issuance costs, guaranteed payments for the use of capital, and income, deduction, gain or loss from hedging transactions.

   There are changes in the Final Regulations for certain swap arrangements as well. The modifications in the Final Regulations are welcomed. Additionally, the exclusion of items such as debt issuance costs and commitment fees places enhanced importance on distinguishing debt-related expenses such as those from original issue discount. As explained later, however, taxpayers must be wary of the potential for uncertain application of a broadened anti-avoidance rule.

2. The Final Regulations treat any expense or loss economically equivalent to interest as interest expense if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been interest expense or treated as interest expense. The taxpayer's business purpose and pre-tax cost of funds, however, are ignored.

   The anti-avoidance rules apply to transactions executed on or after the date the Final Regulations are published in the Federal Register. Given their breadth, taxpayers need to be aware of potentially foot-faulting into interest treatment (such as through ordinary hedging transactions) and must be wary of arrangements that are not explicitly described in the Final Regulations and may be subject to the anti-avoidance rules.

3. The Final Regulations use a taxpayer's "tentative taxable income" (TTI) (which is computed without regard to IRC Section 163(j)) as the starting point for determining ATI.

   In a significant change from the 2018 Proposed Regulations, the Final Regulations permit depreciation, amortization or depletion that is capitalized into inventory under IRC Section 263A to be added back to TTI when calculating ATI for that tax year. In this regard, the Final Regulations allow taxpayers that previously chose to follow the 2018 Proposed Regulations to follow the Final Regulations. The ability to add back all tax depreciation, amortization or depletion incurred in the tax year, regardless of whether it is in fact deducted or capitalized into inventory under IRC Section 263A and recovered through cost of goods sold, is a welcome change in the Final Regulations.

   The Final Regulations modify the rules on adjusting ATI upon the sale or other disposition of depreciable property, stock of a consolidated group or interests in a partnership. The Final Regulations also modify rules for transactions within a consolidated group to avoid inappropriate double inclusions, and generally do not treat the transfer of depreciable assets in an IRC Section 381 transaction as a "sale or other disposition" for purposes of adjusting ATI.

   Finally, Treasury determined that further study is needed to coordinate IRC Section 163(j) with other rules limiting the availability of deductions based on a taxpayer's taxable income (such as income-based deductions under IRC Sections 250(a)(2) (Foreign-derived intangible income), 170(b)(2) (charitable deductions), and 172(a)(2) (net operating loss)). Until such guidance is effective, taxpayers may choose any reasonable approach for coordinating these provisions, so long as they apply the approach consistently for all relevant tax years. Treasury applied a similar approach to this issue in recently released regulations issued under IRC Section 250.

Treas. Reg. §1.163(j)-2 makes corresponding changes to reflect modifications to IRC Section 163(j) made by the CARES Act, and adjusts the ATI limitation to 50% for tax years beginning in 2019 and 2020 (though taxpayers may elect out). The 50% ATI limitation does not apply to partnerships for tax years beginning in 2019. Similarly, Treas. Reg. § 1.163(j)-2(b)(3) allows taxpayers to elect to use ATI for the last tax year beginning in 2019 as the ATI for any tax year beginning in 2020. The provision addresses short tax years in 2020 by allowing the ATI in the last tax year beginning in 2019 to be prorated based on the number of months in the short 2020 year.

There are a host of other rules in the Final Regulations that may be of interest to particular cooperatives. There are specific rules that apply to the application of other provisions subjecting the interest expense to disallowance, deferral, capitalization or other limitation in Treas. Reg. §1.163(j)-3.

Treas. Reg. §1.163(j)-4 deals with the rules for C corporations and tax-exempt corporations. These rules will have direct application to cooperatives. Cooperatives that are part of a consolidated group will also find rules here of interest. Treas. Reg. §1.163(j)-6 deals with disallowed business interest expense carryforwards, including the complexities of those arising in a consolidated group.

Many cooperatives have investments in partnerships or LLCs taxed as partnerships. Treas. Reg. §1.163(j)-6 which deals with partnership issues will be of interest to those cooperatives. The most significant change from the Proposed Regulations was the allocation of excess business interest expense (EBIE) and excess taxable income (ETI).

IRC Section 163(j)(4) generally allocates partnership EBIE and partnership ETI to each partner "in the same manner as" the "non-separately stated taxable income or loss of the partnership." These terms are not defined by statute or regulations. As a result, it was unclear how to apply the rule to special allocations. The 2018 Proposed Regulations provided an 11-step approach for determining the IRC Section 163(j) excess items of a partnership allocable to its partners.

The Final Regulations adopt the 11-step approach. Although complex, this approach attempts to preserve the entity-level calculation required in IRC Section 163(j)(4) while also preserving the economics of the partnership, including respecting any special allocations made in accordance with IRC Section 704(b) and its regulations. For partnerships that allocate all items of income and expense on a pro rata basis (pro rata exception), the Final Regulations provide an exception from steps 3 through 11 of the 11-step approach because these partnerships by nature "do not make the kinds of allocations the 11-step calculation is designed to address." Instead, these partnerships would allocate all IRC Section 163(j) items in step 2 proportionately.

The Final Regulations also confirm that allocations under the 11-step process satisfy the requirements of IRC Section 704(b). Specifically, Treas. Reg. §1.704-1(b)(4)(xi) was added to confirm that the allocation of IRC Section 163(j) excess items will be deemed in accordance with the partners' interests in the partnership.

Other partnership provisions that may be of interest to cooperatives include the rules related to partnerships that are now not subject to Section 163(j) because they meet the small-business entity exception. In addition, the rules related to partnership mergers, divisions or partial dispositions of partnership interests have also been changed in the Final Regulations. Most of these changes are favorable for taxpayers.

As indicated earlier, these regulations are lengthy and complex. Careful study and analysis, including modeling different scenarios, is necessary to understand their significance to your cooperative.

Organization Not Exempt Where Its Primary Purpose Is to Develop a Farm

By George W. Benson

Ltr. 202041016 (July 15, 2020) is a final adverse determination letter notifying an organization that it does not qualify for exemption for federal income tax purposes. This adverse determination is of interest because it involves an organization which planned to develop a pistachio orchard and to lease it to a for-profit corporation owned by individual E and other family members. The letter indicates that it was contemplated that the financing for the development would come from a special grant from a donor advised fund created and directed by E's parents.

The organization ostensibly was formed to be a supporting organization of a public charity whose activities consist of "providing residential programs, shelter care, intervention, treatment for problematic sexual conduct, family and individual therapy, mental health services, supervised therapeutic visitation and other community-based wrap-around services to youth and families, including those who have been the victims of human trafficking." In particular, the organization indicated it planned to support the public charity "with respect to [its] current and future programs and efforts to raise awareness of and to combat human trafficking."

While efforts were made to structure the arrangement consistent with acting as a supporting organization, the efforts were unavailing. The IRS concluded:

"Although you state that your purpose it to support [the public charity], your primary purpose is to establish an F farm for the benefit of G. G is a for-profit company owned by your President, E, and his family. You are funding the preparation of the land, planting of the trees and cultivating the crops for the benefit of G. Although you will receive funds from G through a lease agreement, which has not yet been executed, this is more than an incidental purpose. Therefore, you do not qualify for exemption under Section 501(c)(3)."

Accounting for Maintenance and Repair Costs Incurred by a Seasonal Food Processor When Its Production Plants Are Idle

Morning Star Packing Company, L.P. and Liberty Packing Company, LLC ("the partnerships") process tomatoes, providing bulk-packaged tomato products to food processors and customer-branded finished products to the food service and retail trades. According to the Tax Court, together the partnerships account for about 25% of the California processing tomato production, supplying 40% of the United States ingredient tomato paste and diced tomato markets.

The partnerships' business is seasonal. Their production facilities operate round the clock from approximately July to October each year during the tomato harvest. Processed products are sold year round, with inventories largely depleted by the end of June each year. The partnerships use accrual accounting for both financial statement and tax purposes. They use a natural business year ending June 30 for financial accounting purposes. However, because their majority interest partner has a calendar year for tax purposes, the partnerships are calendar year taxpayers for tax purposes.

Each year, the partnerships incur costs to restore, rebuild, recondition and retest their production facilities. The treatment of these costs was in dispute. They largely are incurred after December 31 each year to prepare the plants for the next production season. It appears that it was agreed that the costs were not of a nature that required capitalization.

For financial accounting purposes, the partnerships used full absorption accounting and charged the costs incurred during its natural business year (July through June) to the cost of the crop packed from July to October and sold during the remainder of the year.

The tax treatment was different because of the required calendar year. Following the lead of its accounting treatment, the partnerships treated the costs (both those incurred from July through December and an accrued estimate of costs to be incurred from January through June) as costs of producing the crop processed from July to October. It then allocated those costs between products sold between July 1 and December 31 and those sold after that date. Production costs (actual and accrued) allocable to products sold between July 1 and December 31 were deducted as cost of goods sold. Remaining costs were included in inventory at year-end and deducted as the products were sold the next year.

The IRS challenged the accrual of costs to be incurred after December 31. The case eventually ended up in Tax Court and was recently decided. *The Morning Star Packing Company LP v. Commissioner*, T.C. Memo. 2020-142 (October 14, 2020).

The parties (and the Tax Court) agreed that the accrued costs at issue were recurring and could be estimated with reasonable accuracy. They also agreed that economic performance largely occurred after December 31 each year. The IRS' primary position was that the partnerships should not have accrued the costs because there was no fixed and binding obligation at December 31. Alternatively, the IRS argued that, if the liability was fixed at December 31, the recurring item exception to the economic performance rule did not apply because the expenses were properly matched with income of the tax year when economic performance occurred, not the prior year. See, Treas. Reg. §1.461-5(b)(1)(iv)(B) (among other things, to qualify for the recurring item exception, a taxpayer must show that the amount of the liability is not material or that "the accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs").

The Tax Court concluded that the liability to incur the expenses was not fixed at year-end so the expenses could not be accrued. This rendered application of the recurring item exception moot so the Tax Court did not address whether the expenses during the down period better matched the revenue from the prior processing period or the upcoming processing period.

The Tax Court dismissed the partnerships' argument that an obligation to incur the expenses could be found in its credit agreements and multi-year production contracts with customers. In the Tax Court's view, none of these agreements required the partnerships to incur the expenses. The agreements may, as a practical matter, have required the partnerships to keep the plants in good repair and to incur expenses doing so during the period they were not in production. But the Tax Court concluded that the agreements did not create an obligation that was specific enough to accrue:

"The credit agreements involved in these cases do not specifically set forth

the partnerships' obligations to provide a comparably sufficiently fixed and definite basis. Instead the credit agreements include nonspecific text and generalized obligations....

While [the] production contracts involve extensive product quality specifications, the partnerships' efforts to comply with their customers' specifications are production-run specific. Such compliance necessarily takes place before and during the production run of tomato products for a given customer. The accrued production costs in issue were for goods and services provided after the production run in each year in issue. Furthermore, the parties have stipulated that the accrued production costs in issue are to restore, rebuild, and retest the manufacturing facilities for use during the next production cycle."

The taxpayers in the case were not cooperatives, and, for them, the issue was a timing issue. As with issues of this sort, the principal impact was on income for the year of change.

This issue appears to have arisen principally because the partnerships were not using a natural business year for tax purposes.

Cooperatives that pool sometimes face the question of which pool should bear costs of this sort – the pool for the crop that was just packed or the pool for the next crop to be packed? See, Ltr. 7908032 (November 24, 1978), where a cooperative obtained approval from the IRS to match similar costs with the pool for the next crop to be packed. While the Tax Court did not address this question (since it did not address the applicability of the recurring item exception), the portion of its opinion quoted above suggests that it would view the costs as attributable to the pool for the next crop to be packed.

Expenses Incurred to Prepare Land for Producing Blueberries and Maple Syrup Are Start-up Expenses

Taxpayers planning to commence a new trade or business are required by Section 195 to capitalize and amortize start-up expenses. They are entitled to deduct business expenses under Section 162 or 212 only after the trade or business commences.

Between nondeductible start-up expenses and deductible business expenses often gives rise to disputes. One such dispute recently was the subject of a non-precedential summary decision rendered by the Tax Court. *James Gordon Primus v. Commissioner*, T.C. Summary Opinion 2020-2 (January 7, 2020).

Primus, a resident of New York, purchased (through his Mother) 266 acres of land in Quebec in 2011. At the time of the purchase, Primus was not already engaged in the business of farming. He planned to use the land to produce maple syrup and to raise blueberries.

The land contained almost 200 acres of maple trees, including more than enough mature trees to produce maple syrup commercially. However, to be in a position to produce maple syrup, Primus needed to thin the maple bush and install a system of pipes to collect sap. Primus also needed to purchase equipment, modify a barn to house the equipment and then install the equipment.

The land was not producing blueberries at the time of purchase. To produce blueberries, Primus needed to clear a portion of the land, purchase blueberry bushes, plant them and then wait until they matured and began producing blueberries in commercially marketable amounts.

The years at issue were 2012 and 2013. Primus did not begin actually producing maple syrup until 2017. Primus did not plant the blueberry bushes until 2015 and had not begun producing blueberries at the time of the trial.

Given these facts, the Tax Court concluded that the expenses incurred by Primus in 2012 and 2013 were start-up expenses:

"A taxpayer may not deduct 'start-up' expenses under section 162(a) or 212. [citation omitted]. Startup expenses are, among other things, expenses incurred to create an active trade or business. [citation omitted]. The startup phase occurs before business operations have commenced. [citation omitted]. Expenses are not deductible under section 162 until the business is actually functioning and performing the activities for which it was organized. …

Preparing a property to produce a commodity (such as maple syrup or blueberries) is not a trade or business or income-producing activity before sap is collected or blueberry bushes are planted….

During the years at issue, … petitioner had not collected sap, installed any of the infrastructure needed to convert sap into syrup, or purchased any blueberry bushes. Many other steps remained in order for petitioner to complete the startup phase and collect revenues from maple syrup and blueberry production."

The IRS Rules Yet Again that Gain is Patronage-Sourced

By Christopher R. Duggan

In P.L.R. 202035006 (August 28, 2020), the IRS ruled that gain from the sale of land by an agricultural cooperative will give rise in part to patronage-sourced income that will be deductible if distributed as patronage refunds according to cooperative's allocation plan.

The central holding in the ruling – that gain from the land sale can be treated as patronage-sourced income – is not a difficult question, despite the large portion of the ruling on this question. Because the cooperative purchased and apparently used the land "to facilitate [the cooperative's] processing and marketing cooperative purpose," the land was clearly directly related to or actually facilitated the cooperative's purpose and thus the gain was clearly at least partly patronage-sourced under the Farmland Industries case and other federal tax authorities.

The interesting holdings in the ruling relate to allocation of the gain, though the ruling generally gives insufficient facts to make these holdings very useful.

First, the IRS held that the cooperative could isolate patronage-sourced income from the sale gain based on the current percentage of member versus nonmember business of the cooperative. Because approximately X percentage of the cooperative's business "is" done with member-patrons, the IRS permitted the cooperative to treat X percentage of the gain as patronage-sourced income. The alternative, of course, is to determine the patronage-sourced percentage of the gain with reference to the percentage of member business during some historical period. The ruling doesn't address this alternative, though perhaps the alternative measure would have resulted in a similar percentage to that actually used.

Second, the IRS held that the cooperative could allocate the patronage-sourced gain among "each member-patron." This category apparently includes only current and active member-patrons, not former members, inactive members or nonmember patrons. If so, the ruling confirms previous authorities, though these previous authorities have generally explained in some detail why limitation to current members was acceptable. See, e.g., P.L.R. 201105008 (Feb. 4, 2011); P.L.R. 200935019 (Aug. 28, 2009); Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982).

Third, the IRS confirmed that the cooperative could allocate the patronage-sourced gain according to patronage during a limited Z-year lookback period. Though the ruling does not identify the length of the lookback period, the cooperative represented that the lookback period "will limit the participation in the gain to those member-patrons who were active in the Cooperative during the years to which the gain is attributable." Unfortunately, it is unclear whether the Z lookback period covers the entire period when the cooperative held the land or a more restricted period when the land gained in value.